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EC Regulation of the Banking Sector

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COMMENTARY

EC REGULATION OF THE BANKING SECTOR*

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INTRODUCTION

The removal of the barriers to the provision of banking and financial services throughout Europe has become one of the main objectives of the European Community ("EC"). The liberalization of the banking sector is an area in which much European legislation has concentrated in recent years. The reason for according a high priority to the area of banking is, perhaps, that the creation of a unified banking market in Europe is seen as an important stage in the achievement of one of the central aims of the EC — the economic and monetary union in Europe.

Economic and monetary union ("EMU") essentially involves a three-stage process. The first stage envisages full liberalization of capital movements and increasing cooperation between Member States in the area of economic and monetary policy. The second stage centers on the gradual shift of decision-making from a national level to a community level along with the establishment of a European System of Central Banks to initiate the move towards EC-wide decision making in the area of monetary policy. The third stage contemplates an irrevocable move to lock exchange rates, the replacement of national currencies with a single European currency, and the

* This article was written prior to the recent enactment of certain banking provisions which are described herein as anticipatory. As such, some of the descriptions of the planned implementation of the EC banking regulations have already been executed.

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empowerment of the EC to interfere with national budgets. The first stage has already been largely implemented. The changes anticipated by implementation of the second and third stages are controversial because there are obvious implications for national sovereignty, and, for this reason, the second and third stages may not be implemented for some time.

Certainly, events surrounding the Exchange Rate Mechanism ("ERM") which occurred in 1992 suggest that completion of the second and third stages of EMU may be a long way off. The ERM is an attempt by Member States to achieve exchange rate stability in the EC and, as such, is an important step towards the irrevocable locking of exchange rates under the third stage of EMU. The ERM operates by its members pegging their respective exchange rates and agreeing to limit movement within those rates to certain narrow bands. Membership in the ERM inevitably involves some loss of economic autonomy for the Member States because their ability to use interest rates as part of their economic policy becomes limited. Some members have been forced to maintain their interest rates at very high levels in order to keep their currencies within the ERM bands at a time when their economies would benefit greatly from sharp cuts in interest rates. In some cases, high interest rates have not been sufficient to maintain the ERM exchange rate parities — for instance, Ireland's decision to raise its overnight lending rate to 50% in January 1993 was insufficient to prevent a 10% devaluation of the Irish punt within the ERM later that month. In September 1992, both the United Kingdom and Italy suspended their currencies from the ERM, and since then Spain and Portugal have devalued their currencies within the ERM.

The recent devaluations and suspensions of currencies in the ERM have illustrated that there are considerable divergences between the economies of the various Member States. It has been suggested that, in economic terms at least, there are two tiers of Member States within the EC. The premier league is comprised of Germany, France, the Benelux countries and perhaps Denmark. The lower tier consists of Member States, such as the United Kingdom, Ireland, and Spain, which are perceived to have weaker economies and whose currencies regularly come under pressure. By way of illustration, the increased pressure on the sterling, which resulted in its withdrawal from the ERM in September 1992, was fueled in part by the weakened state of the economy of the United Kingdom. This situation, combined with high German interest rates, caused a run on the sterling in favor of the Deutschemärk. Recent newspaper reports have suggested that pressure within the ERM may now switch to the French franc. It remains to be seen whether France is sufficiently committed to the ERM to be prepared to sustain high interest rates in order to protect its currency at a time when its economy is in recession.

The European Currency Unit ("ECU"), which is referred to a number of times below, is a unit of account used throughout EC legislation relating to banking. It is composed of a "basket" of specified amounts of the currencies of each of the Member States in the EC. Those amounts are revised from time to time. In recent years, there have been an increasing number of bond and note issues in Europe which are denominated in ECU, and it is quite common for banks to make loans available in ECU. It may be interesting to note that the ECU is also a contender for adoption as the single European currency, should the third stage of EMU be implemented. The adoption of a single European currency (whether it is the ECU or one of the other currencies of the EC) would involve a very decisive step towards economic union in the EC because it would require Member States to relinquish their currencies in favor of the single currency. Some Member States are reluctant to take such a step because they regard the loss of their currencies as a blow to their national identity.

