"EC BANKING REGULATION, CENTRALIZATION OR NATIONAL AUTONOMY"

by

J. DERMINE*

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* Professor of Banking and Finance at INSEAD, Boulevard de Constance, 77305 Fontainebleau Cedex, France.

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Centralization or National Autonomy

by Jean Dermine*
INSEAD
F-77300 Fontainebleau, France
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Abstract

The EC internal banking market is operative since January 1993. Early evidence on the effects of European financial integration shows that major driving forces in industry's restructuring are competitive deregulation and taxation. Additional legislative work is needed to achieve open and stable financial markets. Home country control of international banks need to be complemented by host country control. The deposit guarantee schemes should be modified by rendering insured deposits "first order claim". A European authority is needed to ensure that banks do not exploit domestic rents to subsidize international activities. Finally, tax evasion is an issue that remains to be addressed by the EC authorities.

At a meeting of the Council of Ministers held in Milan in 1985, the European Commission proposed a detailed timetable for the complete integration of European markets by January 1993. The aim was to dismantle the technological, regulatory and fiscal barriers which prevented the free flow of goods, capital and persons in the European Community. As concerns banking and financial services, a major issue arises as to whether regulation and supervision must be handled by a unique European authority, or whether it can be delegated to independent national central banks and supervisory bodies. After trying in vain to harmonize national banking regulations over twenty years, the European Commission adopted the principle of the single banking license, the home country control, and the opening of borders with minimal harmonization of regulations. Each country will recognize the competence of foreign authorities to regulate and supervise their own banks. In December 1991 at the Maastricht meeting in the Netherlands, the heads of State or Government signed a draft Treaty on Economic Union ; it provides for the creation of a European System of Central Banks, a European Central Bank and a common currency by 1999 at the latest. The Treaty, which became European Law on November 1, 1993, recognizes explicitly the principle of decentralization of regulation and supervision.

The issues raised in this chapter go far beyond the creation of a European market. They concern international trade in financial services. At a time when the North American Free Trade Agreement (NAFTA) proposes to integrate further the economies of Canada, Mexico and the United States, and when financial services will be the object of further discussion in the new World Trade Organization, it is useful to make a critical review of the approach adopted for the integration of banking markets in the European Union.

The chapter is structured as follows. The European banking industry and the early effects of financial integration are described in the first section. Section Two gives an overview of the European banking legislation. A critical assessment of the regulatory and supervisory framework is developed in Section Three.

The conclusions of the chapter are fourfold.

• Firstly, early evidence on the effects of European financial integration demonstrates that the banking industry is undergoing a major restructuring driven through lower interest rates, competitive deregulation and taxation. This process is just starting in some countries, such as France and the United Kingdom.

• Secondly, more work remains to be done to achieve open and stable markets. In particular, host country prudential supervision is warranted in two cases : to prevent systemic risks in domestic markets, and to protect one class of customers of financial services : the 'uninformed'. The implication is that supervision of international banks (subsidiaries and branches) should be organized jointly by the home and host country authorities.

• Thirdly, as domestic regulators will be responsible for controlling the ownership of banks (public or private), and the degree of market power in their domestic market, a European authority must ensure that banks do not exploit domestic rents to subsidize their international activities.

• Finally, the achievement of an internal banking market should not lead to tax evasion. Substantial work remains to be done to prevent inefficient competitive moves to reduce taxation of income on capital.

EUROPEAN BANKING STRUCTURE

The EC banking industry contains 2183 commercial banks and 2478 savings or mutual banks. As is indicated in Table 1, it is still a fragmented market with leading financial institutions having a substantial market share in their domestic market (84 % in the Netherlands, and 77 % in Denmark). At the European Community level however, the five largest institutions control only 14 % of the market. In Europe, banks play a major role in the financial system with a ratio of total assets to GDP of 1.7, compared to 0.8 in the USA, and 2.8 in Japan. Financial services represent a major source of employment and exports for several countries. As is documented in Table 2 , the share of the labor force occupied in banking, insurance or real estate has grown substantially over the last ten years, reaching more than ten percent in the United Kingdom. Table 3 reports the results of a recent study by the Organization for Economic Cooperation & Development[1] on the relative importance of financial services in international trade. The figures which refer to the share of fees and commissions in trade (excluding interest revenue) show sharp differences across countries, with France leading with a 5.7 % share of goods and services export linked to commissions and fees.

Insert Tables 1, 2 and 3

As is documented in Table 4, the type of ownership of banks in Europe is diverse. Out of the 100 largest credit institutions, only 44 are privately owned. In principle, this raises substantial issues of fair competition between private and public institutions. So far

and to my knowledge, no empirical studies have critically examined the issue, nor has any case been brought to the attention of the European Commission or the European Court of Justice[2]. Moreover, one has to recognize that the public ownership issue could disappear with the large privatization programs underway in several countries.

Insert Table 4

The need for a restructuring of the banking industry arises from the breakdown of uncompetitive market practices. Over the last twenty years, banks from Belgium, Denmark, France and Spain have benefitted from regulation or 'gentlemen's agreements' on interest rates paid on retail deposits. As Table 5 shows, interest margins on demand deposits have reached 11 % on average in Belgium and France over the period 1980-1985.

