The EC single market in financial services

The single market programme was designed to remove barriers to the free movement of goods, services, persons and capital within the European Community. By the end of 1992 the programme was virtually complete, with agreement on over five hundred measures, including almost all of the three hundred originally listed in the EC Commission's 1985 White Paper. An important part of the programme relates to financial services. This article[1] *looks at the main elements of European legislation in this area of the single market and gives details of the main financial Directives.*[2]

Free movement of capital: a prerequisite

A prerequisite for a single market in financial services was the liberalisation of capital movements within the Community. Measures to lift capital controls began with two Directives in 1960 and 1962, requiring the removal of restrictions on capital movements in certain limited areas. Further voluntary measures were taken by the United Kingdom and Germany, including the complete abolition of controls in the United Kingdom in 1979. Other EC countries, however, continued to operate, and in some cases to tighten, capital controls. In 1985, the 1960 Directive was amended to extend the range of capital transactions to be deregulated; and a further Directive in 1988 provided for the progressive removal of remaining controls on capital movements in all Member States by the end of 1992. (Greece and Portugal were, however, allowed to request extensions beyond 1992.)

The EC 'passport'

Creating a single market in financial services means removing regulatory barriers to EC firms operating outside their country of origin. The aim is that authorisation to conduct, for example, investment business in one country in the Community will also constitute authorisation to conduct that business in *all* Community Member States, thus creating a so-called EC 'passport'. EC Member States will 'mutually recognise' (ie accept as adequate) the regulatory standards of other Member States.

Under the passport, an EC firm authorised in one Member State (its 'home state') and wishing to operate in other Member States ('host states') will generally be able to choose whether to supply services through branches (ie to establish a physical presence of the same legal entity) or to supply services on a cross-border basis without having a permanent physical presence in the host state. It will, of course, still be free to apply to set up subsidiaries in other Member States. These subsidiaries will remain subject to local authorisation requirements, on a non-discriminatory basis.

The benefits of a passport

An EC passport helps to increase competition by opening markets to a wider range of participants and by allowing firms to choose the most cost-effective means of supplying services to a particular market. It will, for example, generally allow a firm to operate throughout Europe on a single unified capital base. This removes the need to establish subsidiaries with separate capital (which might not be very easily transferable and therefore might be underutilised if business shifted temporarily from one country to another), or to maintain capital in branches. It will give firms greater flexibility in organising their management structures and internal systems. It will also enable them to deal with fewer sets of regulations and regulators.

The components of a passport

The passport Directives in the different areas of financial services have a number of aspects in common. Each passport Directive, or set of Directives, defines its *scope* in terms of the type of institution and the activities which it carries out, sometimes by reference to particular instruments. This is important because the activities covered by a specific type of authorisation may vary from state to state. In the United Kingdom, for example, the main feature that distinguishes a bank from other types of financial firm, such as a securities firm, is its ability to take deposits. In other countries, a banking licence is required for various other activities, regardless of whether deposits are taken (for example, in France, for leasing activities). A Directive which referred only to 'banks' without further qualification would therefore apply to a different range of activities in different countries.

The Directives require firms to be *authorised* and set out the conditions a firm must satisfy for initial and continuing authorisation. These generally relate to three main areas: the need for adequate management and controls (such as accounting procedures); the minimum level of capital a firm must have for initial and continuing support of its business;

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(2) More details of the wider single market programme can be obtained from the Department of Trade and Industry.

The 1992 programme in context

The objective of creating an EC single market goes back to the 1957 Treaty of Rome which established the European Communities. As a first step, the Treaty called for the progressive removal of tariffs and quotas among Member States over the following twelve years. This was achieved a year ahead of schedule. However, the original impetus towards development of a single market started to fade as the relatively favourable economic conditions of the early 1960s gave way to a series of international crises. Although efforts towards liberalisation continued, protectionist non-tariff barriers began to multiply and several Member States reintroduced capital controls.

