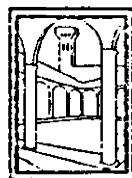

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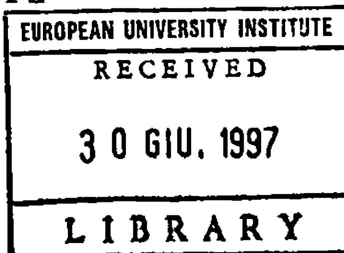

STATES AND MARKETS: REGULATORY COMPETITION AND THE PUBLIC LAW OF BANKS

Carlos PADROS REIG

Thesis submitted for assessment with a view to obtain the Degree of Doctor of the European University Institute

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Florence, June 1997

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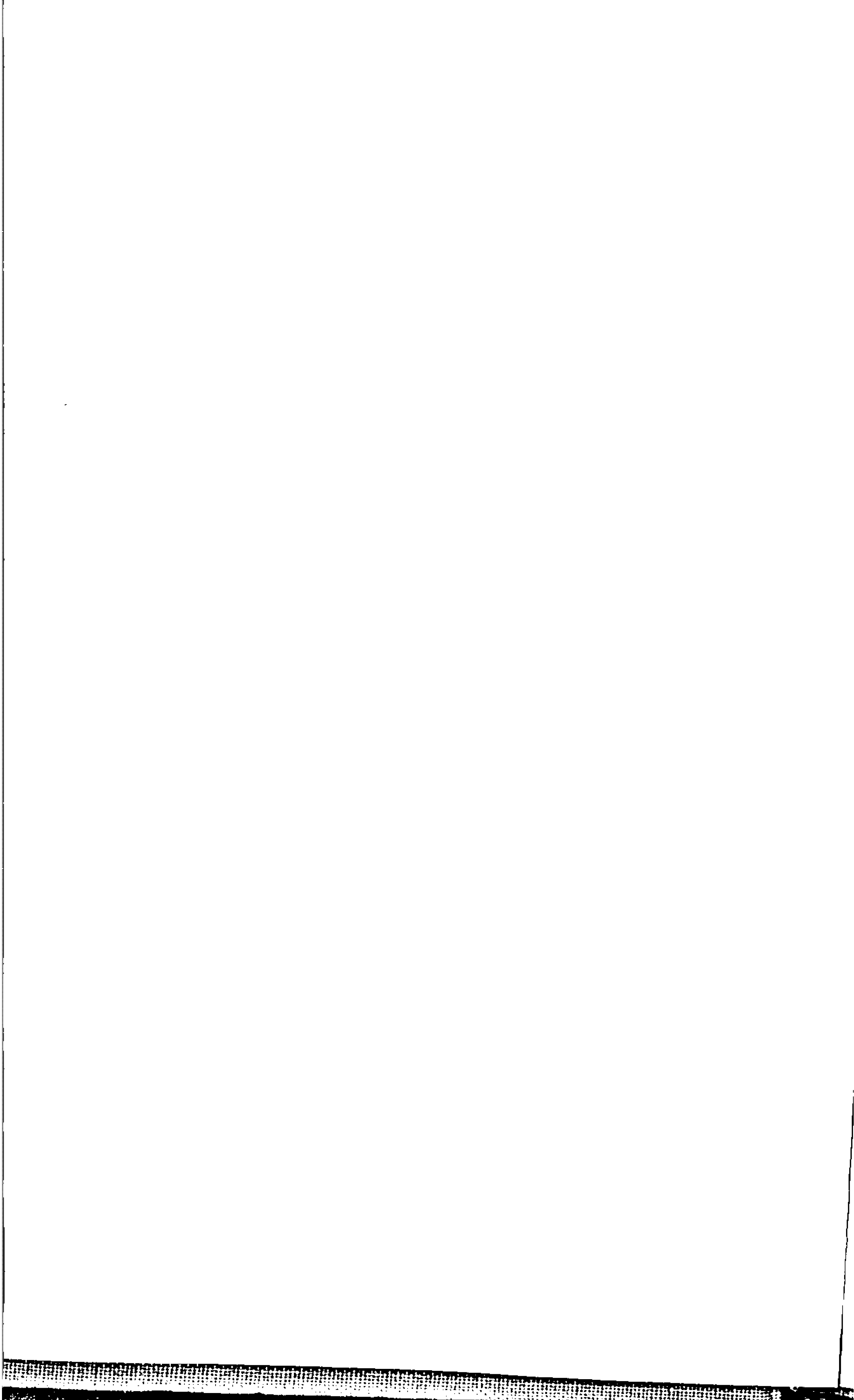

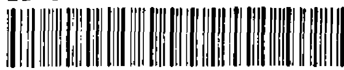
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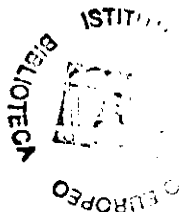

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"What sense does it make to describe today's failure to possess tomorrow's knowledge as error?"

Popper, K. The Poverty of Historicism. 1957.

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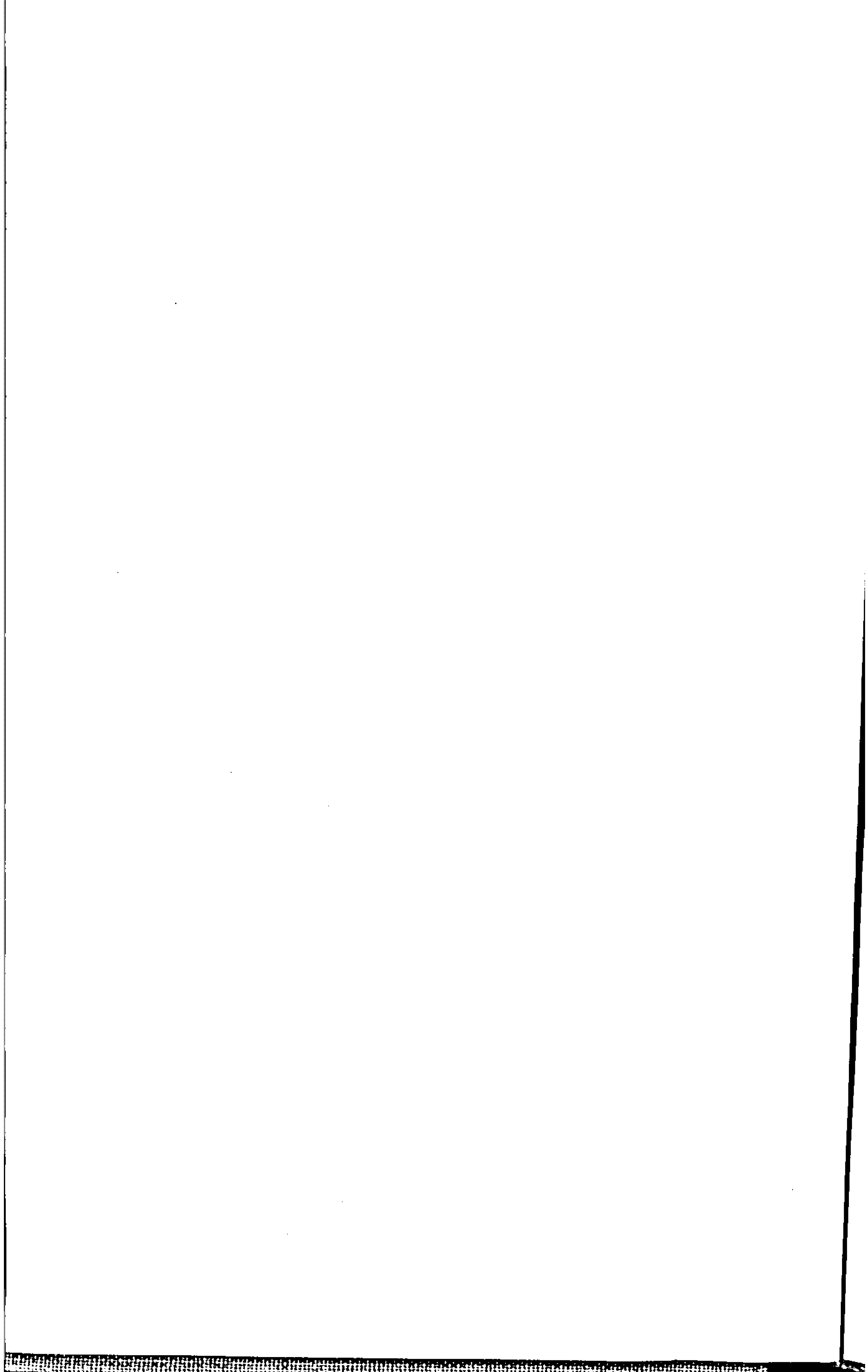

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INTRODUCTION

The task of writing an introduction is one of the most difficult endeavours one may embark upon. The introduction represents the gateway to a research work which most of the times is complex and multifaceted. Moreover, knowledge evolves and the text can only capture a single moment in the whole process of building an analysis. For all these reasons, the present introduction will be rather brief and general. We limit to some methodological remarks and to a presentation of the content and purpose of the thesis.

One of the most immediate questions that could be raised is that of the topic. Why banks?. Banks are a part of the economy which is especially prone to regulatory competition. Increasing financial globalization makes it difficult to maintain regulatory barriers and those remaining create costs that are avoided by regulatory arbitrage. Banks' raw material is capital which is a highly mobile element. On the top of that, the longstanding experience of the US in the field, should be of some usefulness. Finally, banks are attractive since the European Union, by means of the Second Banking Directive, has undertaken a decisive step towards liberalisation. Regulatory competition in this field will be able to give us some clues into the direction of services regulation in general, and into the new institutional dimension of the Union.

However, banks are only one type of financial actors. Securities and insurance industry are gradually occupying spaces traditionally reserved to banks - namely deposit collection and lending - and conversely, banks are extending their product range to cover securities and insurance activities, and are experiencing a process of disintermediation. Hence, it is increasingly impossible to distinguish among financial actors. Concentrating in one of them is just a research need in order to keep the study under manageable dimension. Still, banks remain a legally different industry because of their position in the economic gear and in the payment system. What could actually be questioned is the future of banks themselves or at least their different legal treatment. In any case, the topic of financial services regulation is too large to be covered as a whole, so some subdivision is necessary. This has to be done acknowledging that divisions may not correspond to the reality of the marketplace.

We recognise the artificial institutional separation we incur. Another research project could be based on the effects of regulatory competition taking as a point of reference a cross-industry analysis. This however is not the original intention of this work.

A similar explanation is needed in order to justify the partial analysis of only the public law of banks. As synthesised in the title, regulatory competition is only treated in so far as it refers to the public law of banks. The distinction between public and private law is a fragile one and most of the times, elements of both are intermingled. Nevertheless, the goals pursued by the legal order in the case of banks are markedly different when focusing on public or on private aspects. While public law is concerned, through authorisation and supervision, in aspects as stability and safety, private banking law refers to the transactions executed and to contractual law and investor protection This does not mean that regulatory competition is most suitable to take place in the public law domain. It is just a delimitation in order to circumscribe the research project.

A second general aspect that could be raised is that of regulatory competition and the position of States and markets in the complex task of regulating banks. The idea of the final project came from the fundamental dissatisfaction with the two extreme positions for explaining regulatory competition. On the one side, regulatory competition is viewed as the kingdom of efficiency and market-like mechanisms to discipline governments. On the other side, regulatory arbitrage is viewed as an act of evasion or circumvention, as a limitation of the state capacity and as an imposition of oligarchic and powerful capital markets.

We argue that the sharp distinction between markets and hierarchies is misleading. Regulatory competition has to be seen as a process of social change, relying on both market and non-market mechanisms. To conceptualise regulatory competition as a mere system of efficient allocation of resources means to miss an important part of the picture.

Markets cannot exist without a collective social and institutional base underlying them. Markets are not natural forces, in the sense of corresponding to a pure state of things and predating other kind of social institutions. Conversely, States cannot exist completely ignoring movements of globalization and of economic and systemic interdependence. Thus, the final result is some kind of *medio tutissimus ibis*. This is not related to a theory of minimizing the risks of extreme positions. Instead, there is a profound

conviction that a Hegelian synthesis can be extracted from the two opposing visions.

In what concerns methodology, we were confronted with a delicate question. Building a metatheoretical framework, i.e. a paradigm, involve large scale world-views that cannot be proved or disproved by empirical test. Having in mind this trap, we have tried to avoid falling in it. The analysis is not concerned with proposing a world view with general validity. Instead, we try to present some of the procedural consequences of a paradigm that has already been used as a legal technique in a concrete field.

"Unfortunately, our knowledge about competing organisational forms is far from what a scientist would call conjecture: there are some partial theoretical arguments and there is some empirical evidence. Taken together they still do not add up much to scientific knowledge. In the end, only experience will be able to tell and survival of the fittest will be the ultimate proof"[1]

A different but related issue is that of proving the correlation between our description of the paradigm and the results obtained. We argue that because of regulatory competition, some changes, specially in what concerns structure of the industry are taking place without an explicit legal mandate. This could be labelled as the causation issue. At the best, a correlation can be established between some existing conditions and the result. This is far from proving the causation. The same can be said in the example of barometers. Although barometers predict storms, they do not cause them. In the issue of regulatory competition some directly observable findings are presented. However, they cannot be verified through empirical testing but with recourse to a metatheory.

This fact constitutes a partial explanation for the feelings of uneasiness experienced by those working in the field of regulatory competition. The process is so complex and so many factors play a decisive role that it is labyrinthine to find a direct line of causation. When studying locational arbitrage, one is confronted with a huge range of motives which may induce a firm to change location. The same can be said of consumer behaviour when choosing a financial product. Therefore, more than concentrating our efforts

1.- Steinherr, A. and Huveneers, C, "Institutional competition and innovation: universal banking in the Single European Market", in Mullineux (ed.) *European Banking*, Oxford, 1992 p. 130

in explaining single policy changes in the field, it is wiser to analyse the whole process as an interactive, open-ended track.

We argue this is one of the main shortcomings of applying quantifiable methods of research, singularly economics, to what is, in nature, a non-quantifiable phenomenon.

In the same line of argumentation, we have avoided the temptation of examining a concrete national legal order and its transformation through time. This represented in first place a problem of selection. Second, the structure of the thesis is not appropriate to include a case study in regulation. Finally, there is also the deep conviction that relying on specific changes does not provide an accurate account of a complex process of regulatory competition. In other words, it is materially impossible to explain the transformations experienced in one national legal order without relating them to evolution in other jurisdictions.

Finally, the research has benefited from the environment in which it has developed. The singularity of an institution such as the European University Institute, allows even the most timid researcher to engage in interdisciplinary research. This could be reflected in the following pages where a complementarity is found among economics, social and political science and legal analysis.

Moreover, legal analysis in this field presents some peculiarities as expressed by Cordero: "a full-grown national system, firmly grounded on a wealth of legislative acts further enriched by judicial principles elaborated in countless cases would lend itself to treatment through the normal lawyerly processes of distinguishing, defining, analogizing, etc. However, where there is scarcely any legislation or jurisprudence and the objective is to conceive a way of making what little there is support a new theoretical scheme for a system that is mostly an idea, then the legal mind most apply itself to the task of creation"[2]

The thesis is structured in four main chapters with a touch of circularity.

2.- Cordero, Richard, *The Creation of a European Banking System*, New York, 1990, p. 56

Chapter II presents some general theoretical framework on regulatory competition in order to centre our discussion. Four main points are worth being underlined:

The first conceptualises regulatory competition as a wider phenomenon than market mechanisms. Instead, competition is recovered for the 'legal patrimony' as a social virtue and as a precious tool for knowledge creation. Competition can be seen as a trial-and-error process and as a deductive methodology to discover the boundaries of social organisation.

The second part of the first chapter tentatively presents a model of competition among rules. As any theoretical paradigm, some preconditions must be satisfied in order to recreate the elements which will make possible competition to grow. The functioning of the model is also tackled, with a clear distinction between institutional arbitrage effectuated by destinataries of regulation and the process of policy change of regulators in response - or in anticipation - to the former. Finally, the elements for a balanced evaluation of the competitive paradigm are provided. This balanced evaluation should be undertaken in a comparative manner, that is, analysing if the goals could be better achieved with the adoption of other social techniques.

The third part briefly outlines the scientific potential of network theories in order to explain the overcoming of both market and hierarchical models of regulation.

The final section of the first chapter concentrates in the supposed effects of regulatory competition in the transformation of Europe. In the field of harmonization of technical barriers to trade, there is a clear turn in the policy style used from 1985. The renowned 1985 White Paper, for the first time, introduces the concept of regulatory competition in the legal language of the EU decision making process. This will imply a deep transformation of the Community, overcoming the dichotomies between intergovernmentalism and supranationalism as well as that between centre and periphery. As a corollary of this transformation, the principle of subsidiarity - both in its upward and downward version - represents a revolutionary criterion for the allocation of competences.

Competition among institutions and rules can be a very fruitful strategy of European integration as long as it is linked to a conception of law making as a discovery procedure and not just a mere transfer of tasks to the market.

All these reflections must instrumentally serve us to centre the analysis of EU banking law which is presented in chapter III.

European banking has experienced extremely important changes in recent times. Before the integration move, European banking was characterized by a strong segmentation of national markets and a kind of regulatory policy based on administrative intervention, control of entry and market protection against external competition by means of capital controls. The situation is completely reversed by virtue of the Second Banking Directive and the introduction of the principles of mutual recognition and home country control. The basic aim of the Second Banking Directive is to create a single Community-wide banking market with no internal barriers to movement of banking services, including the opening of branches.

Aside, it is interesting to make reference to the disproportion of the task entrusted and the scarcity of legislative instruments. Generally speaking, the passage of a single directive has successfully transformed the banking panorama in Europe. This confirms the tremendous potential of regulatory competition as an integration mechanism.

This process has been accompanied with a significant degree of centralized harmonisation in important aspects such as minimum capital, disclosure requirements, capital adequacy, concentration of credits and deposit insurance. Therefore, a simultaneous process of regulatory competition and regulatory centralization is has taken place. We will show how this double edged movement contradicts the depiction of the process as a mere deregulation. It also confirms the complementarity of regulation and competition as we argued in the presentation of the model.

The final result is a system of imperfect mutual recognition where the tasks are shared by home and host authorities, as well as by European and national institutions. Regulatory competition has forced administrative cooperation.

A clear distinction made dependent on the type of banking market analysed, is also visible. While wholesale banking, with the presence of informed consumers-operators becomes highly interpenetrated, retail market lies somewhere behind. A similar parallelism could be traced depending on the type of regulation. Structural regulation has been very much affected by this new regulatory environment while conduct regulation is still mainly left to host regulators. This permits us to conclude that the process of banking integration has been very attentive to stability and safety concerns and less to consumer-depositor protection.

A completely different, but at the same time paradoxically twin, regulatory system occupies the pages of **chapter IV**.

The US Dual Banking System has traditionally been characterized as a regulatory model based on regulatory competition. Banks can choose to charter under federal or state jurisdiction. Thus, it presents a paradigm of vertical regulatory competition - as opposed to horizontal regulatory competition at the EU.

However, the original system of duality of jurisdictions has gradually evolved towards a system predominantly regulated at the federal level. Many crucial aspects as reserve requirements or deposit insurance are regulated at Washington by the powerful federal agencies. Thus, the system originally based on competition has been transformed due to federalisation of regulation and to the increasing mismatch which exists between banking regulation and market realities.

One could immediately blame a model of regulatory diversity for not achieving one of its most valuable attributes: to serve as a mechanism of experimentation and regulatory innovation. However, we propose a different reading: it has been the federalisation of regulation which has petrified the norms and barred any reform. On the contrary, states - although their marginal importance - have been quite active in crumbling walls as geographic and product restrictions.

In any case, the US banking system is undergoing an impressive transformation which constitutes the abandonment of the post-depression legislation relating to geographical and product restrictions. We analyse the former and present some indicators of the current debate concerning the latter. This transformation of the Dual Banking System should serve to fuel vitality into an sclerotic system.

We argue that external pressures due to international regulatory competition and globalization are a decisive element in this transformation process. It is precisely this aspect which is analysed in **chapter V**.

The issue of globalization of regulation is going to be present in a higher number of research projects dealing with economic law. Globalization, as the act or state of becoming world-wide in scope of application, will transform concepts as territory, sovereignty and international order. Globalization will naturally work to produce convergence across nations' banking structures. In a global legal structure, decisions taken in one part of the world can have a profound impact in other distant regulatory systems.

The challenge of globalization is to adapt the nation-state structures to a new reality where boundaries are deceived by economic power. Also, at an institutional level, the challenge is presented in the dichotomy between democracy and self-government. It is in the light of these reflections that one has to examine the issue of reciprocity present in the Second Banking Directive. The same could be said of the regulatory treatment of US foreign banking activities or of the activities of foreign banks in the US territory.

Finally, some emerging new institutions for global regulation are analysed. However, none of them offers a fully satisfactory solution to globalization issues. Thus, we propose a new engagement of states and markets; of cooperative and competitive structures to move forward a new era of banking regulation. This new era will be characterised by a combination of deliberative politics structured among a constellation of regulatory networks and epistemic communities self-regulating a competitive environment.

To conclude, one of the most common slips of a young researcher is being over-ambitious. This study is, with no doubt, one of these cases. Despite of that, the analysis is oriented to the achievement of three basic goals:

First, we want to show the limits of the traditional conceptualisation of regulatory competition. For this reason, some new elements are built into the theoretical framework. We argue that, in order to properly understand the model, an observer has also to take into account non-quantifiable elements such as the degree of cultural embededness of a given regulation, the spontaneous emulation of other jurisdictions (i.e. competition without mobility), the reputation effects of a given regulatory behaviour and the dissemination of technical information among the public. All together greatly broadens the image of competition which becomes a true structural tool of social organisation.

Second, we pretend to test the actual functioning of regulatory competition in the field of banking law. We argue that the blind defence of a model *'in abstracto'* is not the most illuminating way of understanding it. Moreover, this second aspect will permit us to falsify the model or to explain its deviations. Again, we do not pretend to exhaustively present all specific aspects of banking regulation. This is not a study of banking regulation but an study on regulatory competition or on the interaction of States and markets in the regulation of banking. Some structural reforms or innovative policies can better be explained under the perspective of competing legal systems.

Third, we try to tentatively present the effects of globalization and international regulatory competition in the governance of the banking system. We are confronted with a model of economic interdependence and global cross-fertilisation of legal systems and regulatory cultures without an explicit order. We are in fact before the paradox of global economic integration with fragmented sovereignty. The role of the State under this new competitive environment must not necessarily be diminished but has to change its traditional form of operation. The significance of Law has to be reshaped in accordance, giving rise to new legal discourse based on deliberation, compromise, innovation and self-adaptation.

CHAPTER II

THE COMPETITION AMONG RULES PARADIGM

"It is via the effect that rules and institutions have on the success of their users, success in terms of the users' capability to solve the problems they face in their environment, that rules and institutions survive and multiply, i.e. are being used more widely"

Vanberg, Viktor and Kerber, Wolfgang, "Institutional Competition among Jurisdictions: an Evolutionary Approach", Constitutional Political Economy, vol. 5 n. 2, 1994, p. 201

2.1. Regulatory competition and market theories

2.1.1. Competition as a non-economic principle and the limits of the economic analysis of law.

Although Public Choice scholars[1] have been the pioneers in identifying and theorising on legal competition, nowadays their approach seems clearly unconvincing. Competition may be viewed not only as an economic concept but as an essential dimension of social organised life.

Competition may be useful to explain a wide range of phenomena, both political and economic. While competition is a highly diffused term in the

[1].- Downs, An Economic Theory of Democracy. New York, 1957; Gwartney and Wagner, Public Choice and Constitutional Economics, JAI Press, Greenwich, 1988, Monroe, The Economic Approach to Politics, New York, 1991; Buchanan, Public Finance and Public Choice, National Tax Journal, 1975; Buchanan and Tullock, The Calculus of Consent: Logical Foundations of a Constitutional Democracy, 1962

fields of domestic markets and international trade, it is however less understood as a tool to rationalise organisations as different as the family or politics. Lato sensu, competition may be understood as a civic and social value which can serve to explore legal and political fields. Competition, or more generally, rivalry and conflict are social phenomena - practically a human condition - which are present in some forms of plural social organisations which are extremely rich and vivid.

It is undeniable that the competitive principle is commonly associated in the legal literature to an economic analysis of law, inasmuch as economics has been the scientific branch which has explored it more vastly. However, the proliferation of economic studies should not make us forget that competition is not an exclusive economic concept. Previously to the scientific development of the concept in the field of economics, competition was an integrating concept of democratic societies.

Therefore, we will try to claim the pertinence of recovering the concept of competition for the legal patrimony, giving it a peculiar meaning and scope.

Democracy and competition are not only non-antagonic concepts but competition is a nuclear element which defines the content of democracy. Thus competition is the highest principle of the plural and democratic organisation. As stressed by the Nobel Prize Stigler, although competition, and more generally rivalry has received more intensive theoretical and empirical analysis in economics it no doubt has a vastly longer history in political than in economic literature. [2]

In the same line of argumentation, the scientific and technological progress has been based on the competitive principle. Kuhn has pointed that the convergent thinking is as essential as the divergent for the scientific advance. Since this two ways of thinking inevitably conflict, it can be deduced that one of the requisites of the best scientific research is its capacity to withstand a tension that occasionally will be nearly unbearable.[3]

Again, conflict has to be understood as a characteristic of pluralistic market society that has come to the fore with remarkable persistence. "It is the natural counterpart of technical progress and of the ensuing creation of new wealth, for which market society is rightly famous. Conflicts arise from newly emerging inequalities and sectoral or regional declines - the counterpart

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[2].- G. J. Stigler, "Economic competition and political competition", Public Choice, Fall 1972, p. 91

[3].- Thomas Kuhn, "La tensión esencial: tradición e innovación en la investigación científica", in *Estudios Metahistóricos*, Madrid, 1983, p. 249. Our translation.

precisely of various dynamic developments elsewhere in the economy. (...) The secret of the vitality of pluralistic market society and of its ability to renew itself, may lie in this conjunction and in the successive eruption of problems and crises. The society thus produces a steady diet of conflicts that need to be addressed and managed".[4] Therfore, plurality and conflict enhance social cohesion and tend to leave behind a positive residue of integration.

