

# THE EUROPEAN MARKET: CREATING A UNIFIED COMPETITIVE BANKING SYSTEM

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## I. INTRODUCTION

The creation of a single market among countries, which just over fifty years ago were engaged in one of the bloodiest wars in history, is one of the greatest experiments ever. The movement toward a single market in Europe has undergone countless changes since the creation of the European Coal and Steel Community (ECSC) in 1951.<sup>1</sup> Today, with the exception of some proposals which did not enter into force as scheduled on January 1, 1993,<sup>2</sup> a single financial services market in Europe appears near completion.<sup>3</sup>

The purpose of this Comment is to provide an overview of the movement toward a single market in Europe and the creation of a unified competitive banking system among the European Union member states.<sup>4</sup> This Comment will trace the evolution of the European Union and will examine its progress towards harmonization. Next, this Comment will discuss the mechanisms for achieving a unified banking system in Europe, and the regulation of that system. Finally, this Comment will evaluate the impact which these measures are having and will likely have on non-European Union banks.

## II. OVERVIEW OF THE EUROPEAN UNION

### A. History

Following the devastation of World War II European political leaders began envisioning an integrated Europe for two

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1. Treaty Establishing the European Coal and Steel Community, April 18, 1951, 261 U.N.T.S. 140, as amended, *Treaties Establishing the European Communities* (EC Official Pub. Office, 1987) [hereinafter ECSC].

2. PAOLO CLAROTTI, E.C. HARMONIZATION IN THE BANKING SECTOR 1 (1992).

3. *Id.*

4. *Id.* Currently there are fifteen members of the European Union: Belgium, Denmark, the Federal Republic of Germany, France, Great Britain, Greece, Ireland, Italy, Luxembourg, Portugal, Spain, and the Netherlands.

reasons.<sup>5</sup> First, World War II left Europe in economic disarray.<sup>6</sup> Second, with the growing political power of both the United States and the Soviet Union, Europe was left in a political vacuum, leaving the smaller countries of Europe in an uncertain and potentially vulnerable position.<sup>7</sup>

With the passing of World War II, Europe began the evolution toward a single market. In the fifty-one years following World War II, Europe has achieved remarkable results in both economic and legal integration.<sup>8</sup> From the ECSC in 1951,<sup>9</sup> which united Germany and France with regard to the regulation of coal and steel, to the Treaty of Rome,<sup>10</sup> which worked to bring about common external trade policies and a single internal market, Europe appears to be close to attaining a unified market.

### *B. European Community Law and a Unified Market Today*

Although the objective of the EEC Treaty to bring about a common market in which goods, services, and capital could move freely among members states failed, the desire to create a common market continued among leaders in Europe.<sup>11</sup> In 1985, the European Commission issued the White Paper containing approximately twenty pieces of proposed legislation which needed to be passed to ensure the goals of financial unification would be met.<sup>12</sup> The White Paper encouraged greater liberalization of capital movements<sup>13</sup> for three reasons: to enable access to efficient financial services; to

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5. GEORGE A. BERMAN ET AL; CASES AND MATERIALS ON EUROPEAN COMMUNITY LAW 3 (1993).

6. *Id.* at 3.

7. *Id.*

8. *Id.*

9. ECSC, *supra* note 1, at 140.

10. Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11 [hereinafter EEC Treaty].

11. Farzaneh Marvasti, *The Single European Act: A Profitable Perspective Not Only for the European Community*, 20 SW. U. L. REV. 175, 175 (1991).

12. CLAROTTI, *supra* note 2, at 1.

13. Completing the Internal Market: White Paper from the Commission to the European Council, COM (85)310 (1985) [hereinafter White Paper].

achieve monetary stability; and to promote an optimal allocation of European savings.<sup>14</sup>

As a result of the White Paper, the Single European Act (SEA) was signed in 1986 by all twelve member states.<sup>15</sup> The significance of the SEA is its focus on creating a single internal market to eliminate all legal, economic, and technical barriers to trade between member states.<sup>16</sup> The SEA combines 320 million people in twelve countries, making it the largest market of all, and enables the member states to compete with the United States and Japan.<sup>17</sup> Although the deadline of January 1, 1993, has passed, it appears that the ambitious program set forth in the SEA will soon be met.<sup>18</sup>

Following the passage of the SEA, a committee of central bank directors and monetary experts produced a report which outlined the essential features of the European Monetary Union (EMU).<sup>19</sup> In December 1991, the European Council reached a final agreement on the EMU at Maastricht.<sup>20</sup> The resulting agreement imposed a commitment on member states to bring about a convergence of monetary policies while at the same time reducing deficit spending and inflation.<sup>21</sup>

The criteria set forth for the EMU included: the creation of the European Monetary Institute in 1994 to coordinate the activities of central banks and to make recommendations on general monetary policies; the requirement that member states without central banks create them; the elimination of excessive deficits among member states; and plans for total monetary unification.<sup>22</sup> Moreover, the plan for the EMU provided that in 1996 the European Council would decide whether to begin the third stage of creating a European System of Central Banks (ESCB) in 1997. The ESCB system is

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14. *Id.* § 124-27.

