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BANKING ON EUROPE: 1992 AND EMU

NANCY LOUISE KESSLER

INTRODUCTION

The market for transnational financial services is rapidly expanding. In order to take advantage of this increasingly important situation, the members of the European Community ("EC" or "Community")[1] have turned their attention to making the EC a major international banking center. To accomplish this, the EC recognizes that it must increase its efforts to remove barriers between Member States.[2] Toward this goal, the EC has passed certain directives to integrate the EC banking market by 1992.[3] The EC and the European Free Trade Association ("EFTA")[4] signed an accord in October, 1991, that extended the EC's banking directives to all EFTA states.[5] In conjunction with the desired integration of

1. The twelve Member States constituting the EC are Belgium, Denmark, France, Germany, Great Britain, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. *See* Treaty Between the Member States of the European Communities and the Kingdom of Spain and the Portuguese Republic Concerning the Accession of the Kingdom of Spain and the Portuguese Republic to the European Economic Community and to the European Atomic Energy Community, 1985 O.J. (L 302) 9.

2. *See* Clarke, *Introduction*, in Planning for Europe: 1992 at 1, 2 (W. Clarke ed. 1989) [hereinafter Clarke, *Introduction*].

3. *See, e.g.*, Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 O.J. (L 386) 1 [hereinafter Second Banking Directive]; Council Directive 89/299 of 17 April 1989 on the Own Funds of Credit Institutions, 1989 O.J. (L 124) 16 [hereinafter Own Funds Directive]; Council Directive 89/647 of 18 December 1989 on a Solvency Ratio for Credit Institutions, 1989 O.J. (L 386) 14 [hereinafter Solvency Ratio Directive].

4. The EFTA members are Austria, Finland, Iceland, Norway, Sweden, Switzerland, and Liechtenstein. *See Lest a Fortress Arise*, Economist, Oct. 26, 1991, at 81, col. 1 [hereinafter *Fortress*].

5. *See* Hill, *Pact Extends EC Banking and Insurance Rules to EFTA States*, Fin. Times, Oct. 23, 1991, at 2, col. 2. Although there are some restrictions, the EFTA states will be able to take advantage of the single license to set up branches within the EC, and EC banks will be able to set up branches within the EFTA. *See id.* These restrictions include limits on "outright takeovers of Nordic banks and insurance companies," temporary limits on the percent of Norwegian banks that can be held by foreign investors, temporary restrictions on the purchase of Norwegian securities by foreign investors, temporary restrictions on direct foreign investment in Norway and Sweden, and temporary restrictions on real estate investment in Austria, Finland, Switzerland, and Iceland. *See id.* These restrictions reflect "Efta sensitivity about an EC invasion of their vulnerable financial services sector." *Id.* The outcome of this deal will be a European Economic Area ("EEA"), the "world's biggest free trade area." *Fortress*, *supra* note 4, at 81. col. 1. The EFTA will not adopt the entire single market program. *See id.*

This deal may be in jeopardy, however, because "[t]he European Court of Justice in Luxembourg has declared the EEA to be incompatible with the EC treaties." *Jealous Judges*, Economist, Dec. 21, 1991 - Jan. 3, 1992, at 58, col. 2. The EC now has two options—it can amend the Treaty of Rome, thus overruling the Court, or it can renegotiate with the EFTA. *See id.*

the banking sector, the EC has also sought to complete an effective Economic and Monetary Union ("EMU").

This Note provides a brief overview of how the EC intends to achieve a single market in financial services by the end of 1992. This Note also analyzes some of the problems either caused or not fully solved by the new legislation and programs. Part I describes and analyzes the various banking regulations recently developed in the EC to help forge a single market in financial services. Part II evaluates the plan for EMU, first formalized by the Delors Report on Economic and Monetary Union in the European Community, published in 1989,[6] and later made binding by the Treaty of Maastricht.[7] This Note concludes that the EC's attempt to integrate its financial services market (by implementing new banking directives) and its attempt to achieve EMU (by implementing the Delors plan or similar proposals) will help establish the EC as a major force in the increasingly internationalized financial services market. This process will be gradual, however, and problems not yet apparent may further delay the process.

I. Banking Regulations

A. *The White Paper and Liberalization of Financial Services*

The Treaty of Rome, which established the EC on January 1, 1958, called for total harmonization of banking laws.[8] Because the Treaty required total harmonization, progress toward an integrated banking market was slow.[9] Prior to 1985, the Member States failed to reach agreement on banking regulation;[10] indeed, Member States continued to regulate the provision of financial services in nationally oriented ways, and such localized regulation prevented the EC from reaching its enormous potential.[11] To advance efforts toward an integrated market, the European Commission ("Commission") issued a report entitled "Completing the Internal Market: White Paper from the Commission to the European Council" (generally known as the "White Paper"), with the goal of completing the process of integration by 1992.[12] The Single Eu-

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6. Committee for the Study of Economic and Monetary Union, Report on Economic and Monetary Union in the European Community (1989) [hereinafter Delors Report].

7. The EC reached a binding agreement on EMU at Maastricht, the Netherlands, in December 1991. *See The Deal is Done*, Economist, Dec. 14, 1991, at 51, col. 1 [hereinafter *Deal is Done*].

8. *See* Clarotti, *Community Objectives and Plans for Banking*, in 1992—The Single European Market 55, 55 (1988).

9. *See id.*

10. *See* Golembe & Holland, *Banking and Securities*, in Europe 1992—An American Perspective 65, 68 (G. Hufbauer ed. 1990).

11. *See* IBI International Business Intelligence, 1992—Planning for Financial Services and the Insurance Sector 4 (1989) [hereinafter 1992—Planning].

12. *See* Completing the Internal Market: White Paper from the Commission to the European Council, COM(85)310 final 27-29 [hereinafter White Paper]; Clarke, *Introduction*, *supra* note 2, at 2.

ropean Act, which reformed the Treaty of Rome, put the White Paper's proposals into effect.[13] The White Paper stressed, as one of its central objectives, the creation of a free internal market in financial services.[14] Rather than continuing with attempts to harmonize *all* aspects of Member States' legislation, however, the Commission altered its aim pursuant to the White Paper and now seeks mutual recognition of each Member State's legislation.[15] The essential elements of legislation, however, must still be harmonized.[16]

There are three main elements underlying the White Paper's approach to achieving a single market for financial services: "harmonization of essential standards for prudential supervision and for the protection of investors, depositors, and consumers; mutual recognition of the way in which each Member State applies those standards; [and] home country control and supervision of financial institutions operating in other Member States."[17] The Commission sought sufficient harmonization of supervision standards such that Member States would agree to recognize the control and supervision of other Member States.[18] In order to meet this objective, the Commission passed several directives, including the Second Banking Directive, in 1989.[19]

1. Banking Directives Proposed by the White Paper

The White Paper's proposals covered a wide range of financial activities including banking, insurance, and securities transactions.[20] The White Paper proposed several banking directives "to harmonize the essential supervisory and prudential rules necessary to secure mutual recognition of national authorization and supervisory systems."[21] The cornerstone directive was the Second Banking Directive, designed to create a single banking license for the EC.[22] In addition, the White Paper proposed other important directives in the Community's quest to integrate the financial markets of the EC, including a directive to impose standards for the own funds (the EC term for bank capital) of a credit

13. *See* Single European Act, 1987 O.J. (L 169) 1; Clarotti, *supra* note 8, at 55-56.

14. *See* Budd, *Financial Services: Capital Movements and Controls*, in Planning for Europe: 1992, at 119, 122 (W. Clarke ed. 1989).

15. *See* Golembe & Holland, *supra* note 10, at 68.

16. *See id.*

17. Brealey & Quigley, Completing the Internal Market of the European Community—1992 Handbook 114 (1989) [hereinafter 1992 Handbook].

18. *See id.*; Second Banking Directive, *supra* note 3, recital 4.

19. *See* Second Banking Directive, *supra* note 3.

20. *See* 1992 Handbook, *supra* note 17, at 114.

21. *Id.* at 116.

22. *See* Coopers & Lybrand, *Banking and Securities*, in Euroscope § 3.1, Sept. 26, 1991, *available in* LEXIS, Europe Library, EURSCP File [hereinafter *Banking and Securities*]; *see also infra* notes 34-110 and accompanying text (discussion of Second Banking Directive).

institution[23] and a directive to impose a minimum solvency ratio for credit institutions.[24] These directives provide the essential minimum standards required for the Second Banking Directive to be effective.[25] In addition to these three major directives, and pursuant to the mandates of the White Paper, the EC is working on various directives relating to other banking concerns.[26]

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23. *See* Own Funds Directive, *supra* note 3; *infra* notes 123-32 and accompanying text.

24. *See* Solvency Ratio Directive, *supra* note 3; *infra* notes 133-53 and accompanying text.

25. *See Banking and Securities, supra* note 22, § 1.

26. In addition to the Second Banking Directive, the Own Funds Directive, and the Solvency Ratio Directive, there is a proposal for a Directive monitoring and limiting exposure to large risks. *See Banking and Securities, supra* note 22, § 7.2. This proposed Directive, *see* Commission Proposal 91/09 of 27 March 1991 for a Council Directive on Monitoring and Controlling Large Exposures of Credit Institutions, 1991 O.J. (C 123) 18, will transform the currently operational Recommendation on monitoring and controlling large exposures of credit institutions into a legally binding directive. *See* Commission Recommendation 87/62 of 22 December 1986 on Monitoring and Controlling Large Exposures of Credit Institutions, 1987 O.J. (L. 33) 10; *Banking and Securities, supra* note 22, §§ 7.1, 7.2. Recommendations are not binding on Member States. *See Banking and Securities, supra* note 22, §§ 7.1, 7.2. The objective of this proposed Directive is to ensure that credit institutions spread their risk of exposure to default by large clients. *See* Coopers & Lybrand Europe, European Banking Law 121 (1990) [hereinafter European Banking Law]. This will hopefully reinforce the stability of the banking sector by "strengthening the prudential supervision and solvency of the Community's banking system." *Id.* Exposure limits in the Directive are more strict than those in the Recommendation—exposures of over 10% of own funds are considered large and must be reported. *See Banking and Securities, supra* note 22, §§ 7.1, 7.2.; *see also infra* notes 123-32 and accompanying text (discussion of own funds). Credit institutions will have to limit their exposure to any one client to 25% of own funds, and will have to limit their total exposure to 800%. *See* European Banking Law, *supra*, at 151. Credit institutions can only overstep these confines in exceptional circumstances, and if they do so, the credit institution must bolster own funds with additional capital. *See Banking and Securities, supra* note 22, § 7.1. This Directive will be applicable to credit institutions as defined by the First Banking Directive. *See id.*; First Council Directive 77/780 of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1977 O.J. (L 322) 30, art. 1 [hereinafter First Banking Directive]; *see also infra* note 40 (definition of credit institution),

There is also an unpublished proposal for a Directive on deposit guarantee schemes for credit institutions. *See* European Banking Law, *supra*, at 151. This proposed Directive will transform the currently operational Recommendation concerning the introduction of deposit guarantee schemes for credit institutions into a legally binding Directive. *See id.* at 122, 151; Commission Recommendation 87/63 of 22 December 1986 Concerning the Introduction of Deposit-Guarantee Schemes in the Community, 1987 O.J. (L 33) 16. The objective of the proposed Directive is to ensure the provision of deposit guarantee schemes in order to protect depositors from potential losses due to bank failures. *See Banking and Securities, supra* note 22, § 8.5.