Despite the reservations of certain Member States about EMU, considerable progress has been made in the liberalization of the banking sector. That progress was marked in December 1989 by the adoption of what is commonly referred to as the Second Banking Directive.[1] The Second Banking Directive demonstrates a change of strategy in the way in which the EC has approached the liberalization of banking in Europe. Whereas the EC had previously concentrated on harmonization of national laws, the approach embodied in the Second Banking Directive centers on the concept of the single banking license. This would enable banks established in one Member State to establish branches and to provide a wide range of services throughout the EC. The concept of the single banking license is un-

1. Second Council Directive 89/646 of 15th December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, amending the Directive 77/780/EEC, 1989 O.J. (L 386) 1 (amended First Council Directive of 12th December 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, 1977 O.J. (L 322) 30) [hereinafter Second Banking Directive].

derpinned by three principles: (1) that the law and practice relating to banks should be harmonized across Member States; (2) that there should be mutual recognition by national supervisory authorities of the controls operated by each other; and (3) that home country control, i.e. supervision of banks, including branches in other Member States, should be undertaken by the supervisory authorities of the Member State where the bank is authorized.

The purpose of this commentary is to examine the Second Banking Directive and to look at complementary legislation in the field of banking which is intended to support the Second Banking Directive.

I. THE DEVELOPMENT OF THE SYSTEM FOR REGULATION OF BANKS

Before considering the Second Banking Directive in detail, it may be useful to look at the background to the attempts to create a unified banking market in Europe. The starting point is the Treaty of Rome 1957.[2] Article 2 of the Treaty describes the task of the EC as follows:

> [B]y establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relationships between the States belonging to it.[3]

Article 52 of the Treaty of Rome provides for the progressive abolition of restrictions on the freedom of nationals of one Member State to establish themselves in the territory of another Member State.[4] "Freedom of establishment" is defined specifically to include the right to set up and manage undertakings under the same conditions as those applying to nationals of the country where such establishment is to be effected. There is a similar requirement relating to the provision of services in Article 59 of the Treaty of Rome. This contemplates the progressive abolition of restrictions on the freedom of nationals of one Member State to provide services within the EC to persons in other Member States.[5]

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2. TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY].
3. EEC TREATY art. 2.
4. EEC TREATY art. 52.
5. EEC TREATY art. 59.

In 1985, a report was issued by the Commission which revealed that little progress had been made over the previous three decades towards the removal of the barriers to free trade within the EC. It was recognized that something needed to be done to accelerate change within the EC. This resulted in the signature of the Single European Act by all the Member States in 1986.[6]

The Single European Act of 1986 amended the Treaty of Rome by adding a new Article 8(a), providing for the completion of the process of creating an internal market by December 31, 1992. The "internal market" is defined as "an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured in accordance with the provisions of [the] Treaty."

Prior to the Single European Act of 1986, progress in the area of banking had been slow. Early Directives relating to the banking and capital sectors placed emphasis on "host country" control, i.e. branches of banks established in one Member State should be authorized and regulated by the authorities in the Member State where the branch was established. The activities of such branches were restricted to those which a domestic bank of the host State could conduct. Directive 73/183[7] required certain Member States to abolish discriminatory requirements relating to foreign branches of banks, such as capital requirements which were more onerous than those applying to domestic banks. However, this Directive made no attempt to coordinate the laws of the various Member States.

The first step towards creating a unified banking market was taken in 1977, in what is known as the First Banking Directive.[8] The First Banking Directive applies to "credit institutions" which are defined as undertakings whose business it is to receive deposits or other repayable funds from the public and to grant credits for their own account. "Credit institutions" should, for the purposes of EC legislation, be distinguished from "financial institutions" which do not accept deposits, but which conduct some or all of the activities associated with banks such as granting credit and taking participations.

The First Banking Directive set out minimum conditions to be

6. Single European Act, 1987 O.J. (L 169).

7. Council Directive 73/183 of 28th June 1973 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, 1973 O.J. (L 194) 1.

8. First Council Directive 77/780 of 12th December 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business for credit institutions, 1977 O.J. (L 322) 30 [hereinafter First Banking Directive].

met before credit institutions could be authorized to operate by Member States. The Directive permitted the granting of authorization only if the credit institution possessed each of the following: (1) its own capital, separate from the resources of its head office; (2) adequate minimum own funds; and (3) at least two persons of sufficient repute and experience effectively directing its business. However, meeting these requirements did not ensure automatic authorization in other Member States since it did not prevent Member States from imposing more stringent conditions. Member States were permitted to make the establishment of a branch of a credit institution with its head office in another Member State subject to the law and procedures of the host Member State. The First Banking Directive did, however, provide for coordination and collaboration between the supervisory authorities of Member States.

Directive 83/350[9] was a step in the direction of "home country" control. This Directive created a system for the consolidated supervision of credit institutions owning 25% or more of the capital of other credit and financial institutions. Such supervision to be exercised by the authorities of the country in which the head office of the credit institution owning the capital was situated.