It is no secret we assume the concept of individualism for the present study. Actions of individuals, as opposed to some social aggregate, are considered as the main source of social interaction.[5] Therefore we adhere to the concept of making public use of private interest.[6] "The (market) process in this simplified image operates without a central authority. It is atomistic, and the accomplishment of social results is inadvertent. That is, the results are produced by innumerable transactions between individuals, none of whom is concerned with aggregate results such as resource allocation efficiency or the general distribution of wealth and opportunity. This lack of specific focus on an aggregate outcome differs from the objective of most of the mass of actors in the political process."[7]

This also reflects a fundamental distinction between considering society as a uniform community with universal shared values or instead a web of individuals which interact among them. Pluralist market society does not pretend to establish a permanent order and harmony: all it can aspire is to muddle through conflicts. Hence, the neo-classical general equilibrium paradigm in economics is clearly insufficient when arguing that competition drives the economy to a situation of equilibrium. Instead, competition may be seen as a process of creative destruction, in which innovation is induced by creative enterpreneurs, leading to a evolutionary creative process through trial and error.[8]

4.- Hirschman, "Social Conflicts as Pillars of Democratic Market Society", Political Theory, vol. 22 n. 2, 1994, p. 212

5.- Gerken, "Institution Competition: An Orientative Framework" in Gerken (ed.) *Competition Among Institutions*, London, 1995, p. 6. "Individual liberty is not merely one element in the definition of a market economy. It turns out that individual liberty is that ingredient in that definition upon which the success of the market process depends. Individual liberty is not a circumstance in spite of which markets work; it is the crucial circumstance which permits the market process to work", Kirzner, *The Meaning of Market Process*. Routledge, 1992, p. 52.

6.- Schultze, C.L., *The Public Use of Private Interest*. Washington, 1977. quoted by Wolf, *Markets or Governments. Choosing between Imperfect Alternatives*. MIT, 1993, 2nd ed. at p. 179.

7.- Komesar, *Imperfect Alternatives. Choosing among Institutions in Law, Economics and Public Choice*, Chicago, 1994, p. 98

8.- Schumpeter, The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest and the Business Cycle. New York, 1934.

In fact, it exists a fundamental ground division related to the concept of the state and the corresponding role of competition and conflict as elements of the legal order:

In a 'Leviathan conception', the State is considered as a web of self-interested institutions which do not act on behalf of the underlying community but for their own benefit. Then, competition among governments or among legal orders could serve to tame Leviathan tendencies of governments. In spite of being self interested, governments would be forced to act on behalf of their electorate.[9] On the contrary, according to the communitarian or benevolent conception, governments respond to citizens' will and competition and conflict are viewed as distorting elements.

The question of the accurateness of one or the other vision cannot be decided on a rational basis but it is largely a matter of ideology. Synthetically expressed, "those who support a Leviathan-view of government would welcome competition as a means of taming the Leviathan whereas those who view governments as benevolent would support coordination or harmonisation of policies"[10]

Thus, to sum up, the concept of competition we will work with in this analysis, has to be dissociated from a pure economic analysis of law. The role of competition and more generally of markets will be pushed far beyond the simple economic theory to acquire a true social and organisational dimension.

The economic approach to legal analysis is usually formulated in terms of a single social goal - resource allocation efficiency. On the contrary, public law should be centered on a debate about which social goals and values are to be promoted and through which institutions. Moreover, although most of the times unexplicity, every public law and public policy analysis contains an unarticulated judgement of which is the best social institution to achieve a particular goal. Given the goal of protecting property, for example, the case for recognising a constitutional right involves the implicit judgement that the adjudicative process protects property better than the political process. In turn, given the goal of promoting safety, the case for removing tort liability involves a implicit judgement that the market or government regulation promote safety better than the adjudicative process. Finally, as we will argue, given the goal of European integration, the best institution to overcome State

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9.- Sinn, "The Taming of Leviathan: Competition among Governments", *Constitutional Political Economy*, vol. 3 n. 2, 1992, p. 187. Vide also, Brenan and Buchanan, *The power to Tax. Analitical Foundations of a Fiscal Constitution*. Cambridge, 1980.

10.- Sinn, "The Taming of Leviathan: Competition among Governments", Kieler Arbeitspapiere n° 433. Institut für Weltwirtschaft an der Universität Kiel, 1990, p. 10.

reluctance is market mechanims. In any case, the choice is always a choice among highly imperfect alternatives. [11]

Again, as summarily explained by Wolf, the choice among social institutions is complex and multifaceted. "It is neither a choice between perfect markets and imperfect governments nor one between imperfect markets and perfect governments. Instead it is a choice between imperfect combinations between them"[12]

Conversely, market is identified as a field where individuals interplay, without considering it as a global mechanism. Somehow, focusing only in market transactions without taking into account of the complex underlying relational character of the market means one cannot see the wood for the trees. Instead, interfirm relations are increasingly considered as a determinant factor in analysing market development as a long term relationship among them. The entire economy can be viewed as a network of organizations where power and trust are basic elements. This opens a fascinating element we just point out: the development of reserach theory in this field should concentrate on the legal analysis of economics, more than in the economic analysis of law.[13]

2.1.2. The role of markets in the legal debate.

It is customary to present markets and legal fields as opposed elements. Those who defend the markets are normally considered to undermine the properties of the legal system. On the other hand, regulatory intervention is justified in case of market failure. Instead, to formulate this discourse in antagonic terms of market forces governing social organizations or political processes constraining markets or correcting their imperfections, is somehow misleading. We argue that they are both preempirical, that is generated by a vision of the world not by empirical observation or logical proof.[14]

It is important to emphasise that this criticism of market and self-interest imaginery is not intended as an argument that the market is the

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[11].- Komesar, Neil, *Imperfect Alternatives. Choosing among Institutions in Law, Economics and Public Choice*, Chicago, 1994, p. 5

[12].- Wolf, Charles, *Markets or Governments. Chossing between Imperfect Alternatives.* MIT Press, 1993 (2nd ed), p. xi.

[13].- "The inter-organizational network may be conceived as a political economy concerned with the distribution of two scarce resources, money and authority", Thorelli, Hans, "Networks: Between Markets and Hierarchies", Strategic Management Journal, vol. 7, 1986, p. 38.

[14].- Rubin, Edward L. "Deregulation, Reregulation and the Myth of the Market", *Washington and Lee Law Review*, vol. 45, 1988.

wrong social mechanism, that efficiency is the wrong social goal, or that economics is the wrong social science. The point rather is that the universalisation of these mechanisms, goals and disciplines do not rest upon any objectively demonstrable foundations[15]. "Supporters must argue for the free market in the course of our ongoing debate about the proper way to organise our society, just as supporters of regulation, redistribution, or the use of sociology must argue for those mechanisms, goals and disciplines. Very often, because the free market efficiency perspective is an appealing approach and is embedded in our cultural traditions, it will prevail. But it is simply a myth to transform these social choices into transcendent necessities"[16]

Therefore nothing appears in the nature of that controversy to suggest that market solutions should be preferred, a priori, to other alternatives. The market simply represents one option that fulfils some purposes and frustrates others.

Maintaining or restoring the free market becomes an ordinary political decision, subject to the same political choice as any other. Some legislators want to regulate the market to appeal to powerful interest groups; others want to preserve the market in order to appeal to different, equally powerful interest groups. There being no saints in sight, our only choice is between rival sinners[17]

Therefore, we argue that the debate polarised around the market options and the classical regulatory harmonization as ideal forms of social organisation is somehow fruitless.

None of the options is neither wrong nor reprehensible but its claim to universal truth is eminently debatable. Structuring the debate according to

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15.- As expressed by Wolf, "because there is no generally applicable formula for choosing between market and non-market alternatives, the results of such comparisons often depend more on the predispositions of the evaluators than on their analysis.", Wolf, *Markets or Governments. Choosing between Imperfect Alternatives*. MIT, 1993, 2nd edition, p. 117.

16.- Rubin, Edward L. "Deregulation, Reregulation and the Myth of the Market", Washington and Lee Law Review, vol. 45, 1988 p. 1264. As expressed by Komesar, "The market process serves a function parallel to the political process. It can serve as an alternative to government action in the achievement of social goals or interests", Komesar, *Imperfect Alternatives. Choosing among Institutions in Law, Economics and Public Choice*, Chicago, 1994, p. 98

17.- Rubin, Edward L. "Deregulation, Reregulation and the Myth of the Market", Washington and Lee Law Review, vol. 45, 1988, p. 1269. "In contemplating the cardinal economic choice, we should consider the total effects associated with each of the options, rather than the shortcoming s associated with only one. We need to understand the more or less predictable shortcomings of governments no less than those of markets", Wolf, Charles, *Markets or Governments. Chossing between Imperfect Alternatives*. MIT Press, 1993 (2nd ed), p. 12.

those positions obscures it and buries its controversial elements at a depth where the opposing sides can react only in an absolute, unreflective way. "If we perceive, instead, the two groups as proposing rival public policies we can more readily evaluate each alternative, even if we must do so without the benefit of a synthesising methodology. We then have the option of recognising that they each may address different social problems or different aspects of an issue, and we can avoid being drawn into global affirmations or dismissals"[18]

Thus, more than being anchored in a preexisting ideological vision of the debate, one should utilise an argumentation based on alternative (non-mutually exclusive) policies.

This position does not force oneself to claim that the market or the traditional harmonization have failed in a given field. Instead, it allows to argue that perhaps, one system is not the policy option that should be used to achieve our goals. "The correct question is whether, in any given setting, the market is better or worse than its available alternatives or the political process is better or worse than its available alternatives. Whether, in the abstract, either the market or the political process is good or bad at something is irrelevant. Issues at which an institution, in the abstract, may be good may not need that institution because one of the alternative institutions may be even better. In turn, tasks that strain the abilities of an institution may wisely be assigned to it anyway if the alternatives are even worse"[19]

Passing to other matters, it has also been argued that legal solutions are superior since they provide greater equity, participation and accountability. As regards participation, we argue that market can be a participatory mechanism in the same way the democratic process is said to be[20]. The producer of marketed output is ultimately accountable to the purchasing power of consumers while the producer of nonmarketed output can be of voting power of their electorate. Going even further, one could argue that both types of producers are disciplined by both type of powers. Thus, regulatory competition can discipline nonmarketed output through a market mechanism and consumer movements can discipline marketed output through nonmarket mechanisms.

18.- Rubin, Edward L. "Deregulation, Reregulation and the Myth of the Market", Washington and Lee Law Review, vol. 45, 1988 p. 1271

19.- Komesar, Neil, *Imperfect Alternatives. Choosing among Institutions in Law, Economics and Public Choice*, Chicago, 1994, p. 6

20.- Wolf, *Markets or Governments. Choosing between Imperfect Alternatives.* MIT, 1993, 2nd edition, p.

Moreover, paradigmatic participatory processes in a legal setting may suffer from capture problems.[21] Special organised interests may influence politics in such a way that instead of being in front of a participatory process, the organised group transforms the common good in a monopoly or cartel protected by regulator's activity. Therefore, market mechanisms, instead of being contrary to participatory democracy can be a protection and reinforcing measure of it.

In what concerns equity, "The choice between markets and governments is complex, and it is usually not binary. Rather than being a pure choice between markets or governments, it is usually a choice between different combinations of the two, and different degrees of one or another mode of allocating resources. If the preferred and predominant choice is in favour of the market, a significant role for the nonmarket (that is government) will and should remain. This role relates especially to (...) establishing and maintaining the legal and other environmental conditions that are essential for the functioning of markets and to the provision of necessary redistributive services and programs that constitute an acceptable safety net for society and that reflect the standards of distributive justice with which that society is tolerably content"[22]

However, in discussing about nonmarket mechanisms to achieve redistributive justice one has to bear in mind that this mechanism suffers also from imperfections. Often, the efforts of the nonmarket to remedy the types and scope of inequities generated by the market are themselves associated with inequities of different type and scope. Those arguing in favour of governmental intervention to bridle markets and relieve inequities seems to ignore that such well-intentioned intervention can also led to situations of inequality, making the remedy as bad as the original problem.

Moreover, it is not accurate to state that market mechanisms can only be used to reach efficiency arguments. There is a crucial distinction between market-excluding mechanisms and market-including mechanisms. For instance, Smith's theory of free trade is a rejection of a market excluding interventionist system, but not of market-including interventions aimed at doing those important things that the market leave undone.[23] Thus efficiency result is only one possible goal of market mechanisms.

21.- Stigler, G. "The Theory of Economic Regulation", Bell Journal of Economics, vol. 2, 1971.

22.- Wolf, *Markets or Governments. Choosing between Imperfect Alternatives*. MIT, 1993, 2nd edition, p. 155, quoting Viner, Jacob, "The Intellectual History of Laissez Faire", Journal of Law and Economics, vol. 3, 1960.

23.- Sen. "Markets and the Freedom to Choose", in Siebert (ed), The Ethical Foundations of the Market Economy, 1994. p. 133

In other words, it is not realistic to affirm that only welfare maximization arguments are to be taken into account when arguing in favour of market-including strategies[24].

As argued by Sen, the distinction between omission and commission is important in understanding the division between the respective roles of the market and of non-market institutions in actual economies, and indeed it is possible to argue, at the same time, both, (1) for more market institutions, and (2) for going more beyond the market.[25] If we take the example of famine prevention, a non-market institution will be represented by direct transfers to affected countries. On the contrary a wider strategy combining both forms of intervention could be designed: government intervention (non-market) is necessary to create jobs to allow people to acquire some purchasing power and at the same time market transactions will bring food to the potential famine victims.

To sum up, as graphically stated by Peacock, the market is not some 'mortal God' which needs to be worshipped with the fervour one associates with extreme 'liberals/conservatives', but it is a mechanism. Whether and in what form one should employ that mechanism depends on normative judgements.[26]

2.1.3. Markets as constrained social processes. A rejection of the liberal theories.

It is misleading to consider that market mechanisms are not constrained at all by ethical grounds. Let us take the example, as Kelman does, of governments who in order to attract business allow them to kill and consume small infants. "Yet a process of competition that sets no limits on the wants that the parties may satisfy would, by its dynamics, make morality exactly that. There is no presumption at all in favour of competition taking place in such cases. It is thus impossible to decide whether an instance of competition

24.- By the same token, it is unrealistic to think that the only institution consistent with efficiency is the market process. We have available a full range of legal solutions based on efficiency. See Mattei, "Efficiency as Equity: Insights fro Comparative Law and Economics" Hastings International and Comparative Law Review, vol. 18 n.1, 1994

25.- Sen. "Markets and the Freedom to Choose", in Siebert (ed), The Ethical Foundations of the Market Economy, 1994. p. 134

26.- Peacock, Alan, "Comment on Amartya Sen, "Markets and the Freedom to Choose", in Siebert (ed), The Ethical Foundations of the Market Economy, 1994. p. 139

among states is justified until one has ethically examined the specific policy at issue"[27]

Thus, market mechanisms are not unconstrained processes. Ethical grounds - in the sense of common shared values that can be agreed within a community by establishing a common field or some kind of harmonization - need to be taken into consideration. As a consequence, we will argue that while economic analysis of the regulatory process places competition and centralisation as alternatives, a more institutionally based theory has to see both concepts as complementaries.

The same is true for the operation of the economic market. It is unrealistic to think that any preference an economic actor might have can be satisfied. On the contrary, the market mechanism itself prescribes some exogenous ethical norms. This is the function of antitrust norms or the limitations by which a firm cannot burn the competitor's plant in order to acquire competitive advantage. Markets does not and cannot exist without the State. "Markets require organisation to function; the market as a social institution and economic force is more fragile and complex than is assumed by its enthusiastic supporters. Nevertheless, the scope and objectives of markets and states cannot be confused. Markets are efficient in allocating scarce resources in the short-run. By contrast, the nation is the conduit for investing in the future. Moreover, the state organises the market by ensuring transparency, fairness and access. Thus, whatever the future scenario is, state and market will co-exist"[28]

Markets only become truly effective when they are part of a wider social system which collectively agrees to set up market mechanisms. The 21st century will probably experience a genuine social and political engagement of markets with networks, associations and local communities along with renewed state intervention. It will remain the task of political institutions to determine social priorities. The most authoritative voices place on the domain of state intervention crucial issues as education and training, the access and financing of healthcare and last, but not least, the production of knowledge i.e. innovations which are the core of economic growth. It is therefore erroneous to think that during the next century markets will rule.

At odds with conservative and pro-market ideologies, markets will never be able to displace governments in making strategic policy choices and

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27.- Kelman, "The Ethics of Regulatory Competition", Regulation, May/June, 1982, p. 43

28.- Boyer and Drache, "Introduction" in Boyer and Drache, *States against Markets. The limits of Globalization*. London, 1996, p. 3

in institutionalising markets. Conceptually, state interventions are placed on a different level in relation to market mechanisms, since public authorities may both create and monitor markets. Our epoch need more political interventions and fewer naïve beliefs that markets will overcome our ignorance and make the strategic choices that governments have been unable, until now, to make and implement.[29]

As pointed out by Streit and Mussler, there are structural similarities between the economic constitution (in the sense of the rules governing the functioning of a market) and the constitutions of political systems (in the sense of securing a rule of law). "Similarly, the constitutional structure of a market systems consists of secured opportunities to act in an autonomous, self responsible way. But equally, institutional provisions are required to prevent an arbitrary use of the concomitant economic power. This structural similarity is combined with a specific form of interdependence between the market system and the political system. Since the political system can set enforceable rules for the economic system whereas the reverse is not possible, a hierarchical relationship is established. However, as the market system is self-organizing, it requires a high degree of autonomy and correspondingly allows rather limited control by the political system"[30]

There has been a deep transformation of the post-war or Fordist model of State in favour of a new alternative form of a restructured State. The fordist model was based of a shared understanding about state intervention in the economy, an elaboration of bureaucratic institutions and a primacy of the public over the invisible hand of the market. Instead, a new restructured state is expanding the role of the individuals and the market (the areas of self-regulation).

Contrary to the central tenets of this kind of restructuring discourse, "the present period does not represent the end of politics - the substitution of political negotiation with neo liberal imperatives. Instead, the profound lack of social consensus, the bypassing of (classical) democratic principles to impose new governing forms, the ongoing fiscal crisis of the state and the continuing crisis in unemployment and consumption, all point to the opening of political spaces and an explosion of alternative visions (...) The particular form of displacement of the national state in a post-Fordist period, however, does not

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[29].- Boyer, "State and Market. A New Engagement for the Twenty-First Century", in Boyer and Drache, *States against Markets. The limits of Globalization*. London, 1996, p. 110.

[30].- Streit and Mussler, "The Economic Constitution of the European Community: from Rome to Maastricht", Constitutional Political Economy, vol. 5 n. 3, 1994, p. 324-25.

mean that political space itself has disappeared or that it has floated upward towards some nebulous and institutional-less international space"[31]

In any case, it remains the difficult task of defining the boundaries of the operation of markets and of the need to establish classical mechanisms of political centralization. We argue this core question may be basically addressed from two different perspectives:

a) inductively: is the well known negotiation process among societal actors.

b) deductively: through a process of trial and error. As suggested by Vanberg and Kerber, "to work out what these guidelines suggests with regard to specific problem-situation is a permanent task for *Ordungspolitik* in a changing world, a task that will largely be a matter of learning from experience, by trial and error". [32]

2.1.4. Competition as a discovery procedure[33] and the problem of knowledge.

Closely related to the debate about the boundaries of market mechanisms in legal orders, one must recognize that we live in a world of limited knowledge. Institutional competition can be a means of discovering both citizens tastes and preferences and new institutional and policy solutions, and thus a way of increasing knowledge.

"The economic process and the essence of its social function is not primarily one of achieving efficiency, but one of revealing knowledge the very availability of which has up until now not been suspected"[34]. Thus the significance of competition lies not so much in the fact, emphasized by traditional economic theory, that it pushes prices down to marginal costs but, instead, in the role it plays in creating and spreading knowledge about what

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31.- Brodie, "New State Forms, New Political Spaces", in Boyer and Drache, *States against Markets. The Limits of Globalization*. London, 1996, p. 395-396

32.- Vanberg and Kerber, "Institutional Competition among Jurisdictions", Constitutional Political Economy, vol. 5 n. 2, 1994 p. 214

33.- Hayek, "Competition as a Discovery Procedure", in Hayek, New Studies in Philosophy, Politics, Economics and the History of Ideas, London, 1978

34.- Kirzner, "The Ethics of Competition", in Siebert (ed), The Ethical Foundations of the Market Economy, 1994. p. 105

consumers want, and how their preferences can be satisfied in a better or less costly way.[35]

We want to emphasize that this dimension of political competition could prove to be a procedure for the discovery of adequate solutions for social structures. Therefore, social solutions could be achieved not only by way of collectively expressed opinions but in decisions taken individually. "If institutional competition necessarily affords the recognition of open social systems that communicate more knowledge and provoke more novelties than a single mind can ever even think of, it does not come as a surprise that a neo-classical approach to this phenomenon turns out to be largely inappropriate. Most of the theories and critiques of institutional competition implicitly assume that its specific results are beyond doubt and known to the omniscient observer"[36]

Therefore, evolutionary market processes have to be seen as open dynamic processes without predefined ends. Competition can be seen as a trial-and-error process and a deductive methodology to discover the boundaries of the social organisation (see supra).

Moreover, it is also important to underline the existence of unintended or side effects that the process of competition among rules presents. A given set of rules may be the result of spontaneous evolution and thus an unintended product of social interaction in the process of cultural selection[37]. This open ended process characterised basically by forces of innovation and imitation, might produce unexpected results. This should not be interpreted as a malfunctioning of the system but as a logical consequence of the initial lack of knowledge present at the initial stage. Therefore, it comes as no surprise that regulatory competition processes are difficult to predict due to the partial existence of knowledge and general future reactions.

35.- Vanberg and Kerber, "Institutional Competition among Jurisdictions", onstitutional Political Economy, vol. 5 n. 2, 1994 p. 198

36.- Wohlgemuth, "Economic and Political Competition in Neoclassical and Evolutionary Perspective", Constitutional Political Economy, vol. 6, 1995, p. 87

37.- Gerken, "Institution Competition: An Orientative Framework" in Gerken (ed.) *Competition Among Institutions,* London, 1995, p. 4. In fact, it is important to underline the difference between searching knowledge starting from a situation of concious ignorance and the process of discovery as an unintended effect. Thus discovery is the very oppositte of deliberate search. As explained by Kirzner, "the kind of discovery steps we have described as making up the market process, on the other hand, are characterized precisely by the surprise involved by the discovery, and by the corresponding earlier unawareness of the nature of one's ignorance" Kirzern, *The Meaning of Market Process,* Routledge, 1992, p. 46.

The lack of understanding on the importance of the process in itself and of the existence of unintended effects has raised some criticism on the process of regulatory competition. Instead, this is, by definition, the functioning of the system, which main virtue is to reveal knowledge which was unavailable.

This is fact makes regulatory competition different to a 'mere' market process. In the latter, the result is always constrained by a given exogenous framework. In a regulatory competition paradigm, the process can affect the rules governing the framework themselves. Thus, regulatory competition present a much richer scenario which cannot be coped by neo-classical economic explanations headed by the Public Choice school of thought.

As Wohlgemuth has illustrated, economic analysis captures only a portion of the regulatory competition paradigm. "The institutional alternatives are treated (by the proponents of traditional theories of market competition) to be known and given in the same measure as the preferences of supposedly omniscient citizens. Hence, institutional competition cannot be modelled as a source of discovery and innovation. It is reduced to a mechanism for allocating mobile factors to given institutional locations, with its outcomes known in advance to be either efficient o inefficient". [38]

In fact this is one of the fundamental differences between the neo-classical economic school of though and the Austrian economists. For the former, data are given and known, and completeness of knowledge is assumed, all together involving a closed-ended vision of the world. By contrast the Austrian view of the world sees it as open-ended. For the Austrian view competition consists of series of discovery steps revealing possibilities which were no part of any set of data. The function of competition in this open-ended world of sheer ignorance is to achieve those discoveries which change the position of the frontiers separating knowledge from ignorance.[39]

Therefore, the process of competition among jurisdictions can be seen as a process of experimentation, exploration and discovery, in which alternative institutional arrangements or social technologies are tried out in an arena in which new arrangements and institutional inventions can constantly appear on stage, challenging established solutions.[40]

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[38].- Wohlgemuth, Michael, "Institutional Competition - Notes on an Unfinished Agenda". Max-Planck Institut zur Erforschung von Wirtschaftssystemen. Diskussionsbeitrag 06-95, p. 4

[39].- Kirzner, "The Ethics of Competition", in Siebert (ed), The Ethical Foundations of the Market Economy, 1994. p. 104

[40].- Vanberg and Kerber, "Institutional Competition among Jurisdictions", Constitutional Political Economy, vol. 5 n. 2, 1994 p. 204

"Being aware of the limits of reason and knowing that, in institutional just as in other matters, we cannot know in advance what works best, we can rationally choose to adopt a framework suitable for competitive evolutionary learning. This should not be understood as an advice to abandon every effort to deliberately shape our institutional environment. It should, instead, be understood as an advice to utilise, in our efforts in institutional construction, the explorative potential of a competitive process of trial and error, a process through which we can hope to achieve at least improvement, if not perfect solutions"[41] Therefore trying to analyse regulatory competition using predictability or stability parameters leads only to a misunderstanding of its operation.