Finally, there is a key banking Directive on Consolidated Supervision of Credit Institutions. *See* Council Directive 83/350 of 13 June 1983 on the Supervision of Credit Institutions on a Consolidated Basis, 1983 O.J. (L 193) 18. This Directive came into effect on July 1, 1985. *See Banking and Securities, supra* note 22, § 4.1. The Directive's objective is to assist national authorities supervising parent credit institutions by consolidating its supervision with that of other institutions in which the parent has a participation. *See* European Banking Law, *supra*, at 114. This Directive applies to credit institutions as

2. Pre-White Paper Banking Legislation

The limited early economic success of the EC highlighted the need for greater integration in the financial services market.[27] The White Paper provided the foundation for financial integration in the EC. Prior to this report, harmonization of the banking sector was slow.[28] Thus, to understand the impact of the White Paper Directives, it is useful to review banking legislation in the EC prior to the White Paper. The most significant such legislation, and the first to attempt to harmonize EC banking laws, was the First Banking Directive, adopted in 1977.[29]

The First Banking Directive, by creating uniform requirements for bank authorization and by encouraging collaboration between Member States' supervisory authorities, abolished some barriers between Member States with respect to the provision of banking services.[30] Yet, despite the passage of the First Banking Directive, major obstacles remained to full liberalization of banking services. These obstacles included: the need for separate authorization to establish branches in other Member States; the subjection of out-of-state branches to host-state supervision; and the imposition on credit institutions of more severe limitations for out-of-state branch activities than for home-office activities.[31] Furthermore, most Member States required that branches of banks established in other Member States provide endowment capital, thereby treating the branch as a new credit institution rather than as a branch office of an existing credit institution.[32] In direct response to these and other obsta-

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defined by the First Banking Directive. *See id.*; *see also* Note, *Putting the Super Back in the Supervision of International Banking, Post-BCCI*, in Annual Survey of Financial Institutions and Regulation, Transnational Financial Services in the 1990s, 60 Fordham L. Rev. S467, S470-71 (1992) (discussion of consolidated supervision) [hereinafter *Post-BCCI*]. In 1990, a Proposal to Extend the Scope of the 1983 Directive was submitted to the Commission. *See Banking and Securities, supra* note 22, § 4.2. "The aim of the proposal is to improve protection for depositors by extending the scope of the 1983 Directive to banks owned by financial holding companies, i.e., with parent companies other than credit institutions." *Id.*

27. *See* 1992—Planning, *supra* note 11, at 4.

28. In fact, the EC passed only three banking directives prior to the White Paper. *See* 1992 Handbook, *supra* note 17, at 115. In contrast, the White Paper suggested 279 proposals for completing the single market. *See* Speech by Mr. Martin Bangemann to the "Institut Royal Des Relations Internationales" on "The Process of European Unification" (Sept. 17, 1991), *available in* LEXIS, Europe Library, RAPID File. Of these 279 proposals, 220 have already been adopted by the European Council. *See id.*

29. *See* 1992 Handbook, *supra* note 17, at 115; 1992—Planning, *supra* note 11, at 39.

30. The conditions for authorization enumerated in the First Banking Directive include requirements for minimum and separate own funds and a requirement that credit institutions be directed by at least two persons "who effectively direct the business of the credit institution." First Banking Directive, *supra* note 26, art. 3(2). The supervisory collaboration consists primarily of requiring the sharing of information necessary for monitoring liquidity and solvency. *See id.* art. 7(1).

31. *See* Reynolds, *Community Law*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 8, 11 (Sept. Supp. 1989); 1992 Handbook, *supra* note 17, at 115.

32. *See* 1992 Handbook, *supra* note 17, at 127.

cles, the Commission passed the Second Banking Directive.[33]

B. *The Second Banking Directive*

The Second Banking Directive, passed in December of 1989, responded to the continuing need for integration in the banking market.[34] This Directive builds upon the work of the First Banking Directive,[35] and is scheduled to be effective January 1, 1993.[36]

The objective of the Second Banking Directive is to create a single banking market.[37] The Directive aims to achieve this single market via mutual recognition by the Member States of each state's authorization of credit institutions.[38] This recognition "will allow credit institutions the freedom of establishment and the freedom to provide services across the Community."[39]

The Second Banking Directive applies to all credit institutions as defined by the First Banking Directive except those exempted under Article 2.[40] Specifically, this Directive does not apply to branches that have already initiated banking activities by conforming to the regulations of the host state.[41]

1. Provisions of the Second Banking Directive

The Second Banking Directive creates a single license for banking within the EC, and mandates that a credit institution's home country regulate the activities of an institution it has authorized.[42] Additionally, the Second Banking Directive introduces common standards for authorization,[43] demands reciprocity,[44] requires harmonization of certain business conditions,[45] creates standard steps for initiation of services,[46] and reserves some specific powers to the host state.[47]

Authorization for the single EC banking license is granted by the state

33. *See id.*
34. *See* Second Banking Directive, *supra* note 3; Clarke, *Financial Services: Banking*, in Planning for Europe: 1992, at 128, 129 (W. Clarke ed. 1989).
35. *See* Second Banking Directive, *supra* note 3, recital 2.
36. *See Banking and Securities*, *supra* note 22, § 3.6.
37. *See* European Banking Law, *supra* note 26, at 127.
38. *See* Second Banking Directive, *supra* note 3, recital 4.
39. European Banking Law, *supra* note 26, at 127.
40. *See* Second Banking Directive, *supra* note 3, art. 2(2). A credit institution, as defined by the First Banking Directive, is "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account." First Banking Directive, *supra* note 26, art. 1.
41. The Second Banking Directive, *supra* note 3, Article 2(2), refers to Article 2(2) of the First Banking Directive. *See* First Banking Directive, *supra* note 26, art. 2(2).
42. *See* Second Banking Directive, *supra* note 3, recital 4, arts. 6(1), 13.
43. *See id.* arts. 4-7.
44. *See id.* arts. 8-9.
45. *See id.* arts. 10-17.
46. *See id.* arts. 18-20.
47. *See id.* recital 15, art. 21.

in which the head office of the credit institution is located.[48] The single license provides that an authorized credit institution can establish branches or provide services in other Member States after notifying its home state of its intentions.[49]

In addition to the single license, the Second Banking Directive introduces the principle of home-country control, whereby a credit institution's home state supervises the institution's banking activities in all Member States.[50] Home-country control is intended to regulate the core banking activities[51] that may be practiced throughout the EC,[52] such as commercial and investment banking services.[53] A credit institution may only engage in activities that are authorized by its home state,[54] and these activities may be more limited than those core activities permitted by the Directive.[55] Each Member State, however, must permit credit institutions authorized elsewhere to engage in the full range of activities permitted by their home state.[56] The home state will provide the host state with

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48. *See id.* recital 4, art. 6(1).
49. *See id.* arts. 19(1), 20(1).
50. *See id.* recital 4, art. 13(1).
51. *See id.* annex. Specifically, core banking activities include:
    1. Acceptance of deposits and other repayable funds from the public.
    2. Lending.
    3. Financial Leasing.
    4. Money transmission services.
    5. Issuing and administering means of payment (e.g. credit cards, travellers' cheques and bankers' drafts).
    6. Guarantees and commitments.
    7. Trading for own account or for account of customers in:
       (a) money market instruments (cheques, bills, CDs, etc.);
       (b) foreign exchange;
       (c) financial futures and options;
       (d) exchange and interest rate instruments;
       (e) transferable securities.
    8. Participation in share issues and the provision of services related to such issues.
    9. Advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating to mergers and the purchase of undertakings.
    10. Money broking.
    11. Portfolio management and advice.
    12. Safekeeping and administration of securities.
    13. Credit reference services.
    14. Safe custody services.

Id.

52. *See id.* recital 12, art. 18.
53. For a listing of core bank activities, see *supra* note 51.
54. *See* Second Banking Directive, *supra* note 3, recital 12. The Second Banking Directive, by virtue of mutual recognition, permits credit institutions "authorized in their home Member State to carry on, throughout the Community, *any or all* of the activities listed in the Annex." *Id.* (emphasis added).
55. *See* 1992 Handbook, *supra* note 17, at 130.
56. *See* Second Banking Directive, *supra* note 3, art. 18(1). The Second Banking Directive requires that "[t]he Member States shall provide that the activities listed in the Annex may be carried on within their territories." *Id.*

information on the credit institutions operating within its territory.[57]

The Second Banking Directive also introduces certain common standards for authorization to engage in banking activities. One such condition is the requirement that the credit institution raise five million ECU[58] in initial capital to become established, although Member States have limited discretion to reduce this amount.[59] Also, prior to authorization, major shareholders must be identified and evaluated for eligibility.[60] Host states can no longer require that branches of credit institutions obtain additional authorization or additional endowment capital to operate within their borders, as they could prior to the operation of the Second Banking Directive.[61] Furthermore, prior consultation is required with host-state authorities if the institution to be authorized is a subsidiary of a credit institution already operating in that host state.[62]

The Second Banking Directive also demands reciprocity, requiring that non-EC states seeking to take advantage of the single EC license afford both effective access and national treatment to EC credit institutions.[63] The European Commission has defined "effective access" as access similar to that accorded to non-EC credit institutions operating within the EC.[64] When Community credit institutions are denied effective access to non-EC financial markets, the European Council can demand that the European Commission negotiate to secure effective access for Community credit institutions.[65] The Commission has defined "national treatment" in financial services as granting a foreign-owned institution "the same competitive opportunities as are available to domestic credit institutions."[66] When Community credit institutions are denied national treatment in a non-EC country, new authorizations for that country's credit institutions can be suspended, either temporarily or permanently, depending on the success of the Commission's negotiations.[67]

The Second Banking Directive further requires that certain business

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57. *See id.* art. 19.

58. The ECU is the EC's currency unit. For a discussion of the ECU, see *infra* notes 239-41 and accompanying text.

59. *See* Second Banking Directive, *supra* note 3, art. 4. Member States can only reduce the amount of endowment capital to a minimum of one million ECU, and must follow stringent reporting requirements. *See id.* art. 4(2). This special minimum capital requirement is available specifically "for small enterprises and banks." *Banking and Securities, supra* note 22, § 3.3.

60. *See* Second Banking Directive, *supra* note 3, art. 5.

61. *See id.* art. 6(1). The First Banking Directive allowed host states to require credit institutions operating within their borders to be authorized by both host states and home states. *See Banking and Securities, supra* note 22, § 2.3. Prior to the Second Banking Directive, host states were also allowed to require additional endowment capital from credit institutions to set up branches within their borders. *See id.* § 3.3.

62. *See* Second Banking Directive, *supra* note 3, art. 7.

63. *See id.* art. 9(3)-(4).

64. *See id.* art. 9(3).

65. *See id.* art. 9(3); European Banking Law, *supra* note 26, at 128.

66. *See* Second Banking Directive, *supra* note 3, art. 9(4).

