"THE REGULATION OF FINANCIAL SERVICES IN THE EC, CENTRALIZATION OR NATIONAL AUTONOMY?"

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THE REGULATION OF FINANCIAL SERVICES IN THE EC,

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Abstract

The paper evaluates the regulatory structure of the European financial services industry. It addresses the issue of hierarchy of regulations, that is the eventual need for centralized regulation at the level of a European Central Bank, harmonization of national regulations, competitive (de)regulation or 'host country' regulation. An economic analysis of the sources of market failure concludes that competition between national regulators will benefit consumers of financial services and the efficiency of financial markets in most cases. The paper warns against an abusive interpretation of the 'public interest' criterion which is used too often to restrict competition. Finally, the paper argues that more work remains to be done to achieve open and stable financial markets.

The integration of the financial services industry in Europe is an excellent case of the legal and regulatory issues involved in the creation of a single economic market. As financial services are heavily regulated, the creation of a common market puts into question the need for a centralized regulation, an harmonization of national regulations and an allocation of responsibility among national regulators and supervisors. To refer to a current debate, the issue is to define the 'subsidiarity' role of 'Brussels'[1] in terms of centralization and harmonization. The purpose of the paper is to address these issues as they relate to the financial services industry[2]. The approach that will be taken follows a stream of economic research which analyses the characteristics of financial products, the arguments for potential market failures, the eventual need for public intervention and the issue of hierarchy of regulations. Although primarily related to the integration of European financial markets, the issues are quite broad and relevant for the countries of the European Free Trade Association (EFTA) or of the North American Free Trade Agreement (NAFTA).

The paper is organized as follows. The process of integration of the European

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[1]The generic term 'Brussels' refers to the European Commission, the Council of Ministers and the European Parliament.

[2]Federalism and banking have a long history in the United States. The author was reminded of the success of Aaron Burr in having a Water Bill passed by the New York State Assembly in 1799. Part of the funds were used to create the 'Republican' Manhattan Company Bank, a competitor to Alexander Hamilton's Bank of New York that was controlled by the Federalists. Competition between the two men ended tragically in a duel with the death of Hamilton in 1804 (Wandell-Winnigerode, 1925).

banking industry is summarized in the first section. Banking is chosen because it is the industry where most of the regulatory issues arise. Whenever relevant, comments will be made about investment services (investment banking) and insurance, the two other components of the financial services industry. An economic analysis of the potential sources of market failures calling for public intervention is developed in the second section. Finally, the process of integration is evaluated in light of this economic analysis.

The conclusions of the paper are as follows. There are two main economic reasons to regulate and supervise financial markets : Consumer protection and financial stability (the prevention of 'systemic' risk). A third argument, the abuse of market power, is not discussed because it is not specific to the financial services industry. It is argued that the '1992' principles of national regulations, home country control, mutual recognition and competition among regulators will benefit greatly the efficiency of European financial markets. The paper warns against an abusive use of the 'public interest' principle referred to in various European directives and cases of the European Court of Justice. Too often, this principle is used to restrict competition and prevent the entry of domestic and foreign firms. It is argued that a centralization of regulations is not necessary and that an international harmonization is warranted in two cases only : When consumers of financial services are not able to evaluate risks or when implicit subsidies have to be levelled off. Finally, it is argued that more work remains to be done to ensure that the actions of independent Central banks lead to the stability of financial markets.

SECTION ONE : EUROPEAN FINANCIAL SERVICES

The actions taken by the European Commission and the Council of Ministers can be divided in three time periods : Deregulation of entry on domestic markets from 1957 to 1973, various attempts toward harmonization of regulations from 1973 to 1983 and the recent proposals of freedom of cross-border services, single license, home country control and mutual recognition.

Deregulating Entry 1957-1973

The objective of the 1957 Treaty of Rome was the transformation of highly segmented national markets into a common, single market. This objective was achieved by two types of measures : The recognition of the right of establishment and the coordination of legislation whenever necessary[3]. In June 1973, the Council adopted a directive on the Abolition of Restrictions on Freedom of Establishment and Freedom to Provide Services in Respect of Self-Employed Activities of Banks and other Financial Institutions. This directive applies the national treatment principle[4] which ensures the equal treatment of national firms of member states on entry in domestic markets and on conditions at which

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[3]see Dassesse and Isaacs (1985).

