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How The 1992 Legislation Will Affect European Financial Services

THE EUROPEAN ECONOMIC Community (EC) was created by the Treaty of Rome of 1957. Its intention was to create an integrated "Common Market" within which goods, services, labor and capital would move freely. In its early years, the implementation of the Treaty of Rome focused on eliminating tariff barriers on trade in goods between the member countries. Barriers affecting capital movements and trade in services were neglected, while those affecting labor mobility, such as lack of recognition of professional qualifications across member countries, were greatly reduced but not eliminated.

A major initiative to eliminate all remaining barriers to intra-EC trade began in 1985. This is referred to as the "single market program" or "1992," its target date for completion (in reality, the end of 1992).¹ The legislation underlying the single market program affects virtually every product area. This paper examines one key portion of the legislation: the regulatory changes

that pertain directly to banking and other financial services.²

In 1985, this sector accounted for 6.4 percent of total output and 2.9 percent of employment.³ Since the sector provides services for other sectors, the integration of EC financial markets will affect efficiency not only within the financial services sector, but also in sectors *using* financial markets.

1992: GRADUAL RATHER THAN SUDDEN CHANGE

The commitment to eliminate the remaining EC trade barriers was formalized in the Single European Act (SEA), which was signed in 1985 and came into force on July 1, 1987. (See the shaded insert on pages 64-65 for additional highlights on EC history and a description of institutions and legislative instruments.) The SEA defines both the goal—"an area without internal

¹For a recent overview of 1992, see Boucher (1991).

²Grilli (1989b) summarizes the numerous restrictions affecting international trade and investment transactions in the financial services sector, both in the EC and in other developed countries.

³See Emerson et al. (1988) for additional details on the economic dimensions of the financial services sector.

frontiers in which the free movement of goods, persons, services and capital is ensured"—and the target date—the end of 1992. It also incorporates reforms to speed up decision-making within the EC by establishing "qualified majority voting" to decide most issues of the reform process.⁴

In 1985, the EC Commission produced a White Paper entitled "Completing the Internal Market." It listed numerous measures thought to be necessary for the completion of the program, many of which have not yet been adopted.⁵ Because of the large number of required measures, all barriers cannot be eliminated at once.⁶

The large number of proposals and the time necessary to consider a given proposal contribute to 1992 being a process rather than an event. Each directive must go through a complex process of discussion, first within the Commission and then in the Council of Ministers. Member state governments must be informed at each stage because they wish to consult with the domestic parties that will be affected. Parliaments of member states, as well as the European Parliament, also comment on each proposal. Finally, each agreement has to be ratified and reflected in the legislation of each member state.

A typical EC directive could take three years from first draft to Council ratification, with another two years or so for full implementation. Only measures close to adoption in early 1992 (or already adopted) will be implemented by the end of 1992; and measures not yet drafted will not be implemented before the mid-1990s.

A SINGLE MARKET IN FINANCIAL SERVICES: THE CORE REGULATORY CHANGES

Before the 1980s, no systematic attempts had been made to reduce trade barriers in financial services. Although services had been addressed when the EC was formed in 1957, the implementation of intra-EC free trade in services had been neglected. Moreover, trade in financial services had not been covered by multilateral negotiations under the General Agreement on Tariffs and Trade (GATT). (This may change in the current Uruguay Round of negotiations.)

More important, many countries maintained exchange controls for capital account transactions long beyond when they liberalized current account transactions.⁷ Without a free flow of financial capital to balance the flows of goods between countries, "free" trade is constrained by capital controls. That is, financial services, which include a range of banking, investment and insurance services, cannot be freely provided across borders if access to foreign exchange is restricted.

Thus, an important step before removing specific restrictions on cross-border trade in financial services is to remove all exchange controls. Such a step was provided for by the Council Directive of June 24, 1988—The Capital Liberalization Directive—which removes controls on all capital flows within the EC and, for

⁴Key (1989) notes that under qualified majority voting, the number of votes of each member is weighted roughly according to its population. To adopt legislation, 54 votes out of a total of 76 are required.

⁵According to Hill (1991), as of December 1991, 65 of the 282 measures outlined in the White Paper remained to be adopted. A goal of the EC Commission was to have all measures adopted by year-end 1991 to allow member nations to convert the directives into national legislation. Problems with the directives are also occurring at the national level. For example, Italy has converted only half of the relevant directives into national law.

⁶Capie and Wood (1990) stress that gradual deregulation of the financial system is unlikely to cause instability. The history of deregulation, they note, reveals that only rapid changes in regulation threaten the stability of the financial system.

⁷According to Bannock et al. (1972), exchange controls are government policies that attempt to control the purchases and sales of foreign currencies undertaken by the residents of a specific country. For example, the Exchange Control Act of 1947 restricted the purposes for which foreign currencies could be bought by British residents and limited the use and retention of foreign currencies and gold they acquired.

An Overview of the European Community

The European Community (EC) is a grouping of 12 member states.¹ These are the original six signatories of the Treaty of Rome in 1957—France, Italy, Belgium, Luxembourg, the Netherlands and West Germany—plus six countries that joined later—Denmark (1973), Ireland (1973), the United Kingdom (1973), Greece (1981), Portugal (1986) and Spain (1986). Further expansion of the EC to include Austria and Sweden, as well as other countries, is a strong possibility. Key dates and events in the history of the EC, including the recent Maastricht Summit Accords on monetary and political union, are provided in the accompanying table.

EC Institutions

There are four major EC institutions. The *Commission* is the civil service of the EC. It is divided into 23 functional areas (Directorates General). There are 17 commissioners who are responsible for managing these areas. The Commission proposes new laws and policies and is responsible for implementing decisions made by the Council.

