The evolution of the concept of supervision over bank activities against the background of experiences of selected European countries

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Abstract— **The subject of considerations is the legal issue of the optimal model of supervision over the functioning of credit institutions. Normative regulation models in selected European countries have been presented with particular reference to the solutions applied in German legislation. Two basic banking supervision systems were identified: institutional type and functional type. Institutional type supervision is exercised by one supervisory institution which deals with irregularities in the functioning of all entities performing bank activities. It has been adopted in Switzerland and in Poland. In this system, the supervision is entrusted to one entity. Functional supervision is exercised, by several supervisory institutions acting jointly, each has their unique statutory competences. The experience of the recent financial crisis indicates a greater effectiveness of the first type of supervision and the need to deepen further the cooperation between national supervision in cross-border activities.**

Index Terms— banking supervision, bank, lending activity, banking law

I. INTRODUCTION

The subject matter of these considerations is the evolution of the concept of legal supervision over banks and legal character of standards limiting the freedom of economic activity in the field of banking. The main question posed in the paper concerns the optimal model of supervision over the functioning of credit institutions which can be worked out following the analysis of previous experiences of selected European countries.

The nature of normative regulation concerning the supervision of financial institutions falls within the sphere of public economic law, but since legalism and security deposits constitute the criteria of this supervision, it is necessary for the banks to observe the rules of both public and private law. The problem of delimitation and mutual relations between public and private law has been the subject of numerous legal discussions since the time of Ulpian. There were attempts to draw a dividing line between the two spheres on the basis of the so called fiscal theory (the assets criterion to which the standard pertained) or on the theory of interest (the criterion of the protected interest) or on the subjective theory (delimitation with respect to entities participating in the legal relation), as well as on the theory of subjugation (Łętowski, 1985). In contemporary doctrine, the delimitation of the public and private spheres takes place in three ways: the separation of laws, the delimitation of norms and relations arising from these laws (Łętowski, 1985).

Władysław Leopold Jaworski, an eminent Polish civilist and constitutionalist of the interwar period discussed the relationship between the public and private sphere using Einstein's theory of relativity. He believed that the division between public and private should not be overestimated, because both types of norms describe the same reality, only from different points of view. The author of the paper also subscribes to this point of view that public law should not be juxtaposed to private law as both types of normative regulations usually have the same form, source and purpose. Although civil law is characterized by a smaller degree of formalism, in the Polish legal system one may not speak of customary law, and a certain number of norms is of *iuris cogendis* nature and the function of these norms is almost analogous to civic-public norms.

Recently, there has been considerable interest in the contact between both branches of law – public and private, which is manifested by the development of a new discipline called public economic law. Still, it is often difficult to classify particular types of legal relationships to any of the categories listed above, as exemplified by regulations on lending or certain European legal norms. Of course, the validity of the division into public law and private law is not questioned here, since it is useful in describing many legal constructions, however, in the viewpoint of the author, the distinction between *ius publicum* and *ius privatum* should not be overestimated, as this can often lead to the presentation of these two branches of one legal system as contradictory. Whereas in a number of cases the

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complementary approach would be more precise. It is particularly evident in banking law in which there are two separate branches i.e. private banking law which deals with the issues related to contracts occurring in banking practice, and public banking law which encompasses issues related to central banking, bank licensing and bank supervision. Until recently, the problem of affiliation of banking law to private or public law has been treated as a purely academic dispute without much significance for the practical functioning of banks. The standards of public and private law on the basis of the functioning of banking, intertwine and are mutually complementary, which is particularly evident in the case of the credit activity in question, where the sphere of public-law interference is particularly extensive. This does not mean, however, that the presented division of normative regulations in the field of banking law is unnecessary. However, the development of financial markets both in Poland and in the world, means that protective instruments derived from private law such as, for example, liability for damages, do not fulfill their function in an appropriate way anymore, and it is often necessary to reach for public-law instruments (Bujak, 2017) (Wiktorzak, 2014). This does not mean, of course, that the subject matter of contracts including credit agreements belongs to the sphere of public law. Such a statement would be extremely contrary to the general systemic rules, such as the method of regulation of civil law norms based on the principle of parity, which is one of the foundations of private law (Wolter, Ignatowicz and Stefaniuk, 2018) (Radwański, 2017). This equality also occurs in credit relations between the borrower and the lender i.e. a bank. The fact that there is no equivalence in the economic sense between these entities because the borrower is a weaker participant in civil law transactions, is not meaningful from the point of view of legal classification. It can only justify better protection for the borrower.