[4]see Walter (1988).

banks are submitted during their activity. It is explicitly recognized that subsidiaries of banks whose parents are established in non-member countries are to be recognized as EC undertakings in every way. Although in 1973 little discrimination remains as to entry in member states, the objective of the initial treaty were still far from being met[5]. International competition through the supply of cross-border services was severely restricted by restrictions on capital flows. Furthermore, there was no coordination of banking supervision, so that banks operating in different countries could be subject to different rules. This leads to the second phase of attempts to harmonize regulations.

1973-1983 Harmonization of Banking Regulations

Progress in harmonization came in 1977 with the adoption of the First Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of Credit Institutions. This directive establishes the principle of home country control. The supervision of credit institutions operating in several Member countries will gradually be shifted from the host to the home country of the parent bank. The 1977 directive is a first step towards the harmonization of regulations. It is a general program which, without providing any specific regulation, calls for further directives. Directives on Supervision of Credit institutions on a Consolidated Basis, on a Uniform Format for Bank Accounts and on Consumer Protection were adopted by 1986. The first banking directive initiated work on Winding up and Liquidation and on the Mortgage Market.

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[5]see Clarotti (1984).

After the 1977 directive, the European banking markets were still fragmented for the following reasons :

.A bank wishing to operate in an other country still had to be authorized by the supervisors of the other country.

.It remained subject to supervision by the host country and its range of activities could be constrained by host country laws.

.In most countries, branches had to be provided with earmarked capital as if it were a new bank.

.Finally, as already mentioned, the supply of international services was severely impaired by the restrictions on capital flows. For instance, the 1984 exports of financial services represented 2 % of output in France and Germany, while the market share of foreign institutions in the same two countries represented 16 % and 4 % respectively.

The task of complete harmonization of national regulations seemed to be a tentacular task which prompted a new approach towards European integration.

The Completion of the Internal Market by 1992 : 1983-1992

Proposed by the Commission at the 1985 Council of Ministers in Milano, a White Paper on the Completion of the Internal Market by 1992 calls for the removal of the physical, technical and fiscal barriers in all industries.

In the context of banking, the White Paper calls for a single banking license, home

country control and mutual recognition. These principles are incorporated in the Second Banking Directive. All credit institutions authorized in one European country will be able to establish or supply financial services without further authorization[6]. The banking model adopted by the EC is the universal banking model. It permits banks to undertake investment banking activities and allows national supervisors to regulate the eventual links between insurance, commercial and industrial groups, and banks. For instance, it is known that the Bank of England would not favor the ownership of banks by industrial groups, while this would be allowed in France or Belgium. The second directive calls for home country control on solvency, but recognizes explicitly that host country regulations will apply for monetary policy reasons and for market position risks. Recognizing that fair competition requires a fair level playing field and minimal harmonization of regulations, the second banking directive calls for minimal equity, harmonized capital adequacy rules, supervisory control of major shareholders and of banks' permanent participation in the non-financial sector[7].

Along with this process is the proposal for a full liberalization of capital flows by June 1990. Exceptions include Ireland and Spain (1992) and Greece and Portugal (1995). It should be mentioned that this capital directive contains a safeguard clause authorizing Member State to take necessary measures in the event of balance of payments problems.

The integration of investment services (investment banking) and insurance proceeds in a very similar manner. As far as investment services is concerned, draft directives for

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[6]As concerns non-EC banks, the 'single' passport applies only to subsidiaries authorized in one country of the EC. Branches do require national authorization.

[7]see Dermine ($1990_{a,c}$).

Investment Services in the Securities Field and for Capital Adequacy provide for a single license, home country control on shareholders, capital adequacy, risk management and compliance with prudential rules. A major difference with the second banking directive is that substantial powers would be given to host authorities in terms of the design of the rules of conduct of business. These include share registration and new issues procedure, securities prospectuses, investment management, investor protection, insider trading and related market practices.