15. Single European Act, 30 O.J. Eur. Comm. (No. L 169) (1987) [hereinafter SEA].

16. *Id.* art. 8.

17. SEA, *supra* note 15, at 183.

18. CLAROTTI, *supra* note 2, at 1.

19. BERMANN, *supra* note 5, at 17.

20. *Id.*

21. *Id.*

22. *Id.*

analogous to the United States Federal Reserve System, with a European Central Bank (ECB) at its core.<sup>23</sup> In the final EMU stage, national currencies would be replaced by a single currency.<sup>24</sup> With the emergence of the EMU much legislation has been passed through directives.<sup>25</sup> These directives have had a profound effect on the regulation of banking in Europe, as well as other financial service areas of the economy. These directives have resulted in the creation of an integrated European banking system.<sup>26</sup>

### III. DIRECTIVES AND BANKING

#### A. *The Foundation for a Unified Competitive System*

Harmonization in the banking sector has come about in Europe through a series of directives which are the foundation for the single market in financial services.<sup>27</sup> The most significant directives which have been passed by the Council are the Freedom of Capital Movements Directive,<sup>28</sup> the First Banking Directive,<sup>29</sup> and the Second Banking Co-ordination Directive.<sup>30</sup> While other important directives have been passed,<sup>31</sup> these three directives have been the most important because they establish the foundation for the single market in the financial services sector.<sup>32</sup>

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23. BERMANN, *supra* note 5, at 17.

24. Due to concerns expressed by the UK, the Maastricht European Council decided that the UK could opt out of the monetary control exercised by the European Central Bank and out of the single currency system for as long as it wished, but without prejudice to its joining at a later date. *Id.*

25. See EEC Treaty, *supra* note 10, art. 189. Directives are one of the three types of legally binding acts which may be passed by Council. Directives shall bind any Member State to which they are addressed, as to the result to be achieved, while leaving to domestic agencies a competence as to form and means. *Id.*

26. See *Banking Integration in the European Economic Community: Impact on the Eurodollar Market*, 3 TRANSNATL LAW 185 (1990) [hereinafter *Banking Integration*].

27. See CLAROTTI, *supra* note 2.

28. Council Directive 88/361/EEC, 1988 O.J. (386) 1 (establishing the free movement of capital within the European Community).

29. Council Directive 77/780/EEC, 1977 O.J. (332) 30.

30. Council Directive 89/646/EEC, 1989 O.J. (386) 1.

31. See *infra* p. 16.

32. CLAROTTI, *supra* note 2, at 1.

### 1. The Freedom of Capital Movements Directive

The Freedom of Capital Movements Directive was passed in 1988, and mandates the abolition of all restrictions on capital movements between member states before July 1, 1990.<sup>33</sup> It allows the free transfer of capital for any purpose, thus permitting cross-border banking.<sup>34</sup> The Freedom of Capital Movements Directive serves two other key purposes. First, its implementation date has been used as a mark to begin the first stage of the EMU. Moreover, the directive helps to create a sense of community because individuals and enterprises can transfer their funds freely throughout the member states.<sup>35</sup>

### 2. The First Banking Directive

Although the First Banking Directive was passed before the SEA established minimum harmonization and mutual recognition as its objectives, it is key to understanding later developments.<sup>36</sup>

The First Banking Directive accomplished three objectives.

- a. It cleared away most of the obstacles to the freedom of establishment of banks and other credit institutions.
- b. It laid down common standards for the granting of banking licenses.
- c. It introduced the basic principle of the cooperation between the supervisory authorities of different member states (by setting up the banking Advisory Committee).<sup>37</sup>

Despite accomplishing these goals, several obstacles had to be eliminated before a truly unified European Community Banking Market could be established. First, a bank or other credit institution

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33. Council Directive 88/361, *supra* note 28. This mandate provides an exemption for Ireland and Spain which may keep certain restrictions until 1992, and Greece and Portugal which may maintain their restrictions until 1995.

34. *Id.* art. 4. Member states may verify the nature of capital movements for statistical and tax administration purposes, as well as for the supervision of financial institutions. *Id.*

35. BERMANN, *supra* note 5, at 616.

36. David H. Lui, *A Bankers Guide to the European Community's 1992 Program*, 107 BANKING L.J. 148, 156 (1990).

37. See CLAROTTI, *supra* note 2, at 2.

required authorizations from eleven different supervisors to establish branches in all member states.<sup>38</sup> Second, banking services could not be provided in all member states because permissible banking activities were not defined.<sup>39</sup> Thus, banks were required to conform with activities approved by host<sup>40</sup> member states.<sup>41</sup> The final obstacle was that a branch in a host country was required to keep its funds separate from its parent's funds.<sup>42</sup> The result was that a foreign branch was required to have its own dedicated capital, thus imposing a greater barrier to operating in foreign countries.<sup>43</sup>

The First Banking Directive failed because it sought to centralize the supervision of banking activities.<sup>44</sup> Member states realized that this directive would prevent uniformity within a reasonable period of time<sup>45</sup> because regulatory policies of different member states reflect different factors such as "geographic location, expertise of banking professionals, and the relationships between the central banks and their respective banking systems."<sup>46</sup>

### 3. Second Banking Co-ordination Directive

In light of the obstacles under the First Banking Directive, a Second Banking Co-ordination Directive was passed by the Council in 1989.<sup>47</sup> This directive creates a single banking license which is

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38. Council Directive 77/780/EEC, *supra* note 29, art. 3.

