

## **The integration of the German and Irish financial systems within the euro – a legal perspective**

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From a European standpoint the natural starting point for a analysis regarding the legal integration of the German and Irish financial systems is the Treaty Establishing the European Community.<sup>2</sup> The main activities of the Community under the Treaty include the establishment of an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital.<sup>3</sup> The Treaty provisions on the freedom of establishment and the free movement of services and capital<sup>4</sup> have played an important role in the effort to integrate the European banking and financial markets. The Treaty provisions on the freedom of establishment<sup>5</sup> have been actively used by European banking and financial groups to establish subsidiaries throughout the EU, in some cases, such as Ireland, with the active encouragement of a home Member State keen to develop an international financial services centre. The European Court of Justice has interpreted the Treaty provisions on services based on a jurisprudence that has emphasised the mutual recognition of standards and qualifications.<sup>6</sup> Out of these ideas emerged the Second Banking Directive<sup>7</sup> and the Investment Services Directive,<sup>8</sup> based on the concept of harmonization of essential standards only, coupled with home supervision of companies, including subsidiaries but not branches, and a notion of mutual recognition of each Member State’s rules, which rules in turn include elements derived from the Community directives.<sup>9</sup> In the banking arena the EU harmonization of standards has also taken place against the global backdrop of the Basle Capital Accords.<sup>10</sup>

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<sup>2</sup> Hereinafter referred to as the “Treaty”.

<sup>3</sup> Treaty, Article 3(1)(c).

<sup>4</sup> Treaty, Part Three – Community Policies, Title III – Free movement of persons, services and capital, Chapter 3 – Services and Chapter 4 – Capital and payments.

<sup>5</sup> Treaty, Part Three – Community Policies, Title III – Free movement of persons, services and capital, Chapter 2 – Right of establishment.

<sup>6</sup> See generally Stephen Weatherill & Paul Beaumont, *EU Law*, Penguin Press, 1999, pp. 671-96.

<sup>7</sup> Second Council Directive of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, OJ L 386, 30.12.1989, p. 1, repealed by Directive 2000/12/EC.

<sup>8</sup> Council Directive of 10 May 1993 on investment services in the securities field, OJ L 141, 11.06.1993, p. 27, repealed by Directive 2004/39/EC.

<sup>9</sup> See generally Stephen Weatherill & Paul Beaumont, *EU Law*, Penguin Press, 1999, pp. 698-702.

<sup>10</sup> See Directive of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ L 177, 30.06.2006, p. 1.

All these developments have taken place at the EU level, rather than the level of the euro area. Of course, the Community's twin tasks of establishing a common market and an economic and monetary union closely interact with one another.<sup>11</sup> The introduction of the euro has, for example, provided an incentive in recent years to attempt a deeper harmonisation of the European capital markets through a raft of EU directives under the Financial Services Action Plan, including the Market in Financial Instruments, Prospectus, Transparency and Market Abuse Directives, as well as the application of International Financial Reporting Standards.<sup>12</sup>

In considering, from a legal perspective, the integration of the German and Irish financial systems within the euro, this paper will focus on the general legal framework for the single monetary policy of the euro area.

Under the Treaty the definition and implementation of monetary policy is one of the basic tasks – if not the basic task – attributed to the central banking system established under the Treaty, commonly known as the Eurosystem and comprising the ECB and the national central banks of the 13 euro Member States,<sup>13</sup> including the Deutsche Bundesbank and the Central Bank and Financial Services Authority of Ireland. Under the Statute of the European System of Central Banks annexed to the Treaty, the nineteen-member Governing Council of the ECB is responsible for the formulation of monetary policy including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the Eurosystem, while the six-member Executive Board of the ECB is empowered to implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council.<sup>14</sup>

Turning first to monetary objectives, the Treaty states that the primary objective of the Eurosystem shall be to maintain price stability. The Treaty further states that, without prejudice to the primary objective of price stability, the Eurosystem shall support the general economic policies in the Community.<sup>15</sup> The Treaty thus establishes a clear hierarchy of objectives for the Eurosystem in which overriding importance is assigned to price stability, which can be properly characterised as the *Grundnorm* of the Eurosystem.

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<sup>11</sup> See, e.g., Treaty, Article 2.

<sup>12</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.04.2004, p.1; Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345, 31.12.2003, p.64; Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390, 31.12.2004, p.38; Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ L 96, 12.04.2003, p.16; Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ L 243, 11.9.2002, p. 1.

