Target 1992

*The **Deputy Governor** discusses[1] some of the issues to be faced in the field of banking and financial services as the European Community moves towards completion of the internal market. He stresses that, if the single market is to be a success, the principle of steady, practical and realistic progress must remain paramount; and the Community's regulatory approach must be based on competition, liberalisation and decentralisation, with no attempt to shut out those from outside Europe.*

*The **Deputy Governor** argues that an attempt to impose complete harmonisation in regulation of banking and investment services in one step would be disruptive and confusing. Instead, applying the principles of mutual recognition of other member states' supervision and harmonised minimum capital standards—principles which are incorporated in the Commission's proposals—provides the best way forward at this stage. Finally, he emphasises that, while access to financial markets may sometimes have to be restricted in the real world, the reciprocity tests in the Second Banking Directive run the risk of driving business out of Europe rather than offering advantages to it; instead, the rules should be discretionary and operated locally by experienced professional supervisors.*

The origins of the internal market programme, or less pompously '1992 and all that', can be traced right back to the Treaty of Rome, and more immediately to Lord Cockfield's White Paper of 1985. The Single European Act of 1986, which followed and which was ratified by all member states, defined the internal market as one 'without internal frontiers in which the free movement of goods, persons, services and capital is ensured'.

But it would be unrealistic to expect that economic integration, which has advanced slowly, in fits and starts, throughout the life of the Community, will suddenly blossom in 1992 into one completely unified market. Instead we should look only for steps which will represent, again using the words of the Act, 'concrete progress towards European unity'. The 1992 programme—which the United Kingdom welcomes—is thus a fundamental part of the progression from customs union through common market to economic union; it should not be seen as an end in itself. Further steps towards convergence of economic performance in the Community will be needed after 1992, and will take time.

The 1985 White Paper listed some 300 legislative proposals for removing barriers to trade within the Community. Many of these may appear trivial but are in fact the building blocks with which the single market must be constructed. The recent agreements on food additives and on cosmetics, for example, may not seem momentous to those of us outside those fields, but the internal market needs to address such matters if it is to have solid foundations. The principle of steady, practical and realistic progress must remain paramount. This is particularly important in financial services, where a hasty adoption of theoretically ideal legislation might prove unworkable in practice and have seriously adverse consequences.

If I may be permitted a brief detour, this principle should be equally applied to calls for monetary union and for the establishment of a European Central Bank. I do not wish to predict or prejudge the recommendations likely to emerge from the Committee set up at the Hanover summit under the chairmanship of M. Delors. But I certainly hope that it will find a series of practical measures to recommend which will run with the grain of the market.

Indeed, we in the United Kingdom are shortly to undertake one such small step by issuing ECU Treasury bills. Of course the Italian government pioneered the issue of official short-term ECU paper, and we hope our proposals will help to develop the ECU market even further. The UK government's bills will be of shorter maturity than the Italian bills; they will be payable on subscription and repayable on maturity in ECUs; and they will not be subject to a withholding tax. We have also taken steps to encourage a secondary market for these bills, and hope that these developments will act as a catalyst for the growth of an ECU money market, which is itself crucial to greater use of the ECU.

I now return to 1992 and the internal market. Following a publicity campaign by our government, awareness of, and interest in, 1992 have grown enormously in the United Kingdom. In the area of financial services, a variety of groups have now been established or reconstituted, including the European Committee of the British Invisible Exports Council, chaired by our chairman today, Sir Michael Butler. For its part, the Bank

(1) In a speech at a conference on 'Target 1992' organised by the Italian Chamber of Commerce in London on 23 September.

of England—through the Governor's City Liaison Committee—launched a survey earlier this year to heighten awareness of the implications of 1992 among financial institutions, and to discover their views on the single market. There is now a growing realisation that the internal market offers an important opportunity for expansion in Europe, although it will also produce the challenge of increased competition at home and abroad.

Nonetheless, I believe that there are still risks that must be avoided if the single market is to be the success for which we hope. Those risks fall loosely into three groups:

- First, as I have already stressed, an internal market cannot be expected to emerge like Venus from the waves, instantaneously complete and whole and beautiful. It is easier to legislate for a single market than actually to create one; work on its completion will continue well beyond 1992.

- Second, the Community's regulatory approach must be based on competition, liberalisation and decentralisation; there is a risk that otherwise bureaucracy may proliferate and stifle growth.

- Finally, the international dimension to 1992 cannot be ignored. The Community should be seeking truly unified internal markets in goods and services but ones which are not closed and which also fulfil a global role. In financial services Europe must maintain the capacity to provide a centre or centres matching and complementing New York and Tokyo in serving the needs of customers from outside as well as within the Community. The openness of centres like London brings much benefit to Europe which would be destroyed by a brick wall round the Community shutting foreigners out.

These risks are less likely to be realised if practitioners become involved in the decision-making processes which will shape the nature of the internal market. The internal market is now at its formative stage; many proposals are being drawn up for implementation in three or four years time. But business needs to understand, and to contribute to, the thinking behind the legislation which underpins the internal market programme. Practitioner input is essential if the outcome is to be workable; realistic expectations are a good basis for progress towards realistic legislation.

To help practitioner involvement, we have now passed a summary of the results of the Bank's questionnaire on 1992 to the firms and trade associations which participated, and are following this up with bilateral discussions with a sample of the firms involved. The initial responses, although encouraging in their optimism, revealed definite gaps in knowledge. Some practitioners are unclear exactly how Community legislation on the single market works and how it will affect them. No doubt the pitfalls of 'eurojargon' explain some of the confusion, as companies struggle to differentiate between terms such as mutual recognition, home and host control, approximation and harmonisation. A brief review of the theory behind this terminology may therefore be helpful.