Insert Table 5

In contrast, spreads were much smaller in Germany and the Netherlands. The major reason for the divergence in spreads was that the market (interbank) interest rate was much higher in some countries than in others, allowing banks from the former group to realize major benefits from deposit rate control and pricing arrangements. Interestingly enough, in the more recent period 1987-1992, one observes a clear pattern of convergence. Interest rate margins are going down in Belgium, France, Denmark and Spain, but they are going up in the Netherlands and Germany. The convergence of spreads is a direct effect of the convergence of short term interest rates brought on by the European Monetary System and the abolition of controls on capital flows. The reduction of interest margins that is observed in many European countries is a first shock to bank profitability.

Besides the lowering of margins on retail deposits, major shocks have resulted from the competitive deregulation process undertaken by national regulators attempting to enhance the attractiveness of their home market. Two examples concern the reduction of

taxes on interest income, and the deregulation of money markets. The case of Belgium documented in Table 6 is symptomatic. Banks in that country used to benefit from tax-free low cost savings deposits ('carnet de dépôts'), which were highly competitive vis-à-vis other financial instruments subject to a 25 % tax rate. In April 1991, the Minister of Finance lowered the tax rate on interest income to 10 % to reduce capital outflows to the neighboring country of Luxembourg. As a result, the tax differential between savings deposits and other instruments was reduced and Belgian banks have seen the low cost fraction of their funding base reduced from 49 % to 34 % in less than two years.

Insert Table 6

Another example of the effects of deregulation can be seen in the money markets. In France, money market funds ('Sicav de Trésorerie'), which were created in the early 1980s, have increased from 8 % of money supply (M2) in 1985 to 45 % in 1992. The commercial paper market, created in 1986, already represents 18 % of short term bank lending to business firms.

The creation of competitive financial products is forcing banks to reduce their costly branch networks. This is often achieved by domestic mergers between the largest banks. Table 7 documents the major mergers that have taken place in Denmark, the Netherlands, Spain and Italy. As is quite apparent, countries such as France and the United Kingdom have not thus far experienced a major restructuring of their banking industry. In addition to domestic mergers, there has been a major expansion into life insurance to exploit more completely the distribution capacity of branch networks. Table 8 documents the significant penetration of banks into life insurance in Spain, France and the United Kingdom.

Insert Tables 7 and 8

Competitive deregulation and taxation have thus far had a much greater effect on

the structure and performance of national banking markets than market penetration by foreign institutions. As Table 9 documents, the market share of foreign institutions in domestic markets has not changed much over the years, whether in an open market such as that of the United Kingdom, or in a fairly closed market such as the German one.

Insert Table 9

These are the early results in banking systems preparing for more competition. They raise substantial issues of fair competition. Indeed, since individual countries are responsible for the type of ownership (private or public) and the degree of concentration on their domestic markets, there is the possibility that some countries will try to create national 'champions' to compete on world markets. One needs a European authority to ensure that banks do not subsidize their international activities with oligopolistic rents earned on the domestic markets[3]. One could argue that oligopolistic rents will disappear in the presence of free entry. However, some industrial organization scholars, such as Vives (1991), take the view that retail banking does not fit the model of 'contestable markets'. In a contestable market, potential competitors discipline established firms since these are vulnerable to hit and run entry. In retail banking, fixed costs incurred in branching, the creation of networks (like ATM systems), the presence of switching costs for consumers, and reputation effects could be effective barriers to entry. Only time will reveal the significance of these barriers, which, in view of degree of concentration existing in some domestic markets, should be monitored closely.

In the next section, I review the major parts of the EC's legislative process. This will be followed by an economic assessment of the regulatory and supervisory framework.

The EC APPROACH TO INTERNATIONAL INTEGRATION

The actions taken by the European Commission and the Council of Ministers can be divided into three time periods : Deregulation of entry into domestic markets from 1957 to 1973, various attempts toward harmonization of regulations from 1973 to 1983, and the recent directives regarding single banking license, home country control, mutual recognition, and freedom of cross-border services[4].

Deregulating Entry (1957-1973)

The objective of the 1957 Treaty of Rome was the transformation of highly segmented national markets into a single common market. This objective was achieved by two types of measures : The recognition of the right of establishment and the coordination of legislation wherever necessary. In June 1973, the Council adopted a directive on *The Abolition of Restrictions on Freedom of Establishment and Freedom to Provide Services for Self-Employed Activities of Banks and other Financial Institutions*[5]. This directive applies the national treatment principle which ensures the equal regulatory and supervisory treatment of all firms operating in one country. It is explicitly recognized that subsidiaries of banks whose parents are chartered in non-member countries are to be recognized as EC undertakings in every way. Although in 1973 entry restrictions could not be discriminatory, the objective of the initial treaty was still far from being met. International competition through the supply of cross-border services was severely restricted by regulations 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 additional burden would raise the costs of operating internationally. This led to the second phase of attempts to harmonize regulations.

Harmonization of Banking Regulations (1973-1983)

Progress in harmonization came in 1977 with the adoption of the First Banking Directive on *The Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of Credit Institutions*[6]. This directive establishes the principle of home country control. Responsibility for the supervision of credit institutions operating in two or more 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*[7], on a *Uniform Format for Bank Accounts*[8], and on *Consumer Protection*[9] were adopted by 1987. The first banking directive initiated work on Winding Up and Liquidation and on the Mortgage Market.

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 that country.

• A foreign bank 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 they were new

banks.

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

The inability to agree on a common set of regulations prompted a new approach towards European integration.

The Completion of the Internal Market (1983-1992)

While most international agreements have used the national treatment principle, which ensures the equal treatment of all firms operating in one country, the European Commission has used a powerful method of integration : home country control with very minimal immediate harmonization of national regulations.