Determination to regain lost momentum towards creating a single market led to the preparation of the 1985 White Paper by Lord Cockfield, outlining essential measures and also specifying a timetable by which they should be achieved to meet the target date of 1992. To help drive the programme forward, amendments were agreed to the original Treaty and embodied in the Single European Act, which came into force on 1 July 1987. The Act widened the range of measures subject to qualified majority voting (rather than unanimity among all Member States) to cover most internal market legislation. At the same time, the EC Commission urged the other main institutions involved in adopting the proposals and taking the necessary decisions—the European Parliament and the Council of Ministers—not to delay the process.

Meanwhile, at the Commission's request, a report was prepared (the Cecchini Report) to try to quantify the potential gains from the programme. The report, published in 1988, identified the financial services sector—banking, securities, insurance and pension funds—as one of the EC markets with most to gain from the liberalisation proposed in the 1992 programme. Prices in this sector differed by over 50% in some instances. Gains would be concentrated in Community countries where a protected environment created cost inefficiencies. The report identified particular distortions to domestic markets as entry barriers, restrictive conduct of business rules and detailed product regulations.

and the 'fitness and properness' of shareholders/controllers (including the managers) of the firm. The authorising home state supervisor must vet large shareholders before initial authorisation is granted and has a continuing responsibility for this area, including further vetting when significant changes are planned.

As well as protecting individual counterparties of a firm, setting minimum capital standards reduces systemic risk which might arise if poorly-capitalised foreign firms failed and disrupted host state markets. It also prevents any unfair competitive advantage which might result if capital requirements were inadequate in some countries. The Directives lay down only minimum capital requirements: if a Member State so wishes it may apply stricter standards to the firms it authorises (although not to firms using an EC passport to do business in its markets).

Since the host state will have an interest in the fortunes of firms using an EC passport to compete in its markets, the Directives spell out the *division of responsibility* between home and host states. In general terms, the home state takes responsibility for the *prudential supervision* of a firm and all its branches and the 'fitness and properness' of its controllers and major shareholders. The *conduct of a firm's business with customers*, on the other hand, is largely the responsibility of the authorities in the host state. The Directives specify that home and host states will need to co-operate and they outline mechanisms for this (for example, by defining 'gateways' for passing confidential information between supervisors).

The Directives also address the issue of relations with *third countries*. The single market programme is explicitly not concerned with a 'fortress Europe'. The intention is to allow firms from third countries access to European markets on the same terms as European firms and so to encourage other countries to give similar access in return to European firms.

Provision has been needed for possible later *adaptations* to the Directives. In general terms, the Directives include 'comitology' provisions which allow Committees composed of the Member States and the Commission to review the operation of those particular Directives and to make certain limited amendments to them without having to resort to the full EC legislative procedure, including two readings by the European Parliament.

Directives may also contain *transitional* provisions, which may, for example, allow some states more time for implementation than others. They also set down when Directives come into effect.

Banking

The creation of a single market in banking has taken a considerable time to achieve. A first step was taken in 1977, with the adoption of the *First Banking Co-ordination Directive*. This applied to 'credit institutions' (which in the United Kingdom means broadly banks and building societies). It required all credit institutions to be authorised and required regulators authorising credit institutions to monitor their solvency and liquidity. Authorisation by host states of credit institutions' branches in other Member States was also made compulsory.

The second major step towards a single market in banking came in 1989 when the *Second Banking Co-Ordination Directive* (2BCD) was adopted, to come into force on

Parallel discussions

Substantial progress on international supervisory co-operation and harmonisation of regulatory standards for internationally active banks has been made in other international fora. The Basle Committee on Banking Supervision, established in 1975, consists of representatives from the central banks and supervisory authorities in the Group of Ten (G10) major industrialised countries[1] and Luxembourg. If the Committee of Governors endorses its recommendations, national authorities implement them in G10 countries. Increasingly, many other non-G10 countries have also chosen to adopt the Basle standards.

The Basle Committee's first aim was to establish principles for international co-operation between banking supervisors to cover banks operating in a number of countries. The Basle Concordat, published at the end of 1975, set out understandings about the division of supervisory responsibility for such banks. The Concordat was revised in 1983 to introduce the principle of consolidated supervision, under which a single authority takes responsibility for the overall supervision of all subsidiaries of a bank. Further principles for the exchange of information between supervisors were published in 1990 and in 1992 as part of a significant extension to the Concordat, setting out minimum standards for the supervisory responsibilities and powers of home and host country authorities.

