EUROPEAN UNION

BANKING

SUMMARY

The banking market in the European Union (EU) is one of the world's largest and most sophisticated, although it remains in many ways a work in progress. The member states of the EU (the "EU-15" consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom) decided over a decade ago to attempt to create a single market for financial services and have completed much of the legal framework to support a single market. As a result, any bank established in any member country gains a "passport" to provide banking services through local branches or across borders throughout the EU. Each bank is regulated by the authorities of its home country and may provide financial products that are permitted by those home-country regulators throughout the EU (subject to the minimum standards set forth in EC directives). This rule also applies to separately-capitalized subsidiaries of foreign banks, which are subject to all of the standards set forth in EC directives, but it does not apply to direct branches.

Several hurdles remain to the completion of a truly unified market. Different tax structures and differences in tax treatment across borders constitute major obstacles to the single market. National rules adopted to protect the "general good" may also create hurdles to cross-border provision of financial services.

U.S. bank subsidiaries established in any EU member state receive national treatment. This treatment was reinforced by the EU's commitment under GATS negotiations in the WTO to provide market access and national treatment to the banks of its trading partners. Direct branches of non-EU member banks are now governed by this commitment. As a result, the concerns of U.S. banks operating in the EU are for the most part quite similar to those of their European counterparts. The European Commission has recently adopted a plan to improve the way the European Union's financial services markets function. The plan focuses on the adaptation of the existing legal framework; improving the retail market in financial services; and enhancing regulatory and supervisory cooperation at EU and international levels. The paper will be presented to the European Union Heads of State and Government at the Vienna European Council in December and will likely guide the agenda for financial reform in coming years.

DESCRIPTION OF THE MARKET

Market Structure

The EU banking market is large and diverse. Aggregate data for the EU-15 are limited, although the availability of data will improve soon as the new European System of Central Banks (ESCB) begins to implement Economic and Monetary Union (EMU). According to the European Monetary Institute (EMI), total bank assets of the EU-15 countries were US$13.8 trillion compared to US$9.9 trillion for the EMU-11 countries and US$5.0 trillion for the United States (year-end 1997 data). The number of banks in the EU-15 countries was about 9,500 in 1997.

The corporate finance market in the EU has traditionally been characterized by a relatively high degree of bank lending compared to securities issuance, though the volumes vary greatly across member states. Total bank credit amounts to 89 percent of total indebtedness of non-financial companies in Germany, 82 percent in France, 68 percent in Italy, and 63 percent in the UK. Commercial paper markets exist in six EU countries (Belgium, Germany, Spain, France, the Netherlands, and the UK), but they play a sizeable role only in France and Spain.

In 1997, the EMI conducted a wide-ranging survey of the EU banking sector in preparation for EMU. The survey identified medium and long-term trends of importance to the stability of the EU banking system. In its 1997 Annual Report, while cautioning against over-generalization, the EMI stated that four main trends could be discerned over the past four years:

1. A decline in banks' profitability;
2. A narrowing of interest rate margins;
3. A rise in non-interest income; and
4. A reduction in staff costs and the number of staff.

The EMI viewed these trends as the result of the combined effect of several factors – financial liberalization, disintermediation, internationalization, and technological change – which have emerged in recent years.

Major Developments in the EU Banking Market

The most significant developments in the EU banking market in the past few years have been the decision to introduce a single currency in eleven member states beginning January 1, 1999, and several developments related to completion of the internal market for banking. (The WTO multilateral financial services negotiations, and their impact on the EU banking market and U.S. banks operating therein, are discussed in the final section of this chapter.)

Economic and Monetary Union (EMU). As of January 1, 1999, the official currency of eleven of the fifteen EU member states (Denmark, Greece, Sweden, and the United Kingdom will not participate initially) will become the "euro." The national currencies of these member states will be phased-out over three years, during which time the national bank notes will continue to circulate as "non-decimal denominations" of the euro. All international transactions, wholesale financial transactions, interbank transactions, and public finances will be conducted in euros from January 1, 1999. Also, all outstanding stocks of government debt will be re-denominated into euros on that date. Banks will have the option of offering consumer accounts and various services denominated in euros starting on that date, and most of the large banks are preparing to do so.

EMU is expected to have substantial and far-reaching effects on the banking sector of the EU. Although opinions vary considerably and a thorough discussion of all of these effects is beyond the scope of this report, many experts agree on the following major effects: increased cross-border competition and continuing consolidation within the euro zone, the elimination of intra-European currency trading and corresponding business adjustments, further development of the European corporate bond market and possible reductions in bank lending, and increased "policy" competition among European governments and possible reduced demand for some governments' bonds.