In the context of banking, the 1985 White Paper calls for a single banking license, home country control, and mutual recognition[10]. These principles are incorporated in the Second Banking Directive[11]. All credit institutions authorized in an EC country will be able to establish branches or supply cross-border financial services in the other countries without further authorization, provided the bank is authorized to provide such services in the home state. These services include :

• Acceptance of deposits and other repayable funds from the public.

• Lending (including consumer credit, mortgage credit, factoring, with or without recourse, financing of commercial transactions (including forfeiting)).

• Financial leasing.

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• Lending (including consumer credit, mortgage credit, factoring, with or without recourse, financing of commercial transactions (including forfeiting)).

• Financial leasing.

• Money transmission services.

• Issuing and administering means of payments (e.g. credit cards, travellers'cheques and bankers'drafts).

• Guarantees and commitments.

• 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) foreign exchange and interest rate derivative instruments;

(e) transferable securities.

• Participation in securities issues and the provision of services related to such issues.

• Advice to undertakings on capital structure, industrial strategy and related questions, and advice and services relating to mergers and the purchase of undertakings.

• Money broking.

• Portfolio management and advice.

• Safekeeping and administration of securities.

• Credit reference services.

• Safe custody services.

The banking model adopted by the EC is the universal banking model. It permits banks to undertake investment banking activities and leaves it to national regulators to control financial conglomerates, the ownership structure of banks, and their relationship with industry. For instance, it is known that the Bank of England does not favor the ownership of banks by industrial groups, while this is allowed in France or Belgium.

The Second Banking Directive calls for home country control on solvency[12]. This extends to the bank itself, its foreign and national subsidiaries which have to be consolidated for supervisory purposes, and its foreign branches. As concerns the latter, the host state retains the right to regulate a foreign bank's activities in the host state to the extent only that such regulation is necessary for the protection of the 'public interest'. Thus the manner in which a bank markets its services and deals with customers can be regulated by the host state. The host state may also intervene in those matters which have been expressively reserved to it, notably liquidity, monetary policy and advertising. A bank constituted in a Member State has the right to open a subsidiary in another Member State on the same conditions as nationals of the latter state. The establishment of a subsidiary bank will be subject to the control of the country in which it is established since that is the 'home' state.

To address a need for a minimal harmonization of regulations, the Second Banking Directive calls for an initial capital of at least ECU 5 Million, harmonized capital adequacy standards and large exposure rules, supervisory control of banks' permanent participation in the non-financial sector[13]. The 1989 Solvency Ratio Directive[14] establishes a Community-wide rule that a bank's own funds must be at least 8 % of its risk-adjusted assets and off balance sheet transactions. Own funds have been defined by the 1989 Own Funds Directive[15], and risk-adjusted and off balance sheet transactions are defined by the Solvency Ratio Directive. The total of a bank's qualifying participations (basically shareholdings of 10 % or more) in undertakings which are not banks, financial institutions, or undertakings engaged in ancillary services such as leasing, factoring, management of unit trusts or data-processing services, may not exceed 60 % of the bank's own funds. Moreover, no single qualifying participation may exceed 15 % of the bank's own funds. A Directive on the Monitoring and Control of Large Exposure[16] states that, since January

1994, a limit of 40 % of capital will be imposed for exposures to a single client, which will be reduced over time to 25 %. The aggregate amount of large exposures (those exceeding 10 % of capital) may not exceed 800 % of such capital.

A supportive piece of legislation is the 1988 Directive on Liberalization of Capital Flows[17]. However, that directive contains a safeguard clause authorizing Member States to take necessary measures in the event of balance of payments problems[18].

A draft directive on Deposit Guarantee Schemes[19] has been accepted by the Council of Ministers in September 1993 (qualified majority with opposition by one country, Germany). It aims to adapt the current deposit insurance mechanisms which are summarized in Table 10.

Insert Table 10

The draft directive provides for mandatory insurance for all EC financial institutions. The coverage per depositor is a minimum of ECU 20,000[20] (15,000 until 1999), with a franchise[21] of maximum 10 %. The principle of home country would apply, that is the insurance system of the parent bank would cover the deposits collected by domestic and foreign branches. The depositor will be informed, and publicity will be controlled to prevent abuse. This is the principle, against which two very important exceptions stand. In the case, where the home coverage is too large vis-à-vis the host coverage (f.i. a French bank operating in Belgium), the coverage of foreign branches cannot exceed that of the host country to prevent 'unfair' competition. In the case where the home coverage is lower than that of the host country, the foreign branch will have the right to obtain supplementary insurance from the host state. Finally, for the branches of non-EC banks, the host country will decide whether they must or not join an insurance system, with the provision that

depositors will be informed about the magnitude of the coverage.

The integration of investment services (investment banking) proceeds in a very similar manner. As from January 1996 on, directives for Investment Services in the Securities Field and for Capital Adequacy provide for a single license, home country regulation and control on shareholders, capital adequacy standards, and compliance with prudential rules. A major difference with the second banking directive is that substantial powers are given to host authorities concerning the design of conduct of business rules. These include share registration and new issues procedures, securities prospectuses, investor protection, insider trading and related market practices[22].

The issue of reciprocity has received considerable attention in non-member countries. Two concerns have to be distinguished : The denial of national treatment, and effective market access comparable to that which the Community grants to third countries. Article 9(4) of the Second Banking Directive deals with the situation where there is discrimination against Community financial institutions, compared with their domestic counterparts in a third country. In this case, the directive provides for the initiation of discussion with the option to suspend new banking licenses for institutions from the third country. In the second case -comparable access- Article 9(3) provides for negotiation with the country without the suspension of the right of establishment. A recent report on the Treatment of European Financial Institutions in Third Countries has been published by the Commission[23]. Although it recognizes the existence of discriminatory treatment in some countries, the Commission recommends negotiating in the framework of the new World Trade Organization. Moreover, the report makes no reference to a temporary suspension of authorization.