In the field of insurance, integration is somewhat lagging, although major progress are underway. Two fields have to be distinguished : Life insurance (including life insurance,pension and general annuities) and non-life insurance (including motor vehicle,fire and property,liability and accident). As regards the later, the principle of single license, home country control and mutual recognition applies to large risks only (business firms with more than 250 employees). Host country authorization and supervision still applies for mass risks (second non-life directive). As regards life insurance, the second directive authorizes free cross-border sales when the initiative is taken by the applicant. Otherwise, host country authorization and supervision is the rule. A proposal for a third life insurance directive has been issued recently ; it would allow the home country principle for life insurance by 1994, although marketing practices could be regulated for public interest. As concerns the choice of contract law, the general rule is that the law applying to the country where the risk is located will be chosen, unless it has been waived explicitly.

From this large review of the directives and recommendations, it appears that the

objective pursued by the European Commission is threefold : Free entry and freedom of cross-border services throughout the Community, the establishment of a fair level playing field with single license, home country control, mutual recognition and minimal harmonization of regulations and, finally, consumer protection. In this respect, reference is often made (for instance in the 1985 White Paper) to the 1978 European Court of Justice 'Cassis de Dijon' case according to which control of the quality of a product is warranted, but can be met adequately by the supervisor of the home country. This path-breaking case strengthens considerably the economic integration process in recognizing a principle of limited sovereignty. However, references are also made to a 1986 non-life insurance Court case according to which control by the host authorities are acceptable as long as they are justified on the ground of the 'public interest' : "Insurance is a sensitive area, and until more progress is made in achieving a common regulatory framework, the only way of safeguarding the interest of individual customers is to insist that policies sold in any Member State must accord with the rule prevailing in that country". A further illustration of the perceived need for consumer protection is the recommendation on deposit insurance : "Member states shall ensure that the deposit-guarantee schemes that exist in their territory cover the deposits of branches of institutions having their head office in another Member state. As a transitional measure, pending entry into force of a deposit-guarantee scheme in all Member States, the latter shall ensure that the deposit guarantee scheme, in which the institutions that have their head office in their territory take part, extent cover to deposits received by branches set up in host countries within the Community which have no deposit-guarantee scheme, under the same conditions as those laid down to guarantee deposits

received in the home country.".

Both the European Commission and the European Court of Justice appear to accept the premise that consumers of financial services need to be protected. In case of public interest, it has been argued by the Court and recognized again in a draft proposal for a third life-insurance directive that host country regulations could be applied. In order to assess the economic coherence of the European framework, it is useful to review the literature on the sources of market failures calling for public interventions.

SECTION TWO : THE ECONOMICS OF FINANCIAL SERVICES REGULATION

An analysis of the characteristics of financial services and of the market failures calling for regulations follows. It attempts to clarify the maxim : "Competition whenever possible, regulation wherever necessary". Although the services provided by banks are interrelated, it is convenient to distinguish four categories : Portfolio management, payment (transmission) mechanism, risk sharing and monitoring or information-related services.

Portfolio management : At low cost, investors can acquire a diversified portfolio of liabilities issued by deficit spending units. The pure case is the mutual fund or unit trust (called SICAV in France and Luxembourg) which supplies a diversified portfolio to the holders of its shares.

Payment mechanism : A second role for banks in the economy is the management of the payment system, that is to facilitate and keep track of transfers of wealth among individuals. This is the bookkeeping activity of banks realized by debiting and crediting accounts.

Risk sharing services : An essential function of banks is to transform the risks faced by the parties, that is to supply risk sharing contracts. First, banks not only supply diversified assets,they also organize efficiently the distribution of the risky income earned on the asset pool. The deposit holders receive a fixed payment while the shareholders receive the residual income. Other insurance services would include liquidity insurance (option for the deposit holder to withdraw quickly at face value) and interest rate insurance (floating rate lending with various ceilings on interest rates).

Monitoring and Information-related Services : Banks perform a useful function in reducing the costs of screening and monitoring borrowers. Private information held by borrowers results in contracting problems because it is costly to assess the solvency of a borrower and to monitor its actions after lending has taken place. The delegation of screening and monitoring to banks is an efficient allocation mechanism. In addition to the classical lending function of banks, one can include in the information-related services most of the 'investment services' activities, such as underwriting and distribution of securities, market making, trust or fiduciary services, and advisory services on corporate governance,merger and acquisition and risk management.