41.- Vanberg, "Cultural Evolution, Collective Learning and Constitutional Design", in Reisman (ed.) *Economic Thought and Political Theory*, Kluwer, 1994 p. 194

2.2. The model of competition among rules.

Having briefly clarified some false analogies of regulatory competition as a market mechanims in the previous pages, we concentrate now in examinig the model of competition among rules itself. It may be defined as "the alteration of national regulation in response to the actual or expected impact of internationally mobile goods, services or factors on national economic activity"[42]

2.2.1. Configuration

In order to allow a paradigm of regulatory competition to operate, some preconditions must be satisfied. These are not simple formal requirements but they highly predetermine the degree and configuration of the competitive mechanisms.

The way individual actors prefer to act depends, among others things, on the way they are allowed to act in alternative circumstances. "The relevant rules of conduct, however, are not necessarily of the same kind in all dimensions of institutional competition. (...) Neglecting concrete (meta-) institutional preconditions of institutional competition not only affects its positive analysis. It might also lead to short-sighted normative conclusions. Similar to simplistic findings claiming market failure, the political alternatives often are drastically reduced to only two alternatives: a supposedly unconstrained market-solution on one side and a supposedly costless and frictionless political solution (e.g. harmonization of regulations) on the other. Hence all, real-life possibilities are neglected"[43]

Therefore, the different degree in which the following elements are present in a legal order will influence both the scope and the functioning of regulatory competition.

1.- rules guaranteeing the decentralization and fragmentation of independent political decision makers. The more space for plurality and diversity we have, the more there will be a positive framework for competition. Thus, institutional competition is both the result of a political design and is constrained by it.

42.- Sun and Pelkmans, "Regulatory competition in the Single Market", Journal of Common Market Studies, vol. 33 n. 1, 1995, p. 68

43.- Wohlgemuth, Michael, "Institutional Competition - Notes on an Unfinished Agenda". Max-Planck Institut zur Erforschung von Wirtschaftssystemen. Diskussionsbeitrag 06-95, p. 6

This kind of design can be explicitly constitutionalized, as in federal systems or be a multilateral agreement among states as in the case of the EU. There exist all kinds of possible combinations between the two extremes: total centralization and competitive federalism.

However, "politicians can hardly be expected to establish and maintain rules conducive to a fully-fledged competition with all its potential attributes, especially in its effects confining the monopoly of power through exit and hence limiting the leeway of political action"[44]. It is thus important the coexistence of other forces like globalization and free movement which exert a powerful pressure towards diversity.

2.- there has to be some jurisdictional mobility[45] or the possibility of regulatory choice. This distinguishes regulatory competition from regulatory mimetism or emulation where movement is not necessary and changes in regulatory policies are the product of cross comparison of policies and not of regulatory arbitrage.

Many of the arguments in favour and against regulatory competition assume a degree of mobility which does not mirror reality.

"It is certainly true that the costs of migrating between jurisdictions tend to be typically high compared to the costs of moving between alternative suppliers in ordinary markets. Yet before any conclusions concerning the effectiveness of competition between governments are drawn, a number of things ought to be considered. First of all, relevant for market-type competition between governments is not only the migration of persons-taxpayers, but also the migration of taxable resources, in particular, capital. Migration costs are typically lower for resources than for persons, and the lower their migration costs are, the more governments are under competitive constraints."[46]

Migration costs are also related to the type of constitutional design chosen[47]. That is, if the choice is a federal or highly fragmented and decentralized state, this will greatly reduce the migration costs and will foster

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44.- Wohlgemuth, Michael, "Institutional Competition - Notes on an Unfinished Agenda". Max-Planck Institut zur Erforschung von Wirtschaftssystemen. Diskussionsbeitrag 06-95, 18

45.- Everybody has present the efforts of planned-economy regimes to impede the mobility of their citizens.

46.- Vanberg, "Constitutionally constrained and safeguarded competition in markets and politics with reference to the European Constitution", Journal des Economistes et des Etudes Humaines, vol. 4 n.1, 1993, p.14

47.- See the previous condition supra.

competitive mobility[48]. Such a constitutional design can be an instrument to increase the effectiveness of inter-governmental competition.

Moreover, it is sometimes forgoten that jurisdictional mobility does not always require an effective physical displacement. For instance regulatory competition implies that private firms have some choice as what regulatory law will govern their activities, either on the territorial principle of prescriptive jurisdiction where the private firm has a choice of where to locate its activities, or on another basis for prescriptive jurisdiction, for example where the private firm can choose its nationality[49]

3.- there has to be information about the regulatory options to permit arbitrage to take place. An evaluation and information collection body may provide for the diffusion of that kind of information. This is somehow the idea of the new European Agencies, as channels of evaluation and distribution of information.

If the costs of obtaining and assimilating information respecting legislative differences are prohibitively high, then citizens will be unable to avail themselves of the information's benefits. Accordingly to the extent that nuances in laws among jurisdictions are disseminated in a timely and accessible manner, the benefits from legislative diversity are enhanced[50]

If competition among rules is to work in a balanced and unbiased way, information needs to be supplied, in order to allow companies and individuals to know the nature of regulation in other countries and to compare the relative merits of the different models of regulation and engage in regulatory arbitrage. The existence of asymmetric information among regulators, suppliers or consumers will undermine the operation of competition among rules.

4.- existing regulatory preferences must not be too much culturally rooted. If a given national market exhibits strong regulatory preferences, an entrant to that market may be, as a matter of fact, economically forced to produce according to these long-standing national regulatory traditions, rather

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48.- For a wonderful examination of competition in a federal system see, Kenyon, Daphne and Kincaid, John, *Competition among States and Local Governments. Efficiency and Equity in American Federalism.* The Urban Institute Press, Washington, 1991.

49.- Trachtman, "International Regulatory Competition, Externalization and Jurisdiction". Harvard International Law Journal, vol. 34 n. 1, 1993 p. 59

50.- Daniels, "Should Provinces Compete?", McGill Law Journal, vol 36, 1991, p. 148

than to exercise the right, upheld by mutual recognition, of operating according to home-country regulations.[51]

Moreover, regulations are inserted within a whole legal system, a complex institutional gear which means that for a regulator may be difficult to respond to regulatory competition by changing one given type of regulation without affecting the coherence and consistency of the whole system. Regulatory policy is embedded in wider national regulatory style and structure. For instance, "in the area of company law and financial market regulation different models of corporate governance or systems of providing corporate finance have proved greater than the sum of their parts over the years. Efforts to reform part of the system, such as to address the 'problem' of short-terminism in Britain, have foundered on the fact that change in one area can only be brought by change in the system as a whole"[52]

Another way of looking at this phenomenon is the fact that most of the times it is impossible to attribute a clear cause-effect relation in examining the decision of one firm to relocate. There are multiple factors which always influence such a decision. When a number of factors affect any outcome it is difficult to clearly establish the impact of a regulatory change.

5.- externalities. The paradigm must control that the consequences of a given regulation are internalized by the jurisdiction who adopts it. In a regulatory competition paradigm there is the risk that a state externalizes the costs of lax regulation to foreign parties. "Regulatory arbitrage is acceptable only when firms are required to bear the regulatory costs properly allocable to their activities and states are required to bear the social costs associated with their regulation or lack thereof"[53]

2.2.2 The functioning of the model

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[51].- Sun and Pelkmans, "Regulatory competition in the Single Market", Journal of Common Market Studies, vol. 33 n. 1, 1995, p. 84. This is also related to the issue of mobility in Europe. A perfect mobility is Europe is highly unrealistic since this would require a complete cultural identificacion with Europe instead with Member States . There would also have to be no substantial language barriers.

[52].- Woolcock, The European Single Market. Centralization or Competition among Rules?, RIIA, 1994 p. 23. See also, Hodges and Woolcock, "Atlantic versus Rhineland Capitalism in the European Community", West European Politics vol. 16 n. 3, 1993

[53].- Trachtman, "International Regulatory Competition, Externalization and Jurisdiction". Harvard International Law Journal, vol. 34 n. 1, 1993 p. 102

Once reached this point, there is still a crucial question to be addressed, i.e. how does the regulatory competition models works?

In answering this question it is analytically useful to distinguish between two interdependent phases or moments in a process of regulatory competition:

a) institutional arbitrage: is the process which involves the choice of rules made by the mobile resources. It is normally characterized by a positive action of those factors implying a movement (normally abandoning one jurisdiction in an exit-option).

b) institutional entrepreneurship: it is constituted by the reactions of institutions to a mix of incentives initialized by the process of institutional arbitrage.

Thus, institutional arbitrage and institutional entrepreneurship are two partial processes of institutional or regulatory competition. The potentialities of regulatory competition and institutional substitution depend, first, on the freedom of owners of mobile resources to leave one institutional domain and enter others. At the same time they are contingent on the freedom of politicians and regulators to provide regulatory alternatives.[54]

Sun and Pelkmans have identified four factors which determine the degree of correlation between the two moments of regulatory competition, i.e. arbitrage (static event) and policy reform (dynamic process). These are:

- the cost differentials implied by differences in national regulations[55]
- the underlying competitiveness of the industry in question relative to its competitors in the internal market.
- the industry's ability and willingness to lobby national regulators to change national regulations; and
- the national regulatory authority's incentive to change national regulations.

54.- Wohlgemuth, Michael, "Institutional Competition - Notes on an Unfinished Agenda". Max-Planck Institut zur Erforschung von Wirtschaftssystemen. Diskussionsbeitrag 06-95, p. 15-16

55.- This of course means that in case of very little cost differentials no process of regulatory competition would be initiated. The process of regulatory competition does not take place unless agents consider worth reacting to those differences. "The incentives and pressure on regulators to undertake such competition will depend on the cost reducing effect of the regulatory change and the extent to which this will increase the market share of domestic industry". Smith, Edward, "Regulatory Competition and the 1992 Process", European Interuniversity Press. Brussels, 1995 p. 57

Nevertheless, although the model is based on mobility, sometimes it is enough with the existence of a potential exit to activate the mechanism of policy modification. Thus, effective border crossing movements are no absolute condition for institutional competition. The threat of potential exit may lead to reactions like institutional imitation or innovation. (with analogy to a contestable market). Even if exit is effectively barred, the observation of the performance of alternative institutional arrangements may press on institutional reform, when recipients have the opportunity of comparing their relative performance.[56]

Under a regime of institutional competition, politicians have an incentive to engage in comparative institutional analysis in order to find out which of the formally established institutions are currently perceived as relatively (in-) adequate by the owners of mobile resources. In other words, the fact of being under competitive pressure, incentive policy-makers to act and not only to react. In this context, institutional competition becomes a information-searching mechanism (see supra) which evaluates the comparative attractiveness of different institutional sets and provides incentives to react both to the threat of exit and to the voice in some imitative or innovative way.[57]

As explained by Wolf, oversight of regulatory output by its 'consumers' generally operates through ambiguous, uneven, and personalized political processes using such signaling and enforcement mechanisms as legislative hearings, lobbying, vote trading, floor amendments, and bargaining. By contrast, in the competitive regime, control over performance is ultimately exercised by consumer behaviour and by competing producers whose competition often occurs across product lines as well as within them. The signaling and enforcement of market like mechanisms are more direct, impersonal and evidently more effective.[58]

This is in close similarity with Hirchsman's theory of exit and voice.[59] At first sight, it seems to exist a negative correlation between exit and voice,

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[56].- Wohlgemuth, Michael, "Institutional Competition - Notes on an Unfinished Agenda". Max-Planck Institut zur Erforschung von Wirtschaftssystemen. Diskussionsbeitrag 06-95, p. 14. See also Mattei and Pulitini, "A competitive model of legal rules", in Breton et al (ed.), *The Competitive State.* 1991.

[57].- See, Rose, Richard, "What is Lesson-Drawing?", Journal of Public Policy, vol. 2 n.1, 1991.

[58].- Wolf, *Markets or Governments. Choosing between Imperfect Alternatives.* MIT, 1993, 2nd edition, p. 128-129.

[59].- Hirschman, A.O. Exit, Voice and Loyalty, Responses to the Decline in Firms, Organizations and States, Harvard Univ. press, 1970; Hirschman, Essays in Trespassing. Economics to Politics and Beyond. Cambridge, 1981.

being exit an economic mechanism and voice a political one. Following that reasoning it will result that the easier exit is, the lower the incentives to exercise the voice option.

However, this argumentation demonstrates to be false in the case of competition among rules. Instead, we argue that the exit option reinforces the voice. Exit is an insufficient mechanism to discipline governments. Individuals must also have the possibility to raise the voice in the form of voting (and conversely).[60]

According to these explanations, decentralization and regulatory competition not only fortify the exit option of individuals but they also strengthen their incentives and instruments to articulate their preferences, i.e. to take up the voice option. Thus decentralization and regulatory competition puts pressure on the political decision makers to follow the citizens' preferences by bolstering exit and voice.[61]

As explained by Gerken, "the notion of exit as a transmission mechanism may be interpreted as follows: owners of internationally mobile factors of production, mainly capital, will direct these to those locations where conditions are most favourable to them. If the exit of capital reduces the overall welfare it may result in reactions of voice in the next elections"[62]

As a consequence, there is a manifestation of competition through voice when local companies lobby their national regulators in a effort to improve the national policy mix offered. For instance, German employers lobbied the federal government for a reduction in corporation tax, arguing that if such reduction was not forthcoming they would be forced to invest abroad. The voice option, accompanied by a credible threat of exit, was the main pressure for policy change. Rather than an individual 'market-based' process, therefore, the pressure tends to be political: more voice than exit.[63]

60.- Epple, Denis and Zelenitz, Allan, "The Implications of Competition Among Jurisdictions: Does Teibout Need Politics?" Journal of Political Economy, vol. 98, 1981. See also, Frey and Eichenberger who argue that political instiutions are needed to secure both the functioning of competition and the existence of voice mechanisms. Frey and Eichenberger, "Competition among Institutions: The Idea of FOCJ", in Gerken, *Competition among Institutions*, London, 1995, p.214

61.- Eichenberger, "The benefits of Federalism and the Risk of Overcentralization", Kyklos, vol 47, 1994, p. 412, parenthesis added.

62.- Gerken, "Institution Competition: An Orientative Framework" in Gerken (ed.) *Competition Among Institutions*, London, 1995, p. 12

63.- Woolcock, The European Single Market. Centralization or Competition among Rules?, RIIA, 1994 p. 28

Again, "if industry has incurred large sunk costs to establish itself within a Member State, or if restructuring would involve large reductions in employment, would probably attempt first to lobby its national government; in other words, it would react in the political market (as opposed to the economic market where mobility takes place)"[64]

In practice, the credible threat of exiting is often enough to bring about substantial changes. Again, in 1981, the German Constitutional Court laid down such strict conditions for private broadcasting that it seemed practically forbidden. Five years later the court became much more indulgent. Commentators argued that German publishing houses had credibly enough announced the intention of using a Luxembourg satellite in order to broadcast to Germany. They would have been beyond any German control. In order to preserve at least some regulatory influence, the Court overruled its former judgement.[65]

The position of industry is also subject to strategic changes depending on the regulatory environment they are confronted with. Once more, in the case of the Beer Purity Law, German firms reversed completely their strategy after the ECJ judgement on the issue. "Here it is interesting to note the volte face of Becks Beer in the case of the German Beer Purity law. Before the result was announced, Becks was a firm advocate of the purity laws maintaining that additives in beer had potentially harmfull effects. However, since the announcement by the Court of Justice that the purity law did not qualify under article 36, Becks have complained to the Federal Government that the maintenance of the purity laws (for domestic firms) could severely impair their ability to compete against Heineken and Stella Artois in the event that these firms adopt an aggressive pricing strategy upon entry into the German market"[66]

Therefore, regulatory competition is a much more rich and complex process than market mechanisms as conceptualized by classical economics. Regulatory competition may be exercised through tipically non-market channels searching for a policy modification.

This kind of competitive pressure without exit can also be related to the concept of emulation. Regulatory emulation is the process whereby regulators

64.- Sun and Pekmans, "Regulatory competition in the Single Market", Journal of Common Market Studies, vol. 33 n. 1, 1995, p. 75

65.- Engel, "Legal Experiences of Competition among Institutions", in Gerken, Ludwig, Competition among Institutions, 1995, p. 99

66.- Smith, Edward, "Regulatory Competition and the 1992 Process", European Interuniversity Press. Brussels, 1995 p. 57 Parenthesis added.

change their policies as a result of observing the regulatory policies pursued by other countries.[67]

The effect of jurisdictional competition is to put jurisdictions under competitive pressures to improve their attractiveness. In modifying the existing regulation, a normal phenomenon is emulation of institutional innovations of the leading jurisdictions. Hence, there are incentives for successful institutional innovations of jurisdictions to be tried out and spread by imitation.

"Change as a result of competition among rules does not, therefore, necessarily require that factors of production physically move. Indeed, in most cases they probably will not. For example, if the regulatory authority in one country sees that the policies pursued by other countries offer the means of improving performance, or more effectively dealing with problems that have arisen in the application of national policy, they will emulate the other policies."[68]

Thus, when effectuating a detailed analysis of the functioning of regulatory competition one has to admit that the process is a complex (can have many different manifestations) and unpredictable (in the sense of open-ended).[69]This in fact represents a further factor in reinforcing the theory that the process in itself constitutes a more important component than single ascertainable results.

2.2.3. A balanced evaluation of the competitive paradigm

These are the benefits of regulatory competition:

1.- plurality and choice of regulation. Within a regulatory competition paradigm, consumers will be able to choose among the goods and services produced according to various national regulations. For instance, in the case of the EU, "given the four economic freedoms of movement, consumers and firms will be able to arbitrage among differences in national regulations

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67.- See also the concept of legal transplant as a vehicle for the circulation of legal models. Mattei and Pulitini, "A competitive model of legal rules", in Breton et al. (ed.), *The Competitive State*. 1991, p. 212. Meny, Ives, *Les Politiques du Mimetisme Institutionnel*, Paris, 1993.

68.- Woolcock, The European Single Market. Centralization or Competition among Rules?, RIIA, 1994 p. 15

69.- Sun and Pelkmans, "Regulatory Competition and the Single Market", Journal of Common Market Studies vol. 33 n.1. 1995

revealed thereby. With mutual recognition, consumers will be able to choose among goods and services produced according to various national regulations. To the extent that greater variety increases utility, consumer welfare will be enhanced. Further, when mobility rests with factors of production allocative efficiency will be improved"[70] Thus, a greater choice of regulation will serve both to increase consumer welfare and to ameliorate allocative efficiency.

2.- disciplining effect on national regulatory systems. With a choice of regulatory regimes, consumer and firm behaviour can serve to tame the Leviathan tendencies of government. For instance, competition among governments lead to less wasteful fiscal policies. Competition provides a discipline mechanism that results in more efficient and innovative production of goods and services. In the context of regulation, one major advantage of decentralization is the possibility that regulatory competition will result in discipline, causing governments to produce regulations which are more efficient and innovative.[71]

3.- Strategy for discovery, experimentation and innovation[72]. Moreover by encouraging the states or sub-national jurisdictions to act as laboratories for development, production and adoption of innovative laws and regulations, the risk of widespread adoption of flawed laws is reduced.[73]

"Crucial for the dynamics of evolutionary competitive processes in ordinary markets are the built-in incentives for experimentation and innovation. Those agents who offer the relatively best hypothesis gain a competitive advantage and hence advance in comparison with their

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70.- Sun and Pelkmans, "Regulatory Competition and the Single Market", Journal of Common Market Studies vol. 33 n.1. 1995, p. 82

71.- Trachtman, "International Regulatory Competition, Externalization and Jurisdiction". Harvard International Law Journal, vol. 34 n. 1, 1993 p. 65. Posner, "The constitution as an Economic Document", vol 56, n.4, 1987.

72.- "Competition tends to act as a discovery procedure. If a multitude of policy experiments takes place it is more likely that the 'best' policy package is discovered than if one harmonized policy package produced by a cartel of governments is implemented". Sinn, "The Taming of Leviathan: Competition among Governments", Constitutional Political Economy, vol. 3 n. 2, 1992, p. 191. Vide also, von Hayek, "Competition as a discovery procedure", in Hayek, New Studies in Philosophy, Politics, Economics and the History of Ideas, London, 1978

73.- Daniels, "Should Provinces Compete?", McGill Law Journal, vol 36, 1991, p. 144. "The competition between national regulations or rules reduces the risk of political compromises resulting in 'bad' central harmonization. EC experience, but alsp experience with other forms of regulation, shows that EC directives may result in regulation which is determined more by political expediency and the need to reach a compromise than by good regulatory practice. Competition between regulators may also reduce the risk of regulatory failure in the shape of regulatory capture by vested interests."Woolcock, The European Single Market. Centralization or Competition among Rules?, RIIA, 1994 p. 16

competitors. This lead implies a temporary monopolistic position and the opportunity to realise supranormal profits. While these profits from successful innovations can be seen as the necessary incentives for making the effort and taking the risk of trying out new hypotheses, the less successful competitors - by loosing market shares - are automatically put under pressure to improve their achievements, either by imitating successful firms or by innovating themselves"[74]

4.- flexibility and capacity of adaptation to local preferences. Regional preferences can be better taken into account.[75] Therefore, policies formulated under competitive conditions are more likely to be in line with the preferences of the residents of different countries. This is particularly true with regard to the expenditure composition of the budget, the choice of tax bases and the extent of redistributive policies. In addition, regulatory competition provides a mechanism for the relevation of those local preferences, which are unlikely to be taken into account by a central monopolistic institution. [76]

This capability of adaptation is also in close correlation with the fostering of participatory politics. In a competitive framework, citizens are incentived to take part in the policy debates and to be interested in the outcomes. This way, they are able to signal their preferences to government more effectively and, once these preferences have been signalled, to monitor the way in which government responds to them.[77]

As Dye puts it, "competition in the private marketplace forces sellers to become sensitive to preferences of consumers. Competition among governments forces public officials to become sensitive to the preferences of citizens. Lessened competition among governments results in higher taxes, poorer performance and greater inefficiencies in the public sector"[78]

5.- more efficient politics since citizens have more direct influence. The incentives of citizens to vote and to actively participate in the political process are higher, the smaller the jurisdiction they live is.[79] In political science as

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74.- Vanberg and Kerber, "Institutional Competition among Jurisdictions", Constitutional Political Economy, vol. 5 n. 2, 1994 p. 200

75.- Eichenberger, "The benefits of Federalism and the Risk of Overcentralization", Kyklos, vol 47, 1994

76.- Sinn, "The Taming of Leviathan: Competition among Governments", Constitutional Political Economy, vol. 3 n. 2, 1992, p. 191. Vide also, Tiebout, "A Pure Theory of Local Expenditures", Journal of Political Economy, vol. 64, 1956

77.- Daniels, "Should Provinces Compete?", McGill Law Journal, vol 36, 1991, p. 142.

78.- Dye, American Federalsim. Competition among Governments. 1990, p. 15

79.- Downs, An Economic Theory of Democracy. 1957

well as in ordinary discourse, decentralization, fragmentation and aproximation of decision centres to citizens, enhance democracy through more involvement of citizens in decision-making, increased participation in the political process, and easier signalling of preferences. This is very unlikely to be captured by economic modes of reasoning. [80]

"In decentralized (competitive) democracies, participating in the political process and collecting information on the various political alternatives, are public goods. Therefore, the population is 'rationally ignorant' and tends to abstain from political activity. In largely decentralized (competitive) countries, on the other hand, citizens' incentives are dramatically different. Individuals can use their information to choose the jurisdiction that provides the best services and the lowest taxes. Information on political alternatives thus becomes a private good. However, information not only empowers citizens to vote with their feet. It is also a precondition to effectively exercise the voice option and to take part in the political process. Consequently, individuals' capability to take up the voice option increases, the more the decentralized (competitive) a political unit is."[81]

6.- competition helps countervailing the public choice-majoritarian bias of governments: " such institutional competition may help to counterbalance the negative effects of public choice. This is particularly clear in the case of location competition. While legislators in principle would have an interest in winning the next election by giving preference to consumer interest over the much smaller number of shareholders, they must also be afraid of the danger of firms of moving away from their location"[82]. Thus, regulatory competition can be seen as a way of protecting mobile minorities.

Moreover, a competitive system might serve to control government powers over citizenry. Political competition, in the sense used above, may yield better prospects for the containment of power than alternative methods of appointing political leaders. This is related to the demistification of formal democracy as the unique form of legitimizing governmental action. Otherwise, governmental power over citizens tends to become unlimited and

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80.- Salmon, "Decentralisation as an incentive scheme", Oxford Review of Economic Policy, vol. 3 n.2, 1987, p. 27

81.- Eichenberger, "The benefits of Federalism and the Risk of Overcentralization", Kyklos, vol 47, 1994, p. 411, parenthesis added.

82.- Engel, "Legal Experiences of Competition among Institutions", in Gerken, Ludwig, Competition among Institutions, 1995, p. 104

uncontrollable in so far as mere democratic legitimization to act is perceived as rendering every act of government just or legitimate. [83]

On the contrary, there are also some disadvantages that must be evaluated:

1.- legal uncertainty and risk of regulatory drift. Regulatory drift results from the fact that national regulations may be altered several times in the course of discovering which regime is the most appropriate. This alteration provokes adjustment costs which have to be afforded by business in order to adapt to new national regulations. Firms will lack the certainty they need in order to plan and execute business strategies. [84]

"The flexibility of competition among rules may have a down side in the shape of higher transaction costs and uncertainty for business. Flexibility means that regulators have an opportunity to experiment, but they may be tempted to do so too often. Frequent changes in policy can result in transaction costs for regulators and the regulated industry. There is also a strong preference among many business interests for clarity and stability in regulation. If changes occur too often the flexibility of competition among rules could prove to be counter-productive"[85]

2.- legislative production costs. It has also been stated that a model of plurality of regulation duplicates the costs of legislative production. Concentrating legislative production in a single government saves the costs of multiple governments incurring separate cost of legislation for the same issue.

