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ARTICLES

EC

Harmonization of Banking Legislation

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Although harmonization of EC banking laws has only just started, it does already have some practical significance, because in adjustments of national laws account is taken to some extent of the ideas developed on the level of the Community. Nevertheless, a number of problems make it doubtful that a meaningful harmonization in that field can be realized in the near future.

Since 1971, the harmonization of banking legislation has been on the agenda of the European Commission in Brussels. The first limited and unofficial proposal for a directive appeared in that year, serving as a basis for an exchange of views. Comments came in from various sides. The result was a new – still informal – draft directive, which appeared by mid-1972. This was a proper directive, though it was limited to the supervision of the way banks conduct their affairs and did not present a monetary policy aiming at the control of liquidity supply. At the time the idea was to harmonize banking legislation as far as possible in one go. Indeed, the basic pattern for a European banking law was then designed, and as far as the basic ideas concerning harmonization of banking legislation are concerned, it is still a helpful document.

In 1972 and 1973 the draft was criticized, mainly by representative European banking organizations. Particularly on the part of Great Britain, objections were raised against harmonizing banking legislation in one big operation; the fundamental ideas of the 1972 draft were left intact except as far as supervision of solvency and liquidity was concerned. Several EC partners turned out to share the British objections, as did the European Commission, which by the end of 1973 abandoned the "all-round" draft in favour of the step-by-step method. This implied that European banking law was to be created in the course of time on the basis of a series of partial directives. The first proposed directive, submitted by the European Commission to the Council, was published on January 17, 1975; the report of the European Parliament appeared on May 12, 1975. It seems that the directive will come into operation in 1977.

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Checked against recognized sound principles, the proposed directive seems an acceptable first step. All that has been said so far in the way of an objective, is that European banking legislation must provide scope for free and responsible banking within the whole Community unhampered by national frontiers. The fourteen articles drafted do no more than indicate the direction into which European banking legislation might develop, implying no actual co-ordination in the first stage. So all we can do for the moment is to check how far the draft presented conforms to sound principles, which we propose to do by confronting it with four fundamental considerations.

Scope for Banking Activities

First, then, European banking law should offer full scope for banks to carry out all basic banking operations associated with payments, loans, and financial services within the Community.

On three main points the draft seems quite acceptable as far as the first consideration is concerned.

☐ The admission of a credit institution will be judged by objective criteria, viz. its own funds and its capable and reliable management. Admittedly, the question may arise whether the definition of a "credit institution" is sufficiently wide, particularly because latitude has been left for tightening it later on. Moreover, the proposal authorizes member states to apply supplementary admission criteria, though the European Parliament has turned down evaluation by "economic need" as practised in Italy and France.

☐ Once admitted, credit institutions are free to undertake all banking activities; that implies that the legislature accepts the principle of universal banking (unlike what is common in Germany, the term does not refer specifically to participations). How far credit institutions want to specialize their activities is exclusively their own concern; obviously they are themselves the best judges of the need to do so.

☐ Finally, while it is justified to create, in the course of time, a banking law that gives credit institutions freedom to establish branches everywhere in the Community, operations will always be supervised – in particular as far as the control of solvency and liquidity is concerned – from the country of origin.

Protection of Customers' Interests

Second, European banking law should – put in general terms – afford to bank customers proper protection of their interests, in particular to those who have entrusted their money to credit institutions. This basic consideration reflects the wish to continue the relationship existing at present between the banks and their customers in the Western monetary system, a relationship that emphasizes the fiduciary character of that system. On the one hand, customers trust their banks, withdrawing their deposits only to a limited degree in a given period. The banks, on the other hand, counting on their customers' trusting attitude, invariably keep less currency at hand than could theoretically be demanded by their clients. They can afford to do so provided they manage their liquidity and solvency in such a way that there is no reason for more withdrawals than is motivated by transactions and normal precaution.