The December 1991 Maastricht Treaty on Economic and Monetary Union has confirmed the Single Market programme. Although the primary objective of the European System of Central Banks shall be to maintain price stability, there are explicit references to regulation and supervision.

"The European System of Central Banks (ESCB) shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system ... The national Central Banks are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the European Central Bank ... The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States in the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system ... The ECB may fulfill specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings"[24].

Although the exact rules governing the functioning of the new system have yet to be worked out, the Treaty is explicit on the principle of decentralization and allocation of regulatory and supervisory powers to national central banks. It is only in very special circumstances and with unanimity in the European Council that the European Central Bank will be allowed to regulate or supervise financial institutions. On October 12, 1993 the last obstacle to ratification was lifted with a ruling by the German Constitutional Court, and the Maastricht Treaty has officially been in effect since November 1, 1993.

Finally, it should be recognized that the single banking market go beyond the twelve members of the European Union. On May 13 1992, the countries of the European Free Trade Association (EFTA)[25], with the exception of Switzerland, joined the European Economic Area (EEA). As concerns banking, it implies that the EEA countries accept the European banking legislation regarding single banking license, home country control, mutual recognition, and acceptance of the common regulations.

ECONOMIC EVALUATION OF EC LEGISLATION

The economic literature has identified several potential market failures which explain the need for banking regulations. The objective in this section is to review the nature of these market failures and to see whether the current European regulatory and supervisory framework is adequate.

With respect to banking services, three independent explanations have been advanced for the existence of potential market failure : Imperfect (asymmetric) information which prevent the proper functioning of unregulated private markets, the potential for bank runs and the related fear of systemic crises, and trade policy issues. Furthermore, the freedom of capital flows raises an additional issue : tax evasion.

Imperfect (Asymmetric) Information and Consumer Protection

The analysis which follows explains why there is a need to protect consumers of financial services. This leads directly to a discussion of the principles of home country control and mutual recognition. Indeed, these rules imply that banking services offered to nationals of a particular country by a branch of a foreign bank are regulated by another country with, possibly, an inadequate degree of protection.

The first and most important case of asymmetric information concerns the imperfect knowledge about the solvency of a banking firm. Depositors find it costly to evaluate the solvency of their bank. Additional sources of asymmetric information concern the

potentially fraudulent character of management, the nature of the legal contract (for instance, the exact nature of a loan covenant), and problems related to conflicts of interest between different departments in a bank. For instance, an M&A advisor should not inform a fund manager about the likelihood of a transaction, otherwise the fund manager will purchase securities of the 'target' firm, the price of shares will increase, making the acquisition more expensive.

The economics literature[26] recognizes that the inability of consumers to properly evaluate the quality of a product can create a market failure. This 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. 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. Regulation (such as minimal qualifications in the legal or medical professions) is a way to ensure a minimum level of quality. In the context of banking, quality refers in part to the degree of solvency of an institution. When depositors are uninformed, there are fewer incentives to limit the riskiness of the assets of a financial institution or its degree of financial leverage (deposit to equity ratio). Indeed, finance theory[27] has shown that, whenever depositors are not properly informed, shareholders of banks do benefit from an increase in risk. With perfect information, depositors would react by requesting an interest rate increase to offset the transfer going to shareholders. With imperfect (asymmetric) information, this would be difficult, raising a well identified and documented moral hazard problem[28]. However, the existence of imperfect information per se does not yet justify public intervention. It has to be shown that private mechanisms cannot succeed.

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 could create a 'free rider' problem. Individually, each customer may prefer not to engage in information search and analysis on the assumption that other investors will do it. In such a situation the provision of private information is too low. Moreover, since information once produced is available to consumers at a very low transfer cost, the evaluation of banks should not be undertaken by each depositor 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 institutions, that is intermediaries investing all deposits in risk free securities (the so-called 'narrow' bank proposal). Depositors would have the choice between institutions 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 warranty provided by the industry. Firms who care for reputation, the value of their franchise and long run profits have an incentive to build an internal control system to reduce risks and fraud. However, a tradeoff will exist between (potentially high) short term fraudulent profit and the benefits of long term reputation. An alternative is for a firm or an industry to provide a guarantee on the quality of the services offered. For instance, the private deposit insurance organized by the industry guarantees clients against potential losses. 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 ways : disclosure, information gathering, reputation, and insurance. However, whenever there is evidence that the market cannot discriminate among firms[29], 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. In this context, a question arises as to whether this should be done privately or quasi-privately as in Great Britain with the self-regulatory organizations (SROs), or whether it should be public. The benefits of flexibility and industry expertise provided by private self-regulation 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, I suggest letting the national regulatory structures compete[30].

The possibility of competitive deregulation raises immediately the question of the need to harmonize regulations at the international level. This issue is particularly relevant in Europe since, according to the home country principle, nationals from one particular country will be offered services from institutions supervised in another country. The answer 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 Tokyo, Paris, Frankfurt, London and New York will shape the developments of local stock exchanges and the outcomes 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'. An alternative to the harmonization of prudential regulations is to grant some supervisory powers to the host state, whenever it is felt that investors are not adequately protected by foreign regulation or supervision. This is precisely the approach adopted by the European Commission which leaves to each host country the right to control foreign branches for reason of 'public interest'. No doubt, these interventions by the host state would be challenged at the European court of justice which will have to define the notion of 'public interest'.