The Community faces a huge task in legislating for the creation of a single market whilst seeking to act swiftly and avoid overregulation. Twelve different and well-established sets of national rules may well be inefficient, but it would not serve the interests of efficiency simply to add a further layer of Community regulations. The alternatives are therefore either to introduce fully harmonised Community-wide regulations to replace national rules or to adopt the principle of mutual recognition whereby each state accepts other states' domestic regulation as equivalent to its own.

The agreement reached earlier this summer on the liberalisation of capital movements in the Community is an example of the first approach, that of Community-wide regulation. Significantly, however, it is an argument for the abolition of regulations rather than their unification. By contrast, measures relating to regulation in specific sectors of financial services tend to provide examples of the second approach, that of mutual recognition of home control. This is well illustrated by the Commission's draft Second Banking Co-ordination Directive. Put simply, this directive would mean that once a bank had met the requirements set by, for example, the Italian banking authorities, it would automatically be permitted to offer its services or establish branches in any other Community country.

This principle of home control, however, arguably runs the risk of encouraging migration of business to the member state with the lowest supervisory standards. The chance of this happening to a large extent may not be very great, but it does exist. The solution is to create harmonised minimum capital standards to operate alongside mutual recognition in order to protect both the consumer and the integrity of the market as a whole. There would also remain an important place for local rules set by the host country, which would govern the local method of conducting business on a non-discriminatory basis. This three-pronged approach of mutual recognition of home control, harmonised minimum standards, and host rules should be an effective way to combine deregulation and liberalisation with consumer protection.

It is this approach which will, I hope, be successfully put into practice in the Commission's proposed directives on banking and investment services. Although it can be argued that complete harmonisation would ultimately be the only way to achieve a truly open and uniform internal market in such services, to attempt to impose it in one step would be disruptive and confusing. Applying the principles of mutual recognition and harmonised minimum standards should prove a major step in the direction of unification and one which is possible and practicable at this stage. Happily, the Commission's proposals do indeed incorporate these principles. In the case of banking, the work of the Cooke Committee in

Basle is also important, and their convergence agreement on capital adequacy, which took account of work already done in Brussels, provides a model on which to base our regulations within the Community. If all member states follow the principles and standards set out in that agreement, it will make mutual recognition much less difficult.

At present, the harmonised capital adequacy ratios cover credit risk but not position risk, which reflects the risk of loss from price movements in securities held by credit institutions for trading purposes. Such loss can all too easily occur at a time of unusual market volatility. It is therefore essential that supervisors are able to maintain an appropriate degree of flexibility to adopt standards above the prescribed minima until such time as more international work on position risk has been completed and further harmonisation is introduced. The same freedom will be needed until the Commission's Investment Services Directive, which will cover securities trading by non-banks, is finalised. That directive must be compatible with the provisions of the Banking Directive and its treatment of banks' securities business. In formulating both directives we should look at the experience of other countries active in trading securities, such as the United States and Japan, and aim for rules which where possible mesh in with those in the other major centres.

The recent Cecchini report estimated that financial services in the Community could grow by some 22 billion ECU as a result of a deregulated internal market. Unfortunately, it will take time for an open market to become fully effective even when the regulatory framework has been put in place. Insurance provides a good example; the transition of that market from the present position, where in many member states insurance is all but closed to cross-border competition, to an open market may well be long and difficult. Established trading patterns and local practices will all take time to break down. But even if Cecchini's estimates at first turn out to be optimistic, a single market will produce growth, will greatly benefit consumers and will give more efficient firms a tremendous opportunity.

As I stated earlier, we must not ignore the external dimension of 1992. A single efficient and competitive internal market should encourage trade between the Community and the rest of the world with great mutual benefit. Some have argued that 1992 will simply open more European doors to foreign competitors. But as M. de Clercq, the Community's External Affairs Commissioner, has said, this need not be so. In fact, the outcome depends on the calibre and preparedness of European businesses. The same factors will govern the Community's ability to play its proper role in the world economy. The alternative approach of attempting to protect the internal market as a whole from international competition would be highly damaging to the future of the European economy.

Ideally, access to financial markets should be unrestricted, but in the real world it may be necessary to accept that access to markets should be to some extent on a reciprocal basis. But it would surely be wrong to introduce unilaterally reciprocity tests to be applied automatically, as was suggested in article 7 of the draft Second Banking Directive. This is a stance symptomatic of introversion rather than a commitment to free trade. The Commission's proposals would, moreover, by their centralisation impose a great bureaucratic burden. They run the risk of driving business out of Europe rather than offering advantages to it. Reciprocity rules need to be discretionary and to be operated locally by experienced professional supervisors.

Before I finish, I should like to welcome the progress already made in Italy in preparation for 1992, even if, as Signor Dini has just observed, there is still much to be done. The gradual dismantling of exchange controls, the modernisation of domestic markets and the rationalisation of institutional structures are major steps in the right direction. I know that there are fears within Italy that the liberalisation of capital movements may prove profoundly destabilising for international flows of funds and, therefore, for the Exchange Rate Mechanism of the EMS. To those harbouring such fears our own abolition of exchange controls in 1979 should provide an encouraging example; we found the once and for all adjustment to external portfolios broadly offset by greater confidence from overseas investors that they might safely bring in capital.

The completion of the internal market will not be easy for any of us and will take time, but the prize is an important one—a fully competitive, modern Community capable both of serving the needs of its own consumers and of maintaining its global position. It is vital that the framework for 1992 be the right one. As I have suggested, this requires patience and persistence, a combination of deregulation and gradual, effective harmonisation and, last but not least, a commitment to competition and free trade on a global basis.