The *Council* is the ultimate decision-making authority. It is a committee whose members represent their own national governments. The Council makes final policy decisions based on Commission proposals. Participants at Council meetings vary according to subject matter. For example, if the topic is finance, then the finance ministers of the 12 member nations attend. If the topic involves the external relations of the EC, then foreign ministers attend. Council meetings involving heads of state occur twice a year. The chairmanship of the Council rotates among member states in alphabetical order for six-month periods. In some areas, such as for most labor and taxation questions, unanimity is required; for most single market issues, however, "qualified majority voting" is used.

The *European Parliament* is a chamber of elected representatives from all member states. It offers opinions on most European

legislation but it has no formal legislative powers.

The *European Court of Justice* is a body of 13 judges, including at least one from each member country. The Court rules on applications and interpretation of EC laws. Judgments of the Court are binding on each member state.

Legislative Instruments

There are four main legislative instruments. To become effective, legislation generally must be "adopted" by the Council. In some circumstances, however, the Commission may make laws itself. Typically, this will involve legislation that is required to implement previous Council decisions.

One instrument is *regulations*, which are legally binding on all member states whether or not ratified by national parliaments. If a regulation conflicts with national law, the regulation dominates. A second instrument is *directives*, which are legally binding only as to their ultimate effect; it is up to member states to decide how to implement the rules in their own national legislation. Virtually all of the 1992 program is being implemented by directives. *Decisions* are the third instrument. Decisions, which are more narrowly focused than directives, are legally binding on all those to whom they are directed. All decisions with financial implications are enforceable in courts of member states. Finally, *recommendations* (or opinions) have no legal support but merely state a view about some desirable condition or policy change.

EC legislation normally is subjected to a lengthy process of consultation and discussion before it is adopted by the Council. The "right of initiative" lies with the Commission. Once the Commission has drafted a proposal, there are consultations with all affected parties both directly and via the relevant ministries of member states. The European Parliament also has the right to be consulted and is given the opportunity to propose amendments.

¹For more details on the EC, see Rosenberg (1991).

Major Post-War Steps Towards European Integration

- 1947 Customs Union formed between Belgium, Netherlands and Luxembourg - "Benelux".
- 1948 Organization for European Economic Cooperation (OEEC) formed to administer U.S. aid for rebuilding post-war Europe.
- 1951 France, West Germany, Italy and Benelux form European Coal and Steel Community (ECSC) providing for a "Common Market" in these products.
- 1957 Treaties of Rome establish the six-member (Belgium, France, Italy, Luxembourg, Netherlands and West Germany) European Economic Community (EEC) and the European Atomic Energy Community (Euratom).
- 1960 European Free Trade Association (EFTA) formed to promote free trade between non-EEC Western European countries - Austria, Britain, Denmark, Finland, Iceland, Norway, Portugal, Sweden and Switzerland.
- 1962 Common Agriculture Policy (CAP) started.
- 1963 Britain's application to join EEC vetoed by President de Gaulle.
- 1965 France boycotts EEC in protest at excessive speed of integration moves.
- 1968 Customs union completed.
- 1970 "Werner Report" calls for Economic and Monetary Union within Europe - including a single currency.
- 1972 European exchange rate "Snake" arrangement formed, but the United Kingdom leaves the Snake after six weeks.
- 1973 United Kingdom, Denmark and Ireland join the EEC.
- 1979 European Monetary System (EMS) formed - establishing the Exchange Rate Mechanism (ERM) and the European Currency Unit (ECU). Britain joins EMS but not ERM.
- 1979 First direct elections to European Parliament.
- 1981 Greece joins EEC.
- 1983 Common Fisheries Policy established.
- 1985 White Paper on completing the internal market published.
- 1986 Spain and Portugal join EEC.
- 1987 Single European Act comes into force.
- 1989 Delors Report calls for Economic and Monetary Union - including a single currency. Undertakings for Collective Investment in Transferable Securities took effect.
- 1990 United Kingdom joins ERM and Capital Liberalization Directive and Second Non-life Insurance Directive took effect.
- 1991 Maastricht Summit Accords on monetary and political union. The third and final stage of Economic and Monetary Union will begin by January 1, 1999. A single European currency will begin by this date (possibly as early as January 1, 1997). An independent European Central Bank will be set up six months before the single currency.
- 1993 Second Coordinating Bank Directive, Own Funds Directive, Solvency Ratio Directive and Second Life Insurance Directive take effect. Council Directive on Investment Services in the Securities Field and the Capital Adequacy Directive likely take effect.

The enforcement of EC laws is the responsibility of the Commission. Where breaches of EC laws are suspected, the Commission may issue a formal letter of notice to the govern-

ments of member states. Where this procedure proves insufficient, the Commission may refer the issue to the European Court of Justice.

the most part, on capital flows between an EC member and a non-member. For most member states, this directive was to apply from July 1, 1990.⁸ The deadline has been met, though several countries, like the United Kingdom, Germany, the Netherlands and Denmark, had eliminated explicit controls before 1988.⁹

Various approaches have been used to quantify the integration of international financial markets. One way to see the effects of the relaxation of capital controls is to examine interest rates on comparable financial instruments in different countries that are denominated in the same currency. The elimination of capital controls should allow capital flows to equalize these interest rates.¹⁰ This is exactly what has happened in the EC countries that have already eliminated capital controls. Figure 1 presents evidence for the United Kingdom, which abolished exchange controls as of October 24, 1979, and undertook a series of domestic liberalization measures in the 1980s. The U.K.'s deregulation has caused the Eurosterling-London Interbank Offer Rate (LIBOR) spread to collapse near zero.¹¹ Similar evidence exists for other EC countries that have liberalized.¹²

This evidence suggests that most of the effects of liberalizing capital flows for some, but not all, countries have already been realized, reinforcing the point that 1992 is a *series* of changes. There are, however, additional gains possible from the 1992 process. One is that 1992 will make it less costly for financial firms from one member country to be authorized to provide services in other EC countries. New financial services, as well as lower prices for existing services, might also occur. Before discussing these potential gains, we will summarize the major directives that pertain directly to financial services.