This criticism, however, does not take into account the ability of other governments to benefit from the law production activities of other governments through emulation. Successful legislation can easily be duplicated without incurring in a costly legislative process.[86]

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[83].- Wohlgemuth, "Economic and Political Competition in Neoclassical and Evolutionary Perspective", Constitutional Political Economy, vol. 6, 1995, p. 85

[84].- Sun and Pelkmans, "Regulatory competition in the Single Market", Journal of Common Market Studies, vol. 33 n. 1, 1995, p. 85-86.

[85].- Woolcock, The Single European Market. Centralization or Competition among Rules?, RIIA, 1994, p. 19. This fact has also been underlined by Roberta Romano who considers among the factors firms consider for moving to Delaware, the legal stability. Romano, R. *The Genius of American Corporte Law.* American Enterprise Institute, 1993.

[86].- This however, opens another problem. It might happen that the risks inherent to an innovative activity are born exclusevely and systematically by one of the jurisdictions. In other words, a government might prefer to free-ride on the innovative activities of others. Instead of positively seeking a better regulatory solution through experimentation, one can wait for others to find it. At the end, the innovative acitvity are shouldered by one or few jurisdictions. See for

3.- economies of scale (if any) cannot be exploited.

4.- risk of externalities which are not taken into account by one jurisdiction when regulating.

5.- redistribution policy becomes less feasible. In fact, it has to be recognized that the competitive model of regulation does not absolutely negate the opportunity and convinience of operating a redistributive system. Instead, what we argue is that under conditions of competition, regulation has to be liberated of redistributive concerns which will be transferred to other - more adequate - policy instruments. Thus, it is clear that a regulation concerning product safety in a given country should not be overburdened with taking into account its redistributive effects. If these exist and should be maintained or corrected, some kind of redistributive mechanism should be implemented.

6. transactions costs. "A stronger rationale for uniformity is found in its ability to reduce costs incurred by transactions executed across multiple jurisdictions. Under a regime characterised by incongruent legislation, individuals or corporations wishing to engage in economic activity in more than one provincial jurisdiction are confronted by search and compliance costs that constitute a barrier to mobility of factors and goods across the country. Search costs involve the costs of identifying and understanding the compliance requirements triggered by multijurisdictional activity"[87]

7.- circumvention, forum shopping and regulatory dumping. Centralization of regulatory authority enables the regulator to reduce the costs that stem from the undesirable evisceration of regulation through regulatory arbitrage.[88] However, when regulatory arbitrage takes place in conditions of fairness, with equal opportunities and possibility of monitoring the options, it should be seen as a natural mechanism of the competitive system.

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this kind of argumentation, Ackerman, Susan Rose, "Risk taking and Reelection: Does Federalism Promote Innovation?", Journal of Legal Studies, vol. 9, 1980.

[87].- Daniels, "Should Provinces Compete?", McGill Law Journal, vol 36, 1991, p. 137

[88].- Trachtman, "International Regulatory Competition, Externalization and Jurisdiction", Harvard International Law Journal, vol. 34 n. 1, 1993 p. 67. In fact it has been affirmed that "the costs of inefficient regulation tends over time to shift from costs of strict compliance to costs of regulatory arbitrage (where) the cost of regulatory arbitrage is the cost of adapting a regulatee's product line, production and distribution system, business locations, and corportae structure to make it legally possible to engage in profitable activities from which the firm would be otherwise excluded" Kane, E.J. "A Market Perspective on Financial Regulation", CATO Journal, vol. 13 n. 3, 1993 p. 317.

8.- regulatory competition is disgregative. We refuse the idea that market mechanisms are a form of non-coercitive organization that has properties of coordination and allocation but has no integrative effects.

It is noticeable that regulatory competition, contrary to what is customarily perceived, is not disgregative. The functioning of regulatory competition is based on the premise that internal market forces would respond to differences in national regulation. The subsequent variations in the flow of goods, services and factors would force the adversely affected (in the sense of loosing regulatory base) Member States to react. Such an iterative process would eventually bring about a 'market driven' regulatory convergence. Since market preferences would probably be better revealed by the dynamics of regulatory competition, regulatory competition would further be a superior solution when considering achievement of the harmonization goal.[89]

This is shown in the case of regulatory competition in corporate law in Canada. When competitive processes are examined more closely, it can be demonstrated that they are capable of producing surprisingly uniform provincial laws. Indeed, it can be argued that the more vigorous the level of inter-governmental competition, the greater the likehood that uniform laws will be generated. "Examination of the contents of reforms in Canadian corporate law shows that inter-governmental competition exerted a harmonizing rather than divisive impact on the Canadian corporate law regime. That is, the mere adoption and marketing of an unequivocally superior corporate law product by the federal government unleashed a wave of reform that achieved nationalist objectives without the contentious and debilitating negotiation that frequently characterizes other Canadian law reform initiatives that rely on co-ordinated processes"[90]

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[89].- Sun and Pelkmans, "Regulatory competition in the Single Market", Journal of Common Market Studies, vol. 33 n. 1, 1995, p. 70. Also, for Bernholz and Faber, "federalism excludes a unification of law either through regulations by the central government or through agreements among the member statesand communities of the federation. In this way a certain competition arises among the communities and member states, not only over the efficiency of public output and the size of the fiscal burden, but also over appropriate organizations and legal institutions. Given the right to emigrate, this competition is supported though a 'voting by feet', in which private organizations and firms compete to attract people. It is obvious that in such a system legal assimilation can succeed only through an imitation of those institutions that prove themselves superior through competition", Bernholz and Faber, "Reflections on a normative economic theory of the unification of law", in Gwartney, James and Wagner, Richard, *Public Choice and Constitutional Economics*, JAI Press, Greenwich, 1988, p. 245.

[90].- Daniels, "Should Provinces Compete?", McGill Law Journal, vol 36, 1991, p. 133 and 155

However, the previous does not lead to the conclusion that regulatory competition brings unambiguously to harmonization and that institutional competition is an alternative way to achieve harmonization, as some defenders as well as critics of it tend to assume. Regulatory competition has to be seen as a way to tentatively try to match different and changing needs and circumstances with a changing variety of institutional answers. The so-called 'ex post' harmonization is only one extreme possibility of an outcome. [91]

The issue has to be examined under a dynamic perspective: "in a highly competitive setting, it is possible that laws may at times be diverse, while at other times highly uniform. If diversity is only a temporary phenomenon, perhaps even a necessary antecedent to uniformity, then perhaps policy-makers should refrain from implementing enhanced co-ordination and centralization"[92] Harmonization is only on possible extreme solution that will take place when a real need is present among social operators.

It is also interesting to note that even if the final result is the same - i.e. an hamonized set of rules - from a quality point of view, the two types of hamonization are completely different. An harmonized outcome, as consequence of centralized processes, produces the petrification of the norm and hinders any capability of adaptation. Hence, to admit that the institutions of a society might stabilize as a dynamic process of competition is far from saying that such a society would petrify[93]

Finally, there are still two other factors to be considered. Firstly, it is important that the preferences of individuals are not too heterogeneous. With a wide divergence in tastes or evaluation criteria, it is difficult to agree on whether a given norm is better or worse, and thus to produce a socially optimal outcome[94]. Secondly, a similar problem appears in the case of industrial standards. In some fields, (i.e. telecommunication), the standards are qualitatively similar in such a way that is impossible to decide in favour of one. This is the case of the emission standards for TV stations (PAL or SECAM) or videotape systems (BETA or VHS). Both in cases of high heterogeneity of preferences and of qualitetively homogeneity among regulations, the operation of regulatory competition might produce non-optimal results and might be conditioned by path-dependence behaviour.

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[91].- Wohlgemuth, Michael, "Institutional Competition - Notes on an Unfinished Agenda". Max-Planck Institut zur Erforschung von Wirtschaftssystemen. Diskussionsbeitrag 06-95, p. 20

[92].- Daniels, "Should Provinces Compete?", McGill Law Journal, vol 36, 1991, p. 140

[93].- Pelikan, "Competitions of Socio-Economic Institutions: in Search of the Winners", in Gerken, *Competition Among Institutions*, London, 1995, p. 177.

[94].- Oates and Schwab, "Economic Competition among Jurisdictions: Efficiency Enhancing or Distort Inducing", Journal of Public Economics, vol. 35, 1988. p. 350

To conclude, the final decision on whether to introduce regulatory competition in a given field should be a balanced one, taking into account the elements analyzed. Once this balanced judgement is accomplished, and a legal order expects favourable effects from institutional competition, it is relatively easy to foster it. The legal order may give foreign products and producers easy access to its market, and it may allow its own nationals to act under foreign rules or to go abroad. If institutional competition within the framework of a legal order turns out not to bring about the effects it has been introduced for, the legal order may, in principle, reverse it at any time. [95]

However, it has to be recognised that "the basis of comparison, on the grounds of which the achievement of competition ought to be judged, cannot be a situation (...) which cannot be brought about by any known means. It ought to be a situation as it would exist if competition were prevented from operating. Not the approach to an unachievable and meaningless ideal but the improvement upon the conditions that would exist without competition, should be the test".[96] In other words, as we argued in the precedent pages in reference to the debate about market and non-market options, regulatory competition has to be evaluated in a comparative manner, i.e. the results that could be achieved in reference to a given social goal, with the adoption of other legal techniques.

It is thus clear that each field of action needs to be examined in the light of its own circumstances and in the light of alternative methods of social organization. Once accomplished this double examination, some general conclusion might be drawn from the operation of regulatory competition mechanisms.

2.2.4 taxonomy of forms of competition

1. Competition among states/competition among rules.

[95].- Engel, "Legal Experiences of Competition among Institutions", in Gerken, Ludwig, *Competition among Institutions*, 1995, p. 108

[96].- F. von Hayek, "The meaning of competition", in F. von Hayek, *Individualism and Economic Order*. 1946, p. 100.

One fundamental distinction has to be traced between the two concepts. The first one refers to the general jurisdictional competition in which states engage in order to foster competitiveness of their national industries. This kind of competition sometimes takes place through the improvement of their legal systems as one of the assets to make a location attractive (among others like public infrastructure, education, telecommunications, etc. ...). Regulatory competition, in this sense, may be defined as "the activity that regulators engage in with the objective of either attracting more investment or business activity or promoting the competitiveness of indigenous industries by providing a more favourable regulatory environment"[97]In all these cases, however, competition takes place within the framework of shaping a national economy and law is purely instrumental to that goal[98]

On the other hand competition among rules refers to the process by which different sets of rules, different regulatory models interact among them in a complex manner. In this case, the analysis is made apart - or at least not primarily dependent - of the potential economic repercussions of changing one given national regulation. This is the concept explored in this research work.

Although in some cases these meanings will coincide, this will not necessarily be the case.

2. Competition within a legal order

There is competition among the legal institutions offered within a legal order. For instance, one entrepreneur can choose among different forms of legal structure in order to develop his firm, ranging from a simple partnership to a public company. Within a set of norms (corporate law), there is diversity in the legal institutions available.

This is also applicable to competition among different types of regulations concerning the same subject matter. For instance, air pollution can be protected using several instruments within a legal order; i.e. public law, torts law and penal law. It is the plaintiff decision to exercise one type of legal action and not another, or to exercise both simultaneously. There is in any case competition among different branches of a legal system

97.- Woolcock, The European Single Market. Centralization or Competition among Rules?, RIIA, 1994 p. 15. See also Krugman, "Competition a dangerous obssession" Foreign Affairs, vol. 73, n. 4, 1994.

98.- See for instance, Porter, The Competitive Advantage of Nations, 1990; Reich, Robert, The Work of Nations, 1991

3. Competition among enforcement institutions

There may be competition among different enforcement institutions, i.e. different jurisdictional orders or different courts applying one field of law.[99]

4. Competition among social institutions

There can also be competition in determining a given tool to achieve a social goal or a given structure for societal organisation. This is the debate about the role of the state and the markets or the distinction between public and private. Competition might determine whether the state as regulator is a more effective social institution for organizing the relevant economic activities than the market and competition among firms.[100]

"The cardinal choice between markets and governments is also reflected by the no longer new 'new federalism'. The 'new federalism' involves a review of the proper roles and responsibilities of federal, state, and local governments, as well as of the public and private sectors. This view relates in a larger sense, to the cardinal issue of markets versus governments. The possible devolution of responsibility that is implicit in the idea of the new federalism carries with it the further implication that responsibilities initially devolved upon lower levels of government might, instead be assigned to the market, or to organizations that are neither the market nor government organizations"[101]

5. vertical competition/horizontal competition.

We are in front of horizontal regulatory competition when rule makers are in the same hierarchical level. On the contrary, vertical competition takes place when one is subordinated to the other: "vertical competition is seen as rivalry over the formal or informal assignment or exercise of powers and distribution of resources. Swiss cantons or Canadian provinces fight against

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99.- For a fascinating historical account of this form of competition see, Berman, *Law and Revolution*, Harvard Univ. Press. Cambridge, 1983. See also, Carroll and Harrison, "On the historical efficiency of competition between organizational populations", American Journal of Sociology, vol. 100 n. 3, 1994.

100.- Trachtman, "International Regulatory Competition, Externalization and Jurisdiction". Harvard International Law Journal, vol. 34 n. 1, 1993 p. 53

101.- Wolf, Charles, *Markets or Governments. Chossing between Imperfect Alternatives.* MIT Press, 1993 (2nd ed), p. 8. This is also related to the tenuous frontier among public and private law.

unilateral initiatives taken by the respective federal governments. French regions and departments are engaged in a silent struggle for life, since it is likely that, in the long term, one of these two intermediate tiers will disappear into significance."[102]

Within the category of vertical competition we can also distinguish between:

a) vertical regulatory competition without hierarchy. Takes place among two rule makers placed in different hierarchical levels but without an express command-control line. This is for instance the case of the power to legislate in a give field where the competence is attributed to both the federation and the states.

b) vertical competition with hierarchy. The term implies an scenario where the two institutions are not on an equal footing. The institution with superior rules could take over if and when it feels that the inferior institution leads to unsatisfactory results.[103]

In relation to this latter point, there is a relation of reverse proportion between both types of competition: the results of horizontal competition in regulation should determine whether some kind of federal intervention (and thus vertical competition) should be initiated. Assuming rational states, such centralized intervention may be justified by comparing the utility of horizontal competition and diversity with the utility of centralization in regulation.[104]

In other words, we have argued that the decision to introduce and foster regulatory competition at horizontal level must be a balanced one depending both on the preconditions and the results which is pretended to achieve. Under this premises it can happen that the functioning of competition at horizontal level produces socially undesired results. This fact in itself constitutes a legitimization for a institutionally superior intervention. Thus, States, when engaged in a process of regulatory competition must pay attention to the consequences of their regulatory actions, otherwise, disfunctions risk to be preempted at a federal level. On the contrary, the evidence of a smooth functioning of competition at a lower level would

102.- Salmon, "Decentralization as an Incentive Scheme", Oxford Review of Economic Policy, vol. 3 n. 2, p. 36

103.- Engel, "Legal Experiences of Competition among Institutions", in Gerken, Ludwig, Competition among Institutions, 1995, p. 96

104.- Trachtman, "International Regulatory Competition, Externalization and Jurisdiction". Harvard International Law Journal, vol. 34 n. 1, 1993 p. 49

exclude any justification for federalization of regulation. This flexible and dynamic criteria in assigning regulatory competences is one of the most valuable assets of the regulatory competition paradigm.

Therefore, it has to be recognised that some form of institutional competition occurs simultaneously on all levels: states compete with each other in an international setting, while regional and local units compete within the state. As expressed by Gerken, these complex interactions have at least three implications for institutional competition:

First, the more extensive the regulatory power of the state, the less the regional units dispose of instruments that they can use for institutional competition on their level, so that regional competition will be less intensive;
Second, as the state is exposed to competition with other states, it is in its interest to co-ordinate or even restrain competition among its regional units, insofar as competitive actions of the regional level, in reality or in perception, interfere with its efforts to compete on the international level;
Third, institutional competition on the international level serves as a discovery procedure also with respect to the vertical division of power in a state in that it may reveal if the prevailing vertical division of jurisdictional competence is inferior to that of competing states.[105]

6. Intrastate competition/interstate competition

a) intrastate competition. In turn, this may be subdivided into competition for a government formation (competitive electoral process) and competition within a government already elected. "Competition for government is competition for votes, competition between parties and candidates to be elected into political office. As competition within government can describe the system of checks and balances between different branches and levels of government"[106]

105.- Gerken, "Institution Competition: An Orientative Framework" in Gerken (ed.) *Competition Among Institutions*, London, 1995, p. 21

106.- Vanberg, "Constitutionally constrained and safeguarded competition in markets and politics with reference to the European Constitution", Journal des Economistes et des Etudes Humaines, vol. 4 n.1, 1993, p.13. In what concerns intrastate competition it has been pointed out that competition among regulatory agencies can serve as an effective control mechanism. "Another way that Congress can control the outcomes generated through agency structure and design is by forcing agencies to compete against one another for regulating turf and regulatory authority", Macey, "Organizational Design and Political Control of Administrative Agencies", The Journal of Law, Economics and Organization, vol. 8 n. 1, 1992; Breton, "The organization of competition in congressional and parliamentary governments" in Breton, *The Competitive State*, Kluwer, 1991.

b) interstate competition. This means jurisdictional competition to attract some mobile resource (citizens, capital, etc.)

2.2.6 Constitutional elements shaping the competitive model

Competition seems conditional on the existence of constitutional rules assigning some powers to at least two levels of government. Thus, jurisdictional plurality has to be guaranteed constitutionally. Regulatory competition would be deceived when the distribution of powers was held unilaterally in the hands of the higher jurisdiction. If the federal level has always the power to re-centralize previously assigned competencies, it is difficult to speak of genuine competition. "In a strict hierarchical setting with the central unit precisely assigning tasks to, and controlling the units of the regional level, only a few possibilities for such a struggle for power (vertical competition) remain. The same holds if a constitution in great detail assigns the regulatory power to the different levels."[107]

Somehow this can be framed within the debate on choice among rules and choice within rules, that is, from a more fundamental distinction between levels of choice. The distinction relates to the meta rules governing a game and the fact of playing the game itself. We must underline the fact that neither the market nor a set of regulations (sub-constitutional norms) are 'self-contained' institutions in the sense that they can operate automatically without a constraining framework.

The discipline of constitutional political economy tries to determine the best rules of the game, at a constitutional level. The choice of a model will greatly determine the way the game is played or the way the societal interactions take place. Conversely, choice is constrained by the status of the existing social institutions through which agents must operate. A social system is the expression of its institutions (meta-rules). "Deliberate constitutional design plays an essential role in shaping the constitutional framework on which the desirable working of evolutionary competition depends"[108]

The very esential fact the law provides for different institutions, might constitute an indicator that the resulting competition is intended by the legislator. In this institutional setting, the federation, the state as opposed to

[107].- Gerken, "Institution Competition: An Orientative Framework" in Gerken (ed.) *Competition Among Institutions*, London, 1995, p. 19

[108].- Vanberg, "Cultural Evolution, Collective Learning and Constitutional Design", in Reisman (ed.) *Economic Thought and Political Theory*, Kluwer, 1994 p. 191.

the municipalities and the rule-makers are somewhat constrained in their action, in the sense of examining the properties of neighbouring alternative regulations. Contrary to the discourse centered on competition as a efficience searching mechanism, this kind of inter-institutional mechanism is the price the constitution willingly pays in order to introduce checks and balances and to further political ends.[109]

"In hobbesian anarchy, 'anything goes' is the order of the day, that is, there are no effective constraints on the ways and means by which persons compete. What we call 'social order' is made possible by effective limits being put on the strategies allowed in competition. Social order means, in other words, that competition is effectively constrained by rules"[110]. Therefore, there is a clear conclusion to be drawn: competition is not an unconstrained phenomenon. Even the more liberal of the markets is institutionally regulated and respects some given rules.

Moreover, the way competition forces are constrained or the way competitive networks are designed at the constitutional level determine the results of their interaction and functioning. Constitutions are thus essential and fundamental elements to model regulatory competition - to limit both its functioning and controlling its restriction.[111] Constitutions have an apparent paradoxical double task of inhibiting and promoting competition.

"To recognize the role of politics in creating and maintaining the institutional-constitutional framework within which the markets operate, means, of course, to raise another question, namely whether and, if so, under what circumstances we may expect the political process to produce an appropriate framework that suitably conditions and safeguards a competitive market order. The obvious starting point in examining this question is the fact that the political rule-producing process itself operates under rule-constraints, notably those that are specified in the 'constitution'. Yet the political process is

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109.- Engel, "Legal Experiences of Competition among Institutions", in Gerken, Ludwig, Competition among Institutions, 1995, p. 97

110.- Vanberg, "Constitutionally constrained and safeguarded competition in markets and politics with reference to the European Constitution", Journal des Economistes et des Etudes Humaines, vol. 4 n.1, 1993, p. 6

111.- A Constitution can be compared to an equivalent, to what in economic markets is antitrust policy. "If there is to be a genuine competition among jurisdictions, the 'Wettbewerdsornung' has to effectively limit the scope for cartel-like ex ante coordination among governments. (...) In analogy to antitrust policy for ordinary markets, it is tempting to think about the idea of restricting the 'concentration' of jurisdictions in order to stimulate institutional competition", Vanberg and Kerber, "Institutional Competition among Jurisdictions", Constitutional Political Economy, vol. 5 n. 2, 1994 p. 215

objectives. Thus, it is said that in a competitive model, the better norms will prevail or that the process serves to discover the best institutional arrangements. However, how do we define the terms better or best ?

"An independent normative criterion, for instance in terms of what the persons involved consider desirable, has to be clearly specified. When such an independent criterion is applied, it will depend on the nature of the selection environment whether that which de facto survives is desirable in terms of the criterion. If we regard the preferences and values of the persons involved as the relevant normative standard, the desirability of evolutionary competitive processes will depend on whether the selection environment allows for responsiveness to these interests and values. When we describe market competition as 'efficient' we, in effect, mean that it is a competitive process constrained by rules that encourage responsiveness to consumer interests. This is what the concept of 'consumer sovereignty' implies".[116]

At the end of the day, a constitution is called to offer some guidance as to the normative criteria to evaluate the process. However, the normative criterion established to evaluate regulatory competition must be set outside the competitive process itself, that is placed in the meta-rules choice or in other words in constitutional design.

"For market competition we adopted the individualist-liberal criterion of consumer sovereignty that sees the desirability of the competitive order of markets in its effectiveness in making producers and suppliers responsive to consumer interests. For institutional competition we suggest an analogous criterion that may be called 'citizens sovereignty' a criterion that takes the preferences of the constituents of, or residents in, a jurisdiction as the relevant measuring rod against which the desirability of its institutional features has to be measured. By analogy, we can now also introduce the idea of a set of rules or a competitive order for the competition among governments or jurisdictions. And it can be said that these rules work better, the more fully they induce the jurisdictions to direct their innovative competitive efforts to the serving of the interest of the citizens"[117]

In the same line, one may argue that, assuming the social goals of economic integration and economic freedom are those endorsed by the European 'constitution', regulatory competition may represent the optimal paradigm, judged under those criteria.

116.- Vanberg and Kerber, "Institutional Competition among Jurisdictions", *Constitutional Political Economy*, vol. 5 n. 2, 1994 p. 208

117.- Vanberg and Kerber, "Institutional Competition among Jurisdictions", Constitutional Political Economy, vol. 5 n. 2, 1994 p. 211-212

Finally to other aspects must be analysed when dealing with the role of constitutional norms.

First, there is the important question of the unsuitability of market processes to achieve redistributive goals. Therefore, constitutional norms must guarantee some kind of redistribution to maintain social cohesion.

Second, the initial distribution of property is fundamental to reach a smooth functioning of decentralized mechanisms. "As with the political process, this focus of the mass participants hardly suggests that all participants are created equal. Some people or entities participate more or more effectively. As with the political process, the extent to which the market process produces efficiency, justness, fairness, or any other goal is largely determined by the pattern of participation (and hence, of the initial assignment of opportunities to participate)"[118]

118.- Komesar, *Imperfect Alternatives. Choosing among Institutions in Law, Economics and Public Choice,* Chicago, 1994, p. 99, parenthesis added.

2.3. Regulatory competition and the transformation of Europe

2.3.1 General

The reflections about market processes as a tool of harmonisation are of crucial and vivid importance in understanding the constitutional political economy of the EU.

As Reich stresses, the role of competition law within the community has an ever increasing importance. But this refers not only to competition law as applied to the economic market but also as a key to understand the new evolution of legal mechanisms and structures. In his own words, "the competition rules have a prominent place in EC Law, but, in addition to that, their underlying principles may also present a new paradigm for understanding the evolution of Community law in creating the internal market, and for adapting to the challenge of implementing new policies, such as environmental and consumer protection. Competition between legal orders, instead of centralised regulation - this seemed to be the new approach of the EC harmonisation process."[1]

This element has deeply changed the way of understanding the European Union. Specially, it implies the erosion of the dichotomy between centre and periphery. The regulatory competition paradigm means that the diversity, plurality and rivalry among Member States are now elements in a complex machinery working towards achieving greater integration. Also, it has proved to be false that the only route to integration was uniformity and explicit harmonisation of national legislations. Instead, an interactive and multidirectional process of competition becomes an stimulus to a much greater flexible integration and union.