39. Lui, *supra* note 36, at 157.

40. Under the First Banking Directive, banking regulation was to be carried out by the host country. Host country is defined by the Second Banking Directive as the Member State in which a credit institution has a branch or where it provides services. Council Directive 89/646/EEC, *supra* note 30, art. 1. Thus, a foreign bank was to be regulated by the country in which it was in. This contrasts with the Second Banking Directive which established that a foreign bank would be regulated by its Home Country. The Second Banking Directive defines home Member State as the country in which a credit institution has been authorized. *Id.* Thus a foreign bank would be regulated by its country of origin, no matter where it was located in the Common Market. Lui, *supra* note 36, at 156.

41. Lui, *supra* note 36, at 157.

42. Council Directive 77/780/EEC, *supra* note 29, art. 3.

43. Lui, *supra* note 36, at 157.

44. *Banking Integration*, *supra* note 26, at 188.

45. *Id.* at 188.

46. *Id.* at 187-88.

47. Council Directive 89/646/EEC, *supra* note 30; see *Banking Integration*, *supra* note 26, at 187.

valid throughout all of the member states.<sup>48</sup> This approach allows EEC based banks to provide financial services throughout the Community, and promotes growth and efficiency in the banking industry. Thus, EEC banks should be stronger competitors within the EEC and throughout the world.<sup>49</sup> The Second Banking Directive sets forth the general rule that each Member State must honor the banking laws and supervisory practices of all other member states.<sup>50</sup> Therefore, member states will be required to accept branches from other member states without the need for applications.<sup>51</sup>

Beyond establishing the principal of mutual recognition,<sup>52</sup> the Second Banking Directive defines the activities which are subject to mutual recognition.<sup>53</sup> These activities include:

1. Acceptance of deposits and other repayable funds from the public.<sup>54</sup>
2. Lending.<sup>55</sup>
3. Financial leasing.
4. Money transmission services.
5. Issuing and administering means of payment (e.g. credit cards, travelers' 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) financial futures and options;

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48. CLAROTTI, *supra* note 2, at 3.

49. *Banking Integration*, *supra* note 26, at 187.

50. *Id.* at 188-89.

51. CLAROTTI, *supra* note 2, at 1.

52. E. Waide Warner, *A Mutual Recognition and Cross Border Financial Services in the European Community*, 55 L. & CONTEMP. PROBS. 7 (1992).

53. Council Directive 89/646/EEC, *supra* note 30, at Annex.

54. *Id.* This activity may only be performed by banks, not non banks. All of the other activities listed may also be performed by non banks. See CLAROTTI, *supra* note 2, at 3.

55. Council Directive 89/646/EEC, *supra* note 30, at Annex (including consumer credit, mortgage credit, and financing of commercial transactions).

- (d) exchange and interest rate instruments; and
- (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, plus advice and services relating to mergers and the purchase of undertakings.
- 10. Money brokering.
- 11. Portfolio management and advice.
- 12. Safekeeping and administration of securities.
- 13. Credit reference services.
- 14. Safe custody services.<sup>56</sup>

If a bank is authorized to engage in these activities under the terms of its home member state license, it is permitted to engage in them in all of the other member states.<sup>57</sup> Although this directive does not impose the universal bank as a model,<sup>58</sup> for banks to be competitive, member states will adopt the most favorable banking measures.<sup>59</sup> To eliminate the initial competitive advantage enjoyed by banks from member states which currently permit all of the activities in the annex, member states will eventually allow all of these activities.<sup>60</sup> This movement to deregulate banking activities is commonly referred to as "the race for the bottom."<sup>61</sup> This competitive system creates a unified banking system which is competitive both within the European Union and the world.<sup>62</sup>

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56. Council Directive 89/646/EEC, *supra* note 30, at Annex.

57. CLAROTTI, *supra* note 2, at 3.

58. A universal bank is a bank which offers a variety of financial services including those listed in the Council Directive, *supra* note 28, at Annex. While the Directive allows the universal bank, it does not impose it, and allows it to compete with other models such as specialized banks and multifunctional banks. CLAROTTI, *supra* note 2, at 3.

59. *Banking Integration*, *supra* note 26, at 192.

60. *Id.*

61. *Id.*

62. *See Warner*, *supra* note 52, at 26.