MAJOR DIRECTIVES

The major directives of the 1992 program for financial services can be divided into four categories: banking, investment services, undertakings for collective investments and insurance.¹³

Banking. Efforts at EC coordination did not begin with the Single European Act for any of the four categories of financial services. Rather, the SEA has accelerated the process of harmonizing regulations. For example, the First Banking Coordination Directive, which was approved by the Council in December 1977, required member states to establish systems for authorizing and supervising credit institutions.¹⁴

A second example is the Consolidation Supervision Directive of June 1983, which required that credit institutions be supervised on a consolidated basis. Any credit institution owning 25 percent or more of the capital of another financial institution was to be supervised on a consolidated basis by the authorities in the owning institution's home state. Another provision mandated the exchange of information between supervising authorities to obtain an overview of a consolidated company's affairs. To assist this supervisory cooperation, the Bank Accounts Directive of December 1986 harmonized accounting rules for credit institutions.

In the 1992 legislation, the Second Coordinating Banking Directive (2BD) is the primary banking directive. The 2BD allows any credit institution authorized in one member country to establish branches and provide banking services anywhere in the EC. While this so-called "common passport" allows home-country authorization, the credit institution must conform to all local laws. Thus, the host country's business rules, such as reporting requirements and res-

⁸Ireland, Spain, Greece and Portugal have until the end of 1992 to comply, with the latter two having the option to delay compliance until 1995.

⁹According to Blundell-Wignall and Browne (1991), the integration of financial markets internationally began in the mid-1970s with the removal of capital controls in Germany, the United States and Canada. Japan and the United Kingdom relaxed capital controls in the late 1970s, while France, Italy and some other EC countries realized the complete elimination of controls by the middle of 1990.

¹⁰This result is analogous to the effect of eliminating trade barriers on goods. When a country eliminates a tariff on a specific good, the difference between the price of the good in the country's domestic market and that in the international market should narrow.

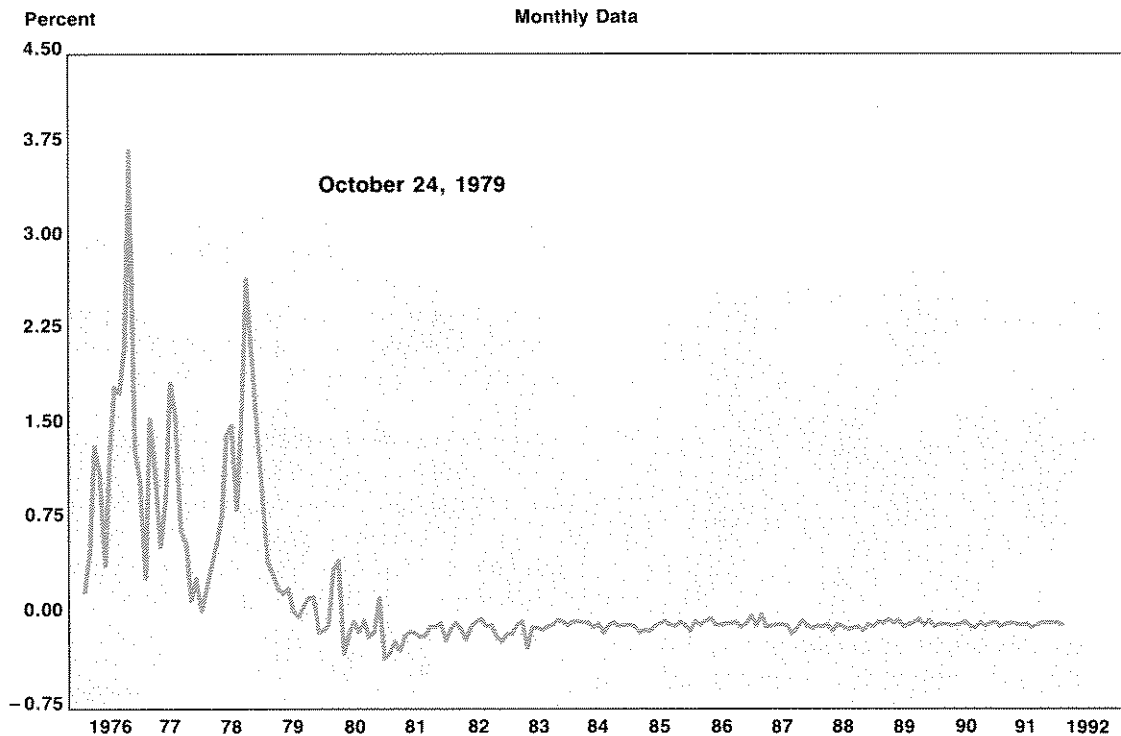
¹¹The two interest rates are ones charged by banks to other banks for three-month loans denominated in British pounds. The Eurosterling rate pertains to loans made outside the United Kingdom and the LIBOR applies to loans made inside the United Kingdom.

¹²See Blundell-Wignall and Browne (1991) for charts similar to figure 1 for Germany, the Netherlands and France.

¹³See U.K. Department of Trade and Industry (1991) for a summary of EC Directives relating to 1992.

¹⁴We refer to credit institutions rather than "banks" because these regulations include institutions other than banks. These would include the European equivalent of thrifts.

Figure 1
Difference Between the Three-Month Eurosterling and Libor Rates



trictions on permissible products and activities, must be followed.