II. The Second Banking Directive

The crucial piece of legislation in the field of European banking regulation is the Second Banking Directive.[10] This was adopted in December 1989 and Member States are required to implement it into their national legislation by January 1993. This directive covers a full range of financing activities, as the following list evidences:

1. Acceptance of deposits and other repayable funds from the public;
2. Lending;
3. Financial leasing;
4. Money transmission services;
5. Issuing and administering means of payment (e.g., credit cards, travelers' cheques and bankers' drafts);
6. Guarantees and commitments;
7. Trading for own account or for account of customers in:
   (a) money market instruments (cheques, bills, c.d.s, etc.);
   (b) foreign exchange;

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9. Council Directive 83/350 of 13th June 1983 on the supervision of credit institutions on a consolidated basis, 1983 O.J. (L 193) 18.

10. Second Banking Directive, *supra* note 1.

(c) financial futures and options;
(d) exchange and interest rate instruments;
(e) transferable securities;

8. Participation in share issues and the provision of services related to such issues;
9. Advice to undertakings on capital structure, industrial strategy and related questions and advice, and services relating to mergers and the purchase of undertakings;
10. Money brokering;
11. Portfolio management and advice;
12. Safekeeping and administration of securities;
13. Credit reference services;
14. Safe custody services; including, *inter alia*:
    - consumer credit,
    - mortgage lending,
    - factoring, with or without recourse,
    - financing of commercial transactions (including forfeiting).[11]

The directive also seeks to abolish any remaining restrictions on the freedom to establish branches of credit institutions and to provide banking services throughout the EC. The crux of the proposal is the single banking license, enabling banks authorized in one Member State to establish themselves via branches in other Member States, without being subject to further significant regulatory constraints. The wide range of permitted activities provided by the Second Banking Directive allows banks to transact in other Member States, once authorized by their home supervisor with respect to those activities. However, the Second Banking Directive does not confer that same freedom of establishment to *subsidiaries* of banks authorized in other Member States, as opposed to *branches* of banks authorized in other Member States. Subsidiaries, as opposed to branches, are required to obtain authorization from the host State in which the subsidiary is to be established. The rationale for this difference in treatment is, presumably, that a branch is, in fact, the same legal entity as its parent, whereas a subsidiary is a separate legal entity requiring separate authorization; the most logical place for that authorization to be given is the Member State where the subsidiary is incorporated.

A. *Minimum Requirements for Authorization*

The Second Banking Directive prohibits Member States from granting authorization to a credit institution if the institution's initial capital is less than ECU 5,000,000. There is, however, an exception

11. Second Banking Directive, *supra* note 1, Annex.

to that prohibition which permits Member States to grant authorization to particular categories of credit institutions whose initial capital is at least ECU 1,000,000, provided that the Member State concerned complies with certain notice and reporting requirements set out in the Second Banking Directive. Before granting authorization, Member States are required to know the identity and the amount of holdings of the shareholders or members of the credit institution who have holdings representing 10% or more of the capital or voting rights. The purpose of imposing minimum standards for authorizations is to ensure that those who deal with credit institutions are afforded an adequate level of protection and to equate competitive conditions throughout the community.

B. *Cross-Border Activities*

The Second Banking Directive also provides that Member States must permit within their territories the transaction of the activities listed in the Annex by a credit institution authorized in another Member State, provided that the credit institution's authorization covers such activities. A credit institution may carry on the activities for which it is authorized in a Member State, other than in its home Member State, either by establishment of a branch or by the provision of services.

The formalities for carrying on banking activities in another Member State vary, depending on whether the credit institution in question wishes to establish a branch in that Member State or, merely to provide services from the Member State in which it is already authorized. In the case of a credit institution wishing to establish a branch in another Member State, it must first notify the authorities of the Member State in which it is authorized and provide those authorities with certain information prescribed by the Second Banking Directive. The information to be provided covers such matters as the identity of the Member State in which the branch is to be established, the types of business intended, the structural organization of the branch, and the names of the persons responsible for its management. Provided that the authorities of the home Member State do not doubt the adequacy of the administrative structure or financial situation of the credit institution, they must communicate the information provided by the credit institution to the authorities of the host Member State. The amount of the credit institution's own funds and solvency ratio must also be communicated to the host Member State by the authorities, together with details of any deposit-guarantee scheme intended to protect depositors in the branch.

The host Member State is required to prepare for supervision of the credit institution within two months of receiving the information provided by the home Member State and, if necessary, to indicate the conditions under which, in the interest of the general good, the activities concerned must be carried on in the host Member State. Upon receipt of a communication from the host Member State or, in the absence of a communication, on the expiration of two months from the time the host Member State was provided with information about the credit institution by the home Member State, the branch may be established and commence its activities.

Where the credit institution wishes to engage in activities in another Member State by providing services from its home Member State, it must notify the authorities of its home Member State of the activities it intends to transact. The authorities of the home Member State must then notify the authorities of the host Member State, whereupon the credit institution may commence its activities.