[1].- Norbert Reich, "Competition between legal orders: a new paradigm of EC law? , Common Market Law Review, 29, n.5 , 1992, p. 861. However it would be unjust to consider the concept of competitive jurisdictions as an recent invention of the European harmonization process. On the contrary, one has to recognize the historical tradition of territorial fragmentation in Europe as one of the crucial factors giving rise to economic and intellectual dominance . Competition among governmental units forced Europe to innovate. See Jones,Eric *The European Miracle,* Cambridge, 1981.

Thus Community legal order, which is increasingly determinant in the shaping of national legal orders[2], presents a ideal starting point for analysing a case of complexity and regulatory plurality. The different legal cultures and legal orders existing in the Member States of the Union have to be matched and made compatible with the necessary guarantee of the four freedoms of the Treaties. Thus, this represents a perfect landscape where unity and diversity must be coexistent.

But how has the Community suffered such a radical transformation? In order to understand this fact, it is illuminating to examine the evolution of the harmonisation of technical barriers to trade, since it represents a key contribution to the development of the concept of competition among rules in the EC.

Till 1985, the conciliation of diversity which implies the existence of national legislations with the goals of the single market was approached from the perspective of a harmonisation or uniformization which resulted from a centralised regulatory policy. The elimination of barriers to free movement was inevitably conducted through the reduction of national legislations to a single community legislation which preempted and substituted the different national laws. Thus, the initial harmonisation strategy was regulatory centralisation.

From 1985 onwards the Community has experimented a complete turn in this field. Regulatory centralisation has been substituted by the use of concepts like mutual recognition and the fixing of minimum requirements we will analyse latter. These new techniques have permitted to progress in the process of integration and harmonisation, and - even more important - to respect national diversity and idiosyncrasies.

To sum up, the legal paradigm for achieving a single market has evolved from the traditional regulatory centralisation as the rule for harmonisation to a new technique based on regulatory competition and the recourse to market mechanisms serving to European integration. This second scenario combines unity and diversity and, plurality of legislations with the respect to Community freedoms and integration. This has to be seen as a true revolution in the nature of both the Community and the Member States' legal orders.

2.- Cfr. Heritier, Knill and Mingers, *Ringing the Changes in Europe. Regulatory Competition and the Transformation of the State.*, Walter de Gruyter, Berlin, 1996.

2.3.2 The reform of the harmonisation policy and the 'new approach'

The construction of a Single European Market requires the elimination of existing national barriers which prevent freedom of movement. The most visible barriers are the imposition of open restrictions to trade. However, together with these barriers the Community soon[3] realised that other measures, not necessarily protectionist, had an equivalent effect to those barriers to trade.[4]

The diversity of technical regulations existing in every country constitutes a good example of this hidden restrictions. For instance, a producer can face a barrier to entry when trying to market a product in a Member State different of that of origin[5]. The producer would be in fact compelled to develop a new product according to the new regulation. This would imply, on the one side, the impossibility of benefiting from economies of scale and on the other, a substantial increase of costs[6].

The European Community, as the founding fathers had in mind, has to be understood as an economic space where circulation has to be totally free. As Siebert has pointed out, the basic strategy in the creation of a Single European

[3].- Voices have been raised considering that initially the Community did not realized the importance of this phenomenon and therefore centred its efforts towards guaranteeing the freedom of establishment more than the equality in the free movement. This is Neven's opinion when stating that "originally, the European Commission and the Council of Ministers did not focus on trying to dismantle discriminatory regulations; rather the emphasis was put on ensuring the right of establishment of foreign (EC) firms. Ensuring adequate entry conditions was not sufficient to avoid an international form of prisioner's dilemma. In this context, national regulators also had little incentive to attract foreign firms through favorable regulations or even to differentiate their regulatory offering from that of neighboring countries. Hence, as long as national markets could be protected from import competition through the imposition of discriminatory rules, regulatory competition could not operate effectively" Neven, "Regulatory Reform in the European Community", American Economic Review, Papers and Proceedings, 1992, vol 82, p.99

[4].- Hence the existence of articles 30 and following in theTreaty of Rome.

[5].- Although this is not necessarily the case, regulation is often used with protectionist intention, as a form to impede the entry of foreign products in domestic markets. The strategic use of dometic regulation implies a segmentation of the Community in twelve national markets, a result that is obviously contrary to the most basic principles inspiring Community Law.

[6].- Despite too often goes unobserved, "differences in national standards on precision instruments may prove costly to a small firm that does not have the capital to invest in the equipement needed to produce multitude of products. To that company, the barrier does not simply raise the costs - it effectively denies market acces. A similar phenomenon is evident in the financial service sector. An insurance company seeking to sell a house insurance policy to a Spanish consumer must establish itself in Spain in order to be able to do so. The cost of establishing a presence may in effect act as a barrier to entry." Quelch, Buzzell and Salama, *The marketing challenge of 1992*, 1990, p. 22

market was the elimination or reduction of market segmentations still existent. These segmentations suppose that an economic agent from one Member State cannot trade with all the potential parts from other States without facing important costs.[7]

For that reason, the approximation of legislations established in the Treaty has not to be understood as an end in itself, but as an instrument to achieve an economic space free of obstacles. The harmonisation is justified in so far the diversity jeopardises the construction and functioning of the single market.[8]

It has to be underlined that the existence of national regulations does not in itself represent a protectionist strategy. Only when those regulations prevent the free movement one can speak of a protectionist strategy[9]. If this proved to be false, that is, that mere existence of different legislations could be equivalent to a protectionist intention, the suppression of national legislation and its replacement by community law would be the proper solution. However, we argue that since this is not the case, this kind of centralised harmonisation has to be reconsidered.

The initial response to this phenomena was the harmonisation conceived as a centralised regulatory policy where Community institutions passed pieces of legislation increasingly detailed[10] which had to be applied

[7].- Siebert, "The harmonization issue in Europe: Prior agreement or a competitive process?", in idem,*The completion of the internal market*. Institut für weltwirtschaft an der Universität Kiel, 1990, p. 54. For Abraham, it is self-evident that "different national standards and regulations lead to market segmentation. Subsequently, we argue that mutual recognition and home country contro eliminate this type of market segmentation". Abraham, F. "Building blocks of the single market. The case of mutual recognition, home country control and essential requirements". International Economics Research Paper n° 75. Centrum voor Economische Studien. Katholieke Universiteit Leuven, 1991, p. 7

[8].-It is interesting to observe some studies which quantify the losses of the impossibility of free-trading throughout the Community caused by technical barriers. Among the sector which are more harmed, that of mechanical engineering stands out. The calculation of costs amount to near 200.000 billions of ECU per year. This and other data appear in Emerson, *The economics of 1992*. New York ,1988, pags 41 a 47. Cfr. also, Cecchini Report, The costs of non-Europe, European Economy, 35, 1988.

[9].- cfr. Valencia, *La defensa frente al neo-proteccionismo en la Comunidad Europea*, Alicante, 1993. From Dassonville (Case 8/74, Dassonville , 1974 ECR 837), the concept of MEE is defined as, "all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or portentially, intra-Community trade are to be considered as measures having an effect equivalent to quantitative restrictions".

[10].- Despite Directive, by definition, must just establish the goals, leaving the means of achieving them to the Member States, a simple exploration of their content reveals that they have become extremely detailed normative instruments. Thus the difference between Directives and Regulations has vanished.

uniformly by Member States. In sum, this model was based on a regulatory model constituted of one European centre and the inferior national powers in what has been graphically called an 'up-bottom process'.

Pelkmans[11], a leading analyst of the process of technical harmonisation describes the functioning of the classical process of harmonisation which was used till the Single European Act. The technique was announced in the 'General Program for the Elimination of Technical Barriers to Trade of 1969'[12]. It consisted in the adoption, after long studies and negotiations, of normative instruments, which fixed in a detailed manner all technical specifications which a product had to comply with in order to circulate throughout the European market. The process was slow and complex.[13]

The centralised harmonisation required agreements that all Member States had to subscribe after a tough process of negotiation in Brussels. Among the shortcomings of this approach one could count:

- excessive formalism and cumbersome procedures;
- time-consuming procedures and slowness of European harmonisation, - aggravated by the fact that those questions demand a great flexibility to be able to respond to technological change -;
- excessive uniformity;
- problems of implementation in Member States;
- lack of political interest by Ministers in technical issues.

Consequently, although the efforts undertaken in the field of technical harmonisation have been huge in the first twenty years of the existence of the Community, the results are rather poor. The process of centralised harmonisation has proved to be ineffective. It is not surprising that by the

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11.- Pelkmans, "The new approach to technical harmonization and standarization", Journal of Common Market Studies, Vol 25 n° 3, March 1987; Pelkmans and Volleberg, "Fifteen years of traditional harmonisation: accomplishments and deficiencies" in idem (ed) *Coming to Grips with the Internal Market*, Working Document 85/05, European Institute of Public Administration, 1986.

12.- Programe of 28 of may 1969, OJ 76 of 17 of june 1969.

13.- As described by Falke and Joerges, "the procedure for developing and testing draft directives and particularly the decision-making procedure is extremely cumbersome and time consuming. According to ESC indications, it takes more than three years between publication of a draft in the Official Journal and the final adoption. The 15 Directives adopted by the Council as a 'package' on 17 September 1984 had been pending for decision for an average of nine years, much to long a period to be able to respond quickly to and flexibly to new needs and steadily accelerating technoogical change". Falke and Joerges, "Traditional harmonisation policy, european consumer protection and the new approach", EUI Working Paper Law n° 91/13, 1991 pag 44

early 1980s the question of the removal of technical barriers to trade in the EC had led to profound feelings of frustration and disappointment[14].

This kind of harmonisation policy was feasible at the very beginning of the Community when the members where few and had more or less homogeneous socio-economic characteristics. With a Community integrated by few members, the differences to be harmonised were less and the agreement on the content of the regulation, although not easy, was attainable. With the enlargement of the Community, the diversity was greatly accentuated and the classical harmonisation manifested its shortcomings.

The Commission was forced to recognise that the objective of completing the Single Market by 1993 could not be achieved relying exclusively in the traditional approach based on centralisation. In 1985 the White Paper on the completion of the Internal Market was published[15] The Commission itself states that:

> "experience has shown that the alternative of relying on a strategy based totally on harmonisation would be over-regulatory, would take a long time to implement, would be inflexible and could stifle innovation"

In order to surmount this 'europesimism', a completely different approach was proposed[16]: harmonisation of minimum standards or key standards, mutual recognition and home country control. Together with those principles, the Single European Act introduces the principle of majority as a voting rule in a significant number of areas and thus relegating unanimity and its inherent problems.

Going even further, we argue that this transformation of the harmonisation strategy can be said to metamorphose the whole European legal order, which gradually changes from a centralist system to a model much closer to federal-like states.[17]

14.- Pelkmans, "The new Approach ..." op. cit pag 253.

15.- Completing the internal Market. White Paper from the Commission to the European Council COM (85) 310 final. Brussels, 14 June, 1985.

16.- Buxbaum, Hertig, Hirsch, Hopts (eds). *European Bussines Law*, 1991, p.6

17.- Somehow, it has been suggested that the new approach for the completion of the internal market implies an americanization of Europe where one firm will be abe to produce a good according to a Member State regulation and trade it throughout the EEC. Quelch, Buzzell and Salama, *The marketing challenge of 1992*, 1990, p. 14.

"If the scope for competition among national rules is limited, because market failures at European level require central harmonisation, there will be a need to conduct more regulation from a European level. This will in turn mean that more effective means of carrying out market regulation at a European level will have to be developed. If on the other hand, there is considerable scope for competition among national rules, the need for central involvement will be limited and national or sub-national bodies may be able to carry out most of the necessary regulation. In other words the scope of competition among rules will determine the demand for new European regulatory policies"[18]

The system of competition among norms, as has been said, is coherent with social organisations founded in a plurality of powers, while, on the contrary, regulatory centralisation corresponds to a unitary vision of things. It is interesting to note that even those countries with a centralist tradition (like France) have supported the system of regulatory competition since they have seen in it an opportunity of stopping a continuous loss of State powers in favour of the central institutions[19].

With the new techniques, what is intended is precisely to avoid the need of passing community norms in substitution of national regulations. In some way, the total harmonisation is abandoned and a form of partial harmonisation is present, where national regulations stand together both among them and with community legislation. Community norms are simply called to establish a playing level field. As noted by Siebert and Koop, "the poor results of the centralised harmonisation procedure gave rise to the idea that there might be no need to define the EC regulation at all but instead to let national regulations exist at the same time. "[20]

The Commission proposes a new formula consisting in fixing through directives the criteria of safety, and protection of collective interests

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18.- Woolcock, "The Single European Market. Centralization or Competition among National Rules?" RIIA, 1994, p. 2. This correlation is also noted, although under a different perspective, by Sun and Pelkmans, "If regulatory competition is introduced via a directive which establishes a certain level of harmonization, the scope for arbitrage is correspondingly lower than if free movement had been recognized without any prior harmonization", Sun and Pelkmans, "Regulatory Competition and the Single Market", Journal of Common Market Studies vol. 33 n.1. 1995, p. 76

19.- This phenomenon is explained by the fact that the changes introduced in the harmonization policy have determined modifications, not only in the substantive field concerned but also a reformulation of the balance of institutional powers and a new protagonism to Member States administrations. We wil examine this point more carefully infra.

20.- Siebert y Koop, "Intitutional Competition. A concept for Europe?", Aussenwirtschaf, 45 (IV), 1990, p. 440

(environment, consumer protection) and reserve to national legislation the rest of the technical characteristics of the products. [21]

Again, with the new system of decentralised and partial harmonisation, national norms are not eliminated but are called to converge towards a common point. On the political side, this possibility of national participation in policy areas considered sensitive, means that the process is more respectful with national policies and policy styles. As previously said, it seems that the Community has finally find a formula which allows the reconciliation of diversity with integration and unity.

1. the principle of mutual recognition:

The principle of mutual recognition lies on the idea that the objectives of national regulations are in most of the cases identical or equivalent among the different Member States. Hence, although the techniques and the controls designed to secure those objective might differ, they essentially pursue the same goals and should be mutually recognised as equivalent.

The principle of mutual recognition or equivalence of national regulations was already formulated by the European Court of Justice in its famous Cassis de Dijon case.[22]. According to this judgement a product which is lawfully commercialised in one Member States has to be admitted to the rest of markets. A Member States cannot forbid the sale of a product in its territory

[21].- Rojo del Aguila, "La aproximación de legislaciones" Gaceta Jurídica de la CEE, 1986, Serie D-3, pag 585

[22].- REWE v Bundesmonopolverwaltung für Branntwein; case 120/78 of 20 of february 1979, 1979 Rec. 662. The case poses the problem of a German negative to allow the comcercialization of the french liqueu Creme de Cassis, considering that this liqueur did not comply with the minimum content of alcohol requirements established by German legislation. The Creme de Cassis or Cassis de Dijon is a beverage with a 17% content of alcohol while in Germany, in order for a product to enjoy the liqueur classification has to have a minimum content of alcohol of 32%. The German opposition was based in a double argument. On one side, the protection of health since according to German oublic officials, a soft beverage would provoke a higher consume. This argument is repeled by the ECJ. On the other side, protection of consumers was alleged since this could be deceived if the product had only 17% of alcohol. In reference to this second line of argumentation, the ECJ upheld its validity but consideres that the restriction caused by the measure is not proportional since the same result could be achieved with an proper labelling.
A similar case is examined in case 178/84 Commission v. Germany. Rec. 1987. 1227 In this cae, the ECJ was confronted with the validity of a 1517 regulation which determined the purity of the beer. This regulation impeded Belgium beer, produced in accordance to other standards to enter German market. See also de Italian pasta case, in Merola, "Produzioni nazionai tipiche ed art. 30 del tratatto CEE: il caso della pasta" Foro Italiano, 1988 IV, 236-246.

although it is produced according to standards or technical requirements which are different to domestic ones.

In fact, national authorities can only impose a few exceptions to the freedom of movement of goods, based on grounds which are defined as those common elements that the whole Community should share. It is no longer possible to restrict importation of products with the mere allegation of technical diversity in elaboration, composition, labelling, etc... [23]

Except for those cases, it results that for whichever marketable product, the applicable regulation is that of the country of origin and not that of destination. (home country v. host country rules). A product made in accordance with domestic legislation of one of the Members States should be granted automatic entry in the rest on the Community markets. Consequently, much of the restrictions and segmentations of the single market are abolished. It is also eliminated the possibility of using domestic legislation in a protectionist way with a view of introducing barriers and obstacles to free competition. [24]

These developments introduce a completely new dynamic[25]. As already manifested in federal type systems, the principle of mutual recognition gives birth to the regulatory competition phenomenon. It is clear that under this paradigm, several different sets of norms are applied within a same territory depending on the origin of the product. The abolition of entry barriers by way of a competitive process among national regulations may be considered as the most important mechanism to foster the Single Market.

23.- Vide for instance the so called 'Danish Bottle case' where Denmark successfully invoked environmenta reasons to block the comercialization of drinks in non-reciclable bottles. Case 302/86, 1988 Rec. 4607.

24.- "National barriers to market entry arise from regulations that are intended to protect the consumer (insurance rates), to prevent a breaking down of the banking system (bank regulations), to protect a specific sector (railroad relative to trucking; the national airline) or semi-governmental organizations (postal services, public television). Here, the country of origin principle would allow a firm to enter the market of another country under the regulation of the country of origin. Markets will become more contestable" Siebert, "The harmonisation issue ..." op. cit. p. 58.

25.- It is quite obvious that the initial intention of the 'White Paper' was more humble. "There is little doubt that the Community's ambition has greatly increased during the years 1985-92. The score-chart measurement, on the other hand, is based on the narrowest approach to EC-1992, namely, the white paper list of 282 measures. Furthermore, the nature of the process of EC-1992 was often not well understood, and the inner dynamics were largely neglected". Pelkmans, "The significance of EC-1992", *The Annals of the American Academy of Political and Social Science*, vol. 531, 1994, p.102

"Free trade through the mutual recognition by Member States of each other's standards has been stressed in the White Paper as a new strategy that can sidestep much of the tedious process of harmonisation which has hindered the process of completing the single market during the past quarter of a century. It is suggested that this method could be applied to thousands of technical norms; the Federal Republic's Council of Economic advisers has concluded that harmonisation could be largely replaced by competition among standards"[26]

Till the Cassis de Dijon judgement, the prevailing opinion within the Community was that the only way of eliminating technical barriers to trade was to make recourse to harmonise national regulations. Therefore the political significance of the Cassis de Dijon judgement was enormous since evidenced that harmonisation was not always necessary.[27] It is thus clear that, for the first time in history, the community case law accepts the existence of other ways to achieve the unity on the internal market apart from centralised harmonisation

However the principle of mutual recognition is not an absolute one and can be exceptioned. It is important to note that the burden of proof of this exception to the principle of mutual recognition lies on the State which tries to restrict the circulation of the product. Moreover, the proof is not an easy task since the State has to convincingly demonstrate that the general rule of freedom is not applicable. In order to obtain one of this exceptions - in accordance with article 36 EEC - a discrepancy with those common elements relating to safety or environmental protection has to be accredited.

In other words, in order to impede the entry of an intracommunity product[28] it is not enough with the allegation of a disconformity with specifications of domestic regulations. Instead, the disconformity has to be such as to prevent the achieving of the common standards.[29]

26.- Bieber, Dehousse, Pinder and Weiler, "Back to the Future: Policy, Strategy and Tactics of the White Paper on the Creation of a Single European Market", in idem, *1992: One European Market?*, 1988, p. 20

27.- Valencia, *La defensa frente al neoproteccionismo en la Comunidad Europea.* Cámara de Comercio, Alicante 1993, p. 61-62

28.- on the debate relating to the possibiity of applying mutual recognition to products originated outside the Community, cfr Tegeder, "Applying the Cassis de Dijon doctrine to goods originating in thrid countries", European Law Review, vol 19 nº 1, 1994.

29.-Even in this case, the principle of proportionality has to be applied. Therefore, the discrepancy between regulations could be solved by a labelling requirement indtead of blocking imports in the host-country. The principle of proportionality is called to play a fundamental role in the balancing of interstate trade relations in the future. As stated by the ECJ, "the Member States are entitled to introduce rules for the protection of the health and life of users but

One of the policy innovations of the Commission has been to extend the principle of mutual recognition to the services sector and specially to insurance and financial services. For instance, as we will develop further, a credit institution which complies with some minimum requirements will be able to operate throughout the Community with just the authorisation granted by its home authority. The requirements and the scope of authorisation will be determined by its home country although some host-country norms will always be applicable. (specially conduct regulation and advertisement and consumer protection issues). This single license will be subject to some minimum requirements in the same fashion as the minimum harmonisation for the movement of goods.[30]

Among the virtues of the new approach some have to be underlined:

first, it avoids the need to undertake difficult negotiations among national representatives of Member States in order to agree a common detailed content for a given regulation;

second, a process of harmonisation will take place through the competitive interaction of several sets of norms within a single economic space. Firms and consumers will be arbiters determining the quality of a regulation. This supposes to extend both the principles of regulatory competition and citizenship's participation;

third, incentives to policy innovation are very much increased at the same time that uniformization and petrification is avoided;

finally, the power of the lobbies is diminished since the political negotiation process is very much reduced. Consequently, the risk of regulatory capture is also mitigated.[31]

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is not entitled to prevent the marketing of a product originating in another Member State which provides a level of protection of the health and life of humans equivalent to that which the national rules are intended to ensure or establish. It is, therefore, contrary to the principle of proportionality for national rules to require such imported products to comply strictly and exactly with the provisions or technical requirements laid down for products manufactured in the Member State in question when those imported products afford users the same level of protection" in case 188/84 Commission v. France. Rec, 1986 paragraphs 13-16.

30.- Quelch, Buzzell and Salama, *The marketing challenge of 1992*, 1990, p. 30.

31.- As pointed out by Majone, "Another important element in a complete explanation of the growth of Community regulation is the interest of multi-national, export oriented industries in avoiding inconsistent and progressively more stringent regulations in various EC and non-EC countries. Community regulation can eliminate or at least reduce this risk. A similar phenomenon has been observed in the United States, where certain industries, faced with the danger of a significant loss of markets through state and local legislation, has strongly supported federal regulation ('preemptive federaism'). For example, the American automobile industry had good reasons to prefer federal regulation of air pollution because of the threat posed by different and

However, mutual recognition has the disadvantage that it may be less beneficial precisely in those sectors where the gains from the single market could be greater.[32] This problem appears when there are several standards of correspondent national regulations which are equally satisfactory from the technical point of view, in such a way that there is no objective reason for the imposition of one of them.

In the case of the television, it exists a compelling need for uniform standards which allow the interconnection of technical apparatus. However, there are both the PAL and SECAM standards and the decision in favour of one or another has to be taken in a negotiated way. "Recent developments in the field of high definition television show how difficult agreement about technical standards continues to be. The D2MAC interim standard imposed by a 1986 EC Directive (86/342/EEC) has been opposed by some satellite operators such as BSkyB who opted for the older, more common, PAL standard. A compromise seems now to have emerged, but only because the Commission has promised to pay some of the costs of simulcasting in both standards at once"[33] This difficulty in choosing standards which are qualitatively equal has till recently sheltered many protectionist and anticompetitive regulations in the telecommunications industry where the existence of this problem is specially acute.

Similar to the situation described, there might be discrepancies in the way of conceptualising the common standards that have to permit the

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inconsistent air pollution standards and also because it feared a kind of political domino effect, in which one state legislature after another would set more and more stringent emission standards without regard to the costs and technical difficulties involved. Thus the car industry, which during the early 1960s had successfuly opposed federal emission standards for motor vehicles, abruptly reversed its position in mid-1965" Majone, "Market integration and regulation: Europe after 1992" EUI Working Paper SPS nº 91/10, p. 12.
Sun and Pelkmans have also expressed a similar view: "The Community's failure to complete its internal market prior to the EC-1992 programme can be explained in large part by the success of national business in persuading their governments to erect all sorts of protective non-tariff barriers. Post-1992, however, the incentives for national industry to capture its national regulators are severely reduced (or, in the extreme eliminated). Rather, the imperative of remaining internationally competitive now dictates the reverse: industry should capture or otherwise pressure its national legislators to enact regulations which favour domestic competitiveness. If such pressure results in deregulation, the political influence of the regulated industry should also decline: entry into the domestic market by foreign producers will dilute the power of the domestic industry vis a vis national regulators". Sun and Pelkmans, "Regulatory competition in the Single Market", Journal of Common Market Studies, vol. 33 n. 1, 1995, p. 71.

32.- Gastios and Seabright. "Regulation in the European Community" Oxford Review of Economic Policy vol 5 nº 2, 1989 pp. 37-60

33.- Majone, "Regulatory Federalism ..." op. cit. p. 309

operation of mutual recognition. This is the case of the wood-working machines, judged by the ECJ in 1986[34]. In this case, the Court was confronted with two national approaches of the concept of safety: German regulation was less strict and relied more on the proper formation of workers who operate with those machinery. On the contrary, French regulation required an special protection to be incorporated in the technical characteristics of the wood-working machines. The Court ruled - against the position of the Commission - that the unexistence of harmonised minimum standards, a Member State could insist in the maintenance of its domestic rules regarding safety. In fact, mutual recognition cannot work in a market unless some essential safety and health standards are agreed. [35]

This harmonisation of minimum standards is the other pillar of the new approach and disciplines regulatory competition once a common and stable framework is assured. In the same direction, it has to be stressed that regulatory competition would be difficult - or will be transformed in a destructive race - when there will be no common political, economic, institutional or cultural basis. As noted by Dehousse, "the advocates of the 'race to the bottom' theory also appear to have over-estimated the risks inherent in the mutual recognition strategy. What they have failed to understand is that mutual recognition cannot operate in a vacuum: for the system to be operational, its basic premise (the equivalence of national provisions) must reflect reality. Where the objectives pursued by the Member States or their methods diverge, mutual recognition is of no help. In this sense, harmonisation and mutual recognition are not mutually exclusive, but rather complementary approaches"[36]

Finally, it has to be recalled that a system based on mutual recognition cannot operate satisfactorily without mutual trust. This important element cannot be assumed in the case of the Community.[37]. In the same line of

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[34].- Case 188/84, Commission v France, Rec. 1986, p. 436.