The 2BD also gives the commission some influence in authorizing institutions from outside the EC—the so-called “Reciprocity Clause.” The first, but not the final, draft of this clause created much controversy and is partly responsible for the label “fortress Europe” that has inappropriately been associated with the 1992 program. (See the shaded insert on page 68 for additional discussion of this topic.)

The 2BD is supported by the Own Funds Directive and the Solvency Ratio Directive. The former provides common definitions for the components of the capital base; the latter uses these definitions to establish minimum asset ratios to be met by all credit institutions. All three directives become effective on January 1, 1993.

Investment Services. A related, but more problematic, set of measures deals with investment services. This category covers all aspects of the markets in tradeable securities, including investment banking, stock brokerage and the organization of the exchanges themselves. The key elements of the 1992 program are formulated in the Council Directive on Investment Services in the Securities Field and the Capital Adequacy Directive, neither of which has been adopted formally.

Until recently, observers generally thought both directives would begin operation at the same time as the banking directives because the 2BD gives banks (and other credit institutions) the right to do securities business throughout the EC on a single passport basis. As time passes, this simultaneity becomes less likely. If an identical single passport is not extended to non-

The Second Banking Directive and Fortress Europe

One of the great concerns, often heard outside the EC, is that the 1992 program will lower barriers to internal trade but at a cost of higher external trade barriers. The 1992 program does not introduce new barriers to trade in goods between Europe and the rest of the world. Nonetheless, a mistaken belief persists that access to the EC market will be harder after 1992.

This belief stems partly from the "Reciprocity Clause" in early drafts of the Second Banking Directive. This required the Commission to evaluate all applications for new subsidiaries where the parent company was based outside the EC. The Commission would have had the power to delay approval if the other country did not offer "mirror image" reciprocity. Mirror image reciprocity would have required that EC firms be allowed to operate in foreign countries, just as they could at home, before access would be offered to nationals of that country. This would have been very restrictive. For example, because there is no legal separation between investment banking and commercial banking in the EC, it would have required abolition of the Glass-Steagall Act in the United States before U.S. banks could gain access to the EC.

This requirement was weakened in later drafts of the directive. The final directive simply calls for negotiations with third coun-

tries (that is, countries outside the EC) in the event that EC firms are denied "effective market access." The critical criterion now is that EC firms should not be discriminated against in third markets—they should be accorded "national" treatment. "Whenever it appears to the Commission . . . that EC 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."¹

If negotiations about unfair treatment in a non-EC country have been initiated, approval of EC market access by credit institutions from that country may be delayed by up to three months. After this time, the Council must decide whether such delays should continue. This procedure will not apply to any firm already authorized to trade in an EC country. Finally, this intervention in the approval process must not contravene "the Community's obligations under any international agreements, bilateral or multilateral, governing the taking-up and pursuit of the business of credit institutions."² The general structure of the reciprocity clause in the Second Banking Directive is expected to be copied for the other major areas of financial services, including investment services and insurance.

¹See Title III, Article 9, paragraph 4 of the 2BD. In official documents, the 2BD is the "Second Council Directive of 15 December 1989."

² See Title III, Article 9, paragraph 6 of the 2BD.

bank securities firms at the same time, they will be at a disadvantage.

A key problem in formulating regulations in investment services has been that the range of activities covered is much more heterogeneous than in the banking area.¹⁵ Arguments have arisen about which activities to include and how much capital should be required for different lines of business. Initial proposals, for example, incorporated such high capital requirements that some businesses objected strongly. Non-bank securities houses argued that the requirements were so onerous, their business would be driven outside their countries. Universal banks, on the other hand, feared they would be at a disadvantage if securities houses had lower requirements than banks.¹⁶ The latest drafts of the directives incorporate a compromise that appears acceptable to both camps. Banks will be permitted to treat their securities business separately and calculate capital requirements under the investment services rules rather than the banking rules.

Another point of controversy concerns the provision of compensation schemes for investors. A commission recommendation in 1986 suggested the establishment of compensation schemes for depositors (that is, deposit insurance) in credit institutions. In the wider area of investment services, the position of compensation schemes is even less clear. Some countries, like the United Kingdom since the implementation of the 1986 Financial Services Act, have compulsory compensation schemes for investment business, while many others do not. This position raises potential anomalies in cross-border business.

A final sticking point in the Investment Services Directive relates to the monopoly of organized stock exchanges over securities trading. Some countries, like France, have argued for the official stock exchange to have a monopoly.

Without a monopoly, the present French system could not be used throughout the EC. Others, especially the British, are strongly opposed.

Undertakings for Collective Investments. In contrast to the banking and investment services directives, the directive governing Undertakings for Collective Investment in Transferable Securities (UCITS), which are open-ended mutual funds, has already come into effect. The Council Directive on the coordination of laws relating to UCITS took effect in October 1989. The directive establishes minimum requirements for authorization of UCITS and permits their marketing throughout the EC. This freedom is subject to the usual proviso that the host state be notified and local marketing rules be obeyed. Minimum requirements are established for adequate risk spreading, the separation of trustees from managers and the specification of acceptable investments.

Before it was implemented, there was some concern that the UCITS Directive would lead to a migration of UCITS managers to countries, like Luxembourg and Ireland, with the most favorable tax treatment. It is too early to determine whether this expectation is correct. To counteract this possibility, however, efforts were made to reduce tax differences. For example, the British budget of 1989 reduced taxes on unit trusts.

Insurance. A final set of directives on financial services deals with insurance. Insurance provides examples of 1992 initiatives already in effect as well as those many years away. The primary directives are the Second Non-Life Insurance Directive and the Second Life Insurance Directive.