<sup>13</sup> Treaty, Articles 105(2), first indent, and 107(1).

<sup>14</sup> Protocol to the Treaty on the Statute of the European System of Central Banks and of the European Central Bank (hereinafter, the 'ESCB Statute'), Article 12.1, first and second paras.

<sup>15</sup> Treaty, Article 105(1).

As part of the legal integration of national central banks into the Eurosystem, most national central banks' statutes had to be adapted before the introduction of the euro in order to reflect the primary objective of the Eurosystem to maintain price stability.<sup>16</sup>

In Germany, the Bundesbank Act defined the main function of the Bundesbank as the safeguarding of the currency and the execution of domestic and external payments. This was understood to imply the objective of price stability, but the Bundesbank Act was amended to make this more explicit. The Bundesbank Act also provided that, without prejudice to the performance of its functions, the Bundesbank shall support the general economic policy of the Federal Government.<sup>17</sup> It is interesting to note that the Eurosystem's secondary objective to support the general economic policies in the European Community was largely formulated on the basis of this provision of the Bundesbank Act.

In Ireland, the Central Bank Acts defined the primary statutory objective of the Central Bank of Ireland in similar terms to the Bundesbank before the euro: to safeguard the integrity of the currency. While this was also interpreted as requiring the maintenance of price stability, the Central Bank Acts were amended to make this more explicit.<sup>18</sup> Unlike in Germany, however, there was no explicit hierarchy of statutory objectives as between safeguarding the integrity of the currency and supporting general economic policies, and the establishment of a secondary objective to support the general economic policies in the Community was a statutory innovation in the Irish Central Bank Acts.

The Eurosystem's primary objective to maintain price stability is often contrasted with the multiple goals of the U.S. Federal Reserve System, whose Board of Governors and Federal Open Market Committee are required under the Federal Reserve Act to 'maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.'<sup>19</sup>

By focusing the monetary policy of the Eurosystem on the primary objective of price stability, the Treaty makes it clear that ensuring price stability is the most important contribution that monetary policy can make to achieving a favourable economic environment and a high level of employment. The basic economic thinking behind setting price stability as the primary objective of monetary policy is that it is the task of other economic actors than central banks, notably those responsible for fiscal and structural policies, to enhance the growth potential of the economy, and that assigning to monetary policy an objective for real income or employment would be problematic

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<sup>16</sup> Treaty, Article 109; see European Monetary Institute, *Convergence Report* (March 1998), 296, 307, 310, 313, 315-16, 318, 322, 330, 333, 337, 340, 344, 348.

<sup>17</sup> See European Monetary Institute, *Convergence Report* (March 1998), p. 310; European Monetary Institute, *Progress Towards Convergence 1996* (November 1996), p. 115.

<sup>18</sup> See European Monetary Institute, *Convergence Report* (March 1998), p. 322; European Monetary Institute, *Progress Towards Convergence 1996* (November 1996), p. 124.

<sup>19</sup> U.S. Federal Reserve Act, Section 2A, 12 U.S.C. § 225a.

since, apart from the positive impact of price stability, monetary policy has no scope for exerting any lasting influence on real income or employment.<sup>20</sup>

Historically, the formulation of the Eurosystem's primary objective to maintain price stability evolved out of the blueprint for economic and monetary union put forward in the 1989 'Delors' report, based in large part on a contribution by the Deutsche Bundesbank.<sup>21</sup> This objective, together with the independence of the new Eurosystem, was a precondition to the willingness of the German authorities to sacrifice the Deutsche Mark, which, as you know, had become the strongest of European currencies because of Germany's long record of low inflation. There is also, as you know, a particularly strong antipathy to inflation among the German public, dating back to the disastrous experience Germany had with hyperinflation in the 1920s.<sup>22</sup>

In broader international terms, the 'oil shock' of 1973 - the quadrupling of oil prices which contributed to plunging much of the industrialised world into an era of soaring inflation and low and volatile growth - is a historical development which marked a turning point in the understanding of the need for price stability. This development has had important legal implications internationally, particularly in the 1990s, as a substantial number of central banking laws have made this objective the primary goal of central banks and monetary agencies.<sup>23</sup>