To summarize, the economics literature identifies a first market failure : imperfect information. This creates a need to protect the 'uninformed' investors. Since the home country principle implies that services offered by a branch of a foreign bank will be regulated by an other country, there is the possibility that the degree of protection could be inadequate. The 'public interest' criterion allows the host country to intervene in such a case.

Bank Runs and Systemic Risks

The second market failure is the potential for bank runs and systemic crisis. Banks are special because the financial contract that emerges -illiquid loans funded by short-term deposits- creates a potential market failure and a 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[31]. In both cases, there may be a loss since illiquid assets will be sold at a discount. Moreover, a bank failure could eventually trigger a signal on the solvency of other banks, leading to a systemic

crisis. Here, a distinction should be drawn between 'domino' effect and systemic crisis.

A 'domino' effect exists if the failure of one bank would directly endanger the solvency of other banks. However, this risk is substantially reduced since banks are systematically collecting and controlling their counterparty exposure through, for instance, netting arrangements. A pure case of systemic run could occur if, lacking information, there is a run by depositors on all banks.

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. Deposit insurance funds in Europe are unlikely to contribute much to reducing systemic risk because they cover small deposits only. Runs are likely to be initiated by large firms or financial institutions. Therefore, lender of last resort interventions by central banks remain the most efficient tool to avoid bank runs and systemic crisis.

The safety net with deposit insurance or lender of last resort creates an additional problem in the European Union. It concerns the potential liability of the lender of last resort and the deposit insurance agency.

As lenders of last resort will be concerned primarily with their domestic markets and banks operating domestically[32], it is legitimate that they keep some supervisory power on all institutions (branches and subsidiaries) operating domestically. That is, host country regulation could apply to limit the risks taken by financial institutions and the exposure of the domestic central bank in cases of bailing out[33]. A first alternative to host country control is to harmonize completely the solvency standards of different countries, but experience has shown that it would be very difficult to reach an agreement on

harmonization of regulations and supervisory practices. Moreover, I do not believe that centralized regulation is necessary, or even desirable. Competition between national regulators should produce efficient standards and prevent regulatory capture by the regulatees as has happened so often in banking in the last sixty years. It thus seems reasonable to let domestic supervisors keep some host supervisory powers on international banks (subsidiaries and branches) having substantial funding at risk in their own country.

Similarly, the national deposit insurance systems mentioned in the second section create their own problems. Since the insurance coverage is different across countries, deposit insurance could be destabilizing if investors start to chase the best coverage. Moreover, the deposit insurance systems currently in place cover the deposits of domestic and foreign banks operating locally. This creates 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 branches by the domestic lender of last resort or the deposit insurance agency. The problem is well illustrated by the January 1992 winding up order made for Bank of Credit and Commerce International, a bank chartered in Luxembourg with significant activities in Great Britain. It automatically created a liability for the British Deposit Protection Board. This important case led to the review of deposit insurance systems in Europe.

The motivation for the 1993 deposit guarantee draft directive is illustrative, as it incorporate several of the arguments discussed previously :"deposit protection is as essential as prudential rules for the completion of the single market...the cost to credit institutions of participating in a guarantee scheme bears no relation to the cost that would result from a massive withdrawal of bank deposits not only from a credit institution in difficulties but also from healthy institutions following a loss of depositor confidence...".[34]

This proposal creates two problems. The first, well illustrated by the German opposition to the draft directive, is that foreign banks could join the German scheme, but the German deposit insurance system would have no power to monitor the risk taken by branches of foreign institutions. There is an accountability problem mentioned earlier. The second problem is that deposit insurance contributes further to reduce private incentives for monitoring the solvency of banks. As I have discussed earlier, the creation of risk free deposits could be organized by the market (the 'narrow bank' proposal), or alternatively, it would be preferable to make insured deposits 'first order' claim. The uninsured deposits bearing larger losses in case of bank failure would have additional incentives to monitor the solvency of financial institutions.

The analysis of the second type of market failure, bank runs and systemic crises, leads to the following conclusion. Since domestic central banks will be primarily concerned with the stability of their domestic markets, they should have the right to control the solvency of banks (subsidiaries and branches) operating in their domestic market. Since in many cases, the solvency would depend on the solvency of an entire group, I recommend joint supervision by the home and host country authorities. The case for sole 'home country' supervision is weak as long as sovereign countries are responsible for the stability of their own markets.

Fair trade

Two issues will be distinguished. The first relates to the implicit guarantee given by central banks. The second refers to the possibility of cross-border subsidization.

Public safety nets or deposit insurance systems can provide an implicit subsidy that can alter competition. For instance, deposit financing can reduce the cost of funding loans, not only because of the tax-deductibility of interest payments, but also because of the implicit guarantee given by the lender of last resort. To foster stability and create a level playing field, the Basle Committee of Banking Supervision and the European Commission have enforced minimal capital requirement, and lending limits on large exposure. From the point of view of competition, 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 exchange exposures do not appear desirable because they do not provide clear competitive advantage to banks[35]. Quite often, the identification of a regulatory subsidy will be difficult. 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 ? There is no case for harmonization as long as the existence of a subsidy yielding a competitive advantage can not be demonstrated. Such a case was 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.