A further initiative in 1987 by the Committee led to agreement on a common risk-weighted approach to the measurement of capital. The Basle Capital Accord, formally adopted in July 1988, set out an agreed framework for capital measurement for internationally active banks and set a minimum of eight per cent for the ratio of bank capital to weighted risk assets. Internationally active banks were expected to observe this ratio by the end of 1992. The relevant EC Directives correspond closely to the requirements of the Basle proposals.

The Committee is continuing work on the capital adequacy framework and has been working with international securities regulators (the International Organisation of Securities Commissions, or IOSCO) towards a joint agreement on the regulatory treatment of market risk.

(1) Belgium, Canada, France, Germany, Japan, the Netherlands, Sweden, the United Kingdom and the United States.

1 January 1993, providing a passport for credit institutions throughout the Community. The scope of the passport under the Directive includes deposit-taking, lending, money transmission services, leasing, participation in securities issues, issuing credit cards, travellers' cheques and other means of payment, securities and foreign exchange trading, and portfolio management and advice. If a credit institution's authorisation in its home state covers these activities, it is now free to supply them throughout the Community.

The passport provisions in the Directive are supported by common minimum regulatory standards. The 2BCD sets minimum standards for the authorisation and prudential supervision of credit institutions, including a requirement for credit institutions to have a capital base of at least ECU 5 million (with lower limits for certain categories of credit institution); minimum requirements for information about major shareholders; and limitations on credit institutions' shareholdings in non-financial companies. The *Own Funds Directive* (with two later amendments) defines what is to count as capital for credit institutions. The *Solvency Ratio Directive* establishes a framework of minimum capital requirements to cover credit institutions' activities, setting a minimum ratio of 8% for own funds to weighted risk assets. These two Directives came into force on 1 January 1993. From 1996, credit institutions' trading activities, including securities business, will be subject to a separate regime established to cover trading risks undertaken either by credit institutions or by investment firms under the Capital Adequacy Directive (see page 95).

The *Large Exposures Directive* (formally adopted in December 1992, to come into effect from 1 January 1994) will harmonise the supervisory rules which cover the exposures of credit institutions to individual borrowers or groups of connected clients. A separate regime will apply to large exposures in credit institutions' trading books under the Capital Adequacy Directive. The Large Exposures Directive requires exposures of ten per cent or more of a credit institution's own funds to be reported to the supervisory authorities and prohibits exposures of more than a quarter of a credit institution's own funds. A credit institution's total large exposures should not be more than eight times the size of its own funds. The Directive recognises a number of exceptions, however, such as exposures to other banks or exposures collateralised by specific assets. It will apply on a consolidated basis to the credit institution's exposures together with those of other credit and financial institutions within the same group. The Directive takes effect from 1 June 1994, but transitional provisions mean that the limits it sets may not be fully operative in some Member States until 2001.

Wider requirements for consolidated supervision are a further key element of the supervisory framework needed for credit institutions to have an EC passport. An earlier *Consolidated Supervision Directive*, adopted in 1983,

required authorities to exercise consolidated supervision 'downwards' where a credit institution owned 25% or more of the capital of another credit or financial institution. This has now been replaced by a new Directive, adopted in 1992 and in force from 1 January 1993, which extends the scope of consolidation 'upwards' to include credit institutions' EC parents, where the parent is a financial institution other than a credit institution, and the financial subsidiaries of parents where the majority of the group's activities are financial in nature. It reduces the threshold for consolidation from 25% to 20% of capital. A further provision allows the Commission to negotiate information-sharing agreements with third countries to assist consolidated supervision of EC credit institutions with large presences outside the Community and of third country groups with sub-groups within the Community.

Securities

In some EC countries, many firms which are not credit institutions carry on investment business. To prevent credit institutions from having a competitive advantage over such investment firms because of different regulatory treatment, a separate passport Directive—the *Investment Services Directive*—has been introduced for investment firms. Negotiations on this Directive were concluded in 1992. It is expected to be adopted formally in 1993 and to come into effect by 1 January 1996. The provisions of the Directive apply to all firms whose regular business is to provide investment services for third parties on a professional basis, with the proviso that a number of clauses do not apply to credit institutions which would come under this definition of investment firm but which already have a passport under the 2BCD.

