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# Towards a Common Market in Banking and Financial Services in the European Economic Community

Stuart Isaacs

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SUMMARY



## I. INTRODUCTION

The last few years have seen increasing discussion on the subject of the single European market in banking and financial services. This discussion is taking place both within the European Economic Community ("the EC") and in third countries, such as the United States and Japan, whose financial institutions will be affected by the EC moves towards the creation of a common market in the banking and financial services sectors. Already, EC legal measures, such as those resulting in the liberalisation of capital movements, and the enlarged freedom of financial institutions to provide services and set up branches EC-wide, have led to substantial changes in the structure of the banking sector.

Two major matters have come to the fore. First, in July 1990, the most important remnants of national exchange controls were abolished. The flows of capital which this has released will provide a keen test of the European Monetary System. Second, there is, and will continue to be, intense debate between the Member States on whether and, if so, how they should move on to Economic and Monetary Union, leading ultimately to a single EC currency and Central Bank.

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This article seeks to provide an overview of some of the main developments taking place within the EC in the banking and financial services sectors. It highlights those areas likely to be of particular concern to financial institutions based outside the EC. It demonstrates the need for those institutions to take stock of the degree of harmonisation of the laws of the EC Member States which has already been achieved, and to be alert to the many future developments in the field.

## II. FREEDOM OF CAPITAL MOVEMENTS

Because the freedom of capital movements is closely related to the economic, monetary and balance of payments policies of the Member States, the relevant EC Treaty provisions are more restrictive than those which deal with the free movement of goods, persons and services; and they must be read in conjunction with the Treaty provisions concerning economic policy.

### *A. Within the European Community*

Article 67(1) of the Treaty,[1] which deals with the liberalisation of capital movements *between* EC Member States, provides that,

> Member States shall progressively abolish between themselves all restrictions on the movement of capital belonging to persons resident in Member States and any discrimination based ont he nationality or on the place of residence of the parties or on the place where such capital is invested.

The European Court of Justice has defined a "movement of capital" to be a financial operation essentially concerned with the investment of the funds in question rather than renumeration for a service.[2] Therefore, capital movements must be distinguished from current payments. A movement of capital may take place between Member States even though the funds in question do not move outside the Member States concerned; for example, where a capital transfer takes place within a single Member State between residents of different Member States.

Any person resident in the EC may take advantage of the liberalisation provisions of Article 67(1). In this regard, "person" includes companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the EC.[3] Residence is to be determined according to the definitions in the exchange

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[1] TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [hereinafter EC Treaty].

[2] Joined cases 286/82 and 26/83, Luisi and Carbone v. Ministero del Tesoro, 1984 ECR 377.

[3] EC Treaty, Article 58.

laws of the Member States. So, for example, the United Kingdom subsidiary of a US parent corporation obtains the same protection as any other UK company.

The obligation on Member States to liberalise capital movements between themselves is only "to the extent necessary to ensure the proper functioning of the common market."[4] The assessment of what are the requirements of the common market at any particular time rests with the EEC Council.[5]

Until recently, the obligations of the Member States with regard to the liberalisation of capital movements were contained in the First Directive of 11th May 1960, as amended.[6] It laid down liberalisation arrangements which varied according to categories of transaction grouped together into separate lists. Certain capital movements were required to be unconditionally liberalised, and in relation to still other Member States were not required to adopt any liberalising measures.

However, in June 1988, the Council adopted Directive 88/361.[7] This directive repealed the First Directive with effect from 1 July 1990 (Article 9) and introduced from that date a complete liberalisation of capital movements in the EC, subject only to transitional arrangements for some Member States and specific safeguard provisions to enable Member States to reintroduce restrictions on short-term capital movements for up to six months should monetary or exchange-rate policies be disrupted. The new regime applies to all capital transactions, including those which were previously excluded such as financial loans and credits, current and deposit account operations, and transactions in money market securities.

*B. Between the European Community and Third Countries*

The Treaty, in Article 70, also contains provisions concerning the liberalisation of capital movements *between* the EC and third countries:

> 1. The Commission shall propose to the Council measures for the progressive coordination of the exchange policies of the Member States in respect of the movement of capital between those States and third countries. For this purpose the council shall issue directives, acting by a qualified majority. It shall endeavour to attain the highest possible degree of liberalisation. Unanimity shall be required for

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[4] EC Treaty, Article 67.

[5] EC Treaty, Article 69.

[6] 1959-1962 O.J. SPEC. ED. 49; 1963-1964 O.J. SPEC. ED. 5. *See also* Council Directive 85/583, 1985 O.J. (L 372) 9; and Council Directive 86/566, 1986 O.J. (L 332) 22.