## B. Regulating a Unified European Banking System

As discussed previously, the Second Banking Directive establishes a single license approach,<sup>63</sup> which authorizes a bank or credit institution to supply services throughout the European Community through either branches or cross-border services.<sup>64</sup> In order to obtain a unified banking system, the Second Banking Directive and other related directives have established standards which regulate the adequacy of a branch's administrative structure and its financial situation.<sup>65</sup> Thus, a minimum harmonized supervisory standard for credit institutions has been created.<sup>66</sup>

### 1. Second Banking Directive and Minimum Harmonization

The Second Banking Directive establishes several provisions for minimum harmonization which must be established by banks for mutual recognition and the issuance of the Single Banking License.<sup>67</sup> First, a minimum capital base is required before a bank is permitted to receive authorization to conduct business in another Member State.<sup>68</sup> The minimum capital base requirement provides that authorities shall not grant authorization in cases where initial capital is less than five million European Currency Units (ECU).<sup>69</sup> Although this provision does not preclude member states from applying higher minimum capital levels for its own institutions, it is unlikely that member states will do so because of competition against foreign institutions.<sup>70</sup> This is an example of the "race to the bottom,"<sup>71</sup> and how the unified banking system will enjoy stability while maintaining intra-community competition.

Second, the Second Banking Directive requires the supervision of major shareholders as a prerequisite to receipt of authorization to do

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63. BERMANN, *supra* note 5, at 621.

64. CLAROTTI, *supra* note 2, at 3.

65. BERMANN, *supra* note 5, at 621.

66. Warner, *supra* note 52, at 12.

67. Lui, *supra* note 36, at 157.

68. Council Directive 89/646/EEC, *supra* note 30, art. 4.

69. *Id.* art. 4.

70. *Id.* art. 4; see Lui, *supra* note 36, at 158.

71. Lui, *supra* note 36, at 158.

business in another Member State.<sup>72</sup> This provision requires disclosing the identity and the amount of holdings of any major shareholders who own or control greater than ten percent of the bank, before authorization is granted.<sup>73</sup> If the authorities deem that these shareholders or members are not suitable, they may refuse authorization.<sup>74</sup> Competition prevents member states from enforcing more stringent levels of control on local banks because foreign credit institutions are not required to comply with local rules that are more rigid than their own.<sup>75</sup>

Third, the size of participation in non-credit institutions by credit institutions is limited for purposes of stability.<sup>76</sup> This limitation provides that credit institutions are limited to qualified holdings of no more than 15% of that institution's own funds in a single non-financial undertaking.<sup>77</sup> Moreover, financial institution's total participation in non-financial undertakings may not exceed 60% of that firm's own funds.<sup>78</sup>

Fourth, the Second Banking Directive requires Home States to have sound administrative and accounting procedures, as well as adequate internal control mechanisms.<sup>79</sup>

Fifth, under the Second Banking Directive, a minimum level of capital is required for new banks.<sup>80</sup> This provision differs from the First Banking Directive<sup>81</sup> because it eliminates the requirement that branches operating in a separate Member State meet separate minimum fund requirements.<sup>82</sup>

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72. Council Directive 89/646/EEC, *supra* note 30, art. 5.

73. *Id.* art. 5.

74. *Id.*

75. *Id.* art. 4; *see* Lui, *supra* note 36, at 158.

76. Council Directive 89/646/EEC, *supra* note 30, art. 12.

77. *Id.* art. 12.

78. *Id.*

79. *Id.* art. 13.

80. Council Directive, *supra* note 30, art. 4; *see* Lui, *supra* note 36, at 160.

81. *See* Council Directive 77/780/EEC, *supra* note 29.

82. *See* Council Directive 77/780/EEC, *supra* note 29; Council Directive 89/646/EEC, *supra* note 30.

#### IV. SECOND BANKING DIRECTIVE AND HOST COUNTRY CONTROL

While the Second Banking Directive establishes the regulations for minimal harmonization among member states,<sup>83</sup> Host member states will retain primary responsibility for other regulations.<sup>84</sup> The areas which host member states will likely retain regulatory power include supervision of liquidity and monetary policy.<sup>85</sup> Moreover, Host Countries may also apply additional restrictions based on general public interest.<sup>86</sup>

#### V. OTHER RELATED EUROPEAN COMMUNITY LEGISLATION

Although the Second Banking Directive provides a wide range of provisions to ensure the protection of depositors,<sup>87</sup> other legislation was required before mutual recognition and Home Country control would take effect.<sup>88</sup> Although the required date for the implementation of these measures, January 1, 1993 has passed, the major legislation required for setting up the single European market in financial services is in place.<sup>89</sup> The purpose of this additional legislation is to ensure the solvency of European banks, and protection for depositors.<sup>90</sup>

##### A. Own Funds

A directive on own funds was approved in April, 1989.<sup>91</sup> The purpose of this legislation is to harmonize the meaning of capital.<sup>92</sup> The definition of "own funds" is a credit institution's own capital,<sup>93</sup>

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83. Council Directive 89/646/EEC, *supra* note 30, art. 4, 5, 12 and 13.