It is the banks that carry the primary responsibility for such an understanding, and for that reason they must provide for a sound composition of their balance sheets; legislation and supervision only be complementary and reinforcing. Under normal circumstances, monetary authorities will never assume responsibility for the state of affairs in banking. And rightly so! We may in this context recall the objective admission criteria mentioned above, and anticipate the discussion on proper supervision of liquidity and solvency which is to follow. Deposit insurance, already included in the 1972 draft and later again referred to by the European Commission, may be added later as a measure for the protection of clients' interests.

Liquidity and Solvency Supervision

Third, European banking law should make provisions for the effective supervision of the liquidity and solvency of credit institutions. It seems desirable briefly to examine the implications of this supervision, especially with reference to the division of responsibility indicated above. Supervision, which will always have to be based on ratios, runs through three phases. In the first, numerator and denominator are defined; in the second, the size is determined, and in the third, compliance is checked.

It may be instructive to know how such a three-phase programme is implemented in the Netherlands. There, the numerator is constituted by the liquidity assets a credit institution needs to hold in order to meet obligations on demand. The denominator consists of the deposits made, for they represent the amounts that can be demanded. The ratio of the two is designed to express as well as possible what "being liquid" means. Next, the size of numerator and denominator is determined in such a way as to account accurately for differences in withdrawability. The result is a highly differentiated set of ratios, which seems to work reasonably well as an instrument of liquidity supervision. At any rate, in Dutch banking no serious liquidity problems have been experienced in the whole of the post-war period, nor are they likely to occur in the near future. However, that is no proof that this kind of supervision can indeed pass muster.

Supervision of solvency, like that of liquidity, has until now largely aimed at maintaining a formally correct state of affairs. Here, the description of "own funds" in the numerator of the ratio should be a matter of primary concern. In respect of bank solvency funds can only qualify as "own" if they are at the unconditional, immediate, and permanent disposal of the credit institution. The denominator contains risk-bearing liabilities, especially credits. The motive is that own funds must cover the risks incurred in operations. If the ratio has been properly set and is complied with, the value of deposits remains untouched; the credit institution is then formally solvent. Serious efforts have been made to set up a system of solvency supervision on that basis, because it would neatly distinguish between the various risks inherent in different assets. The result of these efforts was, again, a differentiated set of ratios. It is not encouraging to check the development of bank solvency against the ratios recommended, and one wonders whether the starting points were properly chosen.

A bank will never succeed in being completely liquid in a formal sense, because in our monetary system there will always be more demand deposits than liquid funds. As already pointed out, that is inherent to the fiduciary monetary system. Consequently, the liquidity ratio is invariably hypothetical; it merely indicates that, within the limits of probable withdrawals, the credit constitution can meet its liabilities. And that is not the same as the basic consideration accepted so far.

Solvency supervision is subject to the same kind of criticism. After all, it can give no guarantee that the financial risks of banking will be borne exclusively by the bank's own funds. The risks concern a possible nominal decline of the assets or the equity, when the bank's debtors are in arrear on interest and redemption, or when withdrawals exceed the limits of what is normal. Such a situation could occur at any time, and it is not feasible to cover the risks involved entirely through the solvency ratio. It follows that this ratio can only guarantee the nominal value of the deposits received within the same limits of probability as apply to the liquidity ratio. Here again, there is a modification of the basic considerations. The question arises what the implications are for the definition of numerator and denominator, for the determination of their size, and for the consequences of sticking to the ratio, in respect of both the liquidity and the solvency ratio.

The relative validity of the ratios as such must be recognized, and consequently also the relativity of the contrast between the differentiated, precise approach, and the overall approach, which plays a part in the debate on the supervision of banking operations in the European setting. Clear and unambiguous definitions of numerator and denominator are needed under either approach. The practical versatility of banking operations in the EC requires versatile ratios, such as those mentioned in art. 6 of the draft directive (about which the last word has not yet been spoken!). Roughly speaking, the solvency ratio proposed in that article implies that the nominal size of deposits is assured when there are no short-term liquidity problems.