Two independent explanations have been advanced for the existence of market failure in the financial services industry : Imperfect information and the need to protect

consumers, and the potential for bank runs and systemic crisis. A third source of market power, abuse of market power, will not be discussed as it applies to all industries.

Information and Consumer Protection

The economic literature recognizes that the inability of consumers to evaluate properly the quality of a product can create a market failure. The literature distinguishes three types goods : search goods, whose quality is apparent before purchase, experience goods, whose quality is apparent after consumption, and 'trust' goods, whose quality is not always apparent even after consumption[8]. An inefficiency may arise because the quality of a service is not valued properly by the market and reflected into higher prices so that there is insufficient incentives for firms to produce quality. For instance, it may be difficult for depositors to assess the quality of the assets of a bank and its degree of solvency. Or it could be difficult to evaluate the quality of incompetent or dishonest financial advisors.

Such situations create the need for two types of regulations to protect consumers. Regulations can control entry in a market (the 'fit and proper' criterion) or conduct behavior (capital adequacy, risk taking, insider trading...). In this context, there is an important issue as whether this regulatory task should be performed by private or public organizations, and in an international and global marketplace, whether there is a need to harmonize regulations.

Our analysis of the argument of imperfect information and consumer protection will

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[8]see Kay-Vickers (1986) and Mayer-Neven (1991).

proceed in three steps. First, a private market solution to the information problem is searched for. Next, we analyze the set of circumstances under which the regulation of entry and conduct is justified. Finally, the conditions requiring an international harmonization of regulations are analyzed.

A natural solution to the imperfect information problem is the provision of information and regulation of disclosure. However, the evaluation of bank risks is a costly activity which has the nature of a public good. Since it is available to consumers at a very low transfer cost, the evaluation of banks should not be undertaken by each depositors but could be delegated to a public agency or a private rating firm. Furthermore, since small account holders may find the cost of interpreting the rating high and/or since they care about risk free deposits only, two alternatives could be developed. The first is to have deposit insurance. The second is to create risk free banks, that is intermediaries investing all deposits in risk free securities. Depositors would have the choice between banks offering a higher but risky return and those providing quasi-risk free deposits. It would appear that the evaluation of risks is not inherently more difficult in banking than in other industries. A main difference is that it is quite likely that a large fraction of depositors care for risk free deposits, but these could be provided by the markets.

In addition to the disclosure and evaluation of information, there are two alternative private ways to reduce the imperfect information problem : Reputation and industry insurance-warranty. Reputation implies that firms who care for the value of their franchise and long run profits have an incentive to build internal control system to reduce risks and fraud. However, as was shown in the Boesky-Levine case in the United States, a tradeoff will

exist between (high) short term fraudulous profit and the benefits of long term reputation. An alternative is for a firm or an industry to provide a warranty to guarantee the quality of the services offered. For instance, the fund of a stockbrokers association guarantees clients against potential dishonest behavior of its employees. Peer monitoring or industry self-regulation prevent deviant behavior.

This analysis has shown that the information problem can be solved privately on the market in several different ways. However, whenever there is evidence that the market cannot discriminate among firms, then there is a case for the government to regulate entry and ensure a minimal quality, as is done for instance in the medical and legal professions. The argument is that regulation is necessary to maintain a minimum desired level of quality. A question arises as whether this should be done privately or quasi-privately as in Great Britain with the Self-Regulatory Organizations (SRO) or whether it should be public. The benefits of flexibility and industry expertise provided by private self-regulations have to be balanced against the risk of capture by the SROs whose members have an obvious incentive to limit entry and competition. As there is currently no empirical evidence in favor of one system or another, we suggest to let the national regulatory structures compete.

Competitive (de)regulation raises immediately the issue of the need to harmonize regulations at the international level. The answer to this question is again related to imperfect information. Competition among national regulators or private clubs is desirable whenever the parties can evaluate the quality of regulatory systems. For instance, competition among regulators in Paris, Frankfurt, London and New York will shape the development of local stock exchanges and the outcome will be optimal if participants can

discriminate among different regulatory systems. Harmonization of rules to ensure minimal quality would be necessary only if the market cannot discriminate. This suggests that the degree of international harmonization could vary for different activities and classes of investors, the 'informed' and the 'non-informed'.