84. Lui, *supra* note 36, at 161.

85. *Id.*

86. *Id.* at 161-62.

87. *Id.* at 162.

88. *Id.* at 162. See Council Directive 88/361/EEC, *supra* note 28, art. 22.

89. CLAROTTI, *supra* note 2, at 1, 6. The major legislation which is currently in place includes, the Freedom of Capital Movements Council Directive, *supra* note 28; the Second Banking Directive, Council Directive 89/646/EEC, *supra* note 30; the directive defining funds, Council Directive 89/299/EEC, 1989 O.J. (L 124/16); the Solvency Ratio Directive, Council Directive 89/647/EEC, 1989 O.J. (L 386/14); the Large Exposure Directive, Council Directive 92/121/EEC, 1993 O.J. (L 29/1).

90. Lui, *supra* note 36, at 162.

91. Council Directive 89/299/EEC, 1989 O.J. (L 124/16).

92. *Id.*; see Lui, *supra* note 36, at 162.

93. Council Directive 89/299/EEC, *supra* note 89; see Lui, *supra* note 36, at 162.

which is divided for assessment by distinguishing between internal and external elements.<sup>94</sup> The internal element is primary capital and is comprised of paid up equity, share capital, share/premium accounts, and reserves.<sup>95</sup> External elements are funds which are not exclusively controlled by the bank.<sup>96</sup> External funds include subordinated debt and redeemable shares.<sup>97</sup> Under this directive, external elements must not exceed 50% of the internal elements.<sup>98</sup> Thus, the minimum level of capital which a bank must have is maintained beyond capital which the bank does not have sole control over.

### B. Solvency Ratios

A directive on solvency ratios was also adopted in December, 1989<sup>99</sup> to limit the amount of exposure to a banks own funds.<sup>100</sup> Limiting exposure is accomplished by establishing a minimum level, whereby a bank's own funds must be at least eight percent of all its risk based assets, including off balance sheet items.<sup>101</sup> This percentage is adjusted to reflect varying degrees of risk with the level of a bank's own funds which are available to meet such risks.<sup>102</sup> The level of a bank's own funds thus reflects the amount of risk which the banks' assets are exposed to.<sup>103</sup>

### C. Large Exposures

A directive regulating the level of large exposure a credit institution may have was adopted on December 21, 1992.<sup>104</sup> This

94. Council Directive 89/299/EEC, *supra* note 89; *see* Lui, *supra* note 36, at 162.

95. Council Directive 89/647/EEC, *supra* note 89; *see* Lui, *supra* note 36, at 163.

96. *Id.*

97. *Id.*

98. *Id.*

99. Council Directive 89/647, 1989 O.J. (L 386/14); *see* Lui, *supra* note 36, at 163.

100. CLAROTTI, *supra* note 2, at 4.

101. Lui, *supra* note 36, at 162.

102. CLAROTTI, *supra* note 2, at 4. For example, governments of OECD countries are considered as having zero percent risk; banks represent for other banks (always within OECD) a risk of 20 percent; and residential mortgages represent a risk of fifty percent. All the other risks, namely all the loans to commercial and industrial companies, have a weighting of 100 percent. *Id.* at 4-5.

103. *See* Lui, *supra* note 36, at 162.

104. Council Directive 92/121, 1993 O.J. (L 29/1).

directive limits a credit institution's exposure to a particular client or group of connected clients.<sup>105</sup> Exposure is considered large, and thus prohibited, when its value exceeds ten percent of the institutions own funds.<sup>106</sup> Moreover, a credit institution's total level of large exposure is limited to 25 percent of the institution's own funds.<sup>107</sup> The result of this directive, like the others, is to ensure competition among credit institutions while protecting depositors.

#### D. Deposit Insurance

A system for establishing a minimum level of deposit insurance for credit institutions has been recommended by the Commission, but no final directive has been passed.<sup>108</sup> The recommendation provides that deposit insurance should be mandatory among Member State credit institutions, but leaves each Member State free to determine whether these systems should be publicly or privately organized.<sup>109</sup> While a minimum level of deposit insurance has not yet been established, the member states are discussing a base level of 15,000 ECUs.<sup>110</sup>

#### E. Consolidated Supervision

The issue of regulating credit institutions on a consolidated basis was dealt with in the 1992 directive on the rules on the annual and consolidated accounts of banks.<sup>111</sup> This directive broadens the scope of the 1986 directive<sup>112</sup> on the rules for regulating banks on a consolidated basis.<sup>113</sup> The 1992 directive expands which institutions are regulated on a consolidated basis from institutions where the parent company is a credit institution,<sup>114</sup> to groups where the parent company is a financial

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105. *Id.*

106. Council Directive 92/121, *supra* note 104; see CLAROTTI, *supra* note 3, at 5.

107. Council Directive 92/121, *supra* note 104. see CLAROTTI, *supra* note 2, at 5.

108. CLAROTTI, *supra* note 2, at 6.

109. *Id.* at 6. Currently only four member states have followed this recommendation and six others already have a deposit insurance scheme.