Although the role of authorization and supervision will rest primarily with the home Member State, the host Member State will retain a limited supervisory role. The authorities of the host Member State may require all credit institutions having branches within its territory to provide periodic reports for statistical purposes. They may also punish breaches occurring with respect to matters falling within the power of the host Member State under the Second Banking Directive. Additionally, there is a general power vested in host Member States to prevent and punish irregularities which are contrary to legal rules adopted "in the interest of the general good" and to adopt rules governing the form and content of advertising by credit institutions "in the interest of the general good." Furthermore, the Second Banking Directive provides for the host Member State to retain responsibility for the supervision of the liquidity of branches of credit institutions, in cooperation with the authorities of the home Member State pending further coordination of laws. Host Member States also retain responsibility for measures resulting from the implementation of their monetary policies, although such measures must not discriminate against credit institutions authorized in other Member States.

C. *Reciprocity*

The issue which caused the most controversy during the course of the negotiation of the Second Banking Directive was that of reciprocity. Broadly, this means that banks from outside the EC might not be permitted access into the EC unless EC institutions are themselves given reciprocal treatment in the home country of the particular bank. The original text of the Second Banking Directive proposed a bureaucratic investigation system which would be triggered automatically whenever a bank from outside the EC sought entry to a Member State. This provoked a very unfavorable reaction both from within the EC, where the United Kingdom was concerned that such a stipulation would threaten London's position as a financial center, and from banks outside the EC, particularly the United States and Japan which feared that the reciprocity provisions were designed to create a "fortress Europe" from which they would be excluded. For a time, it was unclear whether reciprocal treatment meant that banks from the EC operating in third countries (i.e. non-EC countries) should enjoy identical privileges to those afforded to foreign banks within the EC, or whether it simply meant that EC banks operating in third countries should not be treated less favorably than local banks in those countries. The issue has now been resolved by revising the contentious provision of the Second Banking Directive so that the EC may take retaliatory measures where EC banks do not enjoy rights comparable to local banks in third countries. However, there is still some latitude within the provision for the negotiation of "comparable access," i.e., to procure the same freedom for banks from the EC which operate in third countries as third country banks enjoy in the EC.

The Second Banking Directive requires the authorities of Member States to inform the Commission of the authorization of a credit institution which is a direct or indirect subsidiary of an undertaking governed by the laws of a third country and, similarly, the acquisition by such an undertaking of a credit institution in the EC. Member States must also inform the Commission of, what is described as, "any general difficulties encountered by their credit institutions in establishing themselves or carrying on banking activities in a third country."

The obligation to provide such information is tied in to the requirement that the Commission compile periodic reports on the treatment accorded to EC credit institutions in third countries regarding establishment, the transaction of banking activities, and the acquisition of holdings in third country credit institutions. If the Commission considers that a third country is not granting EC credit institutions access to its markets comparable with that granted by the EC to credit institutions from that third country, the Commission may apply to the Council of the European Community for a mandate to negotiate comparable opportunities. If, however, the Commission considers that EC credit institutions in a third country are not offered the same opportunities as domestic credit institutions in that country, the Commission may itself initiate negotiations with the country concerned. Moreover, it may, at the same time, require Member States to limit or suspend decisions regarding requests for authorization from, or for the acquisition of holdings by, institutions in third countries for a maximum period of three months. The Council is empowered to extend the period of limitation and suspension. The Second Banking Directive provides that such limitation and suspension measures (whether by the Commission or the Council) will not apply to those credit institutions or their subsidiaries duly authorized by one Member State which wish to either establish a subsidiary in the EC or to acquire a holding in a credit institution within the EC.

D. *Limitations on Harmonization*

The Second Banking Directive permits Member States to establish stricter rules than some of those enacted in the Second Banking Directive itself — for instance, Member States are permitted to insist on initial capital in excess of the minimum of ECU 5,000,000, as specified in the Second Banking Directive. Requirements regarding notification of significant shareholdings in credit institutions, and limitations on shareholdings held by credit institutions in undertakings which are neither credit institutions nor financial institutions are examples of two other areas where Member States may impose more stringent obligations on credit institutions than those set out in the Second Banking Directive. This creates the possibility of credit institutions deliberately seeking authorization from a Member State whose rules are more liberal. This possibility is considered by the Second Banking Directive. One of its recitals requires Member States to deny authorization, or to withdraw it, where it is clear that a credit institution has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State in which it intends to conduct the greater part of its activities.

III. Complementary Legislation

It is intended that the Second Banking Directive will be supported by a number of other complementary Directives which are already in force or are under consideration. The following sections describe such complementary legislation.