[35].- Majone, "Comparing strategies of regulatory Rapprochement". Paper prepared for the OECD Symposium on Managing Regulatory Relations between levels of Governments. Paris, 4-6 October 1993. mimeo.

[36].- Dehousse, "Integration v Regulation? Social Regulation in the European Community", EUI Working Paper Law n° 92/23, 1992, pag 17

[37].- Majone, "Comparing Strategies ..." op. cit pag. 25. Despite of that, the same author has affirmed that : "In fact, mutual recognition pressuposes a higher degree of cooperation among member states than the commerce clause of the US Constitution requires among individuals states. "Majone, "Market integration and regulation ..." op. cit. p. 22 . Thus, perhaps, mutual recognition is too dependend on the good will and altruism of sigle Member States.
"The mutual trust issue refers also to the guarantee of effective enforcement mechanisms. Without being sure that other countries will properly enforce national and EC regulations, there

reasoning, Pelkmans affirms that mutual recognition is indispensable for frontiers to disappear, and mutual confidence is indispensable for mutual recognition. Confidence building measures will have to include minimum health standards and first of all guarantees about the quality of local inspection and against fraud.[38]

2. harmonisation of 'essential requirements':

As has been anticipated, the principle of mutual recognition requires the determination of a common framework where to operate. In other words, not all kind of regulation of a given sector could be managed by the process of regulatory competition and consequently by national authorities. It exists an area of compulsory centralised harmonisation which has to allow considering the rest of the regulation as equivalent among member States[39].

As noted by López Escudero, one has to distinguish between mutual recognition in a restricted or narrow sense and mutual recognition in a wide sense.[40] In the former meaning, the host state has to allow the marketing of a product if the core elements (minimum standards) of the home country coincide with its own ones - it is precisely the intervention of the community level that assures that those essential requirements will be homogeneous - In the latter, i.e. the wide sense mutual recognition, the marketing is possible regardless of the equivalence between norms.

is a tendency to harmonize as much as possible to be sure that mutual recognition wil result in equivalent legislations. Woolcock, "The Single European Market ..." op. cit. p. 39.

38.- cfr. Pelkmans, "A grand design by the piece? An appraisal of the internal market strategy", in Bieber, Dehousse, Pinder and Weiler, *1992: One European Market?*, op. cit. p. 379.
Despite of that, cooperation and mutual trust can emerge even under the hypothesis of a self-interest behaviour. Cfr. Ashworth,*Trench Warfare: 1914-1918. The live and let live system* New York, Holmes & Meier, 1980, where the author details some amazing exampes of cooperation between enemies in war such as not to bomb during breakfast. See also, Axelrod, R. *The evolution of cooperation*. New York, 1984; Oye, Kenneth, *Cooperation under Anarchy*. Princetown Univ. Press, 1986.

39.- "The White Paper's 'new strategy' of relying as far as possible on mutual recognition and its egal enforcement has limits beyond which much legislation is still required. Two new elements have been introduced in order to make the legislative process less sluggish than in the past thirty years: more scope for majority voting in the Council under the Single European Act: and the White Paper's new approach, designed to confine legislation on standards to the essential requirements for health and safety, while delegating the task of defining detailed technical specifications to European standards institutions". Bieber, Dehousse, Pinder and Weiler, "Back to the Future: Policy, Strategy and Tactics of the White Paper on the Creation of a Single European Market", in idem, *1992: One European Market?*, 1988, p. 24

40.- Also called principle of equivalence.

Of these two possibilities, the first in the one opted by the ECJ case law[41], that is, regulations are mutually recognised once some minimum standards have previously been harmonised. Thus, mutual recognition is not an automatic and generalised instrument.[42]

Therefore, the existence of a European regulation of essential requirements, should guarantee that regulatory competition takes place in a fair way. As previously said, those who present the competitive race as a race to the bottom' or 'race to laxity', ignore the existence of those essential requirements. "The specification of EC essential requirements is widely recognised as an effective counterweight for this process of downward harmonisation."[43]

Therefore, the competitive advantage of national legislation will be unable to be acquired harming principles such as safety, health or consumer protection. Moreover, it could be argued that the contrary is more likely. Since regulators will be limited by a common floor, the only way of competing will be an increase on the regulatory quality. The impossibility of attracting firms offering a laxer regulation will force the differentiation through quality and a 'race to the top' in regulatory quality[44].

As shown by one of the most prominent European political scientist, the 'new approach' implies a double approximation to the issue of harmonisation.

41.- Except in the Säger v Dennemeyer case (case 76/90, judgement of 25 july 1991, ECR I-4221) where the Court seems to favour the application of the mutual recognition principle in a wide sense, that is, without requiring a previous equivalence of minimum standards. However, the case presents some special feautures such as being a freedom to provide services case and the fact that the english patents office performed the service without moving to the other state. In other words, neither party crossed a broder despite they were of different Member States.

42.- López Escudero, "La aplicación del principio de reconocimiento mutuo en el Derecho comunitario", Gaceta Jurídica de la CEE, Serie D, vol 19, Enero 1993. pp. 138 y 142.

43.- Abraham, F. "Building blocks of the single market. The case of mutual recognition, home country control and essential requirements". International Economics Research Paper nº 75. Centrum voor Economische Studien. Katholieke Universiteit Leuven. 1991, pag.15

44.- As noted by Woolcock, "There is also clear evidence of the ability of national regulators to maintain standards above those of common EC floor. This is possible when, for example, there exists a broad national consensus on the need for such higher standards. This would suggest that the kind of pressure that would otherwise be forthcoming from companies that face higher costs either does not materialize, because the companies themselves are a part of the consensus, or is neutralized by the political desire on the part of governments not to risk undermining the nationa consensus between parties or with interest groups. This kind of consensus has been important in the social policy field in Germany and in the environmental field in Germmany, the Netherlands and Denmark" Woolcock, "The Single European Market ..." op. cit. p. 40. Cfr, also, Vogel who introduces the so called California effect. Vogel, David, *Trading-Up: Consumer and Environmental Regulation in a Global Economy*. Harvard University Press. Cambridge, 1995.

On the one side, the principle of mutual recognition implies a deregulation since reduces the number of European community's norms. On the other side, implies a re-regulation, that is a change is the type of regulatory activity of the Community who now will focus in passing norms with minimum harmonisation of essential requirements. Thus one has always to bear in mind this double aspect of deregulation and re-regulation of the 'new approach' in order to understand its functioning. Harmonisation of minimum standards and mutual recognition are not alternative options but two pieces of the same machinery. [45]

The Community legal order has evolved from a system of centralised integration with a uniform and unique norm, to a system of negative and decentralised integration, were basic norms are only passed to prevent that national norms would jeopardise the single market's freedoms. To sum up, the actual parameter of the Community is to allow everything which is not forbidden and not to forbid what is not allowed by Community norms, as happened in the old paradigm. "The Commission, and particularly Commissioner Cockfield, was determined to seek broad political support for the notion of economic integration by (national) deregulation. (...) The White Paper gives the impression of a slant towards negative integration - which is tantamount to deregulation in the more conventional economic sense of enlarging the freedom of economic agents in the market."[46]

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[45].- A similar argumentation is brought by Reich in comparative study of the American and European models of regulation. Following this author it has to be distinguished between two functions of regulation at a central level:

"la primera debe eliminar las barreras artificiales al libre comercio que se crean por los monopolios, cárteles, sistemas de distribución selectiva y análogos, y al mismo tiempo debe prevenir que las regulaciones de los Estados miembros provoquen un efecto similar que dificulte el libre movimiento de bienes y servicios ('negative centralized state'). Por otro lado, es imposible eliminar todas las regulaciones, incluso si éstas actúan como barreras al comercio. De otra forma, las políticas sociales y las regulaciones protectoras no podrían llevarse a cabo y ello comportaría una peligrosa desintegración social y desequilibrio. Es imposible insistir sólo en una parte del proceso de integración - la eliminación de las barreras- sin tener en cuenta la segunda - creación de unos estándares protectores para el nuevo mercado".

Reich, "The regulatory crisis: American approaches in the light of European experiences" ABA Journal, 1983, vol. 3, p.697.

[46].- Pelkmans, "A grand design by the piece? An appraisal of the internal market strategy", en el libro *1992: One European Market?* op. cit. p. 364. The difference between negative and positive integration is crucial in order to understand the new harmonization strategy in the Community. Negative integration is limited to the elimination of regulatory barriers which could limit integration as well as preventing the adoption of new ones with similar effect. On the contrary, positive integration requires express measures of integration. As it is obvious, negative integration has an advantage which is the fact that no new regulatory instruments need to be agreed . Instead, it is enough with controlling the elimination of existing

On the top of that, the distinction between essential requirements - which are centrally regulated - and technical specifications - which can be mutually recognised - is not merely quantitative but qualitative. It corresponds to the basic distinction between 'performance standards' and 'specification standards', being the essential requirements the former and technical specifications the latter. In order to illustrate this qualitative distinction, Majone uses the following example: a regulation prescribing that ladders must have steps of x centimetres of thickness constitutes an example of specification standards, while a performance standard would establish that steps must resist a certain maximum weight.[47]

Specification standards tend to hinder innovation while performance standards foster flexibility and innovation at the same time that reduce costs. A new type of ladder which would be made of a thinner but more resistant material will not be allowed according to a specification standard, while will be so under a performance one.

The development of technical standards and its conformity assessment is delegated to non-governmental bodies. The principles of mutual recognition and private certification ('normalisation priveé') are the cornerstones of the new method of harmonisation of legislations.[48]

It is also important to underline the liberalisation measures that the growth of European standardisation bodies has supposed. Till the functioning of CEN and CENELEC, domestic industries controlled national standardisation administrations with resulting incompatibilities and lack of coordination.

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discriminatory regulations. Cfr. Scharpf, F. "Negative and Positive Integration in the Political Economy of European Welfare States", EUI Jean Monnet Chair Papers n. 28, 1995. "The history of European integration is one of deep ambiguity and continuous conflcit between two alternative political-economic projects, a free-trade and a supranational welfare state-building project. While the former involves common market-making, primarily through negative integration by removal of trade barriers, the latter aims at a positive reconstruction at a supranational level of a national welfare-state regimes made obsolete by economic integration (...)(Today) European integration has becomed locked in a negative market-making, deregulatory mode, (that) perfectly fits the interests behind the 'Thatcherist' alliance of neo-liberalism and nationalism that has come to dominate European integration in the 1980s", Streeck, "Public power beyond the Nation-State. The case of the European Community", in Boyer and Drache, States against Markets. The Limits of Globalization. London, 1996, p.301-302, parenthesis added.

47.- Majone, "Mutual Recognition in Federal Type systems", EUI Working Paper SPS n° 93/1, 1993, p.5

48.- Ehlermann, "Compétition entre systèmes réglamentaires", Revue du Marché commun et de l'Union européenne, n. 387 avril 1995, p. 222

With the increasing use of committee-based standardisation procedures much of the protectionist use of technical standards has lost weight. [49]

"Hierarchical control of standard-setting within network monopolies is considered no longer appropriate due to recent trend towards vertical disintegration, deregulation and internationalisation. As a consequence of the growing number of interfaces between decentralised subsystems, alternative external institutions, in particular, committees, markets and regulatory commissions, play an increasing role within the standardisation processes"[50]

An important difference between the old centralised system of harmonisation and the present one is the promotion of flexibility and innovation. According to the old paradigm, European regulation scrupulously detailed all possible aspects of the product, predeterminig all the elaboration process. In this way, any new option was impeded to the extent it was not foreseen by the harmonising instrument. On the contrary, the 'new approach' permits the producer to introduce innovations and developments with the only condition of respecting the minimum requirements. Moreover, the diversity of technical regulations is no longer able to obstruct community trade. [51]

It should be clarified that the 'new approach' does not imply that States can act absolutely restricless in those areas not regulated at Community level. As Dehousse explains, "this division of labour between the Community and its Member States by no means implies that the latter enjoy full discretion in fields which are not regulated at the Community level. On the contrary: though Member States retain their competence as regards societal values like health and safety or the environment, their regulatory policies must take into account the general Community framework in which they take place. Besides, several types of Community intervention are necessary in order to make mutual recognition possible."[52]

49.- Genshel, P. and Werler, R. "From National Hierarchies to International Standarization: Modal Changes in the Governance of Telecommunications", Journal of Public Policy, vol. 13, n.3 1993. See in general, Commission of the European Communities, "Commission communication on the deveopment of European Standarization - Action for faster technological integration in Europe" OJ 34 C20, 28 January, 1991.

50.- Knieps, "Standarization: The Evolution of Institutions versus Government Intervention" in Gerken (ed.), *Competition among Institutions*, London, 1995 p. 283

51.- Rojo del Aguila, "La aproximación de legislaciones" Gaceta Jurídica de la CEE, 1986, Serie D-3, pag 584

52.- Dehousse. "1992 and Beyond: The institutional dimension of the Internal Market Programme", Legal Issues of European Integration, 1989, n. 1, p. 114.

Finally, one has to acknowledge the significant effort made by the European institutions to improve the harmonisation system. "It is therefore somewhat disingenuous that the older and costly form of harmonisation is often invoked as a prima facie justification for the alternative: regulatory competition. To the extent that the obsolete examples of the 'old harmonisation' are presented as the current reality of harmonisation, they are misleading . More important still, it is crucial to understand that the mere threat of regulatory competition as a realistic alternative to recent forms of harmonisation disciplines the harmonisation process itself"[53]

Thus, three considerations follow the previous argumentation: first, the analysis of the traditional model of harmonisation is not an argument in favour or against the theory of regulatory competition. It serves only to historically put in context the birth of regulatory competition in Europe. Second, the debate between both models cannot be presented as a either/or option. There will always be elements of both in the future harmonisation strategy as demonstrated by the complementarity of mutual recognition and minimum standards. Third, and finally, it is important to underline the disciplining effect that regulatory competition produces on central institutions. We argue this is a case of vertical regulatory competition between central institutions and Member States. The sole possibility of introducing regulatory competition at horizontal level as a successful harmonisation mechanism forces the Commission and the Council to offer efficient alternatives in order not to loose their legitimacy in conducting harmonisation policies.[54]

2.3.3 Regulatory competition in the European Union

We argue that regulatory competition implies a true transformation of the European Union. But, what are the institutional and political consequences of the new regulatory competition paradigm?

53.- Sun and Pelkmans, "Regulatory Competition and the Single Market", Journal of Common Market Studies vol. 33 n.1. 1995, p. 87

54.- This vertical regulatory competition has two aspects as we will demostrate infra. The first one is the exposed in the text which takes place in a down-up direction . The second is the disciplining effect that the possibility of preemption by central institutions have on the behaviour of Member States when operation horizontal regulatory competition. In this case, vertical regulatory competition takes place in a up-down line, i.e. in favour of central institutions.

With the same pragmatism which is present in the 'While Paper' the designers of this new strategy were aware that a Community with fifteen members needed a reform in the decision making mechanisms. Otherwise, the collapse had occurred when fixing the minimum standards and there would have been no improvement of the statu quo.

Thus, the Single European Act introduces a fundamental change[55] in the harmonisation process: the introduction of article 100A of the Treaty. This article makes reference to article 189B which means the substitution of the principle of unanimity - till the moment the principle governing all decisions on harmonisation of legislations according to article 100 - by that of qualifided majority. As Isaac has noted, this fact constitutes a decisive step against the 'intergovernmental drift'.[56]

Together with the Cassis de Dijon judgement and the publication of the White paper, the SEA constitutes a third dynamization factor[57]. Given the diversity of national interests, the principle of unanimity represented a true obstacle to achieve a further progress.[58] Moreover, it has been proved that the areas that have recorded an inferior level of development are precisely those areas subjected to the unanimity principle.[59]

55.- It has been said that without the introduction of the principle of qualified majority, the Single European Market would never had been a reality. Ehlermann, "Compétition entre systèmes réglamentaires", *Revue du Marché commun et de l'Union européenne*, n. 387 avril 1995, p. 222

56.- Isaac, *Manual de Derecho Comunitario General*. 1992, 2nd edition, p. 23

57.- Cfr. Ehlermann, "The internal market following the Single European Act", CMLRev. 24, 1987.

58.- Quelch, Buzzell y Salama, *The marketing challenge of 1992*, 1990, p. 29. In the same direction, Dehousse affirms that "the most important institutional development as regards the completion of the internal market is beyond any doubt the introduction by the Single European Act of qualified majority voting in several sectors where unanimity was required under the EEC Treaty" Renaud Dehousse, "Completing the internal market: institutional constraints and challenges" in Bieber, Dehousse, Pinder and Weiler, *1992: One European Market?*, 1988, p. 319.

59.- Schmitt von Sydow points out the introduction of qualified majority should not serve to margin dissenting countries but to facilitate a consensus building process. "The possibilities of majority voting which have been considerably extended by the Single European Act especially for internal market policies pursue the same objective. The aim is not to marginalise disagreeing Member States systematically, but to deprive delegates of the protection of the right to veto. This effect is demonstrated by the experience in the domains where the majority rule has already been applicable, namely the European Coal and Steel Community and the management and regulatory committee procedures of the EC. There have been about 30.000 votes since 1962; 99,9% where in favour of the Commission's draft and, most important, almost all of them were unanimous", Schmitt von Sydow, H. "The Basic Strategies of the Commission's White Paper", in Bieber, Dehousse, Pinder y Weiler, *1992: One European Market?*, 1988, p. 97

We are confronted with a paradox labelled as the 'joint decision trap': the majority principle may represent unanimous decisions while the principle of unanimity may lead to no decisions at all[60]. This all or nothing approach has also consequences for the content of the regulation itself and particularly for the principle of proportionality: "while the EC Court imposes a proportionality requirement on national regulations when they hinder intra-EC trade, EC regulation remained excessive for two reasons: excessive detail, usually accepted so as to attain unanimity; and a lack of confidence in mutual recognition, so that 'minimum harmonisation' was unacceptable. Therefore, the costs of the old harmonisation were considerable: failure ('nothing') was frequent and accomplishment of harmonisation tended to be too hevay-handed ('all')"[61]

Following Pelkmans, "this emphasis on qualified majority and flexibility has had at least four beneficial consequences: a much higher speed of decision making than before 1985; far more decisions per year (greater effective decision making capacity); more scope for open policy debates with new options, alternatives, and policy innovation, prompted by the need for coalition building in the process of forming blocking minorities or passing majorities (by the Commission, active member states, and the Council presidency); and finally, a higher quality of regulation since, without vetoes, it is hard to impose on others costly, cumulative provisions"[62]

The majoritarian vote, progressively substituting unanimity at the end of a transition period, could be seen as the great innovation of the community treaties and the great symbol of supranationality.[63]

The 'new approach' contrary to the old system of mere cohabitation of different community legal orders, means an interaction of those different orders in the framework of a common community norm. Therefore, from

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60.- cfr. Scharpf who has coined the term 'joint decission trap' , Scharpf, "The joint-decision trap: lessons from german federalism and european integration", Public Administration, vol. 66, 1988.

61.- Sun and Pelkmans, "Regulatory Competition and the Single Market", Journal of Common Market Studies vol. 33 n.1. 1995, p. 87

62.- Pelkmans, "The significance of EC-1992" The Annals of the American Academy of Political and Social Science, vol 531, 1994, p. 98 . It is also important to note that the position of the ECJ within the system of mutual recognition provides strong incentives for the Council and the Commission to act. "The ECJ is therefore an active participant in European regulatory policy in the sense that it can determine that health and safety measures in one country are equivalent to those of another. If the Council does not set the minimum requirements the ECJ can. This has had the effect of providing the Council with an incentive to regulate.", Woolcock, *The Single European Market. Centralization or Competition among Rules?* RIIA, 1994, p. 11

63.- Isaac, op. cit. p. 53.

now on, one must identify two components of community law: legislation passed by the central institutions and the laws passed by every state, which by virtue of the principle of mutual recognition directly influences the shaping of domestic law. For that reason, the states acquire a relevant protagonism in the integration process, to the extent that the decisive factor will not be any longer uniformity but plurality of normative sources. No doubt that one of the consequences of the 'new approach' is to reformulate the normative sources of the community[64].

It is nothing strange that this new regulatory policy at the community level (which has a global character going much further than free movement of goods), has not provoked feelings of mistrust among Member States. From a self-interest point of view, states are much better off in this process than in one of traditional centralised harmonisation. As Majone has observed, "unlike harmonisation, mutual recognition does not involve the transfer of powers to the Community but, at most, it restricts the freedom of action of Member States."[65]. In other words, "mutual recognition provide Member States with a degree of autonomy which, under the old 'all-or-nothing' perspective, could be retained only by maintaining intra-EU barriers"[66]

Under the umbrella of the White Paper, the new harmonisation system does not pretend the elimination of national norms but its convergence towards what could be called a common legal order. This new strategy is clearly inspired in a federal culture. The debate between the advantages of a centralised model and those supporting the values of diversity and multiplicity could be finally reformulated.

Moreover, the new systems diminishes the technocratic or expertise temptation. Instead, the community institutions are entrusted with a task of

64.- However, as underlined by Ehlermann, there is a striking paradox: the reformulation in the field of the creation of law is not accompanied by a parallel phenomenon in the field of enofrcement and control. "The need of a centralized control by the Commission (or by the European independent agencies) is biger the less reliable is the control exercised by firms and citizens (est d'autant plus grand que le controle decentralise par les enterprises et les citoyens est faible). In other words, the more firms and citizens want their rigths to be respected, the more the Commission has to intervene. Ehlermann, "Compétition entre systèmes réglamentaires", Revue du Marché commun et de l'Union européenne, n. 387 avril 1995, p. 226

65.- Majone, "Regulatory Federalism in the European Community" Government and Policy, 1992, vol 10 p. 308. "Nevertheless it would be important to distinguish between de jure and de facto national control over policy. While competition among rules leaves more nominal control over regulatory policy in the hands of national authorities, the reality may be different. Extensive market liberalization combined with the intense competitive pressures from mutual recognition, means the scope for genuine policy choice may be limited", Woolcock, op. cit. pag. 18.

66.- Sun and Pekmans, "Regulatory competition in the Single Market", Journal of Common Market Studies, vol. 33 n. 1, 1995, p. 71

guardians of the competitive process among states, building mechanisms of arbitration, information and evaluation. "The fathers of the Treaty have tried to avoid that the Community becomes a kind of harmonisation monster or what is still worse in a kind of paternalistic state with interventionist aspirations and pursuing a technical perfectionism more than a spirit of serving citizenship"[67] This way, the Community seems to have found the formula which permits the reconciliation of diversity and integration as the basis of the European Union.

This competition among rules is coherent with systems based on a plurality of powers, while regulatory centralisation is easily identifiable with a centralist model. The election of one or another strategy will be determinant of the structure and the process of integration. "A basic issue is whether uniformity in the institutional arrangement is needed at all - whether institutional variety is not a merit per se, allowing national preferences to play. The strategies of ex-ante and ex-post harmonisation have an important feedback to European integration. If ex-ante harmonisation is the appropriate approach, the institutional arrangement of the twelve EC countries have to be adjusted by a bargaining process in Brussels. If a competitive process is relied upon, harmonisation will occur over time and the solution will not have to be found immediately. Moreover, the extent of harmonisation will be determined in a decentralised process of private decisions and national policy choices"[68]

There is still another important consequence which has to be underlined. Mutual recognition is not only addressed to the problems of protectionism and market fragmentation. It goes further since originates a regulatory competition dynamic. This competitive process among domestic rules as a form of eliminating entry barriers acquires a precious dimension in fostering the single market. [69] While mutual recognition is a static notion - an

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[67].- Mattera, *El mercado único europeo*. Madrid, 1991. p. 193.

[68].- Siebert, *The new economic landscape of Europe*, 1991, pag 3-4. The guiding principle should be as much competition as possible and harmonization when necessary. See Ehlermann,"Compétition entre systèmes réglamentaires", Revue du Marché commun aet de l'Union européenne, n. 387 avril 1995, p. 220. In any case, it has to be denounced that those who so often invoke federalism as a form of protecting cultural diversity and plurality of ideas, latter complain the lack of common road-speed rules in highways, social uniform protection or common limits of blood-levels of alcohol. The concept of federalism is too ofetn invoed in an empty way. Cfr. Hailbronner, "Legal Institutional Reform of the EEC: What can we learn from the Federalism Theory in Practice", Aussenwirtschaft, vol 46, n°3-4, 1991, p. 254.