II. Development of international cooperation in the field of banking supervision

As indicated earlier, there are voices about the predominance of elements of public law in normative regulations of credit institutions. This is associated with the need to ensure greater security for participants in modern legal trading, characterized by greater diversity and international character which increases the importance of international law (Kosikowski, 2000). Therefore, actions are undertaken to coordinate the cooperation between credit institutions. These activities have recently been intensified thanks to a number of unification processes, especially in the European Union. That is why many organizations were formed to coordinate lending activities between individual countries. Activities of these organizations indirectly affect the bank loan agreements concluded in our country. One of the oldest organizations of this type is the Basle Committee on Banking Regulations and Supervisory Practices established in 1974. The organization appeared under this name until the end of the 1980s, when it was renamed simply to the Basle Committee on Banking Supervision. Institutionally, it is located at the Bank for International Settlements (BIS). It was founded by central bank governors from ten most developed countries in the world, the G10 group. Currently, the Committee has representatives from 12 countries. These are senior employees of central banks and banking supervision authorities from Belgium, France, the Netherlands, Japan, Canada, Luxembourg, Germany, Sweden, Switzerland, the USA, Great Britain and Italy (Lipka-Chudzik, and Daniluk, 1993). Although this organization is of an elite nature, as it covers only a small group of countries, the decisions taken therein are of significant importance for the entire global credit economy. On the Basel Committee on Banking Supervision, preside bankers with extensive professional experience and a long internship, which makes them an authority in banking circles.

In the history of law, it is often the case that some solutions to prevent irregularities are implemented only after these irregularities already occurred. This is also true for the field of banking. The Basel Committee for Banking and Supervision (also called the Basel Committee on Banking Rules and Supervisory Procedures) was created as a result of reaction of European bankers to the bankruptcy of Herstatta bank (Zdyb, 1998). It was a 100-year-old German bank that went bankrupt in 1974 because of too much capital involvement in speculation on the dollar market. The losses resulting from erroneous investment decisions were so large that the credit liquidity could not be maintained. After the bankruptcy of Herstatta's banking house, the first prudential regulations were introduced as a result of international cooperation within the Committee. These regulations concerned the need to limit the involvement of credit institutions in open operations on the foreign exchange market. The degree of this limitation depends on the amount of equity owned by a particular bank. The principles articulated during the debates of the Committee for Banking and Supervision were successively introduced into legal regulations in the EU member states, as well as in countries outside Europe (Zawadzka, 1995). In addition to the bankruptcy of Herstatta, the reason for the creation of the Basle Committee on Banking Regulations and Supervisory Practices was the crisis on international financial markets. This crisis was the result of lack of control over international credit institutions, which in the 1970s, through excessive lending, triggered a "debt trap" for developing countries. Ill-conceived credit policy may initiate a domino effect of bankruptcies as there is no international rescue institution of the last instance (such as the central bank in case of national banking systems) which could restore trust to banks whose credit assets have been frozen (Kaźmierczak, 1992).

III. Concepts of banking supervision and its role in the state

In this section the author will discuss the intervention of the state in the activity of individuals in the area of lending and will show the relationship between the banking supervision system and the functioning of the banks from a historical perspective.

Banking supervision should not be a "night-watchman", as supporters of overly liberal politics advocate, because it would

threaten losses of depositors and banks themselves, as exemplified by the recent numerous bank scandals. The supervision should not have a "total" form interfering with even the smallest decisions. The fact that it has such a character is determined by the economic system of the state where supervision is carried out. The increase of the state's influence is most often the result of irregularities existing in a given sector. This influence often takes a curious size, which H. Zitzmann rightly points out. He writes that *after the period of inflation, which brought far greater losses than just bankruptcies of some banks, it was rather necessary to protect the banks from the state than to protect the banks by the state* (Zitzmann, 1966). The public law impact on the credit sector should be narrowed down to the necessary minimum. That's why Napoleon remarked that *the bank should be dependent on the government, but not excessively.* This directive is still applicable in French banking law and despite the passage of time it has not lost its validity (Karpiński, 1961).

State intervention in banking is characteristic especially for totalitarian regimes. It was visible both in the socialist system, where the lending activity was covered by the state monopoly, as well as in fascist Germany where banks were the focal point of the ruling circles and were treated as a source of money which to be spent on armaments. It should be highlighted that the totalitarian form of influence on the economy never worked in the past, always leading the country to ruin.