Investment services are defined more precisely in an annex to the ISD, and correspond closely to the activities that fall within the scope of the passport for banks. The annex covers transactions undertaken in a range of instruments on firms' own account or as agent for customers, including portfolio management and underwriting. The investment instruments include transferable securities; undertakings for collective investment in transferable securities (UCITS, which in the United Kingdom take the form of authorised unit trusts); money-market instruments; financial futures contracts; forward interest rate agreements (FRAs); interest rate, currency and equity swaps; and options to buy or sell any of these. Related 'non-core' services are also covered (such as foreign exchange services connected with the provision of investment services).

In addition to providing a passport for investment firms, the ISD also covers a number of other issues. In particular, in recognition of the fact that a passport to trade in securities without assurance of access to local stock exchanges would in many countries be worthless, the ISD provides for such access, with transitional concessions for some countries. The Directive also in effect gives a passport for 'regulated markets' which can, provided they meet certain conditions, provide cross-border access to their trading systems. Progress on the ISD was delayed for some eighteen months by difficulties in agreeing an approach to the publication of trades on regulated markets that would accommodate both quote-driven and order-driven market systems.

The *Capital Adequacy Directive*, which is expected to be adopted formally in 1993 and to come into effect together with the ISD by 1 January 1996, sets minimum capital requirements for investment business, covering market risks and also large exposures. To allow investment firms and credit institutions to compete fairly in securities and banking business, the same requirements will apply to both in respect of their 'trading' exposures. Credit institutions will accordingly be required to classify their assets as belonging either to their trading or banking book and to apply the securities regulations to the former and the banking regulations (under the Own Funds and Solvency Ratio Directives) to the latter. A similar provision requires investment firms to separate out any banking assets and to apply the banking regulations to them.

The *UCITS Directive*, agreed in 1985 and in force from 1989 for most Member States (from 1 April 1992 in Greece and Portugal), provides a different kind of passport and sets out the conditions on which a particular kind of product (as opposed to service) can be marketed across borders. The Directive sets out requirements for the authorisation of collective investment schemes and on this basis allows a scheme authorised in one EC country to market its units in other Member States (subject to compliance with notification procedures and local marketing regulations).

Insurance

Separate Directives have been agreed over the years to cover different types of insurance business—life assurance (the *First, Second and Third Life Assurance Directives*) and non-life insurance (the *First, Second and Third Non-Life Insurance Directives*). Each 'generation' of Directives builds on and modifies the previous generation. A different regime of Directives applies to motor insurance. The methods used by insurers to share or reallocate risk (co-insurance and reinsurance) are also covered by separate Directives.

The first generation Directives allowed insurers to establish branches or agencies in other EC Member States, subject to local authorisation, and required Member States to ensure that insurers maintain a minimum level of reserves. The second generation Directives allowed cross-border provision of services as well as local establishment. They instituted a 'dual regime' for cross-border business in both life and non-life business, which will remain in force until the third generation takes over in 1994. In each case, a more liberal regime applies in certain limited circumstances. For life assurance, it applies where a prospective policyholder goes to another Member State on his own initiative to look for a policy. For non-life insurance business, it applies in respect of large risks (such as marine and aviation insurance). In both cases, the assurer or insurer only has to notify the relevant authorities and may then start writing business

The European Economic Area Agreement

The European Economic Area (EEA) Agreement, signed in May 1992, will extend the principles of the EC single market to six member countries of the European Free Trade Association (EFTA): Austria, Finland, Iceland, Liechtenstein, Norway and Sweden. The remaining EFTA country, Switzerland, voted in December 1992 against participation. The adaptations to the agreement required as a result of the Swiss vote are under active discussion. The aim is to bring the revised agreement into force as soon as possible.