The second issue discussed earlier is the possibility that oligopolistic home markets could generate rents used to subsidize foreign activities. The issue arises because of the fear

that some countries could allow concentration on their domestic banking markets. Quite obviously, the trade policies in the Netherlands and the United Kingdom are quite different, with the British Office of Fair Trading preventing excessive concentration on the domestic market, while the Dutch authorities have allowed substantial concentration in their domestic market.

Taxation of capital income

To enhance the attractiveness of their home market, various countries have reduced the taxation of income on capital, at least relative to the taxation of labor income. From a fiscal policy perspective, it would seem that the creation of a single EC banking market should not affect the relative taxation of labor and capital income. Obviously, this will not be the case as long as there is no harmonization of taxation, or sharing of information by tax authorities. Table 11 reports the amount of liabilities of national banks vis-à-vis non-bank non-residents.

Insert Table 11

Even acknowledging the expertise of some banking centers, it would appear that the volume of deposits housed in a few small countries is abnormally large. Proposals for a common withholding tax on interest revenue have been rejected so far by Luxembourg and the United Kingdom with the argument that the euro-market would be transferred to a non-EC country[36]. An alternative proposal, that would suffer a similar concern, would be to lift bank secrecy. That is, the fiscal authority of one Member State would have the right to obtain information about bank deposits in another EC country. In the United States, the Federal tax authorities succeed in obtaining this type of information. To reduce the size of

potential capital outflows, I recommend the lifting of bank secrecy for EC investors only. Investors from a non-EC country, not being affected by the proposal, would find EC financial markets quite attractive. As concerns some EC investors, they might wish to transfer their bank accounts to a non-EC country. This is a risk that should be taken, especially as the rules could be reversed if necessary.

CONCLUSION

The purpose of the chapter has been to analyze the EC's internal banking market. While most international agreements have used the national treatment principle and kept domestic authorization and supervision, the European Commission has used a powerful innovative method of integration : Opening of markets with single banking license, home country control, mutual recognition and very minimal harmonization.

The policy conclusions are fourfold.

• Firstly, early evidence on the effects of European financial integration demonstrates that the banking industry is undergoing a major restructuring driven by lower interest rates, competitive deregulation and taxation. In a few countries, such as France and the United Kingdom, the process is only starting.

• A review of the economics of banking regulation calls for further work to improve the stability of European banking systems. The literature has identified three potential sources of market failure calling for national regulations : imperfect information, bank runs, and fair trade. The first source of market failure is the traditional need to protect investors. I have argued that domestic regulation of quality is only warranted in those cases where investors

cannot evaluate the quality of a product. As information disclosure, competition between public or private regulators and the creation of risk free funds will be satisfactory in many situations, different products and classes of investors will require a different regulatory treatment. As an exception to the home country principle, the second banking directive allows host country control for reasons of 'public interest'. This exception is justified as long as it is applied to the 'uninformed' investor. A second market failure calling for regulation and harmonization comes from the need to provide a safety net for liquid deposits and the legitimate need to limit moral hazard and risk taking by banks. From this angle, host regulations of branches of foreign banks are justified to limit the exposure of the domestic lender of last resort. Moreover, I recommend modifying the deposit insurance scheme recently adopted by the European Council of Ministers. Insured deposits should be made a 'first order' claim so as to increase monitoring incentives for uninsured deposits. A third policy issue is the fair 'level playing field'. From this perspective, the international harmonization of regulations is only necessary to limit implicit public subsidies which create a competitive advantage. Moreover, as domestic regulators will be responsible for controlling the ownership of banks (public or private), and the degree of market power in their domestic market, a European authority must ensure that banks do not exploit domestic rents to subsidize their international activities.

• Finally, the achievement of an internal banking market should not lead to tax evasion. Substantial work remains to be done to prevent inefficient competitive moves to reduce taxation of income on capital.

1.OECD, 1993.

2.In 1991, Mr Lilley, UK Trade and Industry Secretary, tried to block the acquisition by Credit Lyonnais of Woodchester Investment, an Irish-based finance company with interest in Britain. The argument was that the acquisition of a private firm by a nationalized French bank was 'nationalization through the back door'. A British Monopolies and Merger Commission's investigation concluded that there was no justification for blocking the deal on competitive grounds.

3.An alternative is to refer all mergers to a single European authority. But, this would run against the principle of decentralization, very much in favor in Europe. Since Sept. 21, 1990, the European Commission can only investigate mergers involving large firms operating in several countries.

4.References on EC integration include Benink (1993) and Foster (1991).

5.Directive 73/183, EEC.

6.Directive 77/780/EEC.

7.Directive 83/350/EEC.

8.Directive 86/635/EEC.

9.Directive 87/102/EEC.

10.The principles of home country regulation and mutual recognition have been inspired by the famous 1987 case Cassis de Dijon (EC Commission vs Germany. 205/84, ECR 3755). In this case, the European court of justice found that Germany could not prohibit the import of liquor that was lawfully produced and sold in France solely because the alcoholic content was too low for it to be deemed liqueur under German law.

11.Directive 89/646/EEC.

12.As discussed in Norton (1991), the EC directives have basic ideas in common with the Basle Concordat (June 1993) on guidelines for consolidated supervision, and the division of supervisory responsibilities between the home and host states.

13.see Dermine (1990, 1993). Compliance with thee regulations will be enforced by national banking supervisors.

14.Directive 89/647/EEC.

15.Directive 89/299/EEC.

16.EC directive 92/121.

17.Directive 88/361/EEC.