110. *Id.* at 6 (stating that coverage should focus on the depositors and not the deposits).

111. Council Directive, 92/30/EEC, 1992 O.J. (L 110/52); see CLAROTTI, *supra* note 2, at 6.

112. Council Directive, 86/635/EEC, 1986 O.J. (L 372/1).

113. See CLAROTTI, *supra* note 2, at 6.

114. Council Directive 92/30, *supra* note 111.

holding company with financial companies and primary credit institutions as subsidiaries.<sup>115</sup> Therefore, supervisors are better able to control the overall solvency and risk exposures of a related group of companies. This is accomplished by preventing these related companies from working around the minimum requirements. Hence, related companies will no longer be permitted to work together to bolster figures.

#### F. Capital Adequacy

The Capital Adequacy Directive (CAD) was proposed by the Commission in 1990, and relates to the field of securities market regulation.<sup>116</sup> Although it did not take effect until January 1, 1996, this directive applies to firms which participate in the trading of securities.<sup>117</sup> Moreover, it provides for a minimum capital requirement against a particular securities position.<sup>118</sup> The CAD provides for the same requirements among banks and non-banks in the securities field, thus creating a level playing field which enables banks and non-banks to compete equally.<sup>119</sup> This measure also establishes minimum standards to protect institutions from instability created by market risk.

#### G. Investment Services Directive

The Investment Services Directive<sup>120</sup> (ISD) provides the framework for establishing a European Passport in the securities field and took effect on January 1, 1996.<sup>121</sup> The ISD allows banks to participate in trading securities under the Second Banking Directive.<sup>122</sup> However, because banks will gain a European banking license under the Second Banking Directive, only three provisions of the ISD may apply to credit institutions.<sup>123</sup>

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115. CLAROTTI, *supra* note 2, at 6; see Council Directive, *supra* note 111.

116. Council Directive, C152/6, 1990 O.J. (revised C50/5, 1992 O.J.).

117. Council Directive C152/6, *supra* note 116; see CLAROTTI, *supra* note 2, at 7.

118. Council Directive C152/6, *supra* note 116; see CLAROTTI, *supra* note 2, at 7.

119. CLAROTTI, *supra* note 2, at 7.

120. Council Directive, 93/22/EEC, 1993 O.J.

121. Council Directive C152/6, *supra* note 116; see CLAROTTI, *supra* note 2, at 8.

122. Council Directive 89/646/EEC, *supra* note 30, at Annex; see Clarotti, *supra* note 2, at 10.

123. CLAROTTI, *supra* note 2, at 10.

1. Investment firms must comply with the proposed Capital Adequacy Directive;<sup>124</sup>
2. Member states shall draw up prudential rules to be observed by investment firms;<sup>125</sup> and
3. Investment firms may have access to stock exchanges and organized securities markets.<sup>126</sup>

The CAD affects banks which participate in the trading of securities in three ways.<sup>127</sup> First, it establishes minimum capital levels for investment firms, including banks which participate in various investment activities.<sup>128</sup> These levels range from 50,000 ECUs to 73,000 ECUs, depending on the activity.<sup>129</sup> This standard differs from the requirement of five million ECUs under the Second Banking Coordination Directive because investment firms participate in a narrower range of activities, thus requiring less capital.<sup>130</sup> Second, the CAD defines the calculation of capital requirements for investment firms and banks with regard to their trading businesses.<sup>131</sup> Third, the CAD establishes definitions for banks and investment firms.<sup>132</sup> Because the definitions of capital for banks and investment firms were originally different, a common definition of capital for banks and non-banks was established.<sup>133</sup> Again, the directive puts banks on a level playing field with non-banks.<sup>134</sup>

The ISD is also important because it requires Home States to draw up mandatory prudential rules for firms authorized within those

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124. Council Directive C152/6, *supra* note 116. CLAROTTI, *supra* note 2, at 10. The CAD provides minimum capital requirements for both investment firms and for credit institutions. These minimum capital requirements are measured against a particular securities position and are basically the same for both banks and non banks. *Id.* at 7.

125. Council Directive C152/6, *supra* note 116; *see* CLAROTTI, *supra* note 2, at 10.

126. CLAROTTI, *supra* note 2, at 10.

127. *Id.* at 12.

128. *Id.*

129. *Id.*

130. *Id.*

131. CLAROTTI, *supra* note 2, at 12.

132. *Id.* at 13.