It is fair to recognize that different countries may wish different degree of protection and regulations, so that an international harmonization is unlikely to satisfy fully all members. But the alternative to free international trade with (imperfect) international harmonization is a 'closed economy' with domestic regulation. The author has little doubt that the benefits of international trade and competition will weigh favorably against the benefits provided by a possibly more satisfactory domestic regulation in a 'closed' economy.

It has been argued that imperfect or asymmetric information creates the potential for a market failure, but appropriate rules on disclosure of information and competition between firms or regulators can solve a large part of the problem. One has to be extremely careful to avoid permanent regulatory interference which can create the 'raison d'etre' of public intervention. For instance, the creation of a safe and publicly insured deposits market reduces the market for information gathering and the creation of risk free funds. A clear example of a potentially perverse effect of intervention is the money market funds market in France which, so far, is virtually risk free. In a case where a distribution company CODEC was close to defaulting on its commercial paper (held by money market funds), the banks intervened to absorb the losses. The argument was that this was necessary to stabilize the money market funds market. The argument of market stability is understandable, but

the intervention creates a false sense of safety and reduces the private incentives to create rating agencies evaluating the riskiness of money market funds[9].

Facing a remarkably similar situation in May 1970, the Federal Reserve Bank of New York refused to lend to Penn Central which was defaulting on its commercial paper. It only did create a liquidity cushion available to banks to absorb temporary disturbances on the commercial paper market[10]. This 'laissez faire' policy should not imply that there is no ground for public intervention to compensate the unlucky or imprudent investors. The argument is that transitory transfer policies should be used in these cases rather than direct and permanent interference with the functioning of private markets.

The second major argument for the regulation of financial institutions is the fear of systemic risk in the banking industry.

The Stability of Financial Markets

Banks are special because the financial contract that emerges -illiquid loans funded by short-term deposits- creates the potential market failure and the need for public intervention. The financial contract creates the risk that depositors run to withdraw their funds. A run can be triggered by a bad news about the value of bank assets or by any unexplained fear. In both cases, there may be a loss since illiquid assets will be sold at a

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[9]The first ratings on French money market funds were made public in April 1991, ten years after the creation of the market.

[10]see Brimmer (1989).

discount. Moreover, a bank failure could eventually trigger a signal on the solvency of other banks, leading to a systemic crisis. A market failure exists because a cooperative solution among depositors cannot be enforced. Collectively, there is no incentive to run, but individually, there is the incentive to be the first on the line to collect the deposits at full value.

This market failure explains banking regulations and the establishment of safety nets to guarantee the stability of banking markets. They have taken the form of deposit insurance and lender of last resort interventions. In Europe, deposit insurance systems have been created recently in most countries.

Country	Coverage (Domestic currency)	Coverage (ECU)
Belgium	BEF 500,000	11,870
France	FF 400,000	57,520
Germany	30 % of equity per deposit	
Italy	Lit 1 billion (100 % for first 200 mil. and 75 % for next 800)	526,400
Netherlands	DG 35,000	15,120
Spain	Pta 1,500,000	11,930
United Kingdom	75 % of deposits up to £ 20,000	21,600
Japan	Yen 10,000,000	60,600
United States	$ 100,000	83,890

Table 1 : Deposit Insurance Systems in Selected Countries.

As is well known, the interventions by Central Banks to protect the banks too-big-to-fail or the setting up of deposit insurance systems create a 'moral hazard' problem. The reason is that the risks taken by some banks are not appropriately priced into higher deposit rates because the depositors are insured. The owners of some banks can reap the potential of high profits, leaving large losses to the insurance agency. The prevention of bank runs and the insurance of deposits disturb the pricing of risks and reduces the incentives for safety and information analysis. The logical response of bank regulators has been to constrain the risks taken by banks which have access to a lender of last resort or a deposit insurance mechanisms. Control of banks' shareholders and equity capital, limits on risks taking and restrictions of activities have been used by public authorities to limit the potential exposure of the lender of last resort or of the deposit insurance agency. This raises naturally the question of international harmonization of regulations from a perspective quite different than the one discussed for consumer protection. In the later case, harmonization was seen as necessary to ensure a minimum level of quality that consumers would not be able to evaluate. In this case it is felt that laxist regulation can give a competitive advantage to some participants who benefit from a free insurance subsidy. To ensure a fair level playing field, international harmonization could be required.