[7] 1988 O.J. (L 178) 5.

measures which constitute a step back as regards the liberalisation of capital movements.

2. Where the measures taken in accordance with paragraph 1 do not permit the elimination of differences between the exchange rules of Member States and where such differences could lead persons resident in one of the Member States to use the freer transfer facilities within the Community which are provided for in Article 67 in order to evade the rules of one of the Member States concerning the movement of capital to or from third countries, that State may, after consulting the other Member States and the Commission, take appropriate measures to overcome these difficulties.

3. Should the Council find that these measures are restricting the free movement of capital within the Community to a greater extent that is required for the purpose of overcoming the difficulties, it may, acting by a qualified majority on a proposal from the Commission, decide that the State concerned shall amend or abolish these measures.

Article 70 exists not out of a spirit of altruism on the part of the EC towards third countries, but for the very simple reason that, if the exchange policies of Member States in relation to capital movements to and from third countries differed, the liberalisation of capital movements within the Community might result in the diversion of funds between Member States. Article 70 therefore calls for the progressive coordination of the exchange policies of Member States, in respect to the movement of capital between them and third countries. It falls short of what would have been a more complete solution, namely the adoption of a common policy towards movements of capital between the Community and third countries.

From 1. 1990, the position is governed by Article 7 of the capital movements directive. It obliges the Member States to endeavour to attain the same degree of liberalisation as that which applies to operations with residents of other Member States. However, there is an important proviso - which recurs in the context of the Banking Directives - namely that Member States remain free to apply to third countries any reciprocal conditions concerning operations involving establishment, the provisions of financial services and the admission of securities to capital markets.

*C. Safeguard Clauses*

For the same reason that the freedom capital movements is tied to the Member States' own economic and monetary policies, a very careful balance needs to be struck between the interests of the EC, on the one hand, and of the Member States on the other. The Treaty, accordingly, includes various safeguard provisions which need to be mentioned.

First, so far as concerns capital movements between the EC and third countries, where Member State A has freer transfer facilities than Member State B, which could lead residents of Member State B to use those other facilities to evade the rules of Member State B, Article 70 empowers Member State B, within defined limits, to take appropriate measures to overcome its difficulties. Second, Article 73 allows protective measures to be taken, again in defined circumstances, where movements of capital lead to disturbances in the functioning of the capital market in any Member State. Third, the Treaty contains other safeguard provisions in Articles 108 and 109; where a Member State is in difficulties as regards its balance of payments.

These measures should be contrasted to Article 7(2) of the capital movements directive which says:

> Where large-scale short term capital movements to or from third countries seriously disturb the domestic or external monetary or financial situation of the Member States, or of a number of them, or cause serious strains in exchange relations . . . between the Community and any third countries, Member States shall consult with one another on any measure to be taken to counteract such difficulties. . . .

This is not a safeguard provision at all, since it does not empower Member States to deviate in any way from the provisions which otherwise apply.

## III. BANKING DIRECTIVES

The Second Banking Directive[8] has been stated by the EC Commission to be the centre-piece of its proposals for the banking sector in the context of the completion of the internal market by 1992. The directive has a three-fold objective with regard to the business of credit institutions: (A) to remove the remaining barriers to freedom of establishment in the banking sector; (B) to provide for the full freedom to offer banking services throughout the EC; and (C) to regulate the operations within the EC of financial institutions established in third countries.

### *A. Freedom of Establishment*

The right of establishment means, in the corporate context, the right of nationals of any Member State established in the EC to set up agencies, branches or subsidiaries anywhere in the EC. The main conditions for freedom of establishment were set out in the First Banking Directive of 1977,[9] which enabled banks of one Member State to establish themselves in another Member

[8] Council Directive 89/646, 1989 O.J. (L 386) 1.

[9] Council Directive 77/780, 1977 O.J. (L 322) 30.

State, but *always* under the same conditions as those applying to local banks. It left three serious gaps. First, the foreign bank still had to be authorised by the banking supervisory authorities of the host Member State. Second, the foreign banks's activities still had to be subject to supervision by the host Member State and its range of activities could be restricted by the laws of the host Member State (for example, as to the products sold/services provided). Third, in most Member States, branches had to be provided with "endowment capital"/"own funds" as if they were new banks.

All these restrictions are removed by the Second Banking Directive. Any bank validly established in one Member State may set up a branch in another Member State and, in doing so, need only comply with the regulations in force in its "home" country. The host Member State may, in general, only exercise control over the branch in respect of questions of liquidity and general monetary policy (but subject to an exception as regards the control of activities relating to the holding and purchasing of securities).