18.The June 1988 capital directive (Article 3) provides for the temporary implementation of capital controls. In the case of large speculative movements, the Commission after consultation with the Committee of Central Banks Governors can authorize capital controls. In very urgent cases, a country can implement them, but must notify the Commission. After consultation with the committee of central banks governors, authorization to pursue capital controls can be given for a period not exceeding six months.

19.Draft directive COM (92) 188.

20.US $ 23,000.

21.The fraction of the deposit that would not be covered by deposit insurance.

22.see Dale (1992).

23.European Commission, 1992.

24.European Commission, 1992.

25.EFTA includes Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, and Switzerland.

26.see Kay-Vickers (1986).

27.Merton (1977).The underlying intuition is that an increase in risk (variance of asset return) allows the shareholders of a firm to reap potentially large gains, while limiting the downside risk to zero because of the limited liability characteristic of shares.

28.see the application of moral hazard to the American S&L industry by L. White (1992).

29.Evidence is a strong word. In most cases, there will be a social-political belief of the need to protect consumers.

30.An additional argument to let the national regulatory structures compete, is that the 'general equilibrium' costs of regulation are not fully understood. With the exception of a paper by Santomero-Watson (1977), most scholars have used partial equilibrium models to analyze the effects of regulations.

31.Calomiris and Gorton (1991) argue that most of the bank runs are linked to a decrease in value of bank assets.

32.It is well known that the Bank of Italy did not intervene to prevent the collapse of the Luxembourg-based Banco Ambrosiano Holding, because it created little disturbance on the Italian financial markets.

33.Bailing out would occur if the failure of a branch of a foreign bank leads to a run on domestic banks.

34.Draft directive COM (92) 188.

35.Dermine, 1993.

36.Association Belge des Banques, 1989.

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Table 1 : Summary statistics on selected national banking systems

	Belgium	Denmark	France	FRG	Greece	Ireland	Italy
No. of commercial banks	85	76	404	299	34	33	267
No. of savings and mutual banks	29	165	421	594[a]	4	2	813
Assets of commercial banks (billion ECU)	239	93	771	518	39	20	588
Assets of other depository institutions (billion ECU)	41	NA	412	1085	19	14	246
GDP (billion ECU)	141	92	869	1072	49	27	783
Total assets/GDP	2.0	1.0	1.9	2.4	1.2	1.3	1.1
Population (millions)	10	5	56	62	10	4	58
Market share of five largest institutions (%)	58	77	43	26	63	45	53
ECU rate (domestic currency per ECU)	43.40	8.05	7.02	2.07	179.00	0.77	1510.00

Source: Dermine (1993)

[a] Does not include 3225 cooperative credit institutions
NA : Not Available

Table 1 continued

	Luxembourg	Netherlands	Portugal	Spain	UK	EEC	USA	Japan	Switzerland
No. of commercial banks	166	89	29	145	556	2183	12689	145[a]	236
No. of savings and mutual banks	49	53	1	188	163	2478	3323	1080	214
Assets of commercial banks (billion ECU)	239	345	45	400	1745	5003	2754	4183	399
Assets of other depository institutions (billion ECU)	NA	223	NA	175	283	2497	1033	3100	382
GDP (billion ECU)	5	203	39	343	764	4387	5720	2623	170
Total assets/GDP	44	2.8	1.1	1.7	2.7	1.7	0.8	2.8	4.6
Population (millions)	0.4	14.8	10.5	38.9	57.2	326.0	247.0	123.5	5.5
Market share of five largest institutions (%)	26	84	56	39	29	14	14	25	60
ECU rate (domestic currency per ECU)	43.4	2.33	173	130.2	0.67		1.1	152	1.8

Source: Dermine (1993)

[a] Include city and regional banks
NA : Not Available

Table 2 : Percentage of Labour Force in Banking, Insurance or Real Estate (%).

	1980	1989
Belgium	6.2	8.6
France	7.5	9.6
Germanuy	NA	7.9
Switzerland	NA	10.5
United Kingdom	8.2	12.7
United States	8.4	11.3

NA : Not available
Source : 0ECD (1991)

Table 3 : Trade in Financial Services
(in percentage of Exports (Imports) of Goods and Services)

	1988	1991
Belgium		
Exports	1.17	2.60
Imports	0.74	1.70
France		
Exports	1.50	5.7
Imports	1.70	6.3
Germany		
Exports	0.74	0.96
Imports	0.12	0.33
Switzerland		
Exports	3.00	3.80
Imports	NA	NA
United Kingdom		
Exports	2.40	3.20
Imports	0.09	0.20
Unites States		
Exports	3.80	4.70
Imports	1.70	2.30

NA : Not available

The data include commissions and fees received or paid related to the following transactions : Foreign exchange, international payments, management of cash balances, factoring, operations in securities, asset management, fiduciary funds, guarantees and endorsements, financial leasing, counselling on takeovers or mergers, participation in barter arrangements.

Source : OECD (1993).