A. *Accounts*

The annual accounts and consolidated accounts of banks and other financial institutions within the EC are regulated by Directive 86/635.[12] This Directive aims to coordinate the provisions relating to the content, format, and layout of the accounts of credit and financial institutions in the different Member States. In light of the increased activity by banks across national borders, this is of particular significance since it permits easy comparison of the accounts of various institutions and facilitates the task of regulating those institutions. This Directive applies to all banks whether incorporated or not. It lays down specific provisions relating to the format of the balance sheets and profit and loss accounts of banks, as well as to the items to be included within them. It also incorporates valuation rules for assets and detailed requirements relating to the contents of notes to the accounts. Additionally, the Directive requires publication of annual accounts, consolidated accounts, annual reports, and consolidated annual reports of credit institutions.

Directive 89/117[13] applies to branches of credit and financial institutions established in a Member State which have their head office outside the Member State. Such branches are obliged to comply with the requirements of Directive 86/635 relating to the publication of accounts and auditors' reports. Directive 89/117 further provides for the accounts and reports to be drawn up and audited in accordance with the laws of the Member State where the head office of the credit or financial institution is situated. Additionally, branches may not be required to publish annual accounts relating to their own activities. Member States may, however, require branches having their head offices in other Member States to provide additional information relating to matters such as their income and costs, staff employed, claims and liabilities attributable to the branch, and certain of their assets. The provisions relating to branches where the

12. Council Directive 86/635 of 8th December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, 1986 O.J. (L 372) 1.

13. Council Directive 89/117 of 13th February 1989 on the obligations of branches of credit institutions and financial institutions established in a Member State, having their head offices outside that Member State, regarding the publication of annual accounting documents, 1989 O.J. (L 44) 40.

head office is situated in non-EC countries are similarly broad, with the accounts to be drawn up and audited in accordance with the requirements of the third country. The host Member State may only require the branch to publish annual accounts relating to its own activities if the provisions of Directive 86/635 have not been complied with or if reciprocity does not exist with the third country.

B. *Winding-up*

The Commission has proposed a Directive to coordinate the rules relating to reorganization measures taken to safeguard or restore the financial situation of credit institutions and the winding-up of credit institutions and deposit guarantee schemes.[14] The Proposed Reorganization Directive places responsibility on the authorities of the home Member State to decide on the implementation of reorganization measures of credit institutions and their branches. "Reorganization measures" are defined to cover measures intended to safeguard or restore the financial situation of a credit institution and, in the case of the United Kingdom, to include powers of the Bank of England to appoint investigators and to revoke authorization under the Banking Act of 1987. These measures would be fully effective against the authorities and creditors of branches situated in other Member States, even where the host Member State does not provide for such measures. Decisions taken by the authorities of the home Member State would preclude the host Member State from taking any reorganization measures unless the home Member State so decides. In the case of credit institutions with head offices outside the EC, the host Member State would have the right to implement its own reorganization measures unless an agreement to the contrary has been concluded with a home country on the basis of the principle of reciprocity.

The Proposed Reorganization Directive also provides that the winding-up of credit institutions should be carried out in accordance with the laws of the home Member State and in collaboration with the authorities of the host Member State if the credit institution has its head office within the EC. In the case of credit institutions having their head office outside the EC, the winding-up procedures of the host Member State would apply. Finally, the Proposed Reorganization Directive places an obligation on Member States to ensure that

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14. Amended Commission Proposal for a Council Directive Concerning the Reorganization and the Winding-Up of Credit Institutions and Deposit-Guaranty Schemes, 1988 O.J. (C 36) 1 [hereinafter Proposed Reorganization Directive].

the deposit-guarantee schemes existing in their territory cover the deposits of branches of institutions having their head offices in other Member States.

The Proposed Reorganization Directive is still under consideration by the Council of the European Community and has been for some time. As yet, there is no indication when it will be adopted.

C. *Own Funds*

Own funds are an important yardstick for the authorities in assessing the solvency of credit institutions. In Directive 89/299 on own funds,[15] own funds are described as the credit institution's own capital which serves to absorb losses which are not matched by prospective profits of sufficient volume.

Directive 89/299 was amended in 1991 by Directive 91/633[16] and again in 1992 by Directive 92/16.[17] Directive 89/299 (as amended) lays down certain elements which comprise a credit institution's own funds. These include paid up capital, reserves, value adjustments, fixed-term cumulative preference shares, subordinated loan capital and other items at the free disposal of the credit institution. The Directive (as amended) imposes limits on the proportion of certain items to be included as against other items.