As far as the Netherlands is concerned, such an approach introduces two new aspects. In the first place there is no need to worry overmuch about some decline of the ratios in the course of time: it may be understandable and acceptable within the framework of banking reliability. In the second place, this very reliability does call for responsible capitalization. The call is the more urgent because, with the capitalization situation of business in general deteriorating, it is extremely important that banks should be utterly reliable as to business financing.

Principle of Non-discrimination

Fourth and last, European banking law should be based on the principle of non-discrimination. In other words, it should not affect the conditions of competition as such. In the preamble to the draft this principle was indeed set forth, but unfortunately it was undermined at a later stage, when the possibility of subjecting certain credit institutions to separate rules was introduced. Great caution is needed here, particularly as fading demarcation lines in banking and the attendant increased competition are rendering the non-discrimination principle more than ever opportune.

So far we have considered the implications of the proposed European banking law only in rough outline and on the basis of four principles. The conclusion may be that, in general, the direction chosen for the first step is the right one. The next, no less important, point will be the elaboration of what has been proposed.

Adaptation of Dutch Banking Legislation

Remarkably enough, the efforts to create a European banking law have already had some practical results, insofar as the EC plans have been taken into account to some extent in adaptations of national laws. The Draft Revision of the Netherlands Credit Institutions Supervision Act, dated July 4, 1975, is a case in point. Let us review in succession the articles relating to admission, the definition of "own funds", the planned deposit insurance, the purport of the business-economic supervision, and the appreciation of participations and mergers. It should be pointed out first that the Dutch Credit Institutions Supervision Act is concerned with socio-economic supervision to control the liquidity supply as well as with business-economic supervision to control the solvency and liquidity of credit institutions, while European banking law will refer only to the latter kind of supervision.

A credit institution is an institution that takes in amounts of money withdrawable within two years, and invests them for its own account. Such an establishment comes under the socio-economic and business-economic supervision of De Nederlandsche Bank (DNB). The State Postal Savings Bank and the Clearing Services get special treatment, coming under socio-economic supervision only. Establishments that, while taking in money for less than two years, do not invest for their own account – "near banks", e.g. – may also be placed under socio-economic supervision because their activities have a monetary character. Establishments not under business-economic supervision are still allowed to take in money, provided a certain minimum – probably to be fixed at *f* 100,000 – is observed. Finally, establishments that take in money for two years or longer and invest it for their own account – mortgage banks, e.g. – may be put under business-economic supervision. Seen as a whole, the new Credit Bank

Supervision Act (CBSA) covers in a balanced, responsible way the various banking activities.

In future, a license will be required for running a credit institution, to be issued by DNB, a stipulation that is in harmony with the draft European banking law. Admission will be granted by objective criteria; the draft mentions as such expertise and honorability of the management, which has to consist of more than one person, and a certain amount of own funds. A limited liability or private company should moreover have a board of at least three directors. The Dutch proposal differs from that for the EC in that it does not recognize "economic need" as a – subjective – criterion to be applied by the authorities.

In the Dutch draft the principles of "scope for free and responsible banking" and "non-discrimination" have been respected, inter alia by its neutrality towards the various legal forms under which credit institutions can be run. Such neutrality also implies that, once an institution has been admitted, the law does not impose any specific restrictions by stipulating, e.g., that certain transactions should be reserved to certain kinds of corporations. Thus, the principle of "universal banking" has been adopted, in accordance with the intentions expressed within the EC. Should an establishment wish to limit its activities to a certain category, then it may do so at its own discretion; the law does not lay down any rules on that score. The same two principles apply to the solvency and liquidity supervision, which is essentially meant to guarantee clients of all credit institutions, whatever their legal form, as much as possible the same banking security. And that brings us to a discussion of the banks' own funds.