67. *See id.*

conditions be harmonized. First, a credit institution's own funds must not fall below the initial capital requirement for authorization.[68] Second, acquisition of a major holding in a credit institution must be approved by the home state.[69] Third, the home state must be given an annual list of major stockholders.[70] Fourth, the credit institution must follow limits on the proportion of its own funds that it can invest in non-financial services undertakings.[71] Fifth, a credit institution must "have sound administrative and accounting procedures and [must also have] adequate internal control mechanisms."[72] Sixth, prudential supervision is the responsibility of the home state.[73] Seventh, host-state authorities will share responsibility with home-state authorities for supervision of liquidity and market risk and implementation of monetary policy.[74] Eighth, host states must allow on-the-spot verification by the home-state authority of information relating to management and ownership of a branch.[75] Finally, all information acquired is subject to the requirements of professional secrecy.[76]

Additionally, the Second Banking Directive creates standard procedures that credit institutions must follow in providing services in another Member State. Initially, a credit institution must notify its home-state authorities of the activities that it plans to undertake in other states,[77] and the home-state authority similarly must notify the host-state authority within one month.[78] The credit institution must then provide the home state with specified significant information about the proposed branch and its activities, which then must be passed on to the host state within three months.[79] The branch can begin business upon receipt of notice from the host state, or after two months have passed since the host state received notification from the home state.[80]

Finally, the Second Banking Directive reserves some powers for the

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68. *See id.* art. 10(1).
69. *See id.* art. 11(1).
70. *See id.* art. 11(4).
71. *See id.* art. 12.
72. *Id.* art. 13(2). Sound administrative and accounting procedures and internal control mechanisms may necessitate that credit institutions employ auditors and disclose to them information enabling them to examine financial statements, ensure compliance with banking laws, and assess the financial condition of the credit institution. *See, e.g.*, G. Penn, Banking Supervision 69-70 (1989) (supervision under UK banking law mandates that a credit institution's reporting accountants perform certain functions).
73. *See* Second Banking Directive, *supra* note 3, recital 4, art. 13(1). Prudential supervision essentially requires that the home state supervise a credit institution's activities and operations to assure that the institution is in compliance with the applicable banking regulations. This may require credit institutions to disclose necessary information to auditors and regulators. *See* Penn, *supra* note 72, at 145-50.
74. *See* Second Banking Directive, *supra* note 3, art. 14.
75. *See id.* art. 15(1).
76. *See id.* art. 16.
77. *See* Second Banking Directive, *supra* note 3, art. 20(1).
78. *See id.* art. 20(2).
79. *See id.* art. 19.
80. *See id.* art. 19(5).

host state. These powers include the ability to require a branch to provide periodic reports on its activities.[81] In addition, host states, after notifying the home state, can take action to ensure that any irregular activity being conducted is ended.[82] Lastly, host-state authorities can also enforce "rules they have adopted in the interest of the general good."[83]

2. Advantages and Comparison to the First Banking Directive

The Second Banking Directive solves many of the problems created by the First Banking Directive. First and foremost, the single banking license will remove the key barrier to integration in the banking market.[84] That is, a credit institution will no longer have to be separately authorized by each Member State in which it does business.[85]

The principle of home-country control will also ensure that all branches of a credit institution, both inside and outside the home state, will be subject to the same supervision.[86] The new EC legislation should help protect the banking industry from another BCCI-style scandal.[87] One cause of the BCCI scandal was an uncertainty over who was ultimately responsible for supervising the bank's activities.[88] This confusion might have been alleviated had the Second Banking Directive been in effect, since the Directive places responsibility for supervision squarely in the hands of the credit institution's home state.[89]

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81. *See id.* art. 21.
82. *See id.* art. 21(2)-(4).
83. *Id.* art. 21(5).
84. *See* European Banking Law, *supra* note 26, at 132.
85. *See* Second Banking Directive, *supra* note 3, art. 6.
86. *See* Clarke, *supra* note 34, at 130.
87. BCCI was incorporated in Luxembourg, a member state of the EC. Thus, had the new legislation been in effect, BCCI would have been subject to it. *See Post-BCCI*, *supra* note 26, at S489; *see also* New, *G-10 Bankers May Discuss Bank Regulation Post-BCCI*, Reuters, Sept. 5, 1991, *available in* LEXIS, Europe Library, MONRPT File (the Second Banking Directive puts regulation in the hands of the credit institution's home country).

Some commentators fear that the EC legislation will not prevent scandals such as BCCI, noting that the EC legislation in preparation for 1992 does not address the problem of deposit insurance. *See* Brasier, *European Business: In Pursuit of Bank Safety*, Daily Tel., July 22, 1991, at 23, *available in* LEXIS, Europe Library, TELEGR File; *Home Thoughts From Abroad*, Economist, Aug. 17, 1991, at 74, col. 1. The EC is now, however, considering a Directive on deposit insurance. *See Struggling Through the Wire*, Economist, Aug. 3, 1991, at 69, col. 1. The Directive places ultimate responsibility for bank losses on the state which authorized the bank to operate. *See Banking: Sir Leon Brittan Considers EEC-wide Legislation to Protect Depositors*, Eur. Rep., July 27, 1991, at 2, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *Protect Depositors*]. Thus, the Directive would force Member States to be more cautious before authorizing a bank to operate. *See id.*

88. *See Protect Depositors*, *supra* note 87, at 2.
89. *See id.*; McCune, *BCCI Scandal Raises Tough Questions For EC*, Reuters, July 23, 1991, *available in* LEXIS, Europe Library, FINRPT File; *see also Behind Closed Doors*, Economist, July 13, 1991, at 14, col. 1 (warning that the single license creates an even larger need for a strong lead regulator and stating that the EC's new legislation on capital adequacy and limiting large exposures is designed to tackle this problem). *See generally*

The harmonization of minimum prudential banking rules, such as those relating to initial capital, liquidity, and solvency, will also enable banks to offer services more freely across the EC.[90] Even commentators who have criticized the legislation's effectiveness in integrating the EC have recognized that

> [t]he new directives will prevent countries from introducing rules that keep each other out, and will also set minimum regulatory standards beneath which member states cannot fall. The effect of the hype itself may also be helpful, perhaps prompting countries to liberalise faster than they otherwise might, and encouraging companies to stop thinking national.[91]

3. Potential Difficulties Relating to the Second Banking Directive

While the Second Banking Directive solves a number of the problems created by the First Banking Directive, others still remain. For example, local control by the host state may cause difficulty. A Member State can legislate for the public good in areas that are not dealt with at the EC level, such as consumer protection.[92] Credit institutions will have to conform to these local rules even if they are branches of institutions headquartered in another state.[93] Therefore, one of the problems with the First Banking Directive—that a branch office may be subject to greater regulatory restraints than would its home office—will still exist under the Second Banking Directive.[94]

The Second Banking Directive's effectiveness may also be hindered by the delay thrust upon credit institutions in obtaining authorization to set up a branch—in particular, delay caused by the notice required to open a branch, to offer new services, and to offer cross-border services.[95] This delay will dilute the effect of the single license, and will also create unnec-

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Post-BCCI, *supra* note 26, at S477-87 (discussion of BCCI and the problems facing EC regulators).

90. *See* Clarke, *supra* note 34, at 130-31. The EC plan to create a single market in banking has been criticized, however. Some commentators warn that there will be little change in banking as a result of the single license. *See* Lascelles, *Early Alliances Fail To Impress—Towards 1992—And the World's Largest Single Market*, Fin. Times, May 9, 1990, at II, col. 1 [hereinafter Lascelles, *Early Alliances*]. "[B]anks expect[ ] to see few major changes in the big corporate and wholesale banking markets, because these are almost totally international anyway." *Id.*; *see also* Kellaway & Dickson, *Painful Birth of the Single Market*, Fin. Times, Dec. 19, 1990, at 16, col. 3 ("in the wholesale markets, which process large transactions, there is already plenty of cross-border action"). This lack of fundamental change may also extend to the retail sector because of the national character of banking. *See* Lascelles, *Early Alliances*, *supra*, at II, col. 1; *see also* Kellaway & Dickson, *supra*, at 16, col. 3 ("deep cultural differences remain in the way business is done"). In addition, setting up a retail banking network will be prohibitively expensive. *See id.*

91. Kellaway & Dickson, *supra* note 90, at 16, col. 3.

92. *See* Second Banking Directive, *supra* note 3, recital 15.

93. *See id.*

94. *See* Clarke, *supra* note 34, at 131.

95. *See* Second Banking Directive, *supra* note 3, arts. 19, 20.

essary bureaucracy.[96]

Additionally, the reciprocity provision has caused concern in non-EC countries. The provision states that the authorization of a subsidiary of a non-EC credit institution to offer services within the EC, and the acquisition by a non-EC credit institution of an interest in an EC credit institution, may be conditioned on reciprocal treatment being accorded to EC institutions in the non-EC country in question.[97] First, the exact implications of the reciprocity requirement are far from clear. The Commission is given a great deal of discretion in determining whether all EC credit institutions enjoy reciprocal treatment in the non-EC country at issue.[98] The only statements made by the Commission concerning the meaning of reciprocity have been made to counter fears that reciprocity may lead to protectionism.[99] The Commission has specifically stated its intention to use reciprocity to advance world trade, not to limit it,[100] and has also declared that reciprocity will not apply retrospectively.[101] Yet, despite these assurances, the results of the provision will not be definite until the Second Banking Directive is fully implemented.

A second reciprocity hurdle centers on the difficulty in applying a single reciprocity standard to different banking practices inside and outside the EC.[102] For example, some Member States and outside countries have a universal banking system, allowing authorized banks to practice commercial banking and securities business simultaneously, while other Member States and outside countries separate the two activities.[103] These different laws may cause confusion when the Commission tries to determine whether reciprocity has been granted.[104] Presumably, the Commission will "have to accept that the federal and state rules regulating the geographical scope of banking activity and separating banking from securities business will apply equally to Community banks."[105]

A third question about reciprocity concerns whether non-EC branches or subsidiaries already authorized to engage in banking within the EC can take advantage of the single license, and thus establish further subsidiaries in other EC states.[106] The Commission has issued a report stating that subsidiaries can take advantage of the single license because they

96. *See* Clarke, *supra* note 34, at 132.

97. *See* Commission of the European Communities, A Common Market for Services 9 (1988) [hereinafter Common Market for Services].

98. *See* Reynolds, *1992 and the Regulation of the Securities Industry*, in 1992—New Opportunities for U.S. Banks and Businesses in Europe 71 (1989) [hereinafter *Regulation of Securities*].

99. *See id.* at 76.

100. *See id.*; 1992—Planning, *supra* note 11, at 141-42; Speech by Sir Leon Brittan, in Toronto (Sept. 20, 1991), *available in* LEXIS, Europe Library, RAPID File.

101. *See* 1992—Planning, *supra* note 11, at 142.

102. *See Regulation of Securities*, *supra* note 98, at 71.

103. *See id.*

104. For a discussion of reciprocity, see *supra* notes 63-67 and accompanying text.

105. *Regulation of Securities*, *supra* note 98, at 71.

106. *See id.* at 71-72.

are considered separate undertakings under the Treaty of Rome, Article 58.[107] This report resolves any question with respect to subsidiaries. Branches, however, are not considered separate undertakings under Article 58 of the Treaty of Rome, and therefore, have no right to the single license even though they may be established within a Member State.[108]

A final criticism of the Second Banking Directive is that the single license will not effectively integrate financial services. Although intended to create a single market, the EC rules have been criticized for, in effect, "continu[ing] to divide the EC according to territorial boundaries"[109] by subjecting credit institutions to differing regulations. If there is really to be a fully integrated EC, perhaps regulation of banking should take place at an EC, rather than a national, level.[110]

C. *Capital Adequacy Requirements*

The liberalization of banking called for by the White Paper necessitated the creation of capital adequacy[111] standards to ensure that the Second Banking Directive's single license would be grounded on uniform minimum standards.[112] In order to rely on the supervision and regulation of the credit institution's home state, the host state needs assurance that minimum standards will be maintained. Thus, standardization of capital adequacy minimums is essential for the success of home-country control, one of the principle aims of the White Paper.