The euro zone will have a single monetary policy, which will be set and implemented by the European System of Central Banks (ESCB). The ESCB will consist of the European Central Bank (ECB), located in Frankfurt, and the national central banks of the EU-15 countries. The decision-making authority of the ECB will reside in the Executive Board (the President and Vice President of the ECB and four other members appointed by the European Council), the Governing Council (the Executive Board of the ECB and the governors of the participating national central banks), and the General Council (the President and Vice President of the ECB and the governors of all the national central banks).

Although the ECB officially opened its doors on June 1, 1998, the precise nature of its approach to implementing monetary policy is still evolving. For example, on July 7, 1998, the ECB announced that it would impose minimum reserve requirements and it laid out some key parameters of the policy; however, it said a final decision on the exact specifications of the reserve requirements would come in November 1998. The Maastricht Treaty which established the ECB makes clear that the primary objective of the ECB is to maintain price stability, and it is only secondarily to support the economic policies of the EU.

Refining the Second Banking Directive. The EU is in the process of attempting to combine the fifteen distinct financial services markets of its member states into a single unified market. This process began in earnest with the liberalization of capital movements within the European Community in July 1990. With the removal by Greece of the final derogation to this decision in May 1994, capital movements within the European Community became essentially unrestricted. Member states must also endeavor to apply the same degree of liberalization to capital movements to and from third countries. (In the case of serious disturbances arising from such capital movements, member states are required to consult one another.)

The freedom to provide banking services across borders, creating a "single market" for banking, was provided by the Second Banking Directive (2BD) in January 1993. This directive established the principles of a single license or "passport" and control by home-country regulators under a regime of common rules on admission and supervision. In July 1997, the European Commission published an "Interpretive Communication" on the functioning of the 2BD. This communication attempted to address what the Commission saw as key deficiencies in the 2BD that were hindering the development of a true, single market for banking. Despite this clarification from the Commission regarding member states' use of the "general good" exclusion to prohibit some banking services, some U.S. banks remain concerned that differing interpretations may continue at the member state level. In the absence of clear guidance at the EU level and a more precise definition of the "general good," some uncertainty remains about which banking services will be permitted.

Proposal on Taxation of Cross-Border Savings Income. In May 1998, the European Commission proposed a new directive "to ensure minimum effective taxation" of savings income in the EU. In the Commission's proposal, each member state would be required to apply either a withholding tax of at least 20 percent or provide information to other member states on interest income from savings. To avoid double taxation, each state would be obliged to credit withholding tax paid in another member state. Banks, or any other entities that pay interest income, would be responsible for implementing the withholding tax or the reporting requirement.

U.S. participants in the EU market have expressed concerns about this proposal. They argue that the system would add significant costs to financial transactions in the EU, impairing the competitiveness of European financial centers and creating incentives for the development of offshore financing structures. They also assert that this requirement would be counter to the international trend of reducing or eliminating withholding tax on interest income and that it would be a significant imposition on financial institutions already strained by the information technology demands of the euro transition and the Year 2000 problem.

Enhancing Consumer Confidence. In May 1996, the European Commission published a Green Paper on "Financial Services: Meeting Consumers' Expectations." The Green Paper drew attention to a number of particular consumer problems that the Commission thought required action. These problems included the refusal by some institutions to sell financial services to nonresidents, poor quality of service, lack of consumer information, and the activities of unregulated intermediaries.

After a series of consultations were held, a Communication from the Commission presented a work plan in June 1997. The work plan included four steps: 1) a proposal for a new directive on "distance selling" of financial services, 2) a call for a "clear commitment" from the industry to voluntarily improve the information provided to consumers, 3) a review by the Commission of the 1987 directive on consumer credit to consider updating the directive to current market conditions, and 4) a series of measures to facilitate development and acceptance of electronic commerce.

Simplifying the Legislative Structure for Banking. In December 1997, the European Commission proposed replacing 19 separate directives governing the banking industry (7 basic and 12 amending) with a single Directive, without changing their substance. The basic directives to be consolidated include the 1977 First Coordinating Directive, the directives on own funds of credit institutions and on the solvency ratio for credit institutions, the 1989 Second Coordinating Directive (2BD), the directive on large exposures, and the directive on supervision on a consolidated basis. The directives on deposit-guarantee schemes, the prohibition of money-laundering, capital adequacy, and the accounting directives on the banking industry would be beyond the scope of this proposed consolidation.