Table 4 : Sector Distribution of the 100 Largest EC Banks

Sector	Number of Banks Ranked among the 100 Largest	Market Share Among the 100 Largest Banks (Percent of Assets)
Public	42	37.9
Co-operative	9	11.0
Mutual	5	1.5
Private	44	49.6

Source: J. Revell (1989)

Table 5 Interest Margins and Operating Expenses of Commercial Banks

	Belgium	Denmark	France	FRG	Italy
Average margin on demand deposits[a]					
(1980-85) (%)	11.2	16.2	11.7	6.5	4.3
(1987-92) (%)	8.7	9.0	9.7	7.2	NA
Average margin on savings deposits[a]					
(1980-85) (%)	5.6	8.9	4.3	2.8	3.4
(1987-92) (%)	3.9	7.0	5.2	2.2	NA
Population per branch	1816	1677	2189	1564	3800
Operating expenses per asset[b] (%)	2.6	2.8	3.2	2.5	3.0
Operating expenses as percentage of gross margin	0.66	0.65	0.65	0.65	0.63

[a]Current short-term rate minus interest rate paid on deposits
[b]Excludes interbank assets ; expenses on non-interbank is calculated as follows: total expenses minus (interbank assets x 1/8%)

Table 5 continued

	Luxembourg	Netherlands	Portugal	Spain	UK	USA	Japan	Switzerland
Average Margin on demand deposits[a] (1980-5) (%)	NA	5.6	NA	14.5	10.8	9.0	5.6	4.8
(1987-92) (%)	NA	6.8	NA	6.0	7.0	7.5	5.4	6.8
Average Margin on savings deposits[a] (1980-85) (%)	NA	2.8	NA	10.7	2.5	1.0	3.8	1.3
(1987-92) %	NA	4.7	NA	9.0	2.0	1.0	2.0	2.6
Population per branch	NA	2000	6031	1127	NA	NA	8700[b]	1622
Operating expenses per asset[c] (%)	1.0	2.5	2.5	3.5	4.2	3.5	1.0	2.0
Operating expenses as percentage of gross margin	0.41	0.65	0.47	0.60	0.65	0.61	0.61	0.55

[a]Current short-term rate minus interest rate paid on deposits.
[b]Does not include 22,000 branches of postal savings banks.
[c]Excludes interbank assets; expenses on non-interbank is calculated as follows: total expenses minus (interbank assets x 1/8%)
NA : Not Available

Table 6: Structure of Banks' Liabilities in Belgium (interbank excluded)
(Belgian Francs, billions)

	Deposits					
	Savings Accounts	Demand Deposits	Term Deposits	Savings Bonds[a]	Total	Savings and Demand Deposits as % of total
1986.....	607.3	450.9	677.6	447.6	2183.4	48
1987.....	690.6	476.1	769.8	455.4	2391.9	49
1988.....	766.6	517.7	805.0	465.0	2554.3	50
1989.....	862.3	572.9	982.2	526.0	2943.4	49
1990.....	757.5	581.2	1229.3	673.3	3241.3	41
1991.....	707.6	604.7	1423.8	794.3	3533.4	37
1992.....	667.3	588.0	1500.0	889.3	3644.6	34

Source: Commission Bancaire (1992)
a Known as 'bons de caisse', these are three- to five- year maturity deposits.

Table 7 : Domestic Mergers in Europe

Belgium	1992	CGER-AG Credit Communal
Denmark	1990	Den Danske Bank Unibank (Privatbanken, Sparekassen, Andelsbanken)
Italy	1992	Banca di Roma (Banco di Roma, Cassa di Risparmio di Roma, Banco di Santo Spirito) IMI - Cariplo San Paolo- Crediop
Netherlands	1990 1991	ABN - AMRO NMB-PostBank-ING
Spain	1988 1989 1992	BBV(Banco de Vizcaya-Banco de Bilbao) Caja de Barcelona-La Caixa Banco Central-Banco Hispano
Switzerland	1993	CS-Volksbank

Table 8 : Market Share of Banks on Life Insurance Market

Germany	3.9 %
Spain	74 %
France	37 %
Italy	< 5 %
Netherlands	10 %
United Kingdom	40 %

Source : Association Belge des Banques (1993).

Table 9: Market Share of Foreign Institutions (% of total assets)

	1986	1989
Germany	4.27	4.61
Belgium	46	47
France	10.9	13.0
Italy	2.45	2.9
UK	62.2	59.1
Japan	2.12	1.4
USA	17.9	21.4

Source : Goldberg (1992), Swary-Toft (1992).

Table 10 : Deposit Insurance Systems in Selected Countries

Country	Coverage (Domestic Currency)	Coverage (ECU)
Belgium	BEF 500,000	12,100
Denmark	DKR 250,000	32,470
France	FF 400,000	60,000
Germany	30% of equity per deposit	
Ireland	£IRL 10,000	12,350
Italy	Lit 1 billion (100% for first 200 mil. and 75% for next 800)	536,400 (100% for first 107,000 and 75 % for next 428,000)
Luxembourg	FLUX 500,000	12,100
Netherlands	DG 40,000	18,800
Spain	Pta 1,500,000	9,765
United Kingdom	75% of deposits (ceiling of £15,000)	75% of deposits (ceiling of 19,350)
Greece	No system	
Portugal	No system	
Japan	Yen 10,000,000	80,000
United States	$ 100,000	85,000

Table 11 : External Position of Banks vis-à-vis the Non-bank Sector
($ billions)

	1989	1992
Austria	10.9	8.9
Belgium	27.1	41.1
Luxembourg	77.2	121.6
Denmark	4.1	4.1
Finland	3?5	1.0
France	32.1	49.1
Germany	39.2	73.3
Ireland	4.4	4.9
Italy	9.1	9.2
Netherlands	31.9	42.2
Norway	1.4	1.3
Spain	20.4	29.3
Sweden	9.5	9.2
Switzerland	178.4	208.7
United kingdom	266.4	313.7
Caribbean Centers	204.5	231.1

Source : BIS (1993). These statistics could underestimate the external position of banks to the extent that fiduciary deposits are not reported.