When adopting regulations in the field of public business law, special care should be taken to ensure that legal provisions are not contrary to generally applicable trading rules and economic laws. Economics, however, should not be treated in a dogmatic way. Indeed, it is not possible to change the direction of its rules, but one can stimulate certain economic processes for the desired purpose by minimizing the influence of the state. Experts in the field suggest to refrain from managing and ordering entities under bank supervision because this would mean that the supervisory body starts to supersede the obligatory tasks of the management and internal control of the supervised. Managing a bank is left to the management boards of banks who must take independent credit decisions by means of autonomous resolutions. The interference of banking supervisors into the bank's powers would no longer constitute supervision, but management. Such interference was typical for the centrally controlled economy in the previous political system in Poland. Although, the socialist economy, characterized by state monopoly in all spheres of economic life (including banking) was abolished and completely discredited, Poland still feels the consequences of decisions taken at that time.

In the process of creating legal standards for credit activity, one must strictly adhere to the principles of economy, because the violation of these principles by law makers always leads to negative consequences and means that a given legal norm does not liquidate the chaos in economic life, but intensifies it even more. The legislator's activity in creating the law regulating economic relations, e.g. in the field of lending, should take into account objective economic laws, but should not automatically repeat them. Appropriate legal instruments will allow the development of the capital market, and thus the entire economy (Żuławska, 1999). Of course, legal provisions should contain only regulations, from which, as a result of interpretation, specific norms of behavior can be created for participants in civil law transactions. Therefore, laws should not incorporate all economic laws nor contain declarations without a specific normative content, they should always come with appropriate instruments to enforce them. Such proceedings of the banking law bodies will be consistent with the principles of legislative technique [see § 10 of the Annex to the Resolution of the Council of Ministers of 5 November 1991 on the principles of legislative technique (M.P. No. 44, item 310), which emphasizes that the Act should not contain statements that do not serve to express legal norms].

However, the principle of compliance of the constructed legal norms with the principles of economy is not absolute. In special situations where it is justified by the common good of the general public, it is possible to adopt solutions that will not lead to economic development. An example here could be restrictive legislation passed during economic crises, states of emergency and wars e.g. restrictive foreign exchange, customs or tax regulations. Although such steps cause a slowdown in economic development, in times of crisis they are fully acceptable. The economic crisis may justify an increase in taxes, the inflows of which should contribute to the state or local government budget and thus enable financing purposes serving the general public. There is one condition here though, all legal measures adopted by the legislator must be well-thought, because the use of disproportionate legal means will not lead to removing an economic crisis, it will enlarge it even further. An example of such instrument under the banking law is taxation of bank deposits. Such a solution will bring some benefit to the state in the form of a tax-deductible amount, but in the longer term it may reduce the amount of deposits, which in turn will limit the crediting of business entities, deepening the crisis. It should be remembered that without feeding business entities and individual consumers with bank credits, the economy comes to a standstill due to the lack of sufficient capital. Banks obtain cash needed for lending, as was indicated earlier, primarily from deposits, therefore their number, and not only the amount of equity, directly affects the possibility of concluding loan agreements by the bank. In the above example, it can be noticed how inadequate use of legal and financial instruments triggers economically determined behavior of market participants. A sensible legislator will strive to obtain only the desired goals without any negative side effects. Restrictions regarding the regulation of the rules of concluding and the content of civil law contracts should meet two conditions: firstly, in principle, they should be consistent with the rules of economy, and if, for the common good, it is necessary to withdraw from them, it should only be in exceptional cases; and secondly, limitations should be imposed equally for everyone, by means of a normative act (Żuławska, 1999).

On the basis of regulations governing the economic law, it is possible to trace back the evolution of the concept of the state

itself. The provisions of the banking law play a special role in the economy because on their basis the administration in power can finance their decisions and reforms. Therefore, totalitarian states (socialist, fascist or other) are trying to create law which will allow its officers to exercise full control over the conclusion of all types of agreements by entities subordinate to their authority. This is particularly evident in the construction of provisions on the control and supervision over all areas of private law activity, including supervision of the credit activity described here. Nevertheless, legislative activities regarding banking law in the Nazi Germany and in states with a centrally planned socialist economy, differed significantly. In the Third Reich the banks could basically function without any obstacles, and the state's interference focused primarily on the use of banks to finance armaments and to accumulate funds and precious metals from subjugated countries. The most vivid example of the use of banking by the Nazis was financing the construction of extermination camps, which was acknowledged and punished at the Nuremberg trial. Whereas in case of countries with centrally governed economy typical for states with a socialist regime (also the Polish People's Republic), there was no need to create extensive regulations for the supervision of lending activities, because banks were under the control of the state, serving the financing of economic plans. Using the historical method, one can show how the provisions regarding the statutory framework for taking up and conducting lending activities have evolved depending on the political and economic system in force in a given state.