The objective of price stability is also linked to the principle of central bank independence. In economic literature the foremost argument put forward in favour of an independent monetary authority is that of price stability, because governments are tempted to create money for their own ends in order to produce economic benefits in the short term, which eventually leads to an increase in the rate of inflation.<sup>24</sup> These considerations led the Treaty drafters to design the Eurosystem as a central banking system that, in the words of the Treaty, shall not 'seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body' when carrying out its tasks and duties.<sup>25</sup> In a decision handed down in 2003 in the *OLAF* case between the ECB and the European Commission, the European Court of Justice drew attention to the link between the objective of price stability and the principle of central bank independence. Both the Court, and Advocate General Jacobs in his advisory opinion to the Court, noted that by shielding the decision-making process of the ECB from short-term political pressures the independence explicitly conferred upon the ECB under the Treaty aims to enable the ECB to effectively pursue the aim of price stability.<sup>26</sup>

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<sup>20</sup> See European Central Bank, *The Monetary Policy of the ECB* (2004), at pp. 10, 43-44.

<sup>21</sup> Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Community*, Office for Official Publications of the European Communities, 1989, para. 32; Karl Otto Pöhl, *The further development of the European Monetary System*, published in the Collection of papers submitted to the Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Communities*, Office for Official Publications of the European Communities, 1989, para. IIB.1.

<sup>22</sup> See Carel C.A. van den Berg, *The Making of the Statute of the European System of Central Banks*, Dutch University Press, 2004, pp. 51-53.

<sup>23</sup> Rosa M. Lastra, *Legal Foundations of International Monetary Stability*, Oxford University Press, 2006, pp. 37-38.

<sup>24</sup> See, e.g., Fabian Amtenbrink, *The Democratic Accountability of Central Banks*, Hart Publishing, 1999, 12-14.

<sup>25</sup> Treaty, Article 108.

<sup>26</sup> Case C-11/00, *Commission of the European Communities v. European Central Bank*, [2003] E.C.R. I -7147, para. 134; Advocate General Jacobs on 3 October 2002, paras. 150 and 155.

An interesting constitutional dimension is that because the primary objective of price stability is written into the Treaty, it can, under the Treaty on European Union, only be amended by means of an inter-governmental conference followed by ratification of the amendments by all the Member States in accordance with their respective constitutional requirements.<sup>27</sup> This makes the existence of this statutory objective more robust in a legal sense than if it were enshrined in secondary legislation.

This aspect surfaced during the negotiations for the Treaty establishing a Constitution for Europe, which was signed by the EU Heads of State and Government in October 2004. During the discussions of the draft Constitution in the Convention on the Future of Europe, some Convention members proposed that supporting sustainable growth and high levels of employment should be added, on an equal footing, to the Eurosystem's primary objective of price stability. However, the vast majority of Convention members rejected this suggestion on the ground that the Eurosystem's current mandate to pursue price stability as a primary objective is based on a broad consensus of policy-makers and economists that maintaining price stability is the best contribution monetary policy can make with regard to the achievement of other economic goals, including growth and employment.<sup>28</sup>

Members of the Convention also touched upon the separate question of the extent to which price stability should be an objective not only for the Eurosystem, but also for the Member States and the Union as a whole. There was general agreement that the Constitution should confirm, as is provided under the existing Treaty, that the activities of the Member States and the Union in connection with the single currency entail compliance with stable prices as a guiding principle. However, a debate ensued on whether or not price stability should continue to be listed among the overarching objectives of the Union. In its contribution to this debate, the ECB wrote a letter to the Irish Presidency of the EU in April 2004 stressing three points. *First*, non-inflationary growth is mentioned as one of the Community's objectives in the existing Treaty. *Second*, price stability is not only the Eurosystem's primary objective, but also forms part of the heart of monetary union for all European citizens; in this sense stable prices clearly benefit society. *Third*, the introduction of a simplified procedure to amend the part of the Constitution which includes the Eurosystem's primary objective of price stability rendered it necessary to include a reference to price stability among the Union's objectives in order to strengthen the Union's commitment to price stability.<sup>29</sup> The ECB's arguments were accepted by the Irish Presidency, and the key objectives of the Union enshrined in the Constitution were reformulated to include price stability as one of the Union's objectives.<sup>30</sup>

Following the rejection of the Constitution in popular referenda in France and the Netherlands in mid-2005, the European Council, under the Germany Presidency, agreed in June 2007 on a mandate for an Intergovernmental Conference (IGC) to

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<sup>27</sup> Treaty on European Union, Article 48.

<sup>28</sup> See European Central Bank, *The European Constitution and the ECB*, ECB Monthly Bulletin, August 2004, pp. 58-59.