The Second Non-Life Insurance Directive establishes freedom of services for cross-border business within the EC. This freedom, however, applies only for large commercial risks. What is

¹⁵Another reason for the relatively faster agreement on banking is that bank regulation had already been well worked out globally—through the Bank for International Settlements and formalized in the Basle Agreement. The 1988 Basle Agreement replaced differing national regulations for measuring capital adequacy by a single, internationally accepted standard. The goals were to strengthen the soundness of the international banking system and remove regulatory differences that affected the international competitiveness of banks. See Blanden (1988).

¹⁶Generally speaking, EC countries did not have counterparts to U.S. banking regulations that limited their spread geographically or their lines of business activity. As a result, a small number of large banks evolved. For exam-

ple, German banking is dominated by a small number of banks engaging in normal commercial banking as well as buying and selling stocks for others, underwriting new stock issues and owning stock on their own behalf. In fact, German banks are represented on the boards of directors of many companies. In the United Kingdom, merchant banks specialized in the securities business, while commercial banks had the bulk of deposits. Since the deregulation of British financial markets that began on October 27, 1986, known as the Big Bang, U.K. commercial banks have gone universal in that they have merchant bank subsidiaries and are expanding into insurance services, especially life insurance. Belgium is the only EC country that separates investment and commercial banking.

referred to as "mass risk," which includes most things insured by people other than their lives— theft and fire damage to personal property— remains subject to numerous restrictions. A new, more liberal regime applies to all marine, aviation and shipment risks, and other fire, property and financial risks for situations in which the policy holder is a large commercial company. Here, the insurer has an obligation to notify the authorities (in the insured company's country), but may write the business directly. For all other businesses, the authorities in each country may continue to control the terms of authorization, premiums, policy conditions and reserve assets.

This Directive took effect in July 1990 and, hence, the large commercial risk market has effectively achieved the single market position already. Unlike banking, this directive did not create a common passport. Thus, branching in other countries is not freely permitted, and establishment still requires authorization in each member state. Two draft "Framework Directives" for life and non-life insurance appeared in 1991 and 1990, respectively. These would establish the single passport for insurance; the fact that the first drafts of these directives did not emerge earlier, however, suggests that they will not be in operation until 1995 at the earliest.

Only modest progress has been made on life insurance so far. The Second Life Insurance Directive was adopted in November 1990 for implementation on May 21, 1993. It only goes a small way, however, toward creating a single market in life insurance. A liberal regime is provided for, but only in cases where the consumer takes the initiative in buying a life insurance policy from a firm in another member country. In all other cases, the restrictive regime applies, under which the insurer may be required to obtain special approval (depending upon local law) and the policy terms may be proscribed.

Under the most recent draft of legislation involving life insurance, whose date of implementation has yet to be agreed upon, insurance companies are permitted to advertise, but they may not approach consumers directly. It also is possible that "local" asset backing for the policy

may be required. This means that, for example, an Italian firm selling insurance in Germany would have to back its German policies with German securities. This draft of the legislation also restricts the role of brokers. For three years after implementation, member states will be able to forbid consumers from seeking policies from other member states through brokers.

Considerable resistance exists in some quarters to the creation of a genuine single market in life insurance. The basic conflict arises because some countries— notably Germany— have had a very conservative attitude to life insurance, while others— like the United Kingdom— have been very innovative. German insurance companies have typically invested in safe fixed-interest securities, and innovation in the industry has been strictly controlled. The United Kingdom, in contrast, allows its firms to invest across a range of assets including property and equities. Thus, the typical British firm's portfolio is riskier than its German counterpart, but has a much higher average yield, producing significantly lower prices for British products.

The Common Passport

Before discussing the reform process, an important distinction must be made between wholesale and retail financial markets. As demonstrated above, the globalization of international financial markets in the 1970s and 1980s has already led to highly competitive wholesale capital markets across many EC countries. These markets, in which financial firms deal directly with each other, experienced considerable competitive pressures in the past 20 years. Faced with the choice of deregulation or the loss of firms to less-regulated environments in other countries, most nations dismantled much of the regulatory structure in wholesale financial markets.

Retail markets, in which consumers deal with firms to borrow money, purchase insurance and trade stock, are quite different and present the biggest problem for deregulation. These markets retain a myriad of complex regulatory structures and external barriers that are generally justified on the grounds that they protect the small consumer.¹⁷ Regardless of whether

¹⁷For example, the U.K. Financial Services Act of 1986 requires any firm selling investment products in the United Kingdom to register with either the Securities and Investment Board or a recognized regulatory organization. The

firm must conform to a complex set of rules, subject itself to inspections and pay membership charges, which include investor compensation schemes.

domestic officials actually believe this or are simply disguising their protection of domestic firms, the abolition of regulations to increase cross-border trade and competition in retail financial markets is the primary challenge of the 1992 program.

Starting with the existing regulatory structures in each member country, the central principle guiding deregulation is that regulators in each member state are competent to judge which firms are "fit and proper" to do business in the industry. Once a firm has been authorized by the regulatory authority in its home country—so-called home authorization—it is automatically authorized to do business in any other member country and is said to have a "common passport."

Previously, many countries have allowed firms from other EC countries freedom of establishment, but this freedom has been subject to a separate process of approval in each country.¹⁸ The abolition of this requirement, therefore, will make it easier for firms to establish subsidiaries in other member countries.

Home authorization, however, is not the end of the story. Firms operating outside their home states still have to obey "host country conduct of business rules."¹⁹ In other words, foreign firms must obey all the local regulations about the nature of acceptable products and the way in which they may be advertised and sold. For example, France does not allow interest payments on checking deposits, while most other EC countries do.

The fact that business rules will continue to differ across countries limits the extent to which there will be a genuine single market. The various rules increase the costs of cross-border activity and are sometimes even anti-competitive. For example, the business rules in some member states define which products can be sold and their respective prices. Thus, one of

the main incentives for attempting to enter new markets—the introduction of new products not offered by local firms—is not guaranteed.