Capital adequacy standards have become increasingly internationalized. In July 1988, the Basle Supervisors Committee on Banking Regulations and Supervisory Practices, representing the major Central Banks and supervisory authorities of Europe, developed the International Convergence of Capital Measurement and Capital Standards, for the Group of 10 nations ("G-10") and Luxembourg.[113] The Basle Committee adopted these new capital standards to encourage and safeguard international financial activity by reducing the risk of insolvency for credit insti-

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107. *See id.*

108. *See id.*

109. Bradley, *1992: The Case of Financial Services*, 12 Nw. J. Int'l. L. Bus. 124, 128 (1991).

110. *See id.*

111. Capital adequacy of credit institutions refers to the minimum level of capital necessary for the safe and prudent operation of the credit institution. *See* Note, *The Proposed Risk-Based Capital Framework: A Model of International Cooperation?*, 11 Fordham Int'l L.J. 777, 784 (1988) [hereinafter *Capital Framework*].

112. *See Banking and Securities, supra* note 22, § 1.

113. Committee on Banking Regulations and Supervisory Practices, International Convergence of Capital Measurement and Capital Standards (1988) [hereinafter Basle Capital Convergence Accord]. The Basle Supervisors Committee is composed of representatives of the Central Banks and supervisory authorities of the G-10 nations and Luxembourg. *See Capital Framework, supra* note 111, at 781. The G-10 nations are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. *See id.* at 777 n.3.

tutions.[114] These standards were also adopted to create a level playing field among competing international banks.[115] Since a majority of the G-10 nations are also members of the EC, it is not surprising that the capital adequacy standards subsequently developed for the EC parallel those for the G-10 countries.[116]

Two directives have been adopted to establish capital adequacy minimums: the Own Funds Directive and the Solvency Ratio Directive.[117] "Own funds" is the EC term for bank capital and is used to assess solvency.[118] A common definition of "own funds" is essential for future banking coordination[119] because capital is a cornerstone of banking supervision. The EC issued its Own Funds Directive on April 17, 1989.[120] The Solvency Ratio Directive expresses the own funds of each credit institution as a proportion of the risk-adjusted value of its assets and off-balance-sheet business[121] and was passed by the EC on December 18, 1989.[122]

1. The Own Funds Directive

The Own Funds Directive applies to all credit institutions as defined by the First Banking Directive.[123] The own funds of credit institutions "are the funds which are the property of the bank, as opposed to *client funds*, which are on deposit with the bank but the property of the clients."[124] The Own Funds Directive defines own funds, or capital, for EC banks.[125] Article Two of the Own Funds Directive identifies a wide range of elements constituting own funds.[126] After the own funds of a

114. *See id.* at 783
115. *See id.*
116. *See* Basle Capital Convergence Accord, *supra* note 113, ¶ 4.
117. *See Banking and Securities, supra* note 22, § 1; Own Funds Directive, *supra* note 3, recital 1; Solvency Ratio Directive, *supra* note 3, recital 9.
118. *See* 1992, *supra* note 167, at 93.
119. *See Banking and Securities, supra* note 22, § 1.
120. *See* Own Funds Directive, *supra* note 3, at 16.
121. *See* Solvency Ratio Directive, *supra* note 3, art. 3(1); *see also infra* note 142 (discussing off-balance-sheet business).
122. *See* Solvency Ratio Directive, *supra* note 3, at 14.
123. *See* Own Funds Directive, *supra* note 3, art. 1; *see also supra* note 40 (definition of credit institution).
124. Common Market for Services, *supra* note 97, at 17 (emphasis in original).
125. *See* European Banking Law, *supra* note 26, at 125.
126. *See* Own Funds Directive, *supra* note 3, art. 2. Specifically,

> [o]wn funds consist of: (i) capital plus share premium accounts but excluding cumulative preferential shares; (ii) reserves and profit and losses brought forward as the result of the application of the final profit or loss; (iii) revaluation reserves; (iv) funds for general banking risks; (v) value adjustments; (vi) other items so long as they are freely available to the credit institution to cover normal banking risks disclosed in internal accounting records and amounts determined by the management. Securities of indeterminate duration can also be included under this heading; (vii) the commitments of members of credit institutions set up as co-operative societies; (viii) fixed-term cumulative preferential shares and subordinated loan capital so long as in the event of bankruptcy or

particular credit institution are measured, regulatory bodies then use that measure to calculate acceptable levels of lending for that institution.[127]

Under the Own Funds Directive, own funds are divided into core capital and supplementary capital.[128] Core capital is composed of equity capital and disclosed reserves, which are the highest-quality capital.[129] Supplementary capital consists of revaluation reserves, undisclosed reserves, subordinated loans, and other items of lower quality.[130] Core capital must compose at least fifty percent of the capital base.[131] Member States, however, are free to adopt more restrictive rules regarding the composition of the capital base or of own funds.[132]

2. The Solvency Ratio Directive

The Solvency Ratio Directive applies to all credit institutions as defined by the First Banking Directive.[133] The Directive works in conjunction with the Own Funds Directive[134] to achieve the White Paper's goal of financial market integration. The Solvency Ratio Directive is intended to provide harmonized and strengthened solvency standards for EC credit institutions in order to safeguard depositors' and investors' funds and to stabilize the banking sector.[135] The Directive applies only to credit risk;[136] other kinds of risk will be dealt with in future proposals.[137] As with the Own Funds Directive, national authorities are free to impose more stringent requirements than those required by the Directive.[138]

The Solvency Ratio Directive sets out risk weights for measuring credit institution assets as a basis for solvency ratios.[139] The ratio consists of the own funds of a credit institution over the total assets and off-balance-sheet commitments, adjusted to reflect risk.[140]

> liquidation they rank after the claims of all other creditors and are not to be repaid until all other debts have been settled.

European Banking Law, *supra* note 26, at 125-26. The following items must be deducted from own funds: "(ix) own shares at book value; (x) intangible assets; (xi) material losses of the current financial year; (xii) holdings in other credit and financial institutions amounting to more than 10% of their capital." *Id.* at 126.

127. *See* Common Market for Services, *supra* note 97, at 17.

128. *See id.*

129. *See id.*

130. *See id.*

131. *See* Own Funds Directive, *supra* note 3, art. 6.

132. *See id.* recital 6.

133. *See id.* art. 1; *see also supra* note 40 (definition of credit institution).

134. *See* Solvency Ratio Directive, *supra* note 3, art. 4.

135. *See* 1992—Planning, *supra* note 11, at 62.

136. Credit risk is the "risk that a borrower will not pay a loan as called for in the original loan agreement, and may eventually default on the obligation." T. Fitch, Dictionary of Banking Terms 164 (1990) (emphasis omitted).

137. *See* Zavvos, *Banking Integration and 1992: Legal Issues and Policy Implications*, 31 Harv. Int'l L.J. 463, 491 (1990).

138. *See* Solvency Ratio Directive, *supra* note 3, art. 10(2).

139. *See* European Banking Law, *supra* note 26, at 133.

140. *See* Solvency Ratio Directive, *supra* note 3, arts. 4-5; *see also* Common Market for Services, *supra* note 97, at 25 ("*own funds* of each credit institution are expressed as a

In order to reflect risk, the value of each asset and off-balance-sheet item will be multiplied by the appropriate risk weight (0, 10, 20, 50 or 100 percent), representative of assessment of risk based on the nature of the counter party.[141] Before being weighted, off-balance-sheet items are given a risk grouping of full, medium, medium/low, or low.[142] Some off-balance-sheet activities increase the risk a bank faces, and as a result are given higher credit-risk groupings. Items secured by collateral will be given a lower weight.[143]

In reflecting risk, distinctions are drawn between different categories of borrowers—for example, Central Banks, governments, credit institutions, and non-bank sectors.[144] Loans to governments and banks are considered less risky than loans to private borrowers.[145]

In addition, distinctions are drawn between EC and non-EC borrowers.[146] All borrowers from Zone A (EC, OECD, and countries with lending arrangements with the IMF) and Zone B (all other) will be generally treated alike.[147] Loans to domestic borrowers will receive a lower risk weight when dealing with foreign Central Banks and governments.[148] In order to prevent the assignment of undeserved high-risk weights, loans to foreign borrowers may receive domestic weights when the standards of the foreign borrower are equivalent to those of the

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proportion of the risk-adjusted value of its assets and off-balance sheet business") (emphasis in original). For a discussion of off-balance-sheet items, see *infra* note 142.

141. *See* Solvency Ratio Directive, *supra* note 3, art. 6. For some examples of asset risk weights, cash on hand would be given a 0%-risk weight, claims on domestic credit institutions would be given a 20%-risk weight, and claims on foreign governments would be given a 100%-risk weight. *See id.*; 1992 Handbook, *supra* note 17, at 123.

For a discussion of off-balance-sheet items and the risk weights assigned to such items, *see infra* note 142.

142. *See* Solvency Ratio Directive, *supra* note 3, annex 1. Off-balance-sheet activities are bank activities which "involve trading financial instruments and the generation of income from fees and loan sales, all of which affect bank profits but are not visible on bank balance sheets." F. Mishkin, The Economics of Money, Banking, and Financial Markets 224 (3d ed. 1992). There are three categories of off-balance-sheet items: 1) "trading in financial futures, options for debt instruments, interest-rate swaps" and foreign exchange market transactions; 2) loan sales, also known as secondary loan participations; and 3) activities involving generation of income from fees from specialized service provisions for customers, such as foreign exchange trades, "servicing a mortgage-backed security," guaranteeing debt, and providing backup lines of credit, such as a "standby letter of credit." *Id.* at 224-25; *see also* Basle Capital Convergence Accord, *supra* note 108, ¶ 42 and annex 3 (discussing off-balance-sheet engagements and their appropriate risk assignments).

143. *See* Solvency Ratio Directive, *supra* note 3, art. 8.

144. *See* Common Market for Services, *supra* note 97, at 25; *see also* Solvency Ratio Directive, *supra* note 3, art. 6 (weights applied to "various categories of asset items").

145. *See* Solvency Ratio Directive, *supra* note 3, art. 6.

146. *See id.* arts. 6-8.

147. *See id.* art. 6.

148. *See* 1992 Handbook, *supra* note 17, at 123; *Banking and Securities*, *supra* note 22, § 6.3.

EC.[149]

Thus, as examples of asset weights, a loan to a non-EC credit institution would be given a 20%-risk weight, a loan to a non-EC private borrower would receive a 100%-risk weight, and a loan to an EC central government would be given a 0%-risk weight.[150] As examples of off-balance-sheet risk weights, a guarantee would be given a full risk weight, while an undrawn agreement to make a guarantee would be given a low-risk weight.[151]

The overall minimum threshold for the solvency ratio is equal to the Basle Committee's minimum of eight percent.[152] Compliance was expected by January 1, 1991, and is required by January 1, 1993.[153]

3. Problems with Capital Adequacy Standards

Although the Own Funds and Solvency Ratio Directives will go a long way toward standardizing capital requirements, the detailed plans may be difficult to apply, difficult to supervise, and difficult to regulate.[154]

There is debate over whether the detailed plans will actually protect banks from insolvency.[155] In some situations, the Directives may actually encourage banks to make risky loans.[156] Consider the case of a nearly insolvent bank and a blue chip corporation. A bank may lend to the nearly insolvent bank with a risk weight of twenty percent rather than lend to the private-borrower blue chip corporation at one hundred percent risk weight.[157] Thus, the bank actually makes a riskier loan under this scenario because the risk weights favor a loan to a bank over a loan to a corporation. Also, in order to compensate for lower profits caused by the higher capital requirements, some banks may actually assume riskier loans.[158]

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149. *See* 1992 Handbook, *supra* note 17, at 123; *Banking and Securities*, *supra* note 22, § 6.3.