The directive also makes provision for the application of these rules in certain circumstances to non-banking institutions which are owned and guaranteed by banks, and which exercise certain activities which the banks themselves are prohibited from carrying out directly, by virtue of the national regulations in force in their home country (e.g. leasing, factoring).

### *B. Freedom to Provide Services*

As things stand at present, there are no EC procedures for facilitating the freedom to provide services in the banking sector. Such freedom is effectively only practised in those Member States which have fully liberalised capital movements. Banks are still at present required to obtain a separate host country authorisation to market and advertise their services in most other Member States, and to restrict their activities to those permitted to domestic banks and subject to host country supervision.

The directive in general terms enables any bank validly established and authorized in a Member State to offer its services in another Member State without having to modify its product to conform with local requirements. It also makes provision for the application of these rules to non-banking institutions owned and guaranteed by banks.

### *C. Specific Points Common to Freedom of Establishment and the Free Provision of Services*

There are many interesting aspects of the Second Banking Directive which are common to the provisions dealing with freedom of establishment and the freedom to provide cross-border services. It is only possible here to highlight three of the most important.

First, there is the concept of "home country control," which lies at the heart of the directive and underlies all EC harmonisation efforts in the banking and financial services sectors. It gives rise to questions of possible incompatibility between national legislation and EC law. In particular, any national measure involving penalties or restrictions on the provision of services or right of establishment must be properly justified and subject to a right of appeal to the courts of the host country, leading to possible references to the European Court for its preliminary ruling on any question of interpretation of EC law which arises in such proceedings.

Second, the concept of "the general good." The directive permits restrictions to be imposed in some circumstances by the Member States where they are in the "general good." The concept is itself nowhere defined, but it is clearly to be restrictively interpreted. It certainly would not permit the host Member State to impose restrictions where the activities in question of the bank concerned were carried out in conformity with the regulations of its home country and the *sole* basis for the restriction being imposed for the general good was that the host country's own laws were not being met.

Third, it is a moot point whether discrimination *against* a "home" national is contrary to EC law. In general, domestic institutions may *not* invoke EC law to defend themselves against their own authorities, if they are subject to less favourable treatment than that which must be applied under the directive to foreign banks operating in the host country; however, the position is unclear.[10] Illustrations of such discriminatory measures include higher minimum capital requirements for domestic institutions and maximum percentage shareholding which may be owned by banks in commercial corporations.

*D. Third Country Institutions*

The position of third country financial institutions under the so-called reciprocity provisions of Articles 8 and 9 of the Second Banking Directive calls for special comment. They have particular importance to the U.S. and Japan.

Reciprocity provisions as such are not new. Article 9 of the First Banking Directive of 1977 provided that Member States should not apply to branches of credit institutions having their head office outside the EC provisions which

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[10] In joined cases 314-316/81 and 83/82, Procureur de la République v Waterkeyn, 1982 ECR 4337, the Advocate General and the European Court left open the question whether the application of a Member State's legislation, which was likely to cause discrimination against nationals of that State, was compatible with EC law. Also, in case 355/85, Driancourt v. Cognet, 1986 ECR 3231, 3232, the Court observed, in the context of the free movement of goods that:

> Community law does not apply to treatment which works to the detriment of national products as compared with imported products or to the detriment of retailers who sell national products a compared with retailers who sell imported products and which is put into effect by a Member State *in a sector which is not subject to Community rules or in relation to which there has been no harmonisation of national laws.* (emphasis added).

would result in *more* favourable treatment than that accorded to branches of credit institutions having their head within the EC. It went on to provide (and this is where reciprocity comes in) that the EC might, by agreement, accord equal treatment, *on the basis of the principle of reciprocity*, to branches of a credit institution having its head office outside the EC throughout the territory of the EC.

Article 8 of Second Banking Directive provides:

> The competent authorities of the Member States shall inform the Commission:
>
> (a) of any authorisation of a direct or indirect subsidiary one or more parent undertakings of which are governed by a third country. The Commission shall inform the Banking Advisory Committee accordingly;
>
> (b) whenever such a parent undertaking acquires a holding in a Community credit institution such that the latter would become its subsidiary. The Commission shall inform the Banking Advisory Committee accordingly.
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> When authorisation is granted to the direct or indirect subsidiary of one or more parent undertakings governed by the law of third countries, the structure of the group shall be specified in the notification which the competent authorities shall address to the Commission in accordance with Article 3(7) of Directive 77/780/EEC.