Regulatory Complications from the Common Passport

The move to a common passport will complicate the regulatory process.²⁰ At this point, only hypothetical situations can be offered to suggest the potential difficulties. While firms require authorization only in their home states, the regulatory authorities of other nations have to monitor the activity of these firms within their domain because they are responsible for consumer protection and adherence to business rules.

To illustrate, suppose a German bank establishes a subsidiary in the United Kingdom after 1992 on the basis of its German banking license. It takes deposits and makes loans in British pounds sterling. As the German banking authorities are responsible for prudential supervision, the bank must file the reports required by these authorities. The bank, however, must also register with the Bank of England, fulfill all reporting requirements and conform to all British banking regulations in the United Kingdom—including reserve requirements and banking codes of practice. It must also pay regulatory fees just as any British bank must do.

The lower costs of establishing an office in the United Kingdom may increase the regulatory burden of both the British and German authorities. Suppose, for example, the German bank gets into difficulties, like a run on deposits, or is involved in a breach of rules, like fraud. Clearly, both British and German authorities will have to get involved to resolve the problem. Indeed, a bank with branches (or subsidiaries) across Europe could draw 12 sets of regulators into a dispute over its operations. The number of regulators would rise even further if the

¹⁸For example, Emerson et al. (1988) note that each EC country allows freedom of establishment for foreign banks; however, the conditions under which this may be done vary substantially across countries. High establishment costs make it difficult for a foreign bank to enter and compete successfully with an existing domestic retail bank. Additional obstacles in certain countries, like Italy and Spain, are restrictions on foreign acquisitions and involvement with domestic banks.

¹⁹For an alternative interpretation of the implications of home authorization in the context of the 2BD, see Key (1989). In our view, home authorization applies to the issue of a license and prudential control, but it does not apply to

any behavior that falls under conduct of business rules. Home authorization is much different than home control. Even though a bank is given a license to operate abroad by its home authorities, the bank's subsidiaries will have to obey all the laws attached to banking practice in the foreign countries in which they operate.

²⁰Capie and Wood (1990) make a similar point that the Second Banking Directive will make supervision and regulation much more complicated. They speculate, however, that this complexity may cause a change in regulation from detailed supervision to one in which central banks are primarily lenders of last resort.

Table 1
Deposit Insurance in the EC¹

Country	Limitations (in U.S. dollars as of July 6, 1990)	Coverage ²		
		Deposits in foreign currency	Deposits in domestic branches of foreign banks	Deposits in foreign branches
Belgium	\$14,706	No	No	No
Denmark	39,708	—	—	—
France	72,033	No	Yes	No
Germany	30% of bank's liable capital	Yes	Yes	Yes
Ireland	16,206	—	—	—
Italy	659,385	Yes	Yes	Yes
Luxembourg	14,706	—	—	—
Netherlands	21,486	Yes	Yes	No
Spain	14,789	No	—	No
United Kingdom	35,730	No	Yes	No

SOURCE: Bartholomew and Vanderhoff (1991).

¹Greece and Portugal have no formal systems of deposit insurance.

²The "—" indicates no information was available.

bank's activities spread beyond banking into securities or insurance.

It is also noteworthy that the British authorities have no power to withdraw the banking license if the bank transgresses business rules in the United Kingdom. Even though the Bank of England could stop a bank from trading temporarily, a high degree of communication and cooperation between regulators of the member countries will be required to manage such a problem. Eventually, there might be a formal regulatory agency that operates on a community-wide basis.

The preceding example, which pertains to all member countries, is relatively simple in comparison to the regulatory issues that might arise when services are provided across national borders. Suppose the German bank takes deposits and makes loans in sterling with retail customers in the United Kingdom only by mail or telephone from its head office in Frankfurt. In this case, the German bank need not register with the Bank of England, but has an obligation to conform to British conduct of business rules. This means that the Bank of England must monitor this business in some way. While cases like this may be of trivial quantitative significance (especially in retail trade), they also may generate the greatest regulatory headaches, in terms

of allocating regulatory responsibilities for the monitoring and enforcement of standards of business practice.

Such jurisdictional problems may be greatest where deposit insurance is involved. Table 1 summarizes the deposit protection schemes for commercial banks in the EC. The amount of protection for depositors varies substantially across countries. This may influence where a specific deposit may be made. The high level of protection in Italy could attract large depositors. By the same token, the different levels of protection may confuse depositors. A Spanish depositor, who made a deposit in a French branch in Spain that fails, for example, may mistakenly believe that the French deposit insurance scheme applies. Since deposit insurance is politically sensitive, controversy is not difficult to envision. The EC Commission has drafted a proposal, not yet published, for the harmonization of deposit insurance, but any changes are unlikely to take effect before the mid-1990s.

The almost complete harmonization of regulatory standards is inevitable when transactions within an industry are predominantly of an international nature. By itself, however, 1992 is unlikely to make the transactions in European retail financial markets to be primarily international. Thus, the regulation of retail financial

markets in Europe involves a compromise between host country control and the creation of a single market. Harmonization of business rules will not be complete and, in some cases, may not be even close.

Product Innovation

The potential gains from removing barriers to the spread of new products across borders seem to be positive and potentially quite large. Lower-cost producers of financial services products would prosper at the expense of less efficient firms that now survive only because of regulations that limit competition by foreign firms. Consumers would benefit from having a greater variety of products from which to choose and would pay lower prices for them.

The basic problem is the resistance by some countries to relaxing domestic regulation of an industry. Frequently, a country's business rules inhibit product innovation. For example, current German regulations restrict the introduction of new insurance products into Germany. Even with a common passport, a foreign insurance firm faces a major deterrent to entering the German market. Taken together, German citizens and foreign insurance firms clearly would benefit from free trade in new products, but it is also clear that some German insurance companies would suffer from the influx of competition.

