COMMENT ON MICHEL BLAIR'S PAPER

Hal S. Scott *

Michael Blair's excellent paper raises three important questions about the EEC's Proposed Second Banking Directive: (1) will it work; (2) how will it affect Canadian, Japanese and U.S. banks; and (3) how will liberalization in the provision of banking services be approached at the international level?

Will it Work?

The EEC's approach is one of mutual recognition combined with minimum harmonization of standards. For example, mutual recognition will require France to allow the branches of Greek banks to do business in France with Greek powers and subject to Greek supervision. But the EEC has agreed that only certain powers must be recognized, *e.g.*, underwriting of securities but not the provision of life insurance, and that all EEC banks must be capitalized at certain minimum levels. This is the minimum harmonization of the standards.

Naturally host states are concerned that banks from other states taking local deposits be solvent. If the foreign bank fails local depositors may lose funds and/or the host state may be forced to act as insurer or lender of last resort. Host state protection under the EEC approach would initially appear flimsy. While banks must meet capital standards, the mere existence of the standards does not guarantee compliance or the absence of bank failure. Book capital and real capital are entirely different matters. The real capital of a bank is determined by the value of assets, such as loans. In most bank failure situations assets turn out to be worth substantially less than book values.[1]

The host state must look to enforcement of the capital standards by the regulators of the home country. The adequacy of

* Professor of Law, Harvard Law School.

[1] *See* R. Bhala, *Perspectives on Risk-Based Capital* (1989), pp. 25-41.

enforcement depends on the monitoring and examination systems used in the home country. In the end, however, even well designed systems break down. The U.S. experience is ample testimony to this fact. Most countries, recognizing this vulnerability, have required foreign branches to maintain local capital which can be used by host state authorities to recompense depositors of failed banks.[2] In situations where local authorities have doubt about the solvency of foreign banks, bank access to retail (individual) deposits may be limited. The Second Banking Directive deprives the host country of both of these lines of defence.[3]

The ultimate source of host state depositor protection under the EEC scheme is for the home state central bank to bail out a failing bank. Where state owned banks are involved, the host state may have more protection because the home state as owner stands behind the bank. Perhaps such understandings exist, at least implicitly. The central bankers are participants in the EEC process through both formal advisory groups and informal coordination. I would suggest that if there is any significant bank failure within the EEC in which local depositors lose funds in a branch of a foreign EEC bank, the Second Banking Directive will fall apart. In a sense the collective EEC central banks are guaranteeing the ultimate success of the current policy.[4]

The Effect on Canadian, Japanese and United States Banks

The Second Banking Directive incorporates a reciprocity requirement requiring other countries to give "reciprocal" treatment to EEC banks.[5] Lack of such reciprocity can lead to an

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[2] For examples, *see* discussion of French and German branch capital requirements in F. Schwank and F. Ryder, eds., *Banks Abroad* (1986), pp. 150, 175-7.

[3] COM (87) 715 final, O.J. No. C 84/1 (March 31, 1988), as amended by COM (89) 190 final-syn 120, O.J. No. C 167/33 (July 3, 1989) (hereafter *Proposed Second Banking Directive*), Arts., 5, 17, 19.

[4] The EEC does anticipate that all states will have deposit insurance systems. Commission Recommendation of December 22, 1986 concerning the introduction of deposit-guarantee schemes in the Community (87/63/EEC), 30 O.J. Eur. Comm. (No. L 33) 16 (1987). But it is envisioned that host states will insure depositors in local branches of other EEC countries' banks. Host state insurers will, therefore, be concerned about the solvency of the banks.

[5] For a general treatment of the reciprocity issue, see H. Scott, "La Notion de Réciprocité dans la Proposition de Deuxième Directive de Coordination Bancaire" (1989), 323 Revue du Marché Commun 45.

outright ban on non-EEC banks incorporating new subsidiaries in the EEC, thus depriving them of a base from which to take advantage of the Second Banking Directive. It may also lead to demands by the EEC that a non-reciprocating country negotiate with the EEC with a view to eliminating any offensive restrictions.[6]

This policy will have a limited impact on banks from Canada, Japan and the United States. The EEC has made clear that existing subsidiaries will be grandfathered. Most substantial banks from outside the EEC already have or will shortly have an EEC subsidiary. Further, the reciprocity requirement only applies to subsidiaries; non-EEC banks can continue to establish branches subject to the individual requirements of host countries. While the powers and required capitalization of such branches will be determined by the laws of the host country (as compared to the home country standard applied to branches of EEC subsidiaries), in several EEC countries this may not make a significant difference.

Reciprocity can have various meanings, ranging from national treatment to mirror-image reciprocity. A national treatment standard would require EEC banks to be treated by host countries at least as well as domestic banks. Under this standard the United States could ban EEC banks from offering securities services since domestic banks were also denied such powers. Host country law, applied in a non-discriminatory fashion, would be determinative. Under mirror-image reciprocity EEC banks would have to be treated outside the EEC at least as well as non-EEC banks were treated in the EEC. Under this test EEC banks would have to be allowed to sell securities in the United States since United States banks were permitted to do so in the EEC.