Article 9 provides:

> 1. The Member States shall inform the Commission of any general difficulties encountered by their credit institutions in establishing themselves or carrying on banking activities in a third country.
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> 2. Initially no later than six months before the application of this Directive and thereafter periodically, the Commission shall draw up a report examining the treatment accorded to Community credit institutions in third countries, in the terms referred to in paragraphs 3 and 4, as regards establishment and the carryingon of banking activities, and the acquisition of holdings in third-country credit institutions. The Commission shall submit those reports to the Council, together with any appropriate proposals.
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> 3. Whenever it appears to the Commission, either on the basis of the reports referred to in paragraph 2 or on the basis of other

information, that a third country is not granting Community credit institutions effective market access comparable to that granted by the Community to credit institutions from that third country, the Commission may submit proposals to the Council for the appropriate mandate for negotiation with a view to obtaining comparable competitive opportunities for Community credit institutions. The Council shall decide by a qualified majority.

4. Whenever it appears to the Commission, either on the basis of reports referred to in paragraph 2 or on the basis of other information that Community credit institutions in a third country do not receive national treatment offering the same competitive opportunities as are available to domestic credit institutions and the conditions of effective market access are not fulfilled, the Commission may initiate negotiations in order to remedy the situation.

In the circumstances described in the first subparagraph, it may also be decided, at any time, and in addition to initiating negotiations, in accordance with the procedure laid down in Article 22(2), that the competent authorities of the Member State must limit or suspend their decisions regarding requests pending at the moment of the decision or future requests for authorisations and the acquisition of holdings by direct or indirect parent undertakings governed by the laws of the third country in question. The duration of the measures referred to may not exceed three months.

Before the end of that three-month period, and in the light of the results of the negotiations, the Council may, acting on a proposal from the Commission, decide by a qualified majority whether the measures shall be continued.

Such limitation or suspension may not apply to the setting up of subsidiaries by credit institutions or their subsidiaries duly authorized in the Community, or to the acquisition of holdings in Community credit institutions by such institutions or subsidiaries.

5. Whenever it appears to the commission that one of the situations described in paragraphs 3 and 4 obtains, the member States shall inform it at its request:

(a) of any request for the authorisation of a direct or indirect subsidiary one or more parent undertakings of which are governed by the laws of the third country in question;

(b) whenever they are informed in accordance with Article 11 that such an undertaking proposes to acquire a holding in a

Community credit institution such that the latter would become its subsidiary.

This obligation to provide information shall lapse whenever an agreement is reached with the third country referred to in paragraph 3 or 4 when the measures referred to in the second and third subparagraphs of paragraph 4 cease to apply.

6. Measures taken pursuant to this Article shall comply with the Community's obligations under any international agreements, bilateral or multilateral, governing the taking-up and pursuit of the business of credit institutions.

These reciprocity provisions are intended to reflect the Community's *policy* towards third country banks. As Zavvos writes:[11]

> The EEC constitutes the leading commercial power in the world. This commercial power is supported by a long financial tradition reflected in the strength of its financial centres (London, Frankfurt, Luxembourg, Paris) and the high standing of its banks which figure on the list of the top international banks.
>
> As a matter of law and of fact the Community is one of the most open banking markets in the world. In this context the Commission believes that in a highly financially interdependent world its banks and other financial intermediaries should enjoy a fair access and equivalent treatment in other world markets. Thus, it focuses on the liberalisation of financial markets within the context of the internal market, it does not lose sight of the efforts undertaken to liberalise financial services on a world scale as in the case of the ongoing negotiations in GATT for trade in services. There is a crucial link between the efforts of the Community to accomplish the internal market and GATT negotiations. The competitive position of the Community's producers of financial services will depend on their ability to exploit the advantages of its unified market.
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> The Commission is of the opinion that in the directive which constitutes the regulatory and supervisory framework for the banking sector, there should be a common stance of the Member States' policies regarding the first establishment of a third country banking institution. In fact, the granting of a single banking license may have an automatic impact not only for the Member State of first establishment but also for all the others. In this connection it is

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[11] Zavvos, *Integration of Banking Markets in the EEC,* 2 J.I.B.L. 53, 61-62 (1988).

justified that a procedure of reciprocity could be activated if the situation arises.

As things stand at present, third country banks which establish a subsidiary in any Member State are entitled to have that subsidiary treated as a national of the Member State in question. This is because, under Article 58 of the EC Treaty, corporations formed in accordance with the law of a Member State and having their registered office within the EC are treated "in the same way as natural persons who are nationals of Member States."

An important feature of the procedure in Articles 8 and 9 is that it will only affect new requests for authorisations. Thefore, banks which wish to avoid the uncertainties of the Commission's examination process might be well advised to form or acquire a subsidiary within the EC before the effective date of 1st January 1993.