Two sources of market failure calling for public intervention and harmonisation have been discussed : consumer protection and systemic risk. It has been argued that in many cases a market for private information will be developed so that regulation and international

harmonization should apply to very specific activities and classes of consumers. The existence of safety nets finds a case for prudential regulations and international harmonization to level the playing field. In the next section, the proposals of the European Commission are evaluated from this perspective.

SECTION THREE : AN EVALUATION OF EUROPEAN BANKING REGULATIONS

It is striking to observe that the motivation for regulation advanced by the European Commission follows very much the first argument for market failure, the need to protect consumers. Leaving aside the freeing of entry and the development of fair competition, banking regulations seem to be perceived as a necessity to protect consumers against losses. Although the principle of home country control is recognized as an efficient way to foster integration, there are several references to 'public interest' and the possibility to rely on host country rules to restrict competition and protect consumers. In contrast, the banking literature is less concerned with risk per se. As long as information flows properly, the risk will be priced into higher deposit rates and investors will have a menu ranging from risk free to 'junk' banks. The 'public interest' criterion should be applied exclusively to cases where consumers cannot discriminate properly. One should avoid policies that restrict competition and most importantly the market incentives to collect, analyze and disseminate information. As was argued, there is a reasonable case to protect the 'small' uninformed investor. The provision of the third life insurance directive which applies the law of the applicant (except when it has been waived explicitly) and leave a time to cancel the policy seems in this

respect quite effective. In banking, risk free funds or banks whose assets are invested exclusively in risk-free government securities could be created to meet the needs of investors who care for riskless asset or who are uninformed.

In contrast to the argument of consumer protection, the economic literature is more concerned with the stability of the banking industry and the fear that there can be circumstances leading to bank runs. Therefore a case is made for some form of insurance - deposit insurance or lender of last resort- to prevent runs. Although a lender of last resort policy is not mentioned explicitly in the European Commission's proposals, there are references to the national deposit insurance systems.

Three features of the European insurance systems make them unique. The first is that, contrary to the FDIC in the United States or the CDIC in Canada, they are totally ignored by the public. Publicity is even forbidden in Germany. The argument seems to be that the announcement of their creation could reduce the confidence in the banking system. Since the coverage per deposit is small and even incomplete in the United Kingdom and Italy, they are unlikely to contribute much to the stability and one would have to rely on lender of last resort intervention of central banks to ensure stability. Secondly, since the coverage is different across countries, it could be destabilizing if depositors start to chase the best coverage. A third feature of the deposit insurance systems is that they cover the deposits of domestic and foreign banks operating locally. This could create an 'accountability' problem. Indeed, any insurance activities require the monitoring of risks taken by the insurer, but the principle of home country supervision would not allow the

control of the foreign entities by the domestic lender of last resort or the deposit insurance agency.

One is left wondering about the creation of deposit insurance systems in Europe. As has been argued, they are unlikely to contribute to the stability of the banking systems. Deposit insurance systems can be interpreted as a tool to create small risk free deposits while putting the cost of bailing out on the insurance fund funded by the banking industry.

It seems to us that the creation of safe deposits should be done without recourse to insurance. European deposit insurance mechanisms should be dismantled. Risk free funds can be created and the market will decide how much will flow into these funds. As to risky banks, they will be evaluated by rating agencies who can provide adequate information.

As there remains a need to foster stability, discretionary lenders of last resort will be necessary. The major advantage of a discretionary safety net as opposed to a more systematic insurance is that it increases the private incentives for monitoring and evaluating bank riskiness. The stability system through deposit insurance or lender of last resort creates two additional problems. They concern the potential liability of the lender of last resort and the implicit subsidy that can be given to domestic banks.