<sup>29</sup> See Letter from Jean-Claude Trichet, President, European Central Bank, to Brian Cowen, President, Council of the European Union, 16 April 2004, *Negotiations on the draft Treaty establishing a Constitution for Europe*, 1, published on the ECB's website at [www.ecb.int/pub](http://www.ecb.int/pub).

<sup>30</sup> Treaty establishing a Constitution for Europe, Article I-3(3), first para.

draw up a Reform Treaty amending the existing Treaties that would confirm that price stability is one of the Union's objectives in very similar terms to those agreed in the European Constitution. In particular, the IGC proposed that a new Article 3(3) on the Union's objectives would provide that the Union 'shall work for the sustainable development of Europe, based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.'<sup>31</sup>

The Treaty does not give a precise definition of what is meant by price stability. Legal commentators agree that the term denotes internal price stability, meaning the volume of goods and services which can be obtained for one euro, as opposed to the stability or strength of the currency in terms of third currencies such as the dollar, yen or sterling,<sup>32</sup> which would have been a relevant consideration for the stability of the currency of a small, open economy such as the old Irish pound. The ECB has defined this price stability in quantitative terms as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below, but close to, 2% over the medium term, which makes clear that not only inflation above 2%, but also deflation, would be inconsistent with price stability.<sup>33</sup>

Turning to the implementation of monetary policy, the Eurosystem's monetary policy operations are carried out in accordance with the principle of decentralisation. The principle of decentralisation is laid down in the ESCB Statute, which says that, to the extent deemed possible and appropriate, the ECB shall have recourse to the national central banks to carry out operations which form part of the tasks of the Eurosystem.<sup>34</sup> In simple terms, this means that German banks obtain liquidity from the Eurosystem through the Deutsche Bundesbank and Irish banks obtain liquidity from the Central Bank and Financial Services Authority of Ireland.

In order to ensure equal treatment, the ECB adopts a Guideline setting out the harmonised terms and conditions under which the Eurosystem's monetary policy operations are required to be executed throughout the euro area. This Guideline sets out the eligibility criteria which counterparties must fulfil in order to be counterparties for Eurosystem monetary policy operations, the procedures relating to the exclusion, suspension and sanctioning of counterparties, the terms and conditions applicable to the Eurosystem's open market operations, including the weekly main refinancing operations, the monthly longer-term refinancing operations and ad hoc fine-tuning operations such as those undertaken by the Eurosystem in recent days and weeks in order to assure orderly conditions in the euro money market. The ECB Guideline also sets out the terms and conditions applicable to the Eurosystem's standing facilities, including the marginal lending and deposit facilities which normally provide the ceiling and floor for overnight lending and deposit rates in the euro market, the tender

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<sup>31</sup> See Council of the European Union, IGC 2007 Mandate, Brussels, 26 June, 2007, Annex 1, available on website of the Council of the European Union at <http://register.consilium.europa.eu/pdf/en/07/st11/st11218.en07.pdf>.

<sup>32</sup> See, e.g., Charlotte Gaitanides, *Das Recht der Europäischen Zentralbank*, Mohr Siebeck, 2005, at pp. 18-20; René Smits, *The European Central Bank: Institutional Aspects*, Kluwer Law International, 1997, at p. 184; Rainer Stadler, *Der rechtliche Handlungsspielraum des Europäischen Systems der Zentralbanken*, Nomos Verlagsgesellschaft, 1996, at p. 100.

<sup>33</sup> See European Central Bank, *The Monetary Policy of the ECB* (2004), at pp. 50-55.

<sup>34</sup> ESCB Statute, Article 12.1, third para.

procedures for the submission and allocation of liquidity bids by counterparties, the criteria for the eligibility of assets accepted by the Eurosystem for the collateralisation of Eurosystem credit operations, and settlement procedures.<sup>35</sup>

In legal terms, each national central bank proposes the particular legal technique it will deploy under national law to implement Eurosystem open market and monetary policy operations. While most central banks rely on private law, bilateral contractual arrangements to govern their open market operations with their respective counterparties, some central banks set out the terms and conditions under which they conduct these operations in binding regulations adopted by the central bank pursuant to regulatory powers conferred upon the central bank under national laws.