Great uncertainty surrounds the actual meaning of "reciprocity" under the Second Banking Directive and whether a lesser standard is imposed on non-EEC countries for avoiding entry bans as compared with demands for negotiation. The actual language of the Directive is ambiguous on this point. It may be read as saying national treatment is sufficient to avoid bans but anything short of "effective market access" for EEC banks might trigger negotiations.[7] Others believe lack of effective market access might trigger bans as well.[8]

Generally the United States, through the federal government and the 50 states, gives national treatment to foreign banks. Even

6 Proposed Second Banking Directive, Art. 7.

7 Article 7(4) of the Proposed Second Banking Directive allows for demands for negotiation when "a third country is not granting to credit institutions of the Community

so, certain states within the United States are more restrictive on entry of foreign banks than banks from other states, and the federal government requires all foreign branches fully to collateralize FedWire overdrafts. None the less, U.S. "national treatment" may fall well short of "effective market access" due to significant restrictions imposed by the United States on all banks with regard to powers and geographic expansion within the United States. The issue for the United States and the EEC is whether national treatment is enough.

Japan gives foreign banks better than national treatment. Foreign banks can do more in some areas, *e.g.*, securities, than domestic banks. The problem for Japan is whether the EEC "effective market access" formula looks only to legal/regulatory restrictions, or also to market share. EEC banks have a minuscule market share of the banking business in Japan, while the Japanese have a significant and growing market share within the EEC. Reciprocity based on negotiated market shares assumes a model of managed trade rather than free competition, at least with the Japanese. It leaves the EEC itself open to market share demands in other sectors where its local producers may be more efficient than foreign ones.

Canada's Schedule II bank approach, under which foreign banks as a whole have a ceiling on market share, would appear to be a clear departure from the national treatment standard. United States banks no longer are subject to the regime as a result of the Canada-United States Free Trade Agreement. EEC banks are not treated like domestic Canadian banks. It can be argued that this departure does not violate the "effective market access" standard in so far as collective EEC or foreign bank market share has not

effective market access and competitive opportunities comparable to those accorded by the Community to credit institutions of that third country". Article 7(5) allows for entry bans where "credit institutions of the Community do not enjoy national treatment *and* the same competitive opportunities as domestic credit institutions in a third country *and* that the condition of effective market access has not been secured" (emphasis added). If the "ands" are conjunctive then lack of national treatment is a necessary condition for an entry ban. If, on the other hand, they are disjunctive, lack of effective market access would be a sufficient condition for the ban.

In the "common position" adopted by the EEC Council on July 24, 1989, Art. 7 has become Art. 9. Article 9(4) allows for entry bans where "Community credit institutions in a third country do not receive national treatment offering the same competitive opportunities as are available to domestic credit institutions *and* that the conditions of effective market access are not fulfilled" (emphasis added). Although the first two clauses have been combined, the same ambiguity about the meaning of the "and" between the now combined first clause and the second clause remains.

[8] See S. Key, "Mutual Recognition: Integration of the Financial Sector in the European Community", Fed. Res. Bull. (September 1989), pp. 593, 600.

actually bumped up against the ceiling, and that individual foreign banks generally receive the subquotas they request. None the less, one must question a system of restraints which is defended on the ground that it does not restrain.

The Search for International Principles for Trade in Banking Services

Negotiations are currently underway within the GATT Uruguay Round to formulate a code for trade in services, including banking as well as other financial services. This effort must consider the comparative merits of alternative principles such as national treatment (the United States' proposal), mutual recognition (the EEC's proposed internal approach), or effective market access (the EEC's proposed external approach). One must also consider the approach of many developing countries that adopt what one might call a minimum market access approach.

I would suggest that the appropriate principle may vary depending on whether one is considering cross-border services on the one hand, *e.g.*, French bank solicits deposits in the United States for its bank in France, or the issue of permissible entry for a foreign bank into another country, whether by agency, branch, and subsidiary, and the regulation of that bank post-entry, *e.g.*, its powers and supervision. For example, whatever the usefulness of the national treatment principle for comparing post-entry treatment of foreign banks with their domestic counterparts, it would seem to offer no guidance for the initial terms of entry. Domestic banks are by definition present in the host country and foreign banks are not. Foreign bank initial entry terms — post-entry expansion is another matter — cannot be judged with reference to treatment of domestic banks.

A number of important considerations are likely to affect the choice of the appropriate principle, such as safety and soundness, consumer protection, monetary policy, and competition. One may envision that host countries will be more restrictive of branch entry and powers than they would be in the case of *de novo* subsidiaries. For branches, safety and soundness depends on the condition of the bank as a whole, and the effectiveness of foreign regulatory systems. This can only be partially alleviated by branch capital requirements. Subsidiaries, on the other hand, may be treated as self-contained units fully subject to host country regulation. This may also lead host countries to be more liberal toward retail deposit-taking by *de novo* subsidiaries than by branches.