133. *Id.*

134. *Id.*

states.<sup>135</sup> Prudential rules are basic rules of conduct and require as a prerequisite to obtaining authorization that firms:

1. have sound administrative and accounting procedures and adequate internal control mechanisms;
2. make adequate arrangements for securities or money belonging to investors so that their ownership rights or claims are protected, and to prevent the firm from using the securities or money for its own account (banks can use money for their own account);
3. are either members of a compensation scheme effective on bankruptcy or default of the firm, or make individual arrangements giving equivalent protection to investors.
4. provide their regulators with such information on request and at such intervals as requested (but not less than quarterly) so that the firm's financial soundness and adequacy or provisions for market risk can be assessed;
5. arrange for adequate records to be kept and retained for a prescribed period, where such records relate to executed transaction (and are of a type sufficient to allow Home States to monitor prudential rules, including rules about market risk); and
6. are structured and organized in such a way as to minimize the risk of clients' interests being prejudiced by conflicts of interests between the firm, its clients, and another.<sup>136</sup>

Moreover, the ISD will allow banks which participate in investment activities to become members of stock exchanges in other

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135. *Id.* at 10.

136. CLAROTTI, *supra* note 2, at 10.

member states without setting up subsidiaries in those countries.<sup>137</sup> Banks will be on a level playing field with investment firms, thus creating more competition in the field of investment services.

#### *H. Prevention of Money Laundering*

Another important piece of legislation is the Directive on the Prevention of Money Laundering which was approved by the Council on June 10, 1991.<sup>138</sup> It prevents abuses in the freedom of the movement of capitals between member states because of drug and other criminally related activities.<sup>139</sup> This directive requires:

1. financial institutions must require identification of their customers (and beneficial owners) when entering into business relations or when conducting one-off transactions over specified thresholds (15,000 ECUs);
2. financial institutions must exercise due diligence in examining unusual transactions;
3. financial institutions must report suspicious transactions to the competent authorities for combating money laundering, and to that extent, bank secrecy has to be lifted;
4. financial institutions are required to establish internal procedures against money laundering, including suitable staff training programs.<sup>140</sup>

These measures have resulted in the standardization of Member State banking laws.<sup>141</sup> The minimum harmonization of supervision and the regulatory standards serve several purposes. First, they provide the basic framework under which mutual recognition can operate.<sup>142</sup> Second, these measures operate as a

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137. *Id.* at 11.

138. Council Directive, 91/308, 1991 O.J. (L 164) 77.

139. CLAROTTI, *supra* note 2, at 15.

140. *Id.*

141. Warner, *supra* note 52, at 13.

142. *Id.*

safeguard to ensure that in the pursuit of a competitive advantage, banks will not race to the bottom in an unrestricted manner. Moreover, these regulations ensure that banks will enjoy cost savings<sup>143</sup> because banks are only required to meet one set of regulations rather than multiple Member State regulations.<sup>144</sup> Through these measures, credit institutions within the European Community will enjoy equality of competition and the stability of a stable banking system that protects investors.<sup>145</sup> While not all of these directives have been approved, those already in place provide a single European market for financial services.<sup>146</sup>

## VI. THE EUROPEAN MARKET AND NON-EEC BANKS

### A. *From Reciprocity to National Treatment*

As discussed previously, the Second Banking Directive establishes a European Passport which allows banks of the different member states to operate freely throughout the European Community.<sup>147</sup> The Second Banking Directive will also create benefits for non-EEC banks.<sup>148</sup>

The benefits which non-EEC banks will enjoy vary, and have been a source of controversy in the area of which non-EEC banks will enjoy the benefits of a European Passport.<sup>149</sup> First, under the Second Banking Directive, subsidiaries of non-EEC banks which are already established in a Member State will be able to operate the

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143. *Banking Integration*, *supra* note 26, at 195.

144. *Id.*

145. See CLAROTTI, *supra* note 2; Lui, *supra* note 36.

146. See CLAROTTI, *supra* note 2, at 17.

147. See Council Directive, *supra* note 30.

148. See *Creation of a European Financial Area*, 36 EUR. ECON. 35 (1988); *Banking Integration*, *supra* note 26, at 195. The Communities financial market will be characterized:

1. by the freedom of establishment and the freedom to provide services within the Community;
2. by coordinated rules relating to the access to or exercise of the profession of financial intermediaries, which are intended to ensure that all users of financial services enjoy the same protection;
3. by coordinated systems of surveillance and control, designed to ensure the stability of the financial system.

*Id.*

149. Lui, *supra* note 36, at 160-61.

same as any other EEC bank.<sup>150</sup> However, branches of non-EEC banks will not have the benefit of operating under a European passport,<sup>151</sup> and will thus be regulated and authorized separately by each of the EEC member states. This is because branches do not have to meet all of the regulatory requirements of subsidiaries.<sup>152</sup>