Treatment of the Banks' Own Funds

The manner in which the banks' own funds have been treated in the draft CBSA is not fully in agreement with the principles defined above. Both there and in the designed European Banking Law the own funds have a double function: they serve as a criterion for admission and as a yardstick of solvency. A true and proper banking function, indeed, designed to instill in the banks' clients that confidence without which a bank cannot carry on its trade. To fulfil this function properly, own funds should be defined, in the Dutch as well as in European banking law, according to criteria that are relevant to banking. The principal criterion is that a bank's own funds must safeguard its continuity, irrespective of its legal form. The Dutch draft-proposal fails in this respect: a definition of "own funds" is sadly lacking, and what is worse, article 10 of the draft CBSA actually leaves open the possibility that it will in the end be related to the legal form. Now that is inconsistent, and also in conflict with specific banking function the own funds must fulfil.

The "own funds" should be made up of such components as are at the immediate, unconditional, and permanent disposal of the credit institution, that is to say:

- ☐ paid-up capital and reserves as far as known to the monetary authorities and as far as not set aside to meet certain liabilities;
- ☐ money the bank has on loan on conditions as regards running term and redemption that enable the bank to use it for a relatively long period;
- ☐ as far as private bankers are concerned, and to a certain limit: their private capital even if not set aside – stringent rules as to the control of such unreserved capital seem essential.

The amount of a member's liability towards his cooperative bank does not meet the criterion of immediate, unconditional, and permanent availability, and cannot, therefore, be counted to that bank's own funds. To our mind, then, it is unwarranted that in the Netherlands the amount of cooperative liability – at f 1,000 per member – is included among the bank's own funds.

Plans for a Deposit Insurance

The new CBSA furthermore is intended to protect, more explicitly than before, the interests of the clients of credit institutions. Hence the plans for a deposit insurance. The Minister has in mind an insurance up to a maximum amount per claim, especially for the benefit of "small creditors". In principle, creditors may indeed benefit from such an insurance, but it seems questionable whether the risk involved is in fact an insurable one. Can a bank's failure to pay up, like fires and crashes, be predicted on the basis of statistics?

Only when that question is answered positively can the risk be insured; unfortunately it cannot be answered. It follows that, creditable though it may be to offer savers and depositors a better guarantee of repayment than they hold at present, the planned type of insurance by itself cannot give them that. Our criticism is not directed against the idea of enhanced safety; we merely suggest that the matter be studied in more detail.

The general trend of the solvency and liquidity supervision in the Netherlands has already been discussed. Three final remarks may suffice here.

- ☐ The very formal Dutch system of determining ratios has been proved too ambitious; it implied guaranteeing more solvency and liquidity than can reasonably be provided.
- ☐ In practice it will be difficult to maintain the present Dutch system very much longer. Indeed, when actual developments make it necessary repeatedly to adjust the norms that were propounded with so much assertion – as happened after the assessments in 1955, 1968 and 1973 – the credibility of those norms becomes highly questionable.
- ☐ On the Western European level ratios are required that can essentially be applied in the same way throughout the EC territory.

On the above considerations, the draft CBSA would have to be revised not only as far as the definition of the "own funds" is concerned, but also in the sense that "simple basic ratios" in accordance with art. 6 of the draft EBL are introduced; art. 23 of the draft CBSA makes it possible to do so.

Participations and Mergers

The last point to be discussed with reference to the draft for a revised banking law in the Netherlands is concerned with the appreciation of participations and mergers. It seems that the planned merger control is an extension of the participation supervision that is already in existence. In most EC countries supervision of that kind is exercised. When in the Netherlands the Amro Bank and the Algemene Bank came into being as the results of great bank mergers, in 1964, DNB imposed the condition that any participation of five p.c. and over was to be judged for permissibility. The new CBSA contains a regulation to that effect (art. 25). As a motivation it can be put forward that mergers should be evaluated by the authorities as regards their solvency and power-concentration aspects.