This is the area where the least progress has been made in the 1992 program. In view of the time required to reach and implement EC decisions, as well as the current controversy about these decisions, the potentially large gains from product innovation and lower prices in many financial services will not be realized any time in the near future.

POTENTIAL BENEFITS OF THE SINGLE MARKET

The preceding discussion raises doubts about how sizable the gains will be from the 1992 legislation in the financial services sector; however, we do not provide an estimate of the

gains themselves.²¹ These doubts are at odds with the potential gains estimated in the Cecchini Report, the best-known attempt to measure such gains.²² This report found substantial potential gains from the creation of a single market in many industries.²³ The gains from the liberalization of the financial services sector, which are presented and examined below, were found to be substantial as well.

Financial Services: The Estimated Gains of Eliminating Trade Barriers

The reduction of trade barriers can generate gains via a number of routes, all of which are driven by increased competitive pressures. For example, the reduction of trade barriers will allow firms with lower production costs to expand their production, increasing total output and economic welfare. Other gains can be realized as larger markets increase the opportunities to use certain production technologies that lower per-unit production costs. Finally, increased competition tends to drive down profit margins, eliminate waste and stimulate the development of new products and less costly methods to produce existing products. Ultimately, the competitive pressures will allow consumers throughout the EC to consume (use) more financial services at lower prices per unit.

The competitive pressures resulting from 1992 are expected to narrow the price differences of a financial service across the EC. As part of the Cecchini Report, Price Waterhouse calculated prices across eight EC countries for the 16 financial services—seven banking services, five insurance services and four securities services—listed in table 2. The average of the four lowest prices for each service was chosen as the likely price after the elimination of trade barriers. The potential price declines for financial services are listed in table 3. Exactly how much of this potential decline will be realized is difficult to estimate, so an expected decline (with a plus/minus 5 percentage-point range) was defined as one-half of the potential decline.

²¹To reiterate, we are not questioning the gains from the abolition of exchange controls; rather, we are questioning the gains from the common passport in light of the continuation of different conduct of business rules.

²²In theory, the abolition of trade barriers for goods traded among a group of countries may or may not yield net benefits. An elementary demonstration of this result can be found in Coughlin (1990).

²³The Cecchini Report estimates that the gains from completing the internal market range from 4.3 percent to 6.4 percent of gross domestic product in the EC. See Coughlin (1991) for an examination of the approach used in the Cecchini Report as well as other approaches used to estimate the economic effects of 1992.

Table 2
List of Standard Financial Services or Products Surveyed

Name of standard service	Description of standard service
Banking services	
1. Consumer credit	Annual cost of consumer loan of 500 ECU. Excess interest rate over money market rates.
2. Credit cards	Annual cost assuming 500 ECU debit. Excess interest rate over money market rates.
3. Mortgages	Annual cost of home loan of 25,000 ECU. Excess interest rate over money market rates.
4. Letters of credit	Cost of letter of credit of 50,000 ECU for three months.
5. Foreign exchange drafts	Cost to a large commercial client to purchase a commercial draft for 30,000 ECU.
6. Travellers checks	Cost for a private consumer to purchase 500 ECU worth of travellers checks.
7. Commercial loans	Annual cost (including commissions and charges) to a medium-sized firm of a commercial loan of 250,000 ECU.
Insurance services	
1. Life insurance	Average annual cost of term (life) insurance.
2. Home insurance	Annual cost of fire and theft coverage for house valued at 70,000 ECU with 28,000 ECU contents.
3. Motor insurance	Annual cost of comprehensive insurance, 1.6 liter car, driver 10 years experience, no-claims bonus.
4. Commercial fire and theft	Annual coverage for premises valued at 387,240 ECU and stock at 232,344 ECU.
5. Public liability coverage	Annual premium for engineering company with 20 employees and annual turnover of 1.29 million ECU.
Brokerage services	
1. Private equity transactions	Commission costs of cash bargain of 1,440 ECU.
2. Private gilt transactions	Commission costs of cash bargain of 14,000 ECU.
3. Institutional equity transactions	Commission costs of cash bargain of 288,000 ECU.
4. Institutional gilt transactions	Commission costs of cash bargain of 7.2 million ECU.

SOURCE: Emerson et al. (1988), p. 102.

Using the expected price declines for financial services, the gains for the eight EC countries examined are estimated to be 21.6 billion ECU, which is 0.7 percent of their gross domestic product.²⁴ The distribution of these gains across the EC are listed in table 4. One's confidence in these estimates, as acknowledged in Emerson et al. (1988), should not be great. First, the price comparisons themselves can be questioned. Products such as "credit" and "life insurance"

have been priced as if the characteristics are the same in each country. For example, no attempt has been made to adjust for theft and mortality differences across countries, and, hence, it is not clear that homogeneous products are compared.

More important, even if price differences exist for identical products, it is far from clear that the 1992 legislation will eliminate such differ-

²⁴The ECU, which stands for the European Currency Unit, is composed of the weighted averages of the currencies of the 12 member countries and is the unit of account for the EC. Even though much negotiation remains, the ECU is

likely to become the single currency of the EC. For a brief history of the ECU, especially recent developments, see Tyley (1991). One ECU was equal to \$1.29 on February 11, 1992.

Table 3
Potential and Expected Price Declines for Financial Services

Country	Potential price fall	Range of expected fall
Belgium	23%	6-16%
France	24	7-17
Germany	25	5-15
Italy	29	9-19
Luxembourg	17	3-13
Netherlands	9	0-9
Spain	34	16-26
United Kingdom	13	2-12

SOURCE: Emerson et al. (1988), p. 104.

ences. The reason is that business rules will continue to differ from country to country, thereby impeding trade in financial services and limiting potential gains to levels below those estimated in the table.²⁵ Thus, the value of the single passport is diminished considerably by the inability of firms entering new markets to offer a full line of products and services.