[69] Nevertheless it has to be taken into account that competition is not an efficient tool for the redistribution of resources, but for allocate them where they are more productive. Being aware of this fact, community institutions hvae accompanied the new competitive process with a significant increase in cohesion funds. "The decissive test of the acceptability of markets in

importing Member State A has to accept as equivalent the regulatory regime of B - regulatory competition is dynamic. Given, or in anticipation of acceptance or mutual recognition, national regulation is adapted (regulatory adjustment) in response to the actual or expected impact of the mobilities induced. As other Member States may do this too, or if initial adjustments were somehow insufficient, iterative processes may develop.[70]

However, it is important to insist that the new harmonisation procedure does not imply that the classical centralised harmonisation has to be completely eliminated. The fixing of minimum standards and basic principles is still necessary in order to prevent a destructive competition and a 'race to the bottom'.[71] In Barfield words, "the defining theme of the EC 1992 process can be seen as a struggle on many policy fronts between those who advocate harmonisation through centrally imposed laws and regulations enforcing uniformity and those who promote competition among national laws and systems with market forces holding sway" [72]

On the practical field, is it necessary to examine the real functioning of the regulatory competition paradigm. According to the postulates of mutual recognition, firms are able to freely market their products throughout the Community and consumers are able to find, in their respective national markets, products of different origins and governed by different sets of norms. The response of those consumers when choosing one product and not another constitutes the signal of the quality of the regulation. This is what we call regulatory arbitrage. It is worth underlying the crucial role that consumers exert in this paradigm.[73]

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modern democratic societies depends fundamentally on the extent to which such markets can coexist with a general setting of 'distributive justice' with which the electorate is tolerably content", Viner, "The Intellectual History of Laissez Faire", *Journal of Law and Economics* vol. 3, 1960, p. 68, quoted by Wolf, Charles, *Markets or Governments. Chossing between Imperfect Alternatives*. MIT Press, 1993 (2nd ed), p. 29.

70.- Sun and Pekmans, "Regulatory competition in the Single Market", Journal of Common Market Studies, vol. 33 n. 1, 1995, p. 70. See our previous diiscussion on institutional arbitrage and institutional entrepreneurship.

71 Reich warns at this point of the risk of a "negative competition between legal order (where) business may choose the country with the worst record of implementation to evade the requirements set by protective Community standards". Reich, op. cit., p. 878.

72.- . Barfield, "Europe 1992. Status and Prospects", Regulation, Winter 1991, p. 43.

73.- However, the consumer or destinatary of the regulation must have the possibility of evaluating and differentiating the product. For many products and services this is not a realistic premise, since information is not available to citizen. The less information is available, the less the possibility of comparison and election. In those cases, public authority instead of citizens, are called to decide on whether a certain level of price-quality or price-risk is acceptable. As explained by Smith, "in the field of product standards consumers will have different preferences for price and quality combinations, and firms will want to set their regulatory standards

The competitive election is possible precisely due to the fact that the new approach combines decentralisation and integration: "Community law based on the principle of subsidiarity encourages decentralised measures which, of necessity, will be divergent and therefore allow competing choices; this should, however, not endanger integration. As a legal consequence of this withdrawal of authority, the Community will usually enact only minimum provisions which allow a competition for 'better rules'. The principles of precedence and direct effect will be applied more flexible to allow for more choice between legal orders and to experiment among different solutions in order to attain social objectives which are only indirectly caught by the EEC Treaty".[74]

Another element to be taken into account is that in a market where different products, subjected to different sets of regulations, coexist, the quality of the regulation serve as a differentiation element. Thus, for instance, consumers tend to buy German products because of the high reputation in quality, and in doing so they are at the same time backing German policy styles. In the same line of argumentation it might be that regulations which are excessively rigid or inefficient, will increase the cost of the product without an additional benefit, which will place it in a competitive disadvantage. This fact will press regulators to redefine the type of regulation, taking as models the policy mechanism enforced by neighbour countries. At the end of the day, there will be a 'de facto' harmonisation taking as model the regulation which has proved more successful.

National regulation is thus permanently subjected to citizens' examination and constantly adapted to avoid creating a competitive disadvantage to domestic producers. Thus regulators might tend to change their policies when observing and evaluating the regulatory policies pursued by other countries. A change in regulation as a result of competition among rules does not necessarily require that the regulated factor moves.[75] Regulatory competition is better understood as a process of consumer arbitrage in the single market and not of locational arbitrage among firms. If this is so,

according to where they see gaps in the market, and not necessarily on the basis of the lowest price/quality combination" Smith, Edward, "Regulatory Competition and the 1992 Process", European Interuniversity Press. Brussels, 1995 p. 64. On the contrary, when decisions are taken by governments instead by millions of consumers, an strategic behaviour, favouring domestic firms might distort reguatory competition. In this line of argumentation, the European administration is called to play a decisive role in the context of regulatory competition, by way of evaluating and providing the necessary information to citizens.

74.- Reich, "Competition between legal orders ...", op. cit. pag 890

75 Woolcock, "The single Euroepan Market ..." op. cit. Cfr. Rose, Richard "What is Lesson Drawing" Journal of Public Policy vol. 2 n.1, 1991; Meny, Ives, *Les Politiques du Mimetisme Institutionnel*, Paris, 1993.

the Member States which are going to experiment major changes are those where consumer was most prevented from exercising that arbitrage, or in other words, the Member States where regulation was dictated to favour domestic industries, regardless of consumer welfare.[76]

The competitive process contributes to underline the more idoneous norms from the point of view of the market and the technological development. Those norms will be emulated by the rest of States, reaching a 'de facto' harmonisation without the need of a centralised decision. The process, however, does not finish here since the effectiveness of those measures will continue to be examined in the future. If regulation does no longer respond to the demands for which it was passed, it is obvious that a process of adaptive change will prevail[77].

For that reason, it has been rightly stated that in the competitive model, the process is as important, if not more, that the result itself. Thus, we might think that the ultimate task of regulatory competition is to discover the best regulations and policies "If we accept that governments are not omniscient, the competitive process is a way of discovering better policies. The Hayekian theme of competition as a discovery process seems to me a powerful reason to support competition among governments"[78] Competition among institutions and rules can be a very productive strategy of European integration as long as it is linked to a conception of law making as a discovery procedure and is not just a mere transfer of that task to the market.

At the same time, competition among legal orders implies a constant process of experimentation and innovation. There is no doubt that confronted with markets and technologies subject to rapid development, regulatory policy must be flexible and dynamic if it wants to effectively respond to social demands. Regulatory competition is much more flexible than a fixed set of harmonised regulations passed by community institutions.[79]

The traditional harmonisation method was based on the implementation of a uniform regulation and did not permit that a single Member State could introduce unilateral modifications to it, even when those

76.- Smith, Edward, "Regulatory Competition in the 1992 Process", European Interuniversity Press. Brussels, 1995, p. 14

77.- This represents an evolutionary theory of law where competition explains the emergence and success of a given legal rule. See Mattei and Pulitini, "A competitive model of legal rules", in Breton et al (ed.), *The Competitive State*. 1991, p. 218

78.- Stefan Sinn, "The taming of Leviathan: competition among governments", Kiel Working Papers n°433, The Kiel Institute of World Economics, 1990, p. 10.

79.- Woolcock, "The single Euroepan Market ..." op.cit. p. 17-18

modifications were necessary to respond to new situations. In this system, innovation in only possible through a re-negotiation of the community norm. This means reopening the difficulties we have mentioned of consensus building, bargaining and defining an accepted content.

Together with this legal aspects, it also exists political reasons which support the advantages of the competitive paradigm. For instance, Siebert and Koop consider that the legislative technique based on competition is the most effective method to gather a weak political consensus: "Since it requires a less centralised decision-making it will be the cheaper, more flexible, and less bureaucratic method. Due to its incentives to improve on the quality of regulations, it will be more efficient in the long run, and by allowing for differences in national preferences, customs, and histories it will be politically more acceptable[80]

Finally, the competitive model permits governments to react individually to the developments that take place in their respective social contexts and to find new solutions to new problems. "This minimises the cost of failure through using the market for regulations as an exploratory device for finding the best institutional arrangements."[81] On the contrary, for the centralised model is much more difficult to prevent errors and the negative consequences of an inappropriate regulation. The effects of a hypothetically inappropriate regulation are multiplied by the fact that it is uniformly applied throughout the Community. This danger is present in the community decision making process, were many directives are not characterised by its technical excellence but by the need of achieving a compromise or by the pressure of given political scenarios.

2.3.4 The principle of subsidiarity and the European constitutional design.

The new paradigm we are trying to present in the previous pages has, both in its origin and in its application, a direct influence in the constitutional design of the European Community and consequently in the type of European integration which is pursued. It is also undeniable that behind each integration strategy, there is a different idea of the construction of Europe, of the way of

80.- Siebert and Koop "Institutional competition versus centralization: Quo vadis Europe", Oxford Review of Economic Policy, vol 9 n° 1 p. 29

81.- Siebert and Koop, "Institutional competition versus centralization ..." op. cit. pag 17. These authors seem to use the same formulation as Justice Brandeis in his famous dissenting opinion in New State Ice Co. v Liebmman. 285 US 262, 311 (1932).

achieving it and of the political and administrative structures which are needed. It is a struggle between two models: one favouring a strong administrative and bureaucratised power, and another closer to political-representative and plural institutions[82].

The Maastricht Treaty has placed subsidiarity as one of the structural principles of the European Union (article 3B)[83]. Despite the critics that has received, because of its indeterminacy, it is beyond doubt that it constitutes a crucial and innovative element. Its introduction in primary community law represents the recognition that a European construction based on a model of centralised regulation is not viable. Susbidiarity, on the contrary, constitutes another element supporting the new paradigm of competition among rules as harmonisation and integration method[84]. As stated by Ehlermann, "subsidiarity appears as the political and legal expression of the notion of competition among rules"[85]

Also, some kind of parallelism could be established between Law and Economics analysis and subsidiarity. Law and Economics argues that the market is the most efficient mechanism for allocation of social resources and regulatory intervention is only justified in cases of market failure. Subsidiarity may be viewed as a corollary of this theory, insofar as it argues that centralisation of authority - suppression of competition among states - is only appropriate where decentralised authority operates less efficiently than centralised authority. Thus both law and economics and subsidiarity would argue that the presumption is in favour of deregulation and decentralisation, respectively, until a market failure is identified.[86]

82.- For Frey and Eichenberger, similar improvement to those alredy reached in economic could also be achieved in the political dimenion, "provided the European Constitution allows for, and actively supports, competition between governments at all levels. The competition between already existing governments must be preserved but in addition a future European Constitution should foster the emergence of competitive new jurisdictions best serving individual preferences", Frey and Eichenberger, "Competition among Jurisdictions: The Idea of FOCJ" in Gerken, *Competition among Jurisdictions*, London, 1995, p. 209.
83.- Cfr. in general, Bermann, G.A., "Taking Subsidiarity Seriously: Federalism in the European Community and the United States", Columbia Law Review, vol. 94, 1994; Van den Bergh, "The Subsidiarity Principle in European Community Law: Some Insights from Law and Economics", Maastricht Journal of European and Comparative Law, Vol. 1, 1994
84.- "The epithet subisdiarity is often used to mean that horizontal competition and diversity in regulation should be maintained, unless the balance of efficiency clearly favors centralization", Trachtman, "International Regulatory Competition, Externalization and Jurisdiction", Harvard International Law Journal, vol. 34 n. 1, 1993 p. 50
85.- Ehlermann, K.D., "Compétition entre systèmes réglamentaires", Revue du Marché commun aet de l'Union européenne, n. 387 avril 1995, p. 220
86.- Trachtman, "International Regulatory Competition, Externalization and Jurisdiction", Harvard International Law Journal, vol. 34 n. 1, 1993 p. 64

Siebert relates the conflict between the two harmonisation strategies with a wider conceptualisation of Europe. "On a constitutional level, this discord is concerned with the manner of organising a society in terms of institutions, it is the conflict of federalism with centralisation. On a philosophical level, it is the clash between liberalism in the European sense and a more planning-oriented approach. We have diverging views in Europe on such issues as confidence in the functioning of markets versus some type of control and interventionism, sovereignty of the consumer versus the need for his or her 'protection', the role and the size of government, spontaneity of autonomous decision-making and decentralised processes versus a constructionism. Europe is in a process of searching for its institutions, and the showdown between the British and the French concepts of Europe is still to come".[87]

On the top of that, the idea of Europe is also important to determine its openness to other participants. While the initial model was an 'exclusive club' reserved to the participant members, the decentralised and competitive approach is suitable for a more open Europe which could allow different degrees of participation and would move away the idea of a 'Fortress Europe'[88].

As previously said, competition among legal orders has to be premised by a common playing field established by Community law in order to be able to recognise the diverse legal options and cultures existing within the Union. Subsidiarity in this sense does not only mean that the central institutions have to act only when they are more capable of achieving the desired result. It also means that, constitutionally, community institutions are not the only actor in the research of appropriate policies and legal mechanisms. Even more graphically it has been said that "subsidiarity is premised on the unassailable proposition that no single level of organisation is appropriate for all social

87.- Siebert, *The new economic landscape of Europe*, 1991, p. 7. According to Buchanan, the new community paradigm implies the overcome of the interventionist-centralist model to establish: "a european federal union with constitutional guarantees which prevent the appearence of a monolitic Europe as a central political unit. The existing national unities will not be reduced to mere administratives districts. " Buchanan, "Una perspectiva americana de la oportunidad constitucional de Europa" Hacienda Pública Española. nº 124, 1/1993, p. 244.

88.- As noted by Woolcock, "the effects of competition among national rules on the evolution of rules in the EC as a whole woll have important implications for third countries. If it results in convergence towards a single set of Euro-rules, third countries will have to contend with a more monolithic EC with all that this implies for trade relations", Woolcock, "The European Single Market. Centralization or Competition among Rules?", RIIA, 1994, p. 4

functions. The principle of subsidiarity is a guide for determining what functions should be allocated to the state."[89]

At the end of the day, the subsidiarity issue becomes a question of what is the role of the States' preferences in the European construction. A federal or quasi-federal structure accompanied by a process of regulatory competition have the advantage of allowing the coexistence of diverse tastes and preferences. This diversity rises the question of how they are going to be matched with the concept of Europe. In a centralised model differences are cancelled and suppressed while in a decentralised one, they coexist and with a proper institutional structure, they are amalgamated.[90]

Woolcock has also related the concepts of regulatory competition and subsidiarity: "the greater the scope for competition among rules, the greater the scope for subsidiarity, when subsidiarity means that the responsibility for decisions rests with the authorities at national or sub-national level. The debate about subsidiarity has, to date, been characterised by a lack of any clear understanding of what the term means, as well as a lack of clear criteria for deciding what should be done, and at which level. An analysis of competition among rules may contribute to this debate by identifying the scope for harmonisation and for competition among rules, and hence the application of subsidiarity. The areas in which competition among rules can operate effectively without the risk of market regulatory failure would be those areas in which regulatory competence could be carried out at national or sub-national levels. The same is also true for the reverse case; in order to ensure that as much regulatory power as possible remains at the national or sub-national level will also need to show that competition among rules may be applied without significant problems". [91]

We are in front of a new political principle within the EC which has the difficult task of matching three opposite perspectives by way of a dynamic conceptualisation of the constitutional issue of territorial distribution of powers: the ever-growing competence of the Community; the loss of jurisdiction by Member States; and the non-recognition of regional entities or states as political actors within the EC. Subsidiarity suggests that more choice

[89].- Trachtman, op. cit. , pag. 99

[90].- However, as explained by Eichenberger, "The factors determining the optimal federative structure of Europe and the various European countries are unknown, as long as they are not revealed by political competition. Thus optimal federalism cannot be planned and implemented from above. In a European constitution, the processes have to be specified that allow optimal federalism to endogenously emerge", Eichenberger, "The benefits of Federalism and the Risk of Overcentralization", Kyklos, vol 47, 1994, p. 414

[91].- Woolcock, "The single Euroepan Market ..." op.cit. p. 2

should be left to local actors on how they regulate certain areas of social policy and permit the to interact in conditions of competition without a central authority.[92]

Apparently, with the Treaty on European Union there is a lessening of the role of the Commission, but this is not exact. What is really taking place is a reconsideration of the roles both of the Commission and of the States in the European construction. Competition among legal orders permits to use decentralisation without falling back into intergovernamentalism and into protectionist measures which in a first stage led a mere formal single market.

Competition among legal orders, subsidiarity and diversity are innovative forms of permitting the development of the Community and at the same time respect domestic idiosyncrasies. Subsidiarity represents a third option between that model of intergovernamentalism and the centralised one. Competition among legal orders also supposes a refusal of the danger of 'brusselization', with a single and interventionist executive branch. Competition among legal orders can match both the goals to be achieved by the Union and a degree of decentralisation and flexibility both acceptable and adequate to the structure and diversity existent among the members of the Union. In conclusion, the dichotomy between suparnationalism and intergovernamentalism can be overcome with the competitive paradigm.

The introduction of the competitive paradigm and the principle of subsidiarity could also be explained as a result of the re-equilibrium of powers which is operated in the Single European Act. With the introduction of the principle of qualified majority in 1987, the States loose part of their weight within the Council of Ministers. A State is no longer able to veto a given policy. This lost of protagonism of the singles States within the Council has to be regained through a correspondent devolution to the national States. "Unlike federal states, the governments of the Member States themselves (jointly and severally) could control absolutely the legislative expansion of jurisdiction/competencies/powers. Nothing that was done could be done without the assent of all national capitals. This fact diffused any sense of threat and loss of power on the part of governments. This era is now passed with the shift to majority voting in the post-SEA period. Governments of the Member States no longer have the 'veto guarantee' and thus have taken a new very hard look at the question. Limiting the competencies of the Community has become one of the most sensitive issues of the Maastricht construct."[93]

92.- Reich, op. cit. p. 889. Parenthesis added.

93.- Weiler, "Journey to an Unknown Destination: A Retrospective and Prospective of the European Court of Justice in the Arena of Political Integration", in Blumer and Scott, *Economic*

Therefore, the implications of subsidiarity for horizontal regulatory competition among states in the field of harmonisation and free movement of goods, are undeniable. However, subsidiarity will also have a strong potential in what regards of vertical regulatory competition between the European central institutions and the Member States. In that respect, Trachtman has asserted that: "the principle of subsidiarity indicates that particular social issues should be addressed at the level of society where they can be addressed most effectively. It thus requires continuous vertical competition for regulatory effectiveness among levels of government. "[94]

This construction introduces a revolutionary criterion for the attribution of shared competencies: effectiveness[95]. Once stated that there is no single authority capable of satisfactorily develop all tasks, the principle of subsidiarity means introducing the factor efficacy as legitimising the assumption of competencies. For this reason, this kind of competitive evaluation among several jurisdictions in order to show that a given competence can be exercised, signifies a strong incentive to foster regulatory proficiency. On the contrary, a faulty regulation would imply a justification for the primacy of Community law and consequently for the centralisation of the competence.

Subsidiarity leads to a refusal of a closed and fixed system of distribution of competencies and to an artificial distinction between exclusive and shared tasks. It is quite fruitless to try to divide social complexity among competencies with rigid boundaries. Applying this reasoning to the distribution of competencies themselves it results that: "if the principle of subisdiarity is viewed as establishing a rule that issues should be addressed at the level where they can be addressed most effectively, this principle establishes a competition for governmental effectiveness among levels of government"[96].

There is a crucial difference between this model and a static model of distribution of competencies. In the latter, the assignment of competencies takes place through the establishment of fixed lists of competencies. Some of

and Political Integration in Europe. London, 1994, p. 150; Idem "The Transformation of Europe", Yale Law Journal, vol. 100, 1991.

94.- Trachtman, op. cit. p. 99- 100

95.- Note that subsidiarity can not be read as indicating that things should be done at the lowest possible level, without any reservation or any normative criterion. This clearly would constitute a recipe for anarchy. On the contrary, effectiveness must not be measured only in economic terms, but in a broader range of values described as effectiveness in implementing a social organization which protects boths markets, cities, families, consumers or less favoured people.

96.- Trachtman, "L'Etat C'est Nous: Sovereignty, Economic Integration and Subsidiarity", Harvard International Law Journal vol 33 n°2 , Spring 1992 , p. 469

these exclusive competencies, once attributed, can be exercised in a improper manner or can harm other states' interests without any risk of being preempted by community law. The guarantee of inmutable detentation of the competence suppress any incentive for a correct use of it. On the contrary, our dynamic model the risk of preemption represent a strong reason to exercise a competence properly and within its limits.

Moreover, this dynamic distribution model implies that the boundaries determining the optimal assignation of competencies will be signalled through a discovery process. We no longer will be able to know beforehand the correct level where allocate a given responsibility. Instead, a trial and error or an open ended self-evaluative panorama is in the horizon.[97]

As formulated in the Treaty, subsidiarity is a double sense clause: it prevents the intervention of the central authority when the goals can be adequately pursued at a lower level, and; legitimises the community intervention in case of malfunctioning of the lower level. If we take air pollution as an example, and we assume that competition among states and standards produces acceptable results, this will impede the centralisation of the competence and of the actions to be taken. (the pretended result is already achieved at the lower level). On the contrary, if one or several states engage in a 'race to the bottom' dynamic resulting in a general deterioration of standards and quality of air, this will legitimise the central intervention. In sum, subsidiarity (in its ascendent aspect) implies a strong incentive to control regulatory competition and state action.

The sharp formulation of the principle of subsidiarity will diminish the 'race to the bottom' fear. The competence that a State can have is not eternally

97.- This is also expresed by Streit and Mussler : "Regarding legislation, the two approaches again differ markedly when dealing with the integration of economic systems: integration by framework activities means that the economic and political actors accept
(1) that universal or abstract rules are effective in coping with the endemic lack of knowledge, and
(2) that competition of legal systems within the Community (Union) can help to improve the institutional framework in an unpredictable way.
Contrarily, integration by intervention implies an interpretation of law as a 'conditional planning program'. Legislation of this kind is based on an understanding of the economic system which wrongly presumes relatively simpe and stable patterns of causation. Since competition is not interpreted as a discovery procedure, competition of legal systems can hardly be expected to perform better than purpose-oriented legislation from above. If however, competition of legal systems within the Community (Union) is considered seriously, a further systemic property of European law becomes more easily accesible. To allow such competition, European law can only provide an abstract framework" Streit and Mussler, "The Economic Constitution of the European Community: from Rome to Maastricht", *Constitutional Political Economy*, vol. 5 n.3, 1994, p. 329-330.

fixed and its quality and results are evaluated on a permanent basis. A given jurisdiction has to be able to demonstrate that the exercise of the competence 'achieve the goals of the pretended action' and that its exercise is superior to an hypothetical community one. In other words, the results obtained in the process of horizontal regulatory competition are going to serve as a negative parameter for allowing vertical regulatory competition between the centre and the periphery. If it is proved that the results are achieved through competitive forces, there will be no reason for legitimising community intervention.

As noted by Reich, "it is interesting to see that, the more the Community occupies fields which were traditionally those left to the Member States, the more the principles of subsidiarity and minimum protection find recognition, thereby allowing increased competition of legal orders within the EC. The extension of Community jurisdiction is paralleled by an extension of competition of legal orders. "[98].

In our opinion, both the 'new approach' of the community's legislative strategy, with an increased protagonism of the principles of minimum standards and mutual recognition, and the introduction of the principle of subsidiarity are blatant indicatives of the adoption of the competitive paradigm as a new formula for the interrelation of legal orders within the Union.

"According to the centralist paradigm, to create a united federal Europe means to organise the polity after the model of the nation state, it means to form a federal government at the image of traditional national governments. The essence of such a process of integration would be to institute, at the federal European level, authorities that replace their respective counterparts at the national level. In other words, in forming the union, the national governments transfer part of their authority or sovereignty to a central European agency. By contrast, according to the competitive paradigm, the principal subject of a European constitution would be the exchange of commitments among the member nations, their joint commitment to rules that serve to constrain what the national governments are permitted to do, in their dealings with each other, with third parties and, most importantly, in relation to their citizens and lower level governments".[99]

98.- Reich, op. cit, pag 894

99.- Vanberg, "Constitutionally constrained and safeguarded competition in markets and politics with reference to the European Constitution", Journal des Economistes et des Etudes Humaines, vol. 4 n.1, 1993, p.21

CHAPTER III

NEW EC BANKING LAW: A MODEL OF HORIZONTAL REGULATORY COMPETITION .

"The Single European Financial Market (SEFM) is not something that will happen as soon as regulators permit it - and not before - all culminating in the annus mirabilis of 1992. The causation of social processes is more complicated. Interests, personalities, technological conditions, institutions, and ideas contribute to the shaping of history.

Pedro Schwartz, "The Single European Financial Market" CATO Journal vol. 10 n. 2, 1990.

3.1. Introduction

We have argued that the model of regulatory competition has an ever growing presence in the regulatory structure of the EU and that their underlying principles may also present a new paradigm for understanding the evolution of Community law in creating the internal market. The banking system is an illustrative example of this regulatory move, specially since European banking law has experienced extremely significant changes in recent times.

Generally speaking, one could say that the newly born European regulation on the matter presents some peculiar characteristics of a model of regulatory competition and at the same time give us some clues for the possible trends of European services law.

In order to examine these characteristics it is convenient to use a diachronical perspective distinguishing between two different historical stages: the first one corresponds to a market for financial products and services strongly segmented among the several Member States and governed in each country by different national norms; the second stage, on the contrary, shows a process of liberalisation and integration that gives rise to an important change in the type of regulatory policy. According to Gual and Vives, in this new scenario, "financial entities move from one highly regulated situation where the interest rates were fixed, the entry was controlled, the market protected against the external competition and with important restrictions to lending transactions, to a new scenario, with market determined interest rates, free entry, no restrictions to competition and a substantial liberalisation in lending transactions. In this transition, the deposit insurance systems are maintained and, generally speaking, solvency requirements and supervision of entities are tightened"[1]

Thus, it is beyond doubt that the financial services industry and more concretely, credit institutions have suffered an impressive revolution, both in its way of operating and in its regulation. Going beyond this mere description, we will try to present some characteristics of this new method of regulation and especially the functioning of regulatory competition. This study claims to be innovative in so far tests in a given sector the effects of competition among regulations and regulators.

However, one must retain that the Single European Financial Market (SEFM) is not something that will happen as soon as regulators permit it - and not before - all culminating in the annus mirabilis of 1992. "A popular view holds that the integration of European financial markets was simply 'dictated' into existence by various legislative efforts of the European Commission in Brussels over the past three decades. But this view strongly presumes that the transformation process in Europen Financial markets has been following some neat timetable of actions and ignores divergent financial regulations and structures of individual markets which are hesitant in giving up centuries of well-entrenched practices"[2]

1.- Gual and Vives, *Ensayos sobre el sector bancario español.* FEDEA Madrid, 1992 p. 100 author's translation.