The EU Directive on Data Protection (sometimes referred to as the Privacy Directive), approved in 1996 and due to take effect in October 1998, may cause problems for U.S. banks operating in the EU. (Indeed, implementation with respect to the United States has been delayed, pending the outcome of negotiations between the Commerce Department and the EU. The objective is to reach agreement on a set of "safe harbor" principles to which U.S. corporations could adhere voluntarily, providing such corporations with a presumption of an adequate level of privacy protection.) This directive is intended to protect the personal information of consumers by placing restrictions on the manner in which corporations can collect, use, store and transmit any data related to an identifiable individual. Under the directive, corporations will generally be required to collect such data only with permission, use it only for stated purposes, maintain its accuracy, and make it available to individuals upon request.

Most importantly for U.S. corporations and other multinational corporations, including European ones, businesses will be allowed to transmit such data across borders only to countries that have been deemed to provide "an adequate level of protection," as determined by the EU. If the United States was found not to provide adequate protection of personal data, this restriction could handicap many types of businesses (e.g., banks and credit-card companies) by preventing them from sharing data on EU customers with home office operations.

Regulatory Structure

Although EMU will transfer the control of monetary policy from member-state central banks to the ECB, the responsibility for bank supervision and regulation will remain at the member-state level. As described above, the Second Banking Directive established the principle of "home-country" supervision under which a financial institution is subject to the authority of the bank regulator in its country of incorporation. This principle applies even for services provided cross-border in the jurisdiction of another regulator. In the case of some services, "home-country" regulators must be notified of an institution's plans to provide the service. (The Commission has indicated that it intends to submit a proposal to abolish the notification requirement.)

Bank Supervisory Agencies in EU Member States

Country	Supervisory Agency
Austria	Federal Ministry of Finance
Belgium	Banking and Finance Commission
Denmark	Danish Financial Supervisory Authority
Finland	Financial Supervision Authority
France	French Banking Commission
Germany	Federal Banking Supervisory Office
Greece	Bank of Greece
Ireland	Central Bank of Ireland
Italy	Bank of Italy
Luxembourg	Luxembourg Monetary Institute
Netherlands	Central Bank of the Netherlands
Portugal	Bank of Portugal
Spain	Bank of Spain
Sweden	Financial Supervisory Authority
United Kingdom	Financial Services Authority (as of June 1998)

U. S. PRESENCE IN THE MARKET

In 1997, approximately 150 subsidiaries and branches of U.S. banks and other financial institutions were operating in the EU-15 countries. This total included 33 in the United Kingdom, 29 in France, 20 in Germany, 13 in Italy, and 11 in Spain. U.S. institutions are located primarily in major financial centers, and they concentrate on wholesale banking operations. However, a few U.S. institutions have pursued a broader strategy, with more locations and a full array of retail products.

TREATMENT OF U. S. FINANCIAL INSTITUTIONS

In the WTO multilateral financial services negotiations, the EU committed to provide access to its banking market on a "most-favored nation" (MFN) basis, including the right to establish branches. The EU's commitment also removed several remaining restrictions on the operations of foreign banks, including the application of "economic-needs testing" in the banking sector in Austria. The reciprocity provisions in the various EU financial services directives (i.e. banking, investment services, and insurance) are automatically superseded by the WTO commitments because of specific clauses in the EU directives. For example, the reciprocity article of the Second Banking Directive provides that "Measures taken pursuant to this Article shall comply with the Community's obligations under any international agreements, bilateral or multilateral, governing the taking-up and pursuit of the business of credit institutions."

As a result of these WTO commitments, very few strictly "national treatment" issues remain for U.S. banks operating in the EU. As mentioned above, the EU offers market access to foreign financial institutions on a MFN basis. The concerns of U.S. financial service companies in the EU market are generally concerns that are shared by all institutions in that market, both foreign and domestic. For example, the cross-border provision of services in the EU is an increasingly sensitive issue for U.S. institutions as they continue to centralize their global activities. Several large U.S. institutions are developing systems in which foreign exchange transactions – whether they are initiated in London, Paris, Rome, or Athens – will be executed from a single location. If this business practice is restricted or hindered by EU member-state application of "general good" provisions, these U.S. institutions will be commercially disadvantaged. However, an EU bank pursuing the same strategy could be equally disadvantaged.