150. *See* Solvency Ratio Directive, *supra* note 3, annex 1.

151. *See id.*

152. *See* Solvency Ratio Directive, *supra* note 3, art. 10; Basle Capital Convergence Accord, *supra* note 113, § III, ¶ 44.

153. *See Banking and Securities*, *supra* note 22, § 6.5.

154. *See, e.g.*, *Capital Framework*, *supra* note 111, at 790-92 (referring to Basle Capital Convergence Accord); Note, *A Note to Congress and the FDIC: After FIRREA, Where's the BIF?*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S411, S442-45 (1991) (discussing risk-based premiums and their potential problems).

155. *See Capital Adequacy: Bringing out the Tin Helmets*, Economist, Oct. 13, 1990, at 88, col. 2 [hereinafter *Tin Helmets*]; *see also Capital Framework*, *supra* note 111, at 791-93 (capital adequacy proposals may actually encourage giving risky loans).

156. *See Tin Helmets*, *supra* note 155, at 88, col. 2; *see also Capital Framework*, *supra* note 111, at 792-93 (capital adequacy proposals may actually "encourage banks to take on higher credit and interest-rate risks").

157. *See Tin Helmets*, *supra* note 155, at 88, col. 2; *see also Capital Framework*, *supra* note 111, at 791 (discussing Basle Capital Convergence Accord).

158. *See Tin Helmets*, *supra* note 155, at 88, col. 2; *see also Capital Framework*, *supra* note 111, at 792-93 (discussing Basle Capital Convergence Accord).

Additionally, commentators are debating whether the eight percent capital requirement is really a meaningful minimum. A higher level of capital will not necessarily be a guarantee of financial stability.[159] As one commentator has argued, ratios "are not magic wands that make banks financially stronger. Banks go bust, by and large, because they make bad loans, not because they lack sufficient capital. If an eight percent capital ratio were a sign of financial virility, rating agencies would pay attention. They do not."[160]

Finally, governments have exploited loopholes in the regulations to help their national banks meet the capital adequacy standards.[161] Thus, some banks that appear to be meeting the standards are not in fact meeting them as they were intended to be met.[162]

D. *Effect of Legislation on Banking*

As a result of the EC banking legislation, credit institutions fear that after 1992 only the financially strongest will survive.[163] Thus, credit institutions are trying to increase their market share and financial strength both domestically and internationally.[164] This effort is evidenced within the EC by consolidations, acquisitions, and alliances, and is evidenced internationally by increased expansion into the United States banking markets.[165] However successful the EC is in implementing its legislation by 1992, the single banking market will not occur immediately;[166] it will take some time for barriers to be eliminated, because national traditions and habits are hard to break.

The single license will affect banking services offered within the EC, both in terms of how they are offered and what the consumer expects.[167] The single license will cause geographic specialization, since a credit institution authorized in a Member State or group of states is only permitted to engage in certain activities.[168] Also, because expansion in all directions simultaneously is tremendously expensive, banks will probably target specific areas.[169] These divisions will likely form along cultural

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159. *See Tin Helmets*, *supra* note 155, at 88, col. 2.

160. *Id.*

161. *See id.*

162. *See id.*

163. *See* Dickins, *Banking in Europe: A Brave New World?*, in The Regulations Governing Banking Across the Community, 8 Int'l Fin. L. Rev. 5, 5 (Sept. Supp. 1989) [hereinafter *Brave New World?*].

164. *See id.*; *see also* 1992—Planning, *supra* note 11, at 181-82, 185-86 (preparing for the single market in banking, from British bankers' perspectives).

165. *See Brave New World?*, *supra* note 163, at 5-6.

166. *See* Reynolds, *supra* note 31, at 11.

167. *See* Euromoney Publications, 1992: A Euromoney Book 94 (1990) [hereinafter 1992].

168. For a discussion of race for the bottom, see *infra* notes 209-21 and accompanying text.

169. *See* 1992, *supra* note 167, at 94.

lines.[170] In fact, there will probably be few, if any, pan-European banks.[171]

The single license, at least initially, may also lead a credit institution to seek product specialization based on the national regulations and historical traditions of that institution's home country.[172] EC legislation cannot instantly erase the distinction between the highly developed banking markets (like those of London and Frankfurt) and the underdeveloped markets (such as those of Greece, Spain and Portugal).[173] If the forecasted race for the bottom takes place[174] and banking sectors become more equal, product specialization may dissolve as credit institutions uniformly offer all services.[175]

The single license will also affect banking services by changing consumer expectations. The potentially intensified competition in the EC should lead to a greater source of services for consumers.[176] This increase in the availability of services may cause credit institutions to lower their prices in order to attract customers.[177]

The legislation should make cross-border financial service offerings less costly and easier to complete.[178] This should help to increase a credit institution's access to consumers[179] in three ways: by starting in new locations, by merger and acquisition across borders, and "by forging cross-border business links."[180] The first is the most costly, in terms of time, management, and resources.[181] The second method is also relatively costly, and national barriers still exist.[182] The last alternative is the

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170. *See id.* Specifically,

> the banking sectors of West Germany, the Netherlands, Flemish-speaking Belgium, Austria and German-speaking Switzerland have long been so bound together by language and history as to set them apart from France, Spain or Italy, while the UK's links with North America, and Denmark's with the other Nordic countries, put them in regions which straddle the very division, between EC and non-EC members, on which the 1992 project is being constructed.

Id.

171. *See id.* Although there will probably be few pan-European banks, Deutsche Bank has expressed its intentions to become one. *See id.*

172. *See id.* at 94-95.

173. *See id.* at 94.

174. For a discussion of race for the bottom, see *infra* notes 209-21 and accompanying text.

175. If no fundamental change in wholesale and retail banking occurs, as forecasted by some commentators, *see supra* note 90, none of these product changes may ultimately occur.

176. *See* 1992, *supra* note 167, at 98; Albrecht, *Europe 1992—The Implications for Banks and Financial Services*, in 1992—The Single European Market, 77, 81 (1988) [hereinafter *Implications for Banks*].

177. *See Implications for Banks*, *supra* note 176, at 81.

178. *See id.*

179. *See* 1992, *supra* note 167, at 95.

180. *Id.*; *see also* Lascelles, *Early Alliances*, *supra* note 90, at II, col. 1 (prospect of 1992 has accelerated cross border alliances).

181. *See* 1992, *supra* note 167, at 95.

182. *See id.* A proposed merger between a Dutch bank and a Belgian bank failed after each bank's management got "cold feet". *See* Lascelles, *Early Alliances*, *supra* note 90, at

least expensive and least risky, and may be particularly attractive to credit institutions who wish to offer complementary services, rather than directly competing services.[183]

1. Effect on Banking Within Individual Member States

Some of the EC Member States will be well situated to take advantage of the overall integrated banking market. Others will receive some benefits, but will experience some difficulty in complying with the new legislation. Still others—because they are highly regulated, underdeveloped, small, or inefficient—will, at least initially, face competitive disadvantages under the single license.

Credit institutions in the United Kingdom and Germany should be very competitive in the single market. These credit institutions are currently allowed to offer the full range of services permitted under the Second Banking Directive, which should give them a competitive edge in engaging in these activities.[184] The German banking market is "relatively conservative, . . . is dominated by the commercial banks," and is "subject to strict regulation" and cautious consumers, all of which may help protect this market from competition.[185]

Luxembourg has favored the implementation of the single market in banking since the single market was first proposed.[186] In addition, Luxembourg enjoys a position as a leading international banking center in the EC, partially as a result of its flexible regulatory scheme and its far-

II, col. 1. Although the failure of this merger may indicate that mergers may be difficult, alliances and defensive consolidation are widespread. *See id.*

183. *See* 1992, *supra* note 167, at 98; Lascelles, *Early Alliances*, *supra* note 90, at II, col. 1.

184. *See* 1992—Planning, *supra* note 11, at 141; *see also* Haslam, Tether, and Barrie, *United Kingdom*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 48, 48-58 (Sept. Supp. 1989) (discussing regulations to which United Kingdom Banks are subject); Schneider, Nissen, and Heckel, *West Germany*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 59, 59-66 (Sept. Supp. 1989) (discussing regulations to which German banks are subject). The London banking market "is such a clear leader that [unfortunately] it can only yield some of that strength to others," especially since its main strength lies in wholesale banking markets which are already highly internationalized. *See* Lascelles, *Prospects Look Less Certain-The Impact of the Free Movement of Capital*, Fin. Times, Nov. 29, 1990, at 35, col. 1 [hereinafter *Prospects Look Less Certain*]. However, the United Kingdom charges high interest rates on personal and commercial loans (not including mortgage loans) and this may lead to competition in the form of lower rates. *See* 1992—Planning, *supra* note 11, at 141. The United Kingdom's market is also highly internationalized so a non-EC banking partner's need to satisfy the reciprocity requirement may hurt the United Kingdom's global ambitions. *See id.*

185. 1992—Planning, *supra* note 11, at 142. A concern for German banks is that their strict standards for capital adequacy "may leave them facing tougher capital standards than their competitors." *Id.* at 143. Recall that the Member States may impose more strict requirements than those contained in the Own Funds Directive and the Solvency Ratio Directive. For a discussion of capital adequacy requirements, see *supra* notes 132, 138 and accompanying text.

186. *See* Schmitt, *Luxembourg*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 34, 34 (Sept. Supp. 1989).

sightedness in being very open to foreign banks.[187] These two factors should place Luxembourg in a good competitive position for 1992.

Despite some weaknesses, Belgian, Danish, and Dutch banking markets should be strong enough to take advantage of the integrated market in 1992. Belgian banks are highly productive, but are relatively small internationally, and may be vulnerable to the increased competition caused by the single license.[188] Danish banks are also small, but are in the process of deregulation,[189] and are trying to expand internationally and to increase their range of offered services.[190] If successful, Danish banks will be relatively well-placed for 1992. In addition, Danish banks are well-capitalized and efficient with high-quality products.[191] These two factors should place Danish banks in a good position to compete in 1992.[192] Dutch banks are highly regulated, conservative, and behind the times in electronic banking,[193] but are trying to increase their competitiveness by seeking cross border banking alliances.[194] Dutch banks, however, should have no difficulty in complying with the capital adequacy requirements,[195] which should help them compete in 1992.

Additionally, Spanish, French, and Irish banks should be relatively successful in 1992 despite some weaknesses. Spanish banks are overabundant and overpriced,[196] but have been merging and expanding into new areas to compete more effectively in the financially integrated Europe of 1992.[197] In addition, the strict Spanish capital adequacy requirements of the 1980s will enable credit institutions there to meet the capital

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187. *See id.* at 36-37.

188. *See* 1992—Planning, *supra* note 11, at 144; *see also Belgium*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 67 app., 67-68 (Sept. Supp. 1989) [hereinafter *Belgium*] (discussing Belgian banking regulations). Belgian banks are pursuing alliances as a defense to potential foreign takeover. *See* 1992—Planning, *supra* note 11, at 144. One example of this is the 1988 alliance between Generale de Banque of Belgium and AMRO of the Netherlands. *See id.* Belgian banks are undercapitalized and may have difficulty complying with the EC capital adequacy requirements. *See id.*; *see also Belgium*, *supra*, at 68 (Belgian banks are not "hugely capitalized" so it will take a while to comply with requirements).