Although Directive 89/299 leaves Member States with discretion as to the use of the items comprising own funds and the fixing of lower ceilings within the maxima set down by the Directive, it obliges Member States to take into consideration increased convergence with a view of ultimately achieving a common definition of own funds.

A key change made by Directive 92/16 was to exempt Danish mortgage cooperatives from the rules relating to the required level of own funds for a limited period. The exemption was rendered necessary by the plans of the Danish government to convert the mortgage cooperatives concerned into public limited companies.

D. *Solvency Ratios*

The Directive on solvency ratios[18] is complementary to the Sec-

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15. Council Directive 89/299 of 17th April 1989 on the own funds of credit institutions, 1989 O.J. (L 124) 16.

16. Council Directive 91/633, 1991 O.J. (L 339) 48.

17. Council Directive 92/16, 1992 O.J. (L 75) 48.

18. Council Directive 89/647, 1989 O.J. (L 386) 14 [hereinafter Solvency Ratio Directive].

ond Banking Directive. Solvency ratios are seen as playing a central role in the prudential supervision of credit institutions.

The solvency ratio is calculated by referring to the credit institution's assets and off-balance sheet items weighted with different degrees of risk (the "denominator"), as against the credit institution's own funds (the "numerator"). Asset and balance sheet items are assigned risk weights, e.g. cash in hand has a nil weight, whereas claims on central governments and central banks of countries which are not members of the Organization for Economic Cooperation and Development ("OECD") and which have not concluded lending arrangements with the International Monetary Fund have a 100% weight.

The Solvency Ratio Directive provides that effective January 1, 1993, credit institutions will be required to maintain their ratios at a level of at least eight percent. Credit institutions which fail to reach eight percent by the deadline will be required to increase their ratios in successive stages. Only temporary fluctuations from the required level are permitted and adequate reasons for the fluctuation must be given to the supervisory authorities.

E. *Large Exposures*

The monitoring and control of risks or exposures are regarded as crucial elements in the prudential supervision of credit institutions. In a Commission Recommendation published in December 1986,[19] a large exposure was defined as an exposure to a client or a group of connected clients whose value equals or exceeds fifteen percent of the credit institution's own funds. The Recommendation on Large Exposures[20] suggested that large exposures should be reported to the authorities at least annually and credit institutions should be prohibited from incurring any exposure to a client or a group of connected clients when the percentage value exceeds forty percent of own funds. Additionally, it recommended that credit institutions should be precluded from incurring large exposures which in aggregate exceed 800% of own funds. The Recommendation on Large Exposures further suggested that those limits should be exceeded only in exceptional circumstances.

In March 1991, the Recommendation on Large Exposures was

19. Commission Recommendation 87/62 of 22nd December 1986 on monitoring and controlling large exposures of credit institutions, 1987 O.J. (L 33) 10 [hereinafter Recommendation on Large Exposures].

20. *Id.*

followed by a draft Directive on large risks.[21] The draft Directive represented a compromise between Member States such as the United Kingdom, which already imposes a limit of twenty-five percent of own funds on loans to an individual customer, and other Member States, which have ceilings of around forty percent.

The Directive on large risks was adopted in December 1992, after considerable discussion, and will be implemented in stages. This Directive mandates that beginning January 1, 1994, banks will be subject to a forty percent ceiling on their loans to a single customer. On January 1, 1999, the ceiling for new loans will be reduced to twenty-five percent of own funds, but the forty percent threshold will still apply to existing credit lines until January 1, 2002. In addition, small German banks with an annual turnover of less than ECU 7,000,000 will be allowed to apply the forty percent ceiling to existing loans until January 1, 2007. There is also an exemption until December 31, 1998 in the Directive on Large Risks for certain Portuguese loans. The Directive on Large Risks differs from the original Commission Recommendation by requiring notification to the authorities of any loan exceeding ten percent (as opposed to fifteen percent) of own funds and by limiting exposures to a client or group of connected clients to twenty-five percent of own funds. However, the overall limit on large exposures of 800%, which was set out in the Recommendation, has been carried through into the Directive on Large Risks.

F. *Consolidated Supervision*

On April 6, 1992, the Council adopted the Second Consolidated Supervision Directive.[22] This Directive widens the basis of consolidated supervision provided for in Directive 83/350 to banking groups where the parent is not a credit institution. The Second Consolidated Supervision Directive is seen as a means of ensuring the harmonious application of the rules relating to credit institutions established by other EC legislation and, in particular, Directive 89/299 on own funds.