IV. Types of banking supervision

Supervision over credit activity can take various forms. There are two basic bank supervision systems: the institutional type and the functional type. There are also intermediate solutions more similar to one or the other system. Institutional type supervision is exercised by one supervisory institution which deals with irregularities in the functioning of all entities performing banking activities. This solution is applied in Switzerland (Comission fe'derale de banque) and in Poland (the Polish Financial Supervision Authority). In this system, the supervision is entrusted to one entity. Functional supervision is exercised by several supervisory institutions acting jointly, each institution has the their exclusive statutory competences . One can speak here of the separation and supervision specialization which means that the same banking unit can be supervised by various entities, depending on the activity it carries out (Góral, 1995). The functional type supervision can be encountered in French, Italian and German law. In France it is held by the National Credit Council (Conseil national de cre'dit) and the Banking Commission (Comission Bancaire), and in Italy by the Inter-ministerial Credit and Savings Committee (Comitato interministeriale per il credito e il visperamo), and the central bank (Bance d'Italia). The activities of these institutions are stimulated by the Basle Committee on Banking Supervision. In Europe the functional supervision model is dominating. For example, in Germany it is carried out jointly by the Federal Office for Banking Supervision (Bundesaufsichtsamt für Kreditwesen) and the Federal Bank (Bundesbank). In the United Kingdom, these bodies are: the Bank of England, the Board of Banking Supervision, and the Department of Trade and Industry. French banking supervision is governed by the Act of 24 January 1984. The organs are; The National Credit Council with normative powers and the Banking Commission which supervises the legality of bank operations. The National Credit Council includes: the Minister of Economy, Finance and Budget (as its chairman), the President of the Bank of France (vice-chairman) and 42 members. The Banking Commission, headed by the President of the Bank of France and the Director of the Treasury, has 4 members appointed by the Minister of Economy, Finance and Budget for the term of 6 years.

A different type of bank supervision is the institutional type. Institutional supervision is characteristic for a country that is known for efficiently functioning credit institutions i.e. the Swiss Confederation. The supervision was introduced there by the Act of 8 November 1934 on banks and saving banks, and is carried out by the Federal Banking Commission. Its task is to control the legality of bank operations and to issue permits. This body is subject to the Federal Council and it reports to it. The council appoints from 7 to 9 members of the Commission for the tenure of 4 years. Reports from the supervision are submitted to the Federal Council (Góral, 1995).

V. Evolution of banking supervision on the example of Germany

Germany is the country with the most interesting experiences in the field of banking supervision. The supervision model adopted there had a very large impact on the economy. The history of work on banking supervision in Germany dates back to 1896, when a Reichstag Member von Arim presented the first draft act on the regulation of deposit bank operations. After the bankruptcy of Dresdner Creditanstalt and the Leipzig Bank, the basic assumptions for establishing the Reich Bank Control Office were introduced. Germany escaped the trap of attempts to nationalize all banks. Although in 1919, a special commission for socialization was established, fortunately for the German banking system, these efforts came to nothing (Zitzmann, 1966). By virtue of the Act of 19 September 1931, the first supervisory institution was established in that country. Initially, it operated as part of the Reich Bank, and then separated as an independent supervisory body (Reichaufsichtsamt). In this form it acted until the end of the WWII and was a manifestation of extremely statist tendencies of that period. After 1945, the supervision was exercised by the central banks of individual Lands (Länder); in 1948, by the predecessor of Bundesbank: Bank Deutscher Länder. At the same time, the Commission for Banking Supervision was established. It consisted of supervisory representatives from individual Länder and the central bank. In 1957, the Deutsche Bundesbank was founded. Its creation did not affect the structure of supervision. It was not until the amendment of the Credit Law Act that a new banking supervision authority, the Federal Financial Supervisory Authority (Bundesaufsichtsamt für das Kreditwesen), was established on 1 January 1958, which

operates to this day in an unchanged form (Aramowicz, 1994). The subject scope of competences of the Federal Financial Supervisory Authority is determined by the notion of a credit institution defined in § 1 of the German Act of 10 July 1961 on Lending (Gesetz über Kreditwesen), taking into account the exceptions specified in § 2 of this Act [Cf. § 1 and § 2 of the German Act of 10 July 1961 on lending activities - Gesetz über das Kreditwesen] (Werner, and von Rottenburg, 1997).

VI. CONCLUSIONS

Summing up the considerations concerning supervision over credit institutions, it should be pointed out that provisions relevant to this matter have evolved to integrate supervision in one institution and to improve the cooperation of home and host supervision authorities in cross-border cooperation. When creating regulations on the functioning of financial institutions, an economic analysis of the law should be taken into account and only this approach allows for optimal legislative solutions that work well under free market conditions.

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