189. *See* 1992—Planning, *supra* note 11, at 141; *see also Denmark*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 68 app., 68-69 (Sept. Supp. 1989) (discussing regulations pertaining to Danish banks).

190. *See id.* at 68; 1992—Planning, *supra* note 11, at 198.

191. *See* 1992—Planning, *supra* note 11, at 198, 211-13.

192. *See id.*

193. *See id.* at 144-45; *see also* Kleyn & Perrick, *The Netherlands*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 38, 38-42 (Sept. Supp. 1989) (discussing regulations to which Dutch banks are subject).

194. *See* 1992—Planning, *supra* note 11, at 144-45.

195. *See* Kleyn & Perrick, *supra* note 193, at 42. They will have no trouble complying with the capital requirements because the Netherlands credit institutions already comply with the Basle Capital Convergence Accord. *See id.*

196. *See* 1992—Planning, *supra* note 11, at 145; *see also* Grant, *Spain's Banks Stay Profitable But Doubts Ahead*, Reuters, July 30, 1990, *available in* LEXIS, Europe Library, MONRPT File ("operating costs are far too high").

197. *See* 1992—Planning, *supra* note 11, at 145; Grant, *supra* note 196. Larger Spanish banks are also expanding into investment banking, in light of the activities permitted

adequacy requirements of the new legislation, thus placing them in a good position for 1992.[198] The French banking sector is in the process of deregulation and privatization,[199] which should help French banks in 1992. However, banking in France is expensive[200] and French credit institutions may have particular difficulty in meeting the capital adequacy requirements.[201] Ireland's major retail banking groups have relatively decent market share, operate internationally, and are fairly well-managed, but Ireland lacks strong, local, specialist banks.[202] Irish banking regulation has recently been changed to allow for the wider definition of banking business mandated by the EC.[203] Since this change was recent, Irish credit institutions may have difficulty in holding their own, at least initially, in the newly permitted areas of banking.

Finally, the single license will probably cause Italian, Portuguese, and Greek credit institutions the most difficulty, at least initially. Italian credit institutions are gradually deregulating, although they are still mostly government-controlled.[204] Retail banking in Italy is inefficient, overstaffed, and expensive, yet the quality is poor.[205] Thus Italian credit institutions have a number of obstacles to surmount to be competitive in 1992. Portuguese banks are similarly strictly controlled by the government, which will create problems in the integrated market of 1992.[206] Finally, the Greek banking market is the most susceptible of the EC markets to an influx of competition after 1992.[207] Such an influx could be

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by the Second Banking Directive. *See* 1992—Planning, *supra* note 11, at 145; Grant, *supra* note 196.

198. *See* Grant, *supra* note 196; *see also* Pombo & Bazan, *Spain*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 43, 43-47 (Sept. Supp. 1989) (discussing Spanish banking regulations).

199. *See* 1992—Planning, *supra* note 11, at 141, 143; *see also*, Lee, Martin, & Carreau, *France*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 16, 16-23 (Sept. Supp. 1989) (discussion of deregulation of French banking market) [hereinafter *France*]; *see generally* Note, *The World Bank and the IMF: At the Forefront of World Transformation*, in Annual Survey of Financial Institutions and Regulation, Transnational Financial Services in the 1990s, 60 Fordham L. Rev. S349 (1992) (discussing privatization).

200. *See* 1992—Planning, *supra* note 11, at 143. The typical French banking consumer's penchant for writing checks and having bank accounts has pushed the price of banking in France to high levels. *See id.*

201. *See* 1992—Planning, *supra* note 11, at 143. In fact, French state-controlled banks have turned to creative sources of funds in their attempt to comply with these requirements. *See France*, *supra* note 199, at 16.

202. *See* 1992—Planning, *supra* note 11, at 238.

203. *See* Johnston, *Ireland*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 24, 28 (Sept. Supp. 1989).

204. *See 1992—Planning* at 143-44; *see also* Tonucci, *Italy*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 29, 29-33 (Sept. Supp. 1989) (effect of single license on banking in Italy).

205. *See* 1992—Planning, *supra* note 11, at 143.

206. *See id.* at 145; *Portugal*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 70 app., 70 (Sept. Supp. 1989).

207. *See Greece*, in The Regulations Governing Banking Across the European Community, 8 Int'l Fin. L. Rev. 69 app., 69 (Sept. Supp. 1989).

very profitable for both the incoming banks and for Greece in general, but Greek banks may not survive to reap the benefits.[208]

2. Effect on Regulation: The Race for the Bottom

In addition to affecting the provision of banking services, the single license may also have a profound effect on the regulation of banking. The single license may force EC Member States to design their regulatory scheme to attract banks. In some ways, this potential for inter-state competition resembles the dynamics of American corporation law.

With respect to American corporations, Professor William Cary has theorized that individual states have adopted very lenient corporation laws to woo corporations to their state.[209] States are motivated by the valuable revenues that they collect from franchise taxes on corporations incorporated within their borders.[210] This competitive process has been referred to as a "race for the bottom."[211] To counter this effect, Professor Cary proposed that there be a federal corporate law which sets out minimum standards for incorporation.[212] Under this proposal, Congress would not adopt specific corporation statutes like those of the states, but would instead adopt a statute that set minimum standards in selected areas of corporation law to govern the largest publicly held corporations, leaving everything else to the states.[213]

The EC's banking regulations are analogous to Professor Cary's proposed federal corporate law. The Second Banking Directive allows a full range of universal banking services, but does not force Member States to permit all of these services, thus leaving it to the home state to decide which services a bank it licenses will be able to pursue.[214] The single license will force a Member State to allow branches authorized elsewhere to engage in any activity permitted by its authorization state.[215] Therefore, there may be incentive for Member States to allow all of the activities permitted within the Annex, in order to reap the revenue earned from authorization, and also to be as competitive as credit institutions authorized in other Member States.[216]

Moreover, Member States will have incentive to impose loose regula-

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208. *See id.*

209. *See* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663, 665-68 (1974).

210. *See id.*

211. *See id.* at 666.

212. *See id.* at 701-03.

213. *See id.*

214. *See* Second Banking Directive, *supra* note 3, at 2; *see also* Gruson & Nikowitz, *The Second Banking Directive of the European Economic Community and Its Importance for Non-EEC Banks*, 12 Fordham Int'l L.J. 205, 216 (1989) (home states may decide what banking activities it will authorize credit institutions to pursue).

215. *See* Second Banking Directive, *supra* note 3, art. 18.

216. *See* Gruson & Nikowitz, *supra* note 214, at 216-17; Bradley, *supra* note 109, at 128, 158.

tion.[217] Credit institutions will have strong incentive to be regulated under the least restrictive system available.[218] Thus, "regulation is likely to be designed to attract business, rather than to provide the highest possible degree of protection for small investors."[219] Therefore, there may be a race for the bottom in the EC both in terms of what activities each Member State permits, and in terms of what regulations a Member State applies.[220] This race could potentially be ended by creating an EC-wide regulation authority.[221]

Cary's proposal for minimum standards imposed at the federal level is applicable to the recent regulatory framework adopted for banking by the EC. The Second Banking Directive, the Own Funds Directive, and the Solvency Ratio Directive comprise the EC's attempt to set minimum standards for banking in the Community. These standards, while ostensibly true minimums which will help to integrate the EC and create stability, may need some bolstering if it becomes apparent that they are insufficient to achieve the desired ends.

II. Economic and Monetary Union

Economic and Monetary Union ("EMU")[222] will provide a foundation for the unification of Europe beyond the single market in financial services. In order to achieve a truly single European market, EMU should accompany the drive to achieve integration in the financial services market.[223]

In June 1988, at the Hanover Summit, the EC endorsed a program for a Single European Market, and the push towards EMU began.[224] The Hanover Communique established the Delors Committee, comprised of

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217. *See* Bradley, *supra* note 109, at 157.

218. *See id.*

219. *Id.* at 133.

220. *See id.* at 133-34, 157. The EC has recognized that loose regulation may be a problem, and has stated in the preamble to the Second Banking Directive that Member States should not authorize banks which appear to be trying to avoid the more strict rules and regulations of another member state. *See* Second Banking Directive, *supra* note 3, recital 8. Alternatively, there may be a race for the top, with Member States imposing even stricter rules in order to draw banking business to their state. *See* Bradley, *supra* note 109, at 128.

221. *See* Bradley, *supra* note 109, at 161. *See generally* Lascelles, *Flaw in the Argument*, Fin. Times, Nov. 7, 1990, at 24, col. 7 (suggesting that EC "will almost certainly need to centralise supervision" for numerous reasons).

222. EMU is the process of creating one integrated market in which there is a single currency, a single monetary policy, and a single economic policy for the entire EC. For a more detailed definition of EMU, see *infra* notes 228-33 and accompanying text.

223. *Cf.* Koeune, *Europe—One Complete Market*, in 1992—The Single European Market 15, 19 (1988) (the drive to achieve integration in financial services should be accompanied by a strengthened European Monetary System, *see supra* notes 235-51 and accompanying text, which was a forerunner of the current program for EMU).

224. *See* Lomax, *Towards A Common Currency*, in Planning for Europe: 1992, at 69, 71 (W. Clarke ed. 1989).

the Central Bank governors from the twelve Member States.[225] The EC gave the Committee specific instructions to explore and formulate tangible steps leading toward EMU.[226] In April 1989, the Delors Committee published its report entitled Report on Economic and Monetary Union in the European Community, intended to provide non-binding guidance in the Community's effort to achieve EMU.[227]

A. *What is EMU?*

The Delors Committee defined economic union and monetary union separately, but the Committee recognized that "[e]conomic union and monetary union form two integral parts of a single whole and would therefore have to be implemented in parallel."[228] The Committee defined economic union in terms of four basic elements: (1) a "single market within which persons, goods, services, and capital can move freely; (2) competition policy and other measures aimed at strengthening market mechanisms; (3) common policies aimed at structural change and regional development; and (4) macroeconomic policy coordination, including binding rules for budgetary policies."[229] In addition, the Committee noted that economic union should be "based on the same market-oriented economic principles that underlie the economic order of its member countries."[230]

The Delors Committee stated that "monetary union constitutes a currency area in which policies are managed jointly with a view to attaining common macroeconomic objectives."[231] The Committee identified three conditions necessary for monetary union: (1) the assurance of total and irreversible convertibility of currencies; (2) the complete liberalization of capital transactions and the full integration of banking and other financial markets; and (3) the elimination of margins of fluctuation and the irrevocable locking of exchange rate parities.[232] The Committee also noted that a single currency, while potentially desirable, is not strictly necessary for a monetary union.[233]

Prior to the Delors Report, the EC made several attempts to achieve EMU.[234] The European Monetary System ("EMS") was the most successful of these attempts.[235] EMS was created on March 13, 1979, by a

225. *See id.* The EC Commission President Jacques Delors chaired the Committee. *See* Ungerer, *Europe—The Quest for Monetary Integration*, Fin. & Dev., Dec. 1990, at 14, col. 1.
226. *See* Lomax, *supra* note 224, at 71.
227. *See* Delors Report, *supra* note 5, ¶ 15.
228. *Id.* ¶ 21 (emphasis omitted).
229. *Id.* ¶ 25.
230. *Id.*
231. *Id.* ¶ 22.
232. *See id.*
233. *See id.* ¶ 23.
234. *See* Ungerer, *supra* note 225, at 14, col. 1.
235. *See How to Hatch an EMU*, Economist, Apr. 22, 1989, at 45, col. 1 [hereinafter *Hatch an EMU*].