The Second Consolidated Supervision Directive distinguishes three categories of parent undertakings: parent undertakings which are themselves credit institutions; parent undertakings which are fi-

21. Council Directive 92/121, 1992 O.J. (L 29) 1 [hereinafter Directive on Large Risks].

22. Council Directive 92/30, 1992 O.J. (L 110) 52 [hereinafter Second Consolidated Supervision Directive].

nancial institutions and whose subsidiary undertakings are exclusively or mainly credit or financial institutions (referred to as "financial holding companies"); and parent undertakings which are neither credit institutions nor financial institutions, but whose subsidiaries include at least one credit institution (known as "mixed-activity holding companies").

The Second Consolidated Supervision Directive provides that where a parent undertaking is a credit institution, the authorities in the Member State authorizing it shall exercise the powers of consolidated supervision. Similarly, where the parent of a credit institution is a financial holding company, consolidated supervision is to be carried out by the Member State which authorized the credit institution. Where two credit institutions authorized in different Member States share the same financial holding company as their parent and one of them is authorized in the same Member State as the parent, the Member State where the parent is authorized shall be responsible for consolidated supervision. If, however, the credit institutions and the parent are authorized in separate Member States, the Second Consolidated Supervision Directive provides for the various Member States to seek to reach an agreement on which Member State should supervise on a consolidated basis.

The position in relation to mixed-activity holding companies and their credit institution subsidiaries is rather different because the Second Consolidated Supervision Directive provides for the Member State in which the credit institution subsidiary is authorized to approach the mixed-activity holding company for information to enable it to supervise the credit institution subsidiary. The information supplied may be verified by on-the-spot inspections.

The Second Consolidated Supervision Directive also provides for the negotiation of agreements with third countries relating to the consolidated supervision of credit institutions whose parent undertakings have head offices in third countries and credit institutions situated in third countries whose parent undertakings have their head offices in the EC. Furthermore, this Directive provides that it is to be implemented by January 1, 1993, whereupon Directive 83/350 will be repealed.

G. *Deposit-Guarantee Schemes*

In December 1986, the Commission issued a Recommendation relating to deposit-guarantee schemes.[23] This Recommendation provided that Member States should ensure that their deposit-guarantee schemes fulfill certain conditions to cover situations where a credit institution is wound-up with insufficient assets. One of the conditions was that the scheme should cover the depositors of credit institutions operating in that Member State but which have their head office in another Member State. The Deposit-Guarantee Recommendation suggested that Member States which did not operate a scheme should be required to implement one by January 1, 1990.

The Deposit-Guarantee Recommendation was followed in 1992 by a Commission proposal for a Directive on deposit-guarantee schemes.[24] By that stage, the collapse of Bank of Credit and Commerce International ("BCCI") had emphasized the need for comprehensive deposit-guarantee schemes, and only ten of the twelve Member States had deposit-guarantee schemes which complied with the earlier Deposit-Guarantee Recommendation.

The Proposed Directive on Deposit-Guarantee Schemes provides for each Member State to ensure that a deposit-guarantee scheme is introduced in its territory which applies to all credit institutions authorized in that Member State. The scheme must cover depositors of branches created by such credit institutions in other Member States. The Proposed Directive on Deposit-Guarantee Schemes permits branches of credit institutions to apply voluntarily to join a scheme in the Member State in which it is established, to supplement the cover provided by the scheme in the Member State in which its head office is situated.

Moreover, the Proposed Directive on Deposit-Guarantee Schemes enables Member States to stipulate that branches of credit institutions whose head offices are outside the EC must join a deposit-guarantee scheme in the Member State, provided that the scheme must not accord to such branches more favorable treatment than is accorded to branches of credit institutions with their head offices within the EC.

It is proposed that schemes should provide minimum cover of at least ninety percent of each depositor's aggregate deposits up to an overall limit of ECU 15,000, and that payment should be made to depositors within three months of the deposits becoming unavailable.

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23. Commission Recommendation 87/63, 1987 O.J. (L 33) 16 [hereinafter Deposit-Guarantee Recommendation].

24. Commission Proposal for a Council Directive on Deposit-Guarantee Schemes, 1992 O.J. (C 163) 6 [hereinafter Proposed directive on Deposit-Guarantee Schemes].

The Proposed Directive on Deposit-Guarantee Schemes provides that the Directive on deposit-guarantee schemes must be implemented by January 1, 1994.

H. *Mortgages*

In 1985, the Commission proposed a Directive which would remove restrictions on credit institutions undertaking mortgage business throughout the EC.[25] The Proposed Directive on Mortgage Credit was intended to apply to credit institutions which engage in mortgage credit activities, i.e., those which receive funds from the public and which provide loans to the public secured by land for the purpose of acquiring, retaining, or improving property. However, the Proposed Directive on Mortgage Credit has been largely overshadowed by the Second Banking Directive which also deals with mortgage credit and may, therefore, be dropped entirely from the legislation program.