Second, the guidelines for the regulation of non-EEC banks which are not currently operating in Europe are also contained in the Second Banking Directive.<sup>153</sup> In the initial version of the Directive, the Commission required that without reciprocity of banking laws between the non-EEC banks and the European Community, the Commission could deny non-EEC banks access to the European Community.<sup>154</sup> This requirement was abandoned in 1989.<sup>155</sup> Today, there is a revised standard for reviewing whether a non-EEC bank may enjoy the benefits of a European Passport.<sup>156</sup> Rather than allowing a bank to be denied a European Passport because its Home Country does not have reciprocity of banking laws with the European Community, a non-EEC bank may only be denied a European passport if the bank's Home Country discriminates against European banks.<sup>157</sup> In other words, non-EEC credit institutions can only be denied access to the European market if that bank's Home Country does not provide the same competitive opportunities for European credit institutions.<sup>158</sup> "Although the revised standard is vague and [may be] vulnerable to political undercurrents within the Community, [it] provides an anti-discrimination mechanism under which Common Market banks must be treated in the foreign nation the same way the foreign nation would treat a domestic bank."<sup>159</sup>

Prior to the revision of the standard from reciprocity to national treatment, the United States might have been prevented

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150. *Banking Integration*, *supra* note 26, at 196.

151. *Id.*

152. *Id.*

153. Council Directive, *supra* note 30, Title III.

154. Lui, *supra* note 36, at 160.

155. *Id.* at 160-61.

156. *Id.* at 161.

157. Council Directive, *supra* note 30, art. 9.

158. *Id.*

159. Lui, *supra* note 36, at 161.

from enjoying entry into the European market because of barriers between commercial and investment banking.<sup>160</sup> Under the requirement of reciprocity, because European banks would be prohibited from participating in securities activities in the United States, the United States could have been denied access to the European Market.<sup>161</sup> However, under the revised standard, it is likely that United States banks and other non-EEC countries will benefit from the European market as long as they do not participate in discriminatory banking practices. Thus, foreign banks incur fewer costs while operating in Europe because they may establish themselves in any Member State, and set up branches wherever market conditions are favorable.<sup>162</sup> In the end this will create more competition in the banking sector while providing tremendous opportunities for non-EEC banks.<sup>163</sup>

#### *B. Establishing a Bank within the European Economic Community*

Non-EEC countries may also establish companies as well as banks within the EEC.<sup>164</sup> The ability of non-EEC countries to do this is provided for in the Treaty of Rome.

Companies constituted in accordance with the law of a Member State and having their registered office, central management or main establishment within the Community shall, for the purpose of applying the provisions of this chapter, be assimilated to natural persons being nationals of member states. The term Companies shall mean companies under civil or commercial law, including cooperative companies and other legal person under public or private law, with the exception of non-profit companies.<sup>165</sup>

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160. *Id.*; see Glass-Steagall Act. This act prohibits banks from participating in securities transactions.

161. *Id.*

162. *Id.* at 165.

163. Lui, *supra* note 36, at 165.

164. *Single European Act*, *supra* note 11, at 190.

165. EEC Treaty, *supra* note 10, art. 58.

Under the EEC Treaty a foreign company must satisfy two conditions to benefit from the European market and from the rule of non-discrimination.<sup>166</sup> First, the foreign company must form a firm or company under the laws of one of the EEC member states.<sup>167</sup> "The second requirement is that the company [including a foreign bank] must have its registered office, central administration, or principal place of business in the Community."<sup>168</sup> Thus, a foreign bank may be established in the EEC if it is established under the laws of one of the EEC member states, and has its registered office, central administration, or principal place of business in the Community.

These requirements are subject to two different interpretations. The broad interpretation is that these place no impediments on a foreign firm seeking to establish its business in that country.<sup>169</sup> The narrow view is that there are restrictions on third-country companies.<sup>170</sup> Because of these differing views and because the EEC has not acted on this issue, it may be advantageous for a foreign bank to establish itself in a Member State with the broader interpretation of the EEC Treaty as soon as possible.<sup>171</sup>

## VII. CONCLUSION

Since the end of the Second World War, Europe has undergone countless changes which have resulted in the creation of a unified market. While all of the mechanisms for creating a single European market in financial services are not in place, a unified market in Europe has been created,<sup>172</sup> resulting in a unified banking system which is designed to be

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166. *Single European Act*, *supra* note 11, at 191.

167. *Id.*

168. *Id.*

169. *Id.* Examples of countries which follow this view include the United Kingdom, the Netherlands, Spain and Luxembourg. These countries do not require companies to actually conduct business in that member state. *Id.* at 191.

170. *Single European Act*, *supra* note 11, at 191. Examples of countries which place restrictions are Germany and France. Restrictions include the requirement that a foreign company formally register in that country, that it maintain a place of business in that country, and that it conduct genuine business activity in that or another specific Member State before it granted rights under article 58. *Id.*

171. *Id.* at 191-92.

172. CLAROTTI, *supra* note 2, at 1.

both competitive and stable.<sup>173</sup> Moreover, the single European market could provide tremendous opportunities for non-EEC firms.<sup>174</sup> While the end result is still unknown, as the world becomes more global, a unified European investment services market may become a world leader in what is now a competitive global marketplace.

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173. Lui, *supra* note 36, at 165.

174. *Id.*