resolution of the governors of the Central Banks of the EC Member States.[236] EMS is comprised "of three complementary parts: the ECU, the exchange rate mechanism, and the mechanisms for monetary cooperation."[237] Of the twelve EC members, only Greece and Portugal have not included their currencies in EMS.[238]

The European Currency Unit ("ECU"), the first component of EMS, is "a basket of the existing currencies, weighted according to the importance of each currency and country in the Community."[239] The ECU is the "official accounting unit" of the EC and is used somewhat in the private marketplace.[240] The ECU may ultimately become the single currency of Europe.[241]

The second part of EMS is the Exchange Rate Mechanism ("ERM"). Each currency belonging to EMS is included in the ERM, which is a central exchange rate set in ECUs that serves as the basis for calculating exchange rates among the member currencies.[242] Thus, each currency has a set exchange rate with all of the other member currencies and these set exchange rates can only fluctuate within strict limits.[243]

The third aspect of EMU consists of monetary cooperation mechanisms. Because the currencies within EMS have strict fluctuation limits with respect to other EMS currencies, the Central Banks of the various EMS countries may need to intervene if the currencies begin to fluctuate too widely.[244] If the currencies are fluctuating too widely, the EMS countries have the option of realigning the currencies, with the strongest currencies being revalued and the weakest devalued.[245] Early in EMS, several currency realignments occurred, but they are becoming far less frequent—the last major one occurred in 1987.[246]

EMS has been fairly successful. Following the realignment of member currencies in March 1983, there has been greater convergence of costs

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236. *See The European Monetary System*, Eur. Rep., Oct. 10, 1990, at 8, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *European Monetary System*].

237. *Id.*

238. *See EMS: Member States Welcome Pound's Entry into ERM but Commission Remains Cautious*, Eur. Rep., Oct. 10, 1990, at 6, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *Commission Remains Cautious*]. On October 8, 1990, the British Pound Sterling entered into EMS. *See id.*

239. Lomax, *supra* note 224, at 75.

240. *Id.* (emphasis omitted).

241. *See* Coopers & Lybrand, *Financial Services* in Euroscope § 5.7.4, Mar. 7, 1991, *available in* LEXIS, Europe Library, EURSCP File [hereinafter *Financial Services*]. In an act of support for the ECU, the European Commission proposed extending the use of the ECU for transactions within the Community budget. *See ECU: Commission Seeks to Extend Use of ECU for Transactions*, Eur. Rep., Jan. 9, 1991, at 1, *available in* LEXIS, Europe Library, EURRPT File.

242. *See European Monetary System*, *supra* note 236, at 8.

243. *See id.*

244. *See id.*

245. *See id.*

246. *See id.*; *see also* Ungerer, *supra* note 225, at 14, col. 1 (following a comprehensive realignment of currencies in 1983, realignments have occurred less frequently).

and prices, and fewer realignments.[247] Also, inflation has been kept low.[248] EMS has further succeeded "in reducing exchange rate volatility, which was its main goal."[249] EMS established fixed exchange rates and eliminated exchange controls.[250] By taking exchange rates and controls out of the hands of national authorities, national sovereignty over monetary policy is rendered impossible.[251]

B. *Renewed Enthusiasm for EMU?*

The success of EMS in integrating financial markets and in reducing inflation has convinced Member States that it is best to operate through EMS, even though it means giving up national sovereignty over monetary policy.[252] This success, in combination with the formation of a single internal market by 1992, has "giv[en] rise to beliefs that over the next few years, a solid groundwork will be laid" for EMU.[253] Now that EMU is considered desirable, debate will center on "questions of whether, when, and to what extent, countries will be ready to surrender sovereignty in the economic, and in the last analysis, the political field."[254] This debate was ignited by the Delors Report, and later extinguished in part by the Treaty of Maastricht.

1. The Delors Report

The Delors Report recommended[255] a three-stage process to achieve EMU. Stage one, which commenced on July 1, 1990, emphasized greater coordination of economic and monetary policies and strengthening and standardizing of the EMS.[256] In addition, during stage one, the internal market should be completed and all Community currencies should be included in the EMS.[257]

Also during stage one, the Member States were to design a new com-

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247. *See* Ungerer, *supra* note 225, at 14, col. 1.

248. *See Commission Remains Cautious, supra* note 238, at 6. A major reason that inflation has been kept low is that "EMS is presaged on a fixed exchange rate with Germany, and since Germany has operated a tight money policy, so the EMS has become a core of low inflation." Lomax, *supra* note 224, at 70.

249. *Hatch an EMU, supra* note 235, at 45, col. 1.

250. *See* Lomax, *supra* note 224, at 70.

251. *See id.* at 70-71.

252. *See id.*; *see also* Ungerer, *supra* note 225, at 14, col. 1 (success of EMS has given rise to belief that EMU can be achieved).

253. Ungerer, *supra* note 225, at 14, col. 1.

254. *Id.*

255. The Treaty of Maastricht varies somewhat from what the Delors Report proposed. *Compare infra* notes 261-75 and accompanying text (stages two and three of the Delors Report) *with infra* notes 287-310 and accompanying text (discussion of the Maastricht Treaty).

256. *See* Delors Report, *supra* note 6, ¶¶ 50-54; Ungerer, *supra* note 225, at 14, col. 1; *Economic and Monetary Union: First Stage Gets Underway*, Eur. Rep., July 4, 1990, at 4, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *First Stage*].

257. *See* Delors Report, *supra* note 6, ¶¶ 50-54; Ungerer, *supra* note 225, at 14, col. 1; *First Stage, supra* note 256, at 4.

prehensive treaty to complete EMU.[258] Even though amended by the Single European Act in 1985 to allow for changes mandated by the 1985 White Paper on Completing the Internal Market, the Treaty of Rome was still insufficient for the completion of EMU, and thus the new treaty was needed.[259] The EC reached agreement on this monetary union treaty at the December 1991 Summit in Maastricht, the Netherlands.[260]

The Delors Report scheduled stage two of EMU to begin on January 1, 1994.[261] The Report suggested that, during stage two, the Commission should reform existing institutions and set up the European System of Central Banks.[262]

The Delors Report also proposed that the European Central Bank ("ECB") would have full authority as an EC institution and would be independent from the dictates of the national authorities.[263] The ECB would be expected to foster price stability, to support the EC's economic policy, to control the monetary policy, to manage the national reserves and exchange rates, and to participate in the coordination of bank supervision by the national authorities.[264] The ECB would be directed by a Council composed of Central Bank governors from the Member States, and by an Executive Board appointed by the leaders of the Member States.[265] The ECB would also manage the monetary policy of the integrated Community during stage two.[266] Although national authorities would retain ultimate responsibility for decisionmaking during stage two, there would be some collective decisionmaking, and the ECB would issue non-binding rules for national budget deficits.[267] The ECB would replace all current EC monetary authorities and realign exchange rates only as a last resort.[268]

The Delors Report further proposed that during the third stage, national authorities transfer all economic and monetary policy-making ability to EC institutions.[269] The Council would then decide economic questions and constrain national budget deficits.[270]

According to the Delors Report, the ECB's decisions would become

258. *See* Delors Report, *supra* note 6, ¶ 18.

259. *See id.* ¶ 61. The Treaty of Rome paved the way for economic union and closer relations among the Member States. *See id.* ¶ 18. As the EC develops, the Commission will need more authority to implement its policies and will therefore need a new treaty. *See id.*

260. *See Europeans Accept a Single Currency and Bank by 1999*, N.Y. Times, Dec. 10, 1991, at A1, col. 1 [hereinafter *Currency and Bank*].

261. *See Financial Services*, *supra* note 241, § 5.7.3.

262. *See* Delors Report, *supra* note 6, ¶¶ 55-57.

263. *See id.* ¶ 32.

264. *See id.*

265. *See Financial Services*, *supra* note 241, § 5.4.

266. *See* Delors Report, *supra* note 6, ¶¶ 55-57.

267. *See id.*

268. *See id.* ¶ 57.

269. *See id.* ¶¶ 58-60.

270. *See id.*

binding during stage three. The ECB would decide all monetary issues, including exchange-rate intervention with non-EC currencies,[271] and would acquire and manage the reserves of the Member States.[272]

Also during stage three, the EC would irrevocably fix exchange rates among the European currencies,[273] and then introduce a single currency.[274] Finally, EC decisionmaking would change in the third stage. Unanimous decisions would no longer be required and majority decisions would be binding.[275]

2. The Ensuing Debate

After the Delors Report was published, but prior to the Maastricht Treaty, the Member States differed over many of the Delors Report proposals. First, the Member States disagreed about the proposal for a single currency.[276] Germany, for example, supported a single currency, but not necessarily the ECU,[277] perhaps hoping that the deutschemark would be the future single currency for all of Europe. The Commission took the view that it was politically unacceptable for any national currency to become the future EC currency.[278] The United Kingdom "proposed a common currency as an alternative and did not rule out the idea that this might one day become a 'single currency.' "[279] The United Kingdom plan proposed that a thirteenth currency, a hard ECU, be introduced during the second stage; this ECU would never be devalued in relation to national currencies.[280] This proposal initially won some support from Spain, Portugal, and France.[281] This debate has been silenced by the Maastricht treaty, however, which has made a single currency—the ECU—inevitable.[282]

Prior to the Maastricht Treaty, the Member States also differed over

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271. *See id.*

272. *See id.*

273. *See id.* A proposal that the ECU basket be irrevocably fixed in the second stage is gaining support and its passage is becoming more probable. *See ECU Freeze Becoming More Probable-Dutch Minister*, Reuters, Oct. 23, 1991, *available in* LEXIS, Europe Library, MONRPT File.

274. *See* Delors Report, *supra* note 6, ¶¶ 58-60.

275. *See id.*

276. *See Economic and Monetary Union: European Commission Calls for Clear Commitment from Member States in Favor of ECU and EMU*, Eur. Rep., Sept. 5, 1990, at 2, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *Clear Commitment*].

277. *See id.*

278. *See Clear Commitment, supra* note 276, at 2.

279. *Id.*

280. *See EMU: Lukewarm Reception for Hard ECU*, Eur. Rep., Jan. 12, 1991, at 2, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *Lukewarm Reception*]; *Economic and Monetary Union: 11-Sided Agreement on Eurofed Statutes*, Eur. Rep., Dec. 5, 1990, at 2, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *11-Sided Agreement*].

281. *See Lukewarm Reception, supra* note 280, at 2; *11-Sided Agreement, supra* note 280, at 2.