I. *Investment Services*

As part of its attempts to create a unified financial market throughout the EC, the Commission has proposed a Directive in the field of investment services.[26] This Proposed Directive closely parallels the Second Banking Directive. It applies to investment firms which are defined in the Directive as "any natural or legal person whose business it is to provide any investment service." "Investment services" are listed in the Annex to the Proposed Directive on Investment Services and include brokerage in financial instruments on behalf of clients, dealing in such instruments as principal, market making, portfolio management, underwriting, investment advice, and custody services.

There is a clear overlap with the Second Banking Directive. The Second Banking Directive contemplates that, under its provisions, credit institutions may be authorized by Member States to engage in activities which fall within the list of investment services. This is recognized by the Proposed Directive on Investment Services which provides, in Article 2, that, in the case of credit institutions authorized

25. Commission Proposal for a Council Directive on the Freedom of Establishment and the Free Supply of Services in the Field of Mortgage Credit, 1985 O.J. (C 42) 4 [hereinafter Proposed Directive on Mortgage Credit].

26. Amended Commission Proposal for a Council Directive on Investment Services in the Securities Field, 1990 O.J. (C 42) 7 [hereinafter Proposed Directive on Investment Services].

by their banking license to engage in securities business, only Articles 9(2), 11 and 13 of the Proposed Directive on Investment Services will apply. These provisions relate to such matters as the following: freedom of access to stock exchanges and securities' markets in the Member State where the branch of the investment firm is established; the requirement by home Member States to make sufficient provision against market risk; and the application of prudential rules by home Member States in areas such as administrative and accounting procedures.

The procedure for obtaining authorization is very similar to that contained in the Second Banking Directive. Investment firms which are not authorized to provide investment services under the Second Banking Directive are required to obtain authorization from their home Member State before providing such services. Before granting authorization, the authorities of the home Member State are required to be satisfied with the level of the investment firm's initial capital and the reputation and experience of the persons directing its business. Once authorized, the investment firm may provide the investment services for which it is authorized in its home Member State to persons in other Member States either by establishing a branch in the host Member State or by provision of cross border services. In each case, the Proposed Directive on Investment Services sets out a procedure to be followed by the investment firm. The procedures are similar to those provided for in the Second Banking Directive. As in the case of the Second Banking Directive, the procedures relating to the establishment of a branch are more extensive than those for the provision of cross border services.

J. *Capital Adequacy*

The Commission has proposed a draft Directive on capital adequacy.[27] Although it is aimed mainly at investment firms which are not banks, it generally affects credit institutions, albeit to a limited extent.

Non-bank investment firms, holding clients' money and/or securities, which receive, transmit, or execute customers' orders, or which manage individual portfolios are required to have an initial capital of ECU 100,000. However, this requirement only exists if they do not deal in any financial instruments for their own account,

27. Amended Commission Proposal for a Council Directive on Capital Adequacy of Investment Firms and Credit Institutions, 1992 O.J. (C 50) 5 [hereinafter Proposed Directive on Capital Adequacy].

nor underwrite issues on a firm commitment basis. Where a firm is not authorized to hold clients' money or securities, nor to deal for its own account or to underwrite issues, the required level of initial capital may be reduced to ECU 50,000. The Proposed Directive on Capital Adequacy stipulates that all other investment firms will require an initial capital of ECU 500,000.

This Proposed Directive contains detailed technical requirements for investment firms and credit institutions in areas such as risk provisions and the monitoring and control of large exposures. However, supervisory authorities are given the option of applying the Solvency Ratio Directive to investment firms' trading book business, rather than the Proposed Directive on Capital Adequacy, provided that the business concerned does not normally exceed five percent of the particular firm's business, nor the amount of ECU 15,000,000.

The progress of the Proposed Directive on Capital Adequacy has been hampered by fears that banks which deal in securities will be discriminated against compared with non-bank investment firms. However, there has been some success recently in reaching a common position on this Proposed Directive which achieves a relatively "level playing field" in terms of the capital requirements applicable to both banks and non-banks.

Conclusion

It is clear that considerable progress has been made to date in the adoption of measures to move the banking sector towards the creation of a unified banking market. However, it is still unknown whether Member States will be prepared to cooperate in the area of closer coordination of economic and monetary policy, and how the reciprocity measures with third countries will work in practice. It is certainly possible that the controversy surrounding the issue of economic and monetary union and its implications on national sovereignty may hamper further progress in the banking sector by souring relations between Member States. As far as the Proposed Directive on Investment Services and the Proposed Directive on Capital Adequacy are concerned, it is apparent that neither will be implemented at the same time as the Second Banking Directive, as was originally contemplated, and that both may, indeed, be subject to further negotiation.