The Agreement will advance existing trading links with EFTA countries. The total EEA area will be the world's largest single market, with some three hundred and seventy million consumers. EFTA countries will adopt almost all EC single market legislation and take on future single market measures adopted by the Community. New EEA institutions will be set up to administer the Agreement and ensure that both the Community and EFTA comply with its rules. A new competition regime, based on existing EC competition rules, will aim to ensure competitive conditions of trade throughout the EEA. There will be closer co-operation between the Community and EFTA in areas such as research and development, the environment and education. EFTA will also set up a new fund (the EEA Financial Mechanism) to assist some of the poorer regions of the Community.

cross-border, subject to home state prudential supervision. For other risks, the relevant authorities in the Member State where the insurer's risk is located or where the assurer has its place of residence may require the insurer or assurer to obtain special authorisation and may exercise significant control over, for example, levels of premiums and policy terms and conditions.

The third generation Directives provide a full EC passport for life assurance companies and non-life insurance companies and therefore significantly change the provisions of the second generation of Directives. Under the passport, which will be available from July 1994, the powers given by the second generation Directives to the authorities in the Member State where the risk is located will be much reduced. For example, they will no longer be allowed to require additional authorisation or prior approval of premiums and policy terms. The Third Life Assurance Directive also lifts restrictions on carrying on both life and non-life insurance business within the same company (a 'composite' insurer) and partly relaxes the ban on the authorisation of new composites.

Pension funds

The legislative framework to apply to pension funds is at a relatively early stage. Banks have the passport for pension fund management under the 2BCD; investment firms will receive it under the ISD; life assurance companies will receive it under the Third Life Assurance Directive. The proposed *First Pension Funds Directive*, still under negotiation, is intended to allow a pension fund in one Member State to choose an insurer or other financial institution in another Member State as its investment manager and to allow the fund's assets to be invested anywhere in the Community.

Making the single market work

While the 1992 programme is fundamental to the creation of a single market, it does not by itself ensure that a fully integrated market will develop. Adequate implementation and enforcement of the Directives will be vital. A report presented to the European Commission in October 1992 (the Sutherland Report) addressed this issue, along with a series of other questions relating to the operation of the single market after 1992. The report stressed the desirability of ensuring a proper balance between subsidiarity and 'level playing fields': national diversity should be allowed, for example, where the economic impact on the Community is negligible, but national measures and divergent interpretations of Community law should not be allowed to fragment the market.

Other related measures

Deposit protection

In addition to the protection afforded to consumers of financial products by the establishment of EC minimum standards in each area of financial services, further legislation is being put in place to safeguard the interests of depositors and investors. For example, a Directive is being negotiated on deposit guarantee schemes, building on a 1986 Commission Recommendation. The proposed *Deposit Protection Directive* brings deposit protection within the ambit of the single market by making it a home state responsibility. It will therefore fall to Member States to ensure that depositors within the Community are compensated for loss arising from the credit institutions which they have authorised. Discussions are also just beginning on a Directive on investor compensation schemes.

Reporting and disclosure

A further framework of EC legislation relates to the publication of accounts for banks, securities firms and insurance undertakings. The *Bank Accounts Directive*, adopted in 1986, extends to credit institutions the provisions which apply to limited companies in general and sets minimum standards for their financial reporting. The *Branch Accounts Directive*, adopted in 1989, abolishes requirements for publication of separate accounts by

branches from other Member States. All firms with an official EC stock exchange listing are required to publish information twice yearly under the *Interim Report Directive*, adopted in 1982. This includes profit and loss statements and an outline of the activities carried out by the company. For insurance firms, requirements for annual published accounts are set out in the *Insurance Accounts Directive*, adopted in 1991.

Various Directives set out conditions with which issuers must comply before their securities can be officially listed on an EC stock exchange. The *Admissions Directive*, adopted in 1979, harmonises conditions for admission to listing. The *Listing Particulars Directive*, adopted in 1980, and the *Prospectuses Directive*, adopted in 1989, set out the information which issuers must provide when their securities are to be listed or offered to the public for the first time. Two further Directives provide for the mutual recognition among EC authorities of listing particulars and prospectuses and also provide for the possibility of similar reciprocal agreements with non-EC countries. Shareholdings in all listed firms will have to be disclosed when any of a series of five thresholds is reached (ranging from ten per cent to two thirds) under the *Disclosure of Major Shareholdings Directive*, adopted in 1988.

The *Insider Dealing Directive*, adopted in 1989 and in force from 1 June 1992, requires Member States to make insider dealing unlawful and to co-operate in obtaining and exchanging information about it for enforcement purposes.