Grilli (1989a) has also raised doubts about the estimates in the Cecchini Report on the likely effects of liberalization on wholesale and retail banking throughout the EC. Grilli doubts whether a perfectly competitive market structure is an accurate approximation of retail banking post-1992. Much evidence suggests that banks have market power in their retail markets that will not be eliminated by the 1992 legislation. For example, within the same country, which is already a homogeneous regulatory and institutional environment, the terms of a deposit contract, such as the interest rate paid on a time deposit, frequently vary across banks. In addition, the transaction costs of switching between domestic and foreign bank accounts will remain after 1992, and a business relationship with a local bank will remain less complicated than with a foreign bank. Furthermore, Grilli argues,

²⁵Evidence that supports this view was highlighted by Grilli (1989b). For individual financial services, he noted that the price dispersion across countries that had already liberalized, like Germany, Belgium, Luxembourg, the Netherlands and the United Kingdom, was no less than across the remaining EC members.

²⁶Separable portfolios means that a bank with subsidiaries in more than one member state will operate a matched

Table 4
Estimated Gains Resulting from the Expected Price Reductions for Financial Services

Country	Total (million ECU)	Percentage of GDP
Belgium	685	0.7%
France	3,683	0.5
Germany	4,619	0.6
Italy	3,996	0.7
Luxembourg	44	1.2
Netherlands	347	0.2
Spain	3,189	1.5
United Kingdom	5,051	0.8
Total	21,614	0.7

SOURCE: Emerson et al. (1988), p. 106.

the use of other, more appropriate market structures produces smaller estimated gains from 1992 than those based on perfect competition.

The bottom line is that the estimates in the Cecchini Report are probably optimistic. Of course, the absence of better estimates precludes any quantitative statements about the degree of overstatement.

Single Currency

The preceding discussion, including the estimates in the Cecchini Report, has presumed that 12 currencies continue to exist within the EC, albeit tied together by the exchange rate target zones of the European Monetary System (EMS). Thus, far from there being a single market in financial services, there will continue to be 12 quite separate markets at the retail level. Within those markets, firms will operate separable portfolios and most retail customers will stick almost exclusively to their domestic environment.²⁶

The creation of a single currency, which was agreed upon at Maastricht, the Netherlands, in

deposit and loan book in each currency. For example, a Dutch bank with a subsidiary in Greece will use drachma deposits rather than guilder deposits to fund drachma loans.

December 1991 will induce major changes, irrespective of the regulatory regime.²⁷ Obviously, the foreign exchange market—and with it the costs of currency conversion—among the EC members will be eliminated. Closely related is the fact that the international accounting of many businesses will be simplified by the elimination of multiple currencies. On the other hand, many contracts will have to be rewritten. For example, a long-term bond contract that requires interest and principal payments in a specific currency, say French francs, will have to be modified.

Generally, retail customers will continue to do business with familiar institutions in their own countries, while wholesale market arbitrage and potential competition ensure that product prices are brought closely into line throughout the EC. These competitive pressures will lead to changes in the regulatory structure so that the conduct of business rules become more similar and, in some cases, identical; otherwise, firms in some countries will be at a competitive disadvantage relative to firms in other countries.²⁸ It is difficult to predict exactly how business rules will be harmonized for each financial service and, thus, how extensive the potential gains from a “free” single market will actually be. A more homogeneous and unitary monitoring mechanism is likely, although its full implications are equally hard to anticipate. Nonetheless, the gains from a single market are more likely to be realized if monetary union is achieved.

CONCLUSION

The goal of 1992 is to create a single European market, a goal that encompasses the financial services sector. Our assessment is that the 1992 reforms are a small step toward the liberalization of the financial services sector. Clearly, 1992 will contribute to the realization of some gains, especially in countries that have previously resisted liberalization. Nonetheless, serious doubts exist about how extensive the changes will be in the near future and, thus, the magnitude of the gains to be realized overall. In reali-

ty, the 1992 legislation will not cause major changes. The reason is that virtually all of the potential efficiency gains in the financial services sector can be (or have been) achieved through the combination of the abolition of exchange controls and the freedom of foreign firms to enter domestic markets. In fact, the former was implemented in July 1990 (in all but Spain, Portugal, Greece and Ireland).

The key innovation of the 1992 legislation is the split between home country authorization and host country conduct of business rules. This dichotomy will create problems. Whereas wholesale markets already are highly integrated, not just within Europe but at the global level, 12 quite different retail markets will continue to exist in the near future. This segmentation means that many existing regulatory burdens will remain; however, regulatory complications may multiply as numerous domestic and EC authorities become involved in the supervision of a single firm. Finally, in some markets, like insurance, rigid regulation of domestic markets will delay any implementation of the current model of a framework directive until well beyond 1992.

The greatest boost to financial market integration, once markets are open, will be the use of a single currency. With a single currency, pressure will mount to revise the regulatory structure so that the conduct of business rules are homogeneous.

Major changes in the regulatory structure lie ahead. It is these changes that will create a single market and allow for the realization of substantial gains in the next century.

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²⁷A recent issue of *The Economist* (“The Deal is Done,” 1991) characterizes the Maastricht Treaty as important as the Treaty of Rome because it lays the foundation for a much closer union of countries via a single currency, a common foreign and defense policy, common citizenship and a parliament with power. A summary of the Maastricht Treaty as it pertains to monetary union can be found in “Mapping the Road” (1991), page 5.

²⁸Not surprisingly, the U.S. legal system has had considerable experience with conflicting laws and regulations across states. The Uniform Commercial Code is an excellent example of states reaching general agreement on numerous laws. See Levine (1976) for additional details.

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