282. For a discussion of the single currency agreed to in the Maastricht treaty, see *infra* notes 298-305 and accompanying text.

the level of power they believed the ECB should have in the second stage. Germany insisted that before moving to the second stage, Member States must achieve progress toward greater economic convergence to assure price stability and healthy public finances.[283] Germany further proposed that the ECB should not be established until stage three.[284] France and the Commission feared that the German demands were merely a ploy to delay EMU.[285] This debate was settled by the Maastricht treaty, wherein it was decided that a forerunner of the ECB—the European Monetary Institute ("EMI")—would be established in stage two, with the full ECB not being established until stage three.[286]

3. The Maastricht Treaty

The Maastricht Treaty, agreed to in December 1991, details the contents and arrangements for advancing to stages two and three.[287] The Treaty, covering both EMU and political union, "creates a so-called European Union and sets its course for years ahead."[288] The Maastricht Treaty "may eventually make the European Union a superpower."[289] The intent of the Treaty is not, however, "to melt member countries into a United States of Europe, but rather to retain the present mosaic of ever more closely cooperating nation states."[290] This Treaty has made EMU significantly more likely to occur by the end of the 1990s.[291] The Treaty calls for the second stage of EMU to begin on January 1, 1994.[292] Stage two will bring "tighter controls on exchange rate fluctuations" and the advent of the EMI that is to be the forerunner of the future ECB.[293]

The Treaty provides an opportunity to move to the third stage of EMU as early as January 1, 1997.[294] In 1996, the Member State governments will determine which Member States' economies have met the strict convergence criteria spelled out in the treaty, including specified levels for inflation, interest rates, budget deficits, and currency stabil-

283. *See Economic and Monetary Union: Ministers Debate Stage Two*, Eur. Rep., Apr. 6, 1991, at 2, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *Debate Stage Two*]; *EMU: Germany Backs Off From Delors Plan*, Eur. Rep., Feb. 27, 1991, at 5, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *Germany Backs Off*].

284. *See Germany Backs Off*, *supra* note 283, at 5.

285. *See Debate Stage Two*, *supra* note 283, at 2.

286. For a discussion of the Maastricht Treaty provisions relating to the implementation of the ECB, see *supra* notes 293, 302 and accompanying text,

287. *See* McCune, *Delors to Propose Eurofed to Manage ECU in Transition to Union*, Reuters, Dec. 13, 1990, *available in* LEXIS, Europe Library, LBYRPT File.

288. *Deal is Done*, *supra* note 7, at 51, col. 1.

289. *Id.*

290. Buchan, *A Heath Robinson Design for Europe*, Fin. Times, Dec. 12, 1991, at 14, col. 3.

291. *See* Balls, *Why Widening the EC Makes Deepening Less Risky*, Fin. Times, Dec. 16, 1991, at 4, col. 3; Buchan, *supra* note 290, at 14, col. 1.

292. *See* Riding, *Measured Steps Toward One Europe: What Was Decided*, N.Y. Times, Dec. 12, 1991, at A18, col. 2.

293. *See id.*

294. *See id*; Balls, *supra* note 291, at 4, col. 3.

ity.[295] Meeting these criteria will enable Member States to move to stage three and adopt a single currency.[296] In order to move to stage three on January 1, 1997, a majority of the Member States must meet the convergence criteria, and a two-thirds majority must approve the move to a single currency and Central Bank.[297]

If the Member States are unable to move to the third stage at that time, stage three and the single currency will be automatically established on January 1, 1999.[298] This move will occur even in the absence of a majority of the Member States or of further approval by the Community.[299] Member States must still meet the convergence criteria to take part.[300] The remaining Member States would then join the third stage as their economies met the required criteria.[301]

During stage three the EMI will be transformed into the ECB.[302] Finally, during stage three, the value of the ECU will become irrevocably fixed.[303]

The Treaty contains an opt-out clause which allows Britain alone to opt out of joining the single currency.[304] Many commentators agree, however, that Britain will be eager to join the Central Bank and the single currency.[305] One commentator has stressed that it would be almost suicidal for Britain to stay out of EMU because "[t]he financial institutions of the City of London, which are so important now in the world of finance, would be relegated to the sidelines."[306] Uncertainty over Britain's future in EMU, however, could hurt Britain,[307] as the confusion could prevent London from being the future site of the ECB.[308]

The economic implications of this Treaty for Europe are twofold. In the short term, "[t]he initial effects will be antigrowth" because countries will be striving to meet the convergence criteria.[309] In the long term, however, Europe's economy should "become more dynamic" with "Eu-

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295. *See* Riding, *supra* note 292, at A18, col. 2; Balls, *supra* note 291, at 4, col. 3.

296. *See* Riding, *supra* note 292, at A18, col. 2; Balls, *supra* note 291, at 4, col. 3.

297. *See* Riding, *supra* note 292, at A18, col. 2.

298. *See id.*

299. *See id.*

300. *See id.*

301. *See Currency and Bank, supra* note 260, at A1, col. 1.

302. *See* Riding, *supra* note 292, at A18, col. 2.

303. *See Mapping the Road to Monetary Union*, Fin. Times, Dec. 12, 1991, at 6, col. 1.

304. *See* Greenhouse, *Europe's Pact on Money Seen as Business Boon*, N.Y. Times, Dec. 12, 1991, at A18, col. 1; *Deal is Done, supra* note 7, at 51, col. 1.

305. *See* Greenhouse, *supra* note 304, at A18, col. 1; *Hollow Victory for Britain as it Launches Two-Tier Europe*, Fin. Times, Dec. 12, 1991, at 3, col. 1; Lewis, *Still Little England?*, N.Y. Times, Dec. 16, 1991, at A19, col. 2; *Opting Out Will Never Be An Option*, The Independent, Dec. 15, 1991, Bus. Sec., at 10, *available in* LEXIS, Europe Library, INDPNT File.

306. Lewis, *supra* note 305, at A19, col. 2.

307. *See* Atkins, *Ashdown Says UK is Condemned to 'Semi-Detached' Status*, Fin. Times, Dec. 12, 1991, at 3, col. 6.

308. *See id.*

309. *See* Greenhouse, *supra* note 304, at A18, col. 1.

rope's capital stock and production potential . . . grow[ing] faster than before."[310]

C. *Pros and Cons of EMU*

The European Commission issued a report in October 1990 on the advantages and disadvantages of EMU for the Community.[311] The advantages include: stable exchange rates; a savings of fifteen to twenty billion ECUs (as a result of elimination of transaction costs among the member currencies); permanent price stability; stronger growth within the EC; and a strengthening of the Community's economic standing internationally.[312] Fundamental problems still exist in the plans for EMU, however. First, convergence of economic and monetary policies will take time.[313] Most Member States only began convergence in earnest at the end of 1991.[314] Some countries which currently enjoy low inflation fear the higher inflation that will accompany convergence, and actually tend to diverge instead of converge "in terms of inflation and the public debt."[315] Also, EMU did not initially have the full support of all Member States—most notably that of the United Kingdom.[316] Now that John Major is Prime Minister of the United Kingdom, however, the government is more solidly behind EMU.[317] The Maastricht Treaty has garnered solid support for EMU,[318] but the position of the United Kingdom is still uncertain.[319]

Second, the creation of the ECB will cause numerous problems. Member States will have to sacrifice sovereignty over monetary policy to the independent ECB as their Central Banks become mere branches of the ECB.[320] Losing the ability to issue currency will have large fiscal implications, perhaps causing budgetary problems for Member States.[321] The Delors Committee recognized these potential budgetary problems but hoped there would be "a tight system of multilateral surveillance or peer

310. *Id.* (quoting Paul Horne, Chief European Economist for Smith Barney).

311. *See Financial Services, supra* note 241, § 5.7.1.

312. *See id.*

313. *See EMU: Convergence is not Built in a Day,* Eur. Rep., July 6, 1991, § II, at 2, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *Built in a Day*].

314. *See EMU: EEC Ministers Achieve Progress on Economic Convergence but Still Split on Stage Two,* Eur. Rep., May 15, 1991, § II, at 3, *available in* LEXIS, Europe Library, EURRPT File [hereinafter *Split on Stage Two*]. As of July 1991, only Italy and Greece had attempted to accomplish any real convergence. *See Built in a Day, supra* note 313, at 2.

315. *Built in a Day, supra* note 313, at 2.

316. *See Economic and Monetary Union: UK Seeks Greater Involvement in European Integration,* Monthly Rep. on Eur., Mar., 1991, § III, at 7, *available in* LEXIS, Europe Library, MONREP File.

317. *See id.*

318. *See Deal is Done, supra* note 7, at 51, col. 1.

319. For a discussion of the opt-out clause, see *supra* notes 304-08 and accompanying text.

320. *See* Lomax, *supra* note 224, at 77; *11 Sided-Agreement, supra* note 280, at 2.

321. *See* Lomax, *supra* note 224, at 78.

pressure to keep national budget policies moving in the same direction."[322]

Third, the proposed ECB is to be independent from Member States and from EC institutions, so accountability may be a problem.[323] The ECB cannot be allowed to act entirely independent from government because it could potentially create and implement disastrous policies if left unchecked. The United Kingdom in particular found democratic accountability wanting in the Delors Report proposal.[324] Germany, on the other hand, found democratic control assured because the ECB will come about through democratic agreement and will be provided with a clearly defined mandate.[325]

Fourth, the ECB poses massive administrative problems due to employment and responsibility shifts.[326] Because the ECB will effectively dismantle the existing Central Banks and will assume responsibility for the monetary policy of the entire Community, a large experienced staff will be needed. There will be a corresponding loss of employment and responsibility at each of the existing Central Banks. Moreover, in order to control the external value of the single European currency, the ECB will need to control the monetary reserves of the EC members.[327] This shift in national reserves will again raise administrative problems and sovereignty issues.

Fifth, the ECB's ultimate location will be controversial because it is certain to become the EC financial center.[328] London would be a possible choice to be the center of EC monetary operations because London is currently the European banking center.[329] London's chances for becoming the future site of the ECB may be hurt however, by the confusion surrounding Britain's right to opt out of EMU.[330] Furthermore, London has some stiff competition. Paris has its own serious ambitions as does Frankfurt, which benefits from its position at the center of Europe's most powerful economy.[331]

Finally, the introduction of a single currency for Europe poses national sovereignty problems. Britain in particular resisted the idea of forsaking the pound for a single European currency,[332] and has not yet

322. McCune, *supra* note 287.

323. *See* Ungerer, *supra* note 225, at 14, col. 1.

324. *See id.*

325. *See id.*

326. *See* Lomax, *supra* note 224, at 77.

327. *See id.*

328. *See* 1992, *supra* note 167, at 162-63.

329. *See* Lascelles, *Prospects Look Less Certain*, *supra* note 184, at 35, col. 1; Riley, *Big Three Join Battle for Supremacy*, Fin. Times, July 4, 1991, at III, col. 1.

330. *See* Atkins, *supra* note 307, at 3, col. 6.; Riley, *supra* note 329, at III, col. 1; *see also supra* notes 304-08 and accompanying text (discussion of opt-out provision).

331. *See* Riley, *supra* note 329, at III, col. 1.

332. *See Debate Stage Two*, *supra* note 283, at 2.

totally committed itself to the single currency.[333] Similarly, Germany was not initially receptive to the idea of the ECU becoming the single currency.[334] Indeed, Jacques Delors feared that hesitation might be fatal for EMU, and that his Committee's plan for EMU might go the way of past attempts at economic and monetary union.[335] These differences and fears have been largely stilled, however, by the Treaty of Maastricht.[336] Although the actual imposition of the single currency will probably be difficult, the future of EMU is virtually assured.

CONCLUSION

The recently enacted banking directives and the renewed effort to achieve EMU will help integrate financial services and create a single market in the EC. These directives, however, have many problems which need to be addressed, and still more problems may become apparent after the legislation is fully operational. Despite these probable difficulties, though, the EC will certainly become a major force in the increasingly internationalized financial services market of the future.

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333. See *supra* notes 304-08 and accompanying text, for a discussion of Britain's right under the Maastricht Treaty to opt-out of the single currency.

334. *See id.*

335. *See Hatch an EMU, supra* note 235, at 45, col. 1.

336. For a discussion of the single currency agreed to by the Treaty of Maastricht, see *supra* notes 298-305 and accompanying text.