As lenders of last resort will be concerned primarily with their domestic markets and banks operating domestically[11], it would seem legitimate that they keep some supervisory power on all institutions operating domestically. That is, host country regulation could

[11] It is well known that the Bank of Italy did not intervene to prevent the collapse of the Luxembourg-based Banco Ambrosiano Holdings.

apply[12] to limit the exposure of the domestic central bank. A first alternative to host country control is to harmonize completely the solvency standards, but experience has shown that it would be very difficult to get an agreement on common harmonization of regulations and supervisory practices. A second alternative is to pursue further the process of harmonization and delegate supervision and regulation to a European Central Bank. The problem of accountability would be solved at the European level but not at the world level. Moreover, we do not believe that a centralized regulation at the level of a European Central Bank is necessary, nor desirable. Competition between national regulators will produce efficient standards and prevent the regulatory capture by the regulatees as has happened so often in banking in the last sixty years. It thus seems reasonable to let domestic lender of last resorts keep some host supervisory powers on all banks operating domestically.

A second and related issue is the recognition that public safety net or deposit insurance systems can provide an implicit subsidy that can alter competition. For instance, the leverage of a bank (increased degree of indebtness) reduces the cost of funding loans, transferring the cost of eventual bank failure to the lender of last resort. To create a level playing field, the Bank for International Settlements and the European Commission have enforced minimal capital requirement and are working on lending limits to a single borrower. The harmonization of prudential regulations is warranted when the objective is to create a level playing field. But harmonization should only be limited to that objective. For instance, the current effort to harmonize the regulation on interest rate risk and foreign

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[12]A provision in the second banking directive allows host country control for 'public policy' or 'monetary policy' reasons. The control of the liability of the lender of last resort could fall in these cases (Dermine, 1990_b).

exchange exposures do not appear desirable because they do not provide clear competitive advantage to banks(Dermine, 1991). Quite often the identification of a regulatory subsidy will be questionable. For instance do links between banks and industrial groups provide a competitive advantage which is subsidized by the central bank who takes a greater risk ? It would seem to us that there is no case for harmonization as long as the joint existence of a competitive advantage and a subsidy is not demonstrated. Such a case was pretty clear in the context of loan funding and capital adequacy. It is much debatable in the context of the links between banks and industrial groups.

An economic argument has been developed for a discretionary lender of last resort and for an international harmonization of regulations, not to ensure quality, but rather a level playing field. It should be observed that the host country regulation of risks and the minimal harmonization principle will reduce potential excess in competitive deregulation, so that flexibility and safety would be maintained.

CONCLUSION

The purpose of the paper has been to analyze the integration of European financial markets. While most international agreement have used the national treatment principle and kept domestic authorization and supervision, the European Commission has used a powerful innovative method of integration : The opening of markets with single license, home country control, mutual recognition and very minimal harmonization. Our analysis of the financial services industry has shown two main sources of economic failure calling for national

regulations and the eventual harmonization of regulations. The first source of market failure is the traditional need to protect consumers. It has been argued that domestic regulation of quality is only warranted in those cases where consumers cannot evaluate the quality of a product. Similarly, international harmonization of regulation is necessary if the market participants cannot discriminate among different regulatory structures. It is the author's view that information disclosure, competition between public or private regulators and the creation of risk free funds will be satisfactory in most situations. In any case, different products and classes of consumers will require different regulatory treatment. A call has been made to limit the 'public interest' argument which not only may limit competition but also harm the spontaneous development of private markets. A second market failure calling for regulation and harmonization comes from the need to provide a safety net and the legitimate need to limit moral hazard and risk taking. From this angle, host regulation may be justified to limit the exposure of domestic lender of last resort and the international harmonization of regulations may be necessary to limit implicit public subsidies. It has been argued that harmonization of prudential regulations should only be done when there is a clear case of implicit subsidy and competitive advantage.

As was the case in the last sixty years, the powers given to national regulators in terms of limits on entry, price competition and marketing practices will no doubt shape the degree of competition and the efficiency of the European financial markets. The European Commission and the European Court of Justice will very likely play a major role in the coming years to limit the discretionary powers of national regulators to what is strictly necessary for consumer protection, the control of the exposure of the lender of last resort

and the level playing field.

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<u>1991</u>

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