In Ireland the main legal instrument for open market operations is a repurchase or repo agreement which the Central Bank and Financial Services Authority of Ireland executes with each Irish monetary policy counterparty, pursuant to which liquidity is extended to a counterparty against the transfer to the Central Bank of Ireland of full title to the marketable securities being taken as collateral for the credit operation. Another legal instrument used for the mobilisation of credit claims, including residential mortgage loans, as collateral is a floating charge taken by the Central Bank of Ireland over a bank's loan portfolio; this floating charge then crystallises into a fixed charge upon the occurrence of a counterparty default. This charge, together with a negative pledge restraining the counterparty from dealing in the charged assets, is registered with the Irish Companies Office, and special legislation has been passed in Ireland in order to ensure that such particulars are required to be so registered in dealings with the Central Bank of Ireland in order to ensure that other parties have constructive notice of the security interests thereby created. All of the remaining terms and conditions applicable to Eurosystem monetary policy operations with Irish counterparties are set out in a set of contractual terms and conditions largely mirroring the Eurosystem's requirements.<sup>36</sup>

In Germany the main legal instrument for open market operations is a general pledge agreement which the Deutsche Bundesbank executes with each German counterparty, pursuant to which liquidity is extended to a counterparty against marketable securities pre-deposited in an account of, and pledged in favour of, the Bundesbank. Another legal instrument used for the mobilisation of credit claims involves a full assignment of such claims in favour of the Bundesbank. All of the remaining terms and conditions applicable to Eurosystem monetary policy operations with German counterparties are set out in a set of contractual terms and conditions that are consistent with the Eurosystem's requirements.<sup>37</sup>

Needless to say, the implementation of monetary policy in a legal environment where there are different legal traditions can give rise to legal challenges, particularly in the context of the cross-border use of collateral in Eurosystem credit operations. Up till now Ireland has been the only common law Member State in the euro, with the other euro area Member States following the Roman-Germanic and Napoleonic legal

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<sup>35</sup> See ECB Guideline of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7), OJ L 310, 11.12.2000, p. 1.

<sup>36</sup> See Central Bank & Financial Services Authority of Ireland, *Documentation on Monetary Policy Instruments and Procedures* (available on request from Central Bank & Financial Services Authority of Ireland).

<sup>37</sup> I am indebted to Julian Langner, Legal Department, Deutsche Bundesbank, for this description.

traditions. With the introduction of the euro as the currency of Cyprus on 1 January 2008, there will be two common law jurisdictions in the euro area.

In recent years there have been a number of legislative initiatives at EU level which have sought to mitigate some of the legal risks involved in the conduct of the Eurosystem's monetary policy and intra-day credit operations.

Under the 1998 EU Directive on settlement finality in payment and securities settlement systems, it is explicitly provided that the rights of the national central banks or the ECB to collateral security provided to them under a pledge, repurchase or similar agreement, shall not be affected by insolvency proceedings against the counterparty to the central bank which provided the collateral security.<sup>38</sup>

Under the 2002 EU Directive on financial collateral arrangements, including collateral arrangements to which EU central banks and credit or other financial institutions are party, a number of formal requirements relating to the creation, validity, perfection and enforceability of financial collateral arrangements were removed. In addition, the effectiveness of title transfer financial collateral arrangements, such as repos, and the effectiveness in insolvency proceedings of close-out netting provisions contained in financial collateral arrangements, was recognised. Attempts were also made to clarify some of the legal uncertainties that can arise with respect to the conflict-of-law issues arising in connection with book-entry securities collateral. This Directive was important not only to enhancing the legal security of the Eurosystem's credit operations, but also the conduct of repo and securities lending transactions and the collateralisation of OTC derivatives transactions by participants in the European and global financial markets.<sup>39</sup>

Finally, an area of monetary policy which is, in legal terms, completely uniform by virtue of the application of directly applicable EU Council and ECB regulations concerns minimum reserve requirements imposed by the ECB whereby credit institutions established in the euro area are required to hold a certain percentage of their short-term liabilities on remunerated reserve accounts with their respective national central banks.<sup>40</sup>

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<sup>38</sup> Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, OJ L 166 , 11.06.1998 p. 45, Article 9(1).

<sup>39</sup> Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements OJ L 168, 27.06.2002 p. 43.

<sup>40</sup> Council Regulation (EC) 2531/98 of 23 November 1998 concerning the application of minimum reserves by the European Central Bank, OJ L 318, 27.11.1998, p. 1, as amended by Council Regulation (EC) 134/2002 of 22 January 2002, OJ L 24, 26.01.2002, p. 1; ECB Regulation of 12 September 2003 on the application of minimum reserves, OJ L 250, 02.10.2002, p. 10.