As to power concentration, a distinction should be made between the concentration of power within a certain group, and domination of the market. While a solvency criterion is fully acceptable, judgment by the authorities on the ground of power concentration within a group is not. The question whether the concentration of shares of a credit institution with a few holders could lead to undue influence on the appointment of the bank's board and managers, is a matter of general company law. Should changes in that respect be desirable, then that law would have to be adjusted. That happened, in fact, in the Netherlands a few years ago, when the Company Act 1972 allotted to employees some say in the appointment of a company's management.

Besides, the legislature seems increasingly to feel the need of some control over power positions leading to market domination, threatening to disturb normal competitive relations. The European Commission, e.g., has already submitted a draft EC Merger Law to the Council of Ministers, according to which bank mergers would have to be evaluated according to the totals of their balance sheets. Such a criterion is inadequate, because similar balance ratios may have to be interpreted quite differently in terms of actual market control. For an adequate assessment, more factors will have to be considered, notably a firm's position on markets for credit money and on credit markets. Their understanding requires specific monetary information and expertise.

Furthermore it should be taken into consideration that banking activities are already drastically controlled by business-economic supervision, which restricts competition by limiting admission and promoting concentration. That is fully acceptable, particularly in the interest of banks' clients. On the other hand there is a wish to maintain some competition, by merger control, for example. Naturally, there is some degree of tension between business-economic and merger control, which makes it recommendable to entrust both to one monetary authority. The CBSA draft does not fully come up to that requirement. DNB will judge whether a planned merger does not lead to "unwanted developments in credit giving". Furthermore, the Ministry of Finance will check if the same merger "could lead to an undesirable development of credit-giving or is, or might become contrary to other considerations of general interest". It seems questionable whether it is a felicitous idea to have two authorities judge a planned merger by the same criterion.

Conclusion

Although harmonization of EC banking laws has only just started, it does already have some practical significance, because in adjustments of national laws account is taken to some extent of the ideas developed on the level of the Community. It might be interesting to investigate the impact on Western Germany, Belgium and England, where banking law has also recently been adjusted, or will be in the near future. That does not mean, however, that the perspectives for the realization of a European banking law are reasonably good; two sets of circumstances make that unlikely. In the first place the envisaged harmonization, if it is to be of real significance, will have to come about within the context of an economic and monetary union. Since the outlook on that score is sombre, prospects for the European banking law are not favourable either. In the second place, even if some headway were made there still would be many obstacles to overcome. Filling in the details of what is included only in outline in the present draft will give rise to many a point of conflict. With the Dutch draft in mind, three points may be listed now as an introduction:

- ☐ the definition of "own funds" and "liquidity" on behalf of supervision. This definition is indispensable for a meaningful harmonization, and if it is lacking, the European banking law leaves, in the wording of the "Fédération Bancaire", "under the umbrella of a suggested harmonization an opportunity for considerable variety due to the possibility of different interpretation of the definitions". To permit effective supervision of solvency, the own funds may – as already said before – include only those components that are at the credit institution's disposal unconditionally, immediately, and permanently;

- ☐ further improvement of the protection of bank clients' interests. The European Commission has proposed a deposit insurance system. Such a system already exists in Germany and is in preparation in the Netherlands, as already mentioned. The other member states have no deposit insurance; France and Italy are known not to favour it. Consequently, it will be difficult to find a solution acceptable to all members;

- ☐ supervision of participations. The present draft is silent on this subject, although the 1972 draft did contain a relevant proposal. Consultations about that proposal have already shown how difficult harmonization would be in view of the wide divergence of national regulations. It will not be easy to draft a regulation that will meet with general approval.

Apart from these points, the attitude towards credit institutions in third countries and the erection of a supervisory body are important questions. All the problems together make it doubtful that a meaningful harmonization of banking legislation within the EC can be realized in the near future.