*E. Particular Aspects of the Reciprocity Provisions*

Although Articles 8 and 9 of the Second Banking Directive are commonly referred to as the reciprocity provisions, it is curious that the word "reciprocity" and its derivatives are not featured anywhere in the directive as adopted. Instead, such phrases as "national treatment," "equivalent treatment" and "comparable . . . effective market access and competitive opportunities" are utilized. It is a moot point whether this language makes for clarity or whether the change has any substantive significance. It is doubtful that it does, least of all because the reason for the change put forward by the Commission at the time was, tautologically, "to clarify the reciprocity provision."

The Commission's examination process enables it to monitor, on a continuous basis, the situation with regard to any third country. This process also empowers a Member State to complain whenever "general difficulties" are encountered by their credit institutions in a third country.

Numerous questions arise as to what is meant by "comparable . . . effective market access" and "competitive opportunities." This leads to the nub of the concerns of third countries about how the Commission will interpret the reciprocity standard and what wider uses may be made of it. One U.S. viewpoint is that the EC is pursuing an active strategy of negotiations to persuade the U.S. and other countries to liberalise their banking regimes, using the ambiguities in the directive as a source of bargaining power. For example, EC institutions may be adversely affected by state legislation according to which foreign banks cannot be state chartered banks. Sir Leon Brittan, the EC Commissioner with responsibility for the banking and financial sectors, described the position in a speech in Washington, in March 1990, more picturesquely as a desire on the part of the Commission to "improve the ventilation of the American banking mansion."

## IV. BROKERAGE SERVICES

There is a considerable overlap between this topic and the topic of the Banking Directives. This is particularly true in view of the list of agreed banking activities contained in an Annex to the Second Banking Directive, which is drawn up on a liberal universal banking model. The most important and far-reaching aspect of the list is the inclusion of all forms of transactions in securities. By way of illustration, the list includes participation in share issues and the provision of services related thereto; advice to undertakings on capital structure, industrial strategy and related questions and advice on services relating to mergers and acquisitions; portfolio management and advice; the safekeeping and administration of securities; and trading for one's own account or for the account of customers in transferable securities. All are covered by the Second Banking Directive.

Also, the carrying on of activities not listed in the Annex are protected by the general provisions of the EC Treaty governing right of establishment and the freedom to provide services, and on the basis of which the Second Banking Directive has itself been adopted. Article 52 of the Treaty provides for the complete abolition of all restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State. Article 59 provides for the complete abolition of all restrictions on the freedom of nationals of Member States established in the EC to provide service within the Community. The European Court has been insisting for many years on these freedoms and extended the concept of the free provisions of services to include the right of the recipient of a service to go to another Member State in order to receive it there. In many ways, the continued partitioning of financial markets at the level of retail services, until very recently might, against this background, have seemed astonishing.

The problems, particularly in the field of the free provision of services, have been practical ones. First, there is the existence of exchange regulations. Second, there are various national regulations aimed at consumer protection, which frequently involve a prohibition on foreigners soliciting investment business, selling financial or brokerage services or supplying credit without prior approval from the authorities of the host country. Third, there are local fiscal regulations which, for example, may tend to favour local lenders (mortgage interest relief; absence of withholding tax requirements).

There now exists a draft directive covering brokerage services. It aims at breaking down the barriers to the freedom to provide such services in the EC. Broadly speaking, the complete liberalisation of capital movements, coupled with the absence of restrictions on the freedom to provide financial services, will greatly increase the competition to which national financial systems are exposed. At the internal level, lower brokerage charges, improved resource allocation and greater volume of investment will be the beneficial effects of the integrated financial system. At the external level, the removal of restrictions should enable

EC financial institutions to compete with those from Japan and the US, due to the establishment of more internationally -oriented finance houses, gains in productivity, a wider product range and an enhanced capacity for innovation.

## V. CONCLUSION

It is increasingly unlikely that a single EC-wide market in all banking and financial services will be achieved, as originally intended, by the end of 1992. However, what is beyond doubt is that such a market will come about within the foreseeable future. All restrictions on capital movements have been swept away. The Second Banking Directive is already in place. The brokerage services directive is under active discussion. Harmonisation moves are also afoot in the field of securities law and in the insurance sector. The importance of timing in the present context is that banks, investment houses and insurers all compete with each other to a certain extent, and thus, banking institutions will have a head start over the other types of institutions in selling competitive products across the EC. This article has hopefully contributed to institutions from outside the EC not being left out in the cold when the single financial market does eventually come about.