2.- Hawanini, Gabriel and Rajendra, Eric, "The Transformation of the European Financial Services Industry: From Fragmentation to Integration", Salomon Brothers Center for the Study of Financial Institutions. Monograph Series in Finace and Economics n. 4, 1989, p. 3

The causation of social processes is more complicated. This is specially true when analysing a process of regulatory competition. Responses to it are neither predictable nor uniform and in most of the cases we are in front of an open ended process, in constant evolution which heavily relies on a trial and error mechanism. It is only the understanding of the very nature of this evolving and dynamic process that will shed light on its study.

3.2. European banking system before integration.

National administrations have used since ever a varied and powerful range of regulations in order to introduce restrictions to banking activity. This is mainly due to the fact that it is considered that banking activities involve a high social value. Thus, for instance, banks provide for liquidity to the mechanism of economic life and stability to the payment system, in such a way that insolvency of a single bank exceeds the purely private repercussions.[3] These justifications on the social value of banks in the whole of the financial system have lead to the promulgation of regulations aimed at guaranteing the stability of the banking system. In any case, the banking industry is one of the most highly regulated and politicized parts of the economy.[4]

Moreover, it is commonly recognized that the banking sector regulation is deeply rooted on historical reasons. The interwar depression has deeply conditioned the regulation of financial institutions. Regulatory systems were therefore set up to prevent a repeat of the banking crisis of the 1930s. Even more damaging was the furnished evidence that the financial sector is exposed to risks that ultimately put the whole economy at danger. This sector needed therefore to be supervised more closely than others. If we add to this the obvious interests of governments to assure priority access to privileged borrowing conditions, government involvement as regulator, as protector from foreign influences and sometimes as owner of major banks, is quite understandable.

As a result, all countries in the world have national banks more often than not protected from foreign competition. "Thus, it is not just the regulatory aspect, to preserve stability, avoid negative spill-over effects and protect savers, but also the key intermediary role of financial institutions in the economic system that has led governments to intervene and tightly control this sector. In this tightly regulated and circumscribed environment internationalisation and innovation had only little scope and lacked strong incentives. To this it may be added that strong competitive forces are quintaessential for innovation in finance. Financial institutions need to be forced to innovate otherwise there is not enough incentive to do it"[5]

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[3].- Aspinwall, "On the 'Specialness' of Banking", *7 Issues in Banking Regulation. 16*, 1983.

[4].- Dorn, James A. "Financial Deregulation in a Global Economy", CATO Journal vol. 13 n. 2, 1993 p. 156.

[5].- Steinherr, A. "Financial innovation, internationalzation, deregulation and market integration in Europe: Why does it all happen now?", in Fair and De Boissieu, Financial Institutions in Europe under new competitive conditions", Kluwer, 1990, p. 50. It is now increasingly argued that was not a market failure what provoked the Great Depression but the

In terms of the regulatory instruments, it is useful to distinguish between those which affect directly to the sector's structure and those which affect the conduct of financial entities. On the one hand, structural regulations provide for functional separation among institutions (such as separation between commercial and investment banking), entry requirements, deposit insurance and the lender of last resort. On the other, conduct regulations can take the form of direct restrictions in the composition of liabilities and assets, norms related with the provision of information, maximum lending amounts, and antitrust policies."[6]

Thus, one could establish the correlation between form of regulation and policy goal in the following manner: structural regulation is aimed at securing the stability of the system while conduct regulation is directed to investor protection.[7]

It should be noticed how, in Europe, the harmonisation process has mainly focused on the first of those aspects: system stability. It is then no surprise to see how the elements of structural regulation have been mainly harmonized while conduct regulation and in general investor protection have been left to the industry itself or to the forces of regulatory competition.

TABLE : TYPES OF FINANCIAL REGULATION (OCDE 1992)

I. PREVENTION OF SYSTEMIC RISKS

A. Restriction of market forces
1. Price regulation
   a. Fixing interest rates, fees, commissions
   b. Permitting price cartels
   c. Direct lending controls and compulsory investment schemes
2. Restrictions on cross-border capital flows

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contrary: "the Great Depression was the result of basic failures of monetary and fiscal policies of the major countires in a beggar-the-neighbour context, not to specific failures of the financial system. The regulatory process came thus to be flawed by a fundamental confusion of cause and effect. ", Masera, R. "Issues in Financial Regulation: Efficiency, Stability and Information", in Fair and De Boissieu, Financial Institutions in Europe under new competitive conditions, Kluwer, 1990, p. 320

6.- Gual and Vives, *Ensayos sobre el sector bancario español.* FEDEA Madrid, 1992, pp. 19-20.

7.- "There remain two central functions of regulation within the financial sector: investor protection and systemic stability. The focus on investor protection is micro; that of system stability is macro", Goodhart, C.A.E. , "Some Regulatory Concers", LSE Financial Markets Group, Special Papern. 79, 1995, p. 6

3. Restrictions on the range of activities
   a. Specialisation of bank
   b. Compartimentalisation banking/securities/insurance
   c. Separation of banking and commerce
   d. Restrictions on cross-border financial services
4. Restrictions on establishment
a. Restrictions on establishment by domestic institutions
b. Restriction on establishment of foreign institutions

B. Prudential regulation
1. Supervision of balance sheet ratios and risk diversification
2. On-site inspection and external auditing

II. PREVENTION OF INDIVIDUAL RISKS

1. Quality standards and codes of conduct
2. Disclosure and information requirements
3. Deposit protection schemes

III. PROMOTION OF SYSTEMIC EFFICIENCY

1. Prohibition of restrictive business practices and cartels
2. Regulation of mergers

The twelve banking systems of the European Community showed before the eighties, a multiplicity of requirements both structural and of conduct, which produced a national segmentation of financial markets.[8] Thus, the conduct requirements applicable in France, for instance, made impossible for a Italian entity to offer its services in that context. Moreover, existing structural regulations in each national jurisdiction caused that a bank undertaking legally licensed under the laws of another Member State was not recognised as such in entering the host country.

Moreover, the European Court of Justice in its Daily Mail case,[9] reaffirmed the French doctrine of 'siège réel' when considered that a legal person was only existent by virtue of the national legislation which created it. Hence a company incorporated under a system, such as the French, which

8.-In the matter, it is interesting to refer to a comparative table for both structural and conduct regulations required by Community member states to financial entities, in Gual and Vives, op. cit. pp. 20-26.

9.- Case 81/87 R. v HM Treasury ex parte Daily Mail, (1988) ECR 5483

requires the 'siège réel' to remain in the state of incorporation, will not be able to take advantage of primary establishment in other Member States contemplated in the Treaty; a financial entity wanting to enter another member state's market had to set subsidiaries according to the host state legislation, or to dissolve and incorporate in the new State. Therefore, there will be a fundamental difference between the right of primary and secondary establishment.

Anyhow, "the motivation for these prudential controls differ from country to country, reflecting both the historical development of regulatory practice and the character of their financial systems. In some countries, public ownership of major financial institutions predominates. Some countries have centralized financial systems in which major financial groups play a leading role, while in others, the system is fragmented either regionally or by type of service. Differences between countries in legal, political and institutional arrangements are compounded by contrasting market structures in financial services. The manner in which the financial system has developed in any country is, inevitably, linked to its history, culture and pattern of development"[10]

The Community's results in the process of harmonisation of banking regulations were very meagre during three decades. Detailed harmonisation proved to be impractical. Several factors lay behind this poor record:[11]

- the first difficulty in imposing Community-level regulations was the crucial function banking has in national economies and its concomitant impact on national sovereignty.
- differing national conceptions of harmonisation of banking law have slowed the process, specially, the divergence between those supporters of hard law and those who prefer soft law measures.
- the procedure for decision making, specially the voting method, has long been a stumbling block. Until the passage of the SEA, article 57(2) of the Treaty of Rome required that directives in the banking sector be passed by unanimous vote in the Council.
- there is an operational link between banking services and capital movement. Thus, taking into account that most Member States had restrictions on capital movement, banking integration was impeded.

10.- Louis, J.V. (Chairman of the Working Group of the ECU Institute), Banking Supervision in the European Community. Institut d'Etudes Européennes. Université de Bruxelles, 1995 p. 21

11.- Zavvos, "Banking Integration and 1992: Legal Issues and Policy Implications" Harvard International Law Journal, vol. 31 n.2, 1990, p. 468.

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On the top of that one has also to blame the traditional method of harmonisation in a moment of political reluctance to go further in the process of harmonisation[12]. Centralized harmonisation has proved to be both inefficient and ineffective. "(Directives) as used so far have not proved particularly effective in drawing the national banking and monetary systems together, or for that matter, in setting up a common market. They have taken an inordinately long period of preparation before widely diverging interests of the numerous parties at national an Community levels have been reconciled and the Council of the EC has adopted them. After their adoption, it has taken years before the Member States have implemented them by introducing them into their respective national legal systems. For example, the 1973 directive on banking (Council Directive 73/183/EEC)[13] took almost ten years to be adopted from the start of the preparatory work on it. (...) The time lag for a banking directive to be adopted from the time the first proposals are discussed in Brussels is so long that it is easy to assume that bankers can hardly be interested in them"[14]

Thus, European banking has historically been characterised by significant differences among the 12 (15) member states. These have arisen from a combination of cultural and economic features and also from the regulatory structures adopted by each country, which are the main focus of the programme of harmonisation under way within the EC. The regulations established have resulted in differing prudential requirements among the Member States and in measures which have proved anti-competitive in several areas.[15]

12.- It has even been affirmed that "the perceived need for such harmonisation had been the main obstacle to financial market integration with negotiations dead-locked over minor details for years", Hoschka, T. "Cross-Border Entry in European Retail Financial Services", PhD Thesis EUI, 1992. p. 51

13.- Directive 73/183/EEC of 28.6.1973 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. O.J. L194/1 of 16.7.1973.

14.- Cordero, Richard, The Creation of a European Banking System. A study of its legal and technical aspects. 1990, pp. 6-7.

15.- Fowle, "1992: Its Impact on European Banks, Their Structure, Operations and Accounts", in the book, *The Single Market and the Law of Banking*, edited by Cranston, London 1991, p. 93 . As expressed in the Cecchini Report, "A common feature of the financial service branches is that the regulatory functions of government while aiming primarily at prudential or safety objectives, also often tend to limit entry into the market as a side effect. The general objective of European market integration is, therefore, to separate out far more clearly the setting and supervision of prudential and safety standards from the issue of market entry", Cecchini Report, European Economy, 35, 1988, p. 86.

Therefore, financial markets were, till quite recently, no more than strictly domestic markets[16]. As a consequence of the prevailing reluctance to open up the national capital markets, and the substantial variations in the national legislation, Community rules on the banking sector were virtually absent until 1973.[17] Diverging national legal and policy frameworks constituted the obstacles that had kept banks operating in separate national systems. The initial prospect for the integration is thus a banking system anchored in national oligopolies strongly regulated, protected and closed to the international flow of capitals and services. The paralel with the US system, specially before the passing of the Bank Holding Companies Act, where the market was segmented among the different states and state banks were highly protected on interstate competition, is unavoidable. In Vives' opinion, "the recent history of European banking has been characterised by a lack of vigorous competition: regulatory capture and concerted action have been the norm rather than the exception"[18]

It has to be stressed how this interventionist system allowed the governments to maintain an active role in the distribution of funds, both directly, through state aids to industry, fiscal privileges to certain economic sectors, and a structure of public owned enterprises, as well as indirectly through political control 'de iure' and 'de facto' on practically the majority of the banking industry.[19]

16.- Cordero, Richard, *The Creation of a European Banking System*, New York, 1990, p. 2

17.- The first important normative instrument is Directive 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" of 28 June 1973, Directive 73/183/EEC, OJ 1973, L194/1, which preceded the so called First Banking Directive (First Council Directive on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions); Directive 77/780/EEC of 5 March 1977, OJ. 1977 L 322/30. Nielsen, *Services and Establishment in European Community Banking Law*. Copenhagen, 1994, p. 22

18.- Vives, "Banking Competition and European Integration", in the book edited by Alberto Giovannini and Colin Mayer, *European Financial Integration*, CEPR, 1992, p. 10

19.- Modigliani, observed that the excessive administrative interventionism in the regulation of the Italian banking sector, did not responded so much to the protection of social interest but to a formula to establish transactions of influences in the center of financial power. The Italian case is the most paradigmatic but is far from being an isolated one. On the contrary, this description given by Modigliani is a common feature of the legal systems of the southern rim of Europe. "We believe that in Italy, legal rules have deliberately been left vague, incomplete and, even, un-enforced. We argue that the current regulatory structure exists in order to perpetuate the ubiquitous involvement of political factions in the government of the economy. In a fuzzy legal climate, many economic transactions must be negotiated or mediated by political intervention. In particular, financial regulation has historically taken the form of strict controls on what activities are to be allowed in the financial sector." F. Modigliani and E. Perotti, "Reforms are overdue" *Financial Times*, 19 November 1990. See also Pringle, "Financial Markets versus Governments" in Banuri and Schor, Financial Openness and National Autonomy,

However, this situation has reversed in recent times. Among the factors that prompted the change of this situation one could count[20]:

- it was realised that capital market integration was a natural extension of the economic integration that was set in motion by the Treaty of Rome[21]. At the same time, capital market liberalisation has proved to be a necessary condition for improvements in efficiency in the flow of goods and factors of production[22];
- the awareness that financial services are an important industry in their own right, creating a dynamic of rising economic interdependence.[23]
- the fear of losing ground industrially and technologically to the USA and Japan as a consequence of global financial deregulation.
- the fact that the 1980's constituted a period of general improvement of key macroeconomic indicators (reduction of inflation and unemployment rates)
- the deregulation of financial markets and the simultaneous introduction of technological innovations persuaded Member States that they need to liberalize financial services and capital movement just to keep up.

Both the need to create a single market in Europe (internal forces) and the internationalisation of financial markets (external forces), being very close to a worldwide scale, produce a deregulatory wage at national level and a regulatory reform at Community level, each movement directed to the

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New York, 1992, p. 89 who argues that the development of nation-wide banking systems in Europe in the eighteenth and nineteenth centuries gave enormous new potential power to the governments of these nations states, enabling them to borrow on a vastly greater scale.

20.- Giovannini and Mayer, *European Financial Integration*, Cambridge University Press, 1991, p. 1 . See also Zavvos, Banking Integration and 1992: Legal Issues and Policy Implications", Harvard International Law Journal, vol. 31, 2, 1990, p. 470-471

21.- "The most prominent explanation of cross-border entry in service industries is that a firm 'follows' its customers into foreign markets. This explanation is particularly dominant in the banking sector. Once the firm decides to actively enter the foreign market by transferring capital and labour, the need for direct acces to banking services in the host market increases. This may induce the hoem financial institution to establish some form of presence itself in the host market in order to better serve the needs of the now multinational firm", Hoschka, T. "Cross-Border Entry in European Retail Financial Services", PhD Thesis EUI, 1992. p. 92

22.- See The Costs of Non-Europe. Commission of the European Communities, "The Economics of 1992", European Economy, n. 35, March, 1988; Viaene, M.J., "Real Effects of the 1992 Financial Deregulation", Weltwirtschaftliches Archiv, vol. 28 n. 4, 1992. Cfr. Financial Integration, Communication to the Council of 18 April 1983 COM (83) 207 Final

23.- As shown in the 1989 IMF International Financial Statistics, European cross-border trade far surpasses trade with third countries.

achievement of financial integration[24]. These tendencies have transformed the regulatory scenario of financial markets in the European Union. The growing globalisation of money markets together with the process of European integration, raised new challenges to financial entities and to their regulators. The liberalisation of domestic financial structures, accompanied with an integrative tendency, involve an increase of competition within the banking industry and as a corollary, the competitive pressures that financial entities face.[25]

But not only economic conditions brought about the change of regulatory policy. The political climate mirrored in new legal structures also had a decisive impact on the future policy. Two aspects must be underlined.

First, the White Paper of 1985[26]. Unlike the sectorial legislation dictated by the Community till 1985, the White Paper identifies measures required to reach the common market in all sectors. For that purposes, the Commission proposes to abandon the rigid and centralist regulatory model and substitute it for a decentralised and flexible one based on mutual recognition of regulations[27]. Of a total of near 300 proposed directives included in the White Paper, some 15 dealt with financial sector.

The second aspect is the passage of the Single European Act in 1986. One of the most significant achievements of the SEA was the amendment of article 57(2) of the Treaty, which originally, required the Council to act by unanimity on measures concerned the banking industry. "One of the most positive results of the Single European Act is that by virtue of articles 6 and 16 of that

24.- It has been stressed that "a more coordinated approach to supervisory standards within the Community arises not only from objectives of the creation of a unified European market but also from the requirement to tackle new banking developments in a more internationally coordinated fashion" Zavvos, "Towards a European Banking Act" CMLRev. vol. 25, 1988 p. 263

25.- Vives, "Desregulación y reforma regulatoria en el sector bancario", *Papeles de Economía Española*, n. 58, 1994, p. 2.

26.- COM (85) Final. 14 June 1985.

27.- When evaluating the traditional way of harmonisation, the Commission stated that, "it would be over-regulatory, would take a long time to implement, would be inflexible and could stifle innovation". See the transformation of Europe, supra. As described by Cordero , "(Directives) as used so far have not proved particularly effective in drawing the national banking systems closer together, or for that matter, in setting up a common market. They have taken an inordinately long period of preparation before the widely diverging interests of the numerous parties at national and Community levels have been reconciled and the Council of the Ec has adopted them. After their adoption, it has taken years before the Member States have implemented them by introducing them into their respective national legal systems. This national implementation has resulted in domestic provisions harmonized only as to the underlying principles but not as to the concrete provisions applicable in practice", Cordero, Richard, *The Creation of a European Banking System*, New York, 1990, p. 6

Act, this special provision with regard to the protection of savings, etc., has been deleted and this is now an area where the Council may act by qualified majority in co-operation with the European Parliament"[28]. Also, in Smits' opinion, "the convergence of the major aspects of banking supervision is facilitated by the inclusion in the European Single Act of a system of majority decision-making which involves the European Parliament much more strongly than before. This system does not apply in all areas but it does apply in that of banking harmonisation which is based on article 57"[29]

Finally, the Single European Act amendment to article 70(1) of the Treaty must also be considered as a positive step towards the liberalisation of capital movement and achievement of a single financial market.

> "The Commission shall propose to the Council the measures for the progressive coordination of the exchange policies of Member States in respect of the movement of capital between those States and third countries. For this purpose, the Council shall issue directives, acting by a qualified majority. It shall endeavour to attain the highest possible degree of liberalisation. Unanimity shall be required for measures which constitute a step back as regards the liberalisation of capital movements".

Therefore, in the field of capital movement regulation the Council may legislate using qualified majority in accordance with the cooperation procedure.

To sum up, this first period is characterised by national protective regulations which fragmented the financial market in purely domestic markets. Financial entities are tightly regulated and there is very little

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28.- Usher, "1992 and the Implications for Banking and Finance: an Overview", in the book *The Single Market and the Law of Banking*, edited by Cranston, London 1992, p.2. It has also been affirmed that, "The lack of progress is explainable by particularly two factors: the one concerns the recession of the world economy during the oil-crisis in the 1970's, the existence of high inflation, increasing unemployment rates and low growth in the Member States economies resulted in protectionist policies rather than commitment for the common market. The second one concerns the legal framework in the Treaty. In the most sensitive areas of the member States internal matters, the Treaty prescribed unanimity for adoption of secondary legislation. Thus the attempts to adopt legislation concerning matters in which the Member States traditionally have strong interests, were most likely to turn out fruitless", Nielsen, *Services and Establishment in European Community Banking Law*. Copenhagen, 1994, p. 22. See also Zavvos, Banking Integration and 1992: Legal Issues and Policy Implications", *Harvard International Law Journal*, vol. 31, 2, 1990, p. 468-469

29.- Smits, "Banking Regulation in a European Perspective" *Legal Issues of European Integration*, 1989, vol. 3, p. 69

possibility of movement across the Community. Without the possibility of movement, there is no room for regulatory competition beyond simple emulation and cross-fertilisation of other models.

3.3. The freedoms era. Banking integration and the new approach.

The European strategy to achieve integration in the Community's financial industry has mainly focused on the achievement of three goals: freedom of movement of capitals; freedom of establishment of financial entities, and freedom to provide cross-border financial services.

3.3.1. freedom of movement of capitals[30]

It is unanimously accepted that free movement of capitals is a prerequisite for creation of a financial market. With this perception, the Treaty established in article 67 that,

> "Member States shall progressively abolish between themselves all restrictions on the movement of capital (...)"[31].

Also, article 61 established a direct connection between free movement of capital and banking liberalisation:

> "the liberalisation of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalisation of movement of capital."

Moreover, there is one particular feature of money which constitutes the main product of banking: mobility. Mobility of money makes national regulation of the banking industry extremely difficult since, unlike goods, money can be transported virtually costlessly and to some extent invisibly. "Hence, border controls are not very effective and low transport costs represent no cost barriers. As long as all countries regulate tightly and control capital movements this potential mobility may not be exploited. But as soon as some countries open their financial markets or as uncontrolled markets exist

30.- Oliver, Peter and Baché, Jean-Pierre, "Free movement of capital between the Member States: recent developments", CMLRev. n. 26, 1989.

31.- The ECJ had two occasions to interpret article 67 as directly applicable, which would have facilitated very much the liberalisation goal. However, this was not the view taken by the Court. Case 203/80, Casati (1981) ECR 2595 and Joined Cases 268/82 and 26/83, Luisi and Carboni v Ministero del Tesoro (1984) ECR 377. Cfr. Tizziano, A. "La sentenza in causa 202/80 Casati", Il Foro Italiano, 1982 vol. 73; Petersen, Michael, "Capital movements and payments under the EEc Treaty after Casati", ELR, vol. 7, 1982

outside of sovereign control, actual international competition occurs and this eventually implies competition among regulators"[32]

In order to achieve the mandate of the Treaty, the Directive on freedom of movements of capitals was passed in 1988.[33] In accordance with the Directive, the liberalization obligation applies to all capital transactions and consequently there is no longer room for authorisation procedures[34]. Clarotti, Chief of the Division on Banks and Financial Institutions has pronounced in the following terms: "a necessary condition to achieve a single financial market was the elimination of capital controls still existing in Member States at the end of 1992. This step, necessary to assure the existence of a market fully integrated, was taken in July 1990, although some countries of the Community where allowed to maintain certain restrictions till 1992 and Greece was granted an exemption till June 1994"[35].

The Directive has eliminated the barriers which limited free movement of capitals, even for payments related to retail banking[36]. It is now possible to

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[32].- Steinherr, A. "Financial innovation, internationalzation, deregulation and market integration in Europe: Why does it all happen now?", in Fair and De Boissieu, Financial Institutions in Europe under new competitive conditions", Kluwer, 1990, p. 53

[33].- Directive 88/361/EEC of 24 June 1988 for the implementation of art. 67 of the Treaty. OJ n. L 178, of 8 July 1988. To be more precise, back to 1962 the Community already adopted legislation requiring Member States to allow free movement of capital for direct investment (First Directive for the implementation of art. 67 of the Treaty, O.J. 1960 p. 921; amended by directive 85/583/EEC O.J. 1985 L. 372/39). At the end of 1986 the Council of Ministers adopted a directive requiring member States to liberalise long-term commercial transactions, bond issues and unquoted securities (Directive 86/566/EEC ameending the First Directive for the implemenattion of art. 67, O.J. 1986, L 322/22). Finally, cfr. Programme for the Liberalization of Capital Movements in the Community. Commission Communication to the Council, COM (86) 292 Final.

See Oliver, Peter and Baché, Jean-Pierre, "Free movement of capital between the Member States: recent developments", CMLRev. n. 26, 1989; Vipond, Peter, "The liberalisation of capital movements and financial services in the European single market: A case study in regulation" European Journal of Political Research vol. 19, 1991. It also stands out the recent passage of the Directive on investment services in the securities field, Directive 93/22/EEC, OJ n. L 141/27, which culminates the liberalisation of movements of capitals in the European market. The Directives provides for mutual recognition of licences of investment firms, home country control and harmonisation of essential supervisory standards, in a similar way the Second Banking Directive does for banking institutions.

[34].- Vanheukelen and Pelkmans, "The European integration of financial markets", European Institute of Public Administration, Working Paper, 1986.

[35].- Paolo Clarotti, "Estructura marco de la supervisión bancaria en el mercado interior europeo", *Papeles de Economía Española*, n. 58, 1994, p. 15.

[36].- Article 1 reads "Without prejudice to the following provisions, Member States shall abolish restrictions on movements of capital taking place between persons resident in Member States".

move capital out of one country and invest it in another country. "Corporations can now move capital and invest it at lower cost though there are still the exchange rate and transactions costs that follow from having twelve national currencies as opposed to one. Finally, given that some member states such as Germany and the UK maintain no restrictions on capital movements to non-EC countries, it is increasingly easy to move capital from inside the EC to anywhere else in the world (and vice-versa)"[37]

Again, "the Capital Movements Directive has obvious liberalising consequences because it will be impossible to prevent individuals and companies moving capital wherever they choose, including capital to purchase financial products outside their own country. Furthermore, the liberalising measure has created the conditions for technical spill-over as understood in integration theory. Over time, then, the deregulation of capital movements will promote trade in financial products"[38]

The very existence of potential international flows of capitals has placed all European credit institutions in direct competition. This entails that, to the extent that domestic entities compete with foreign entities subject to different regulations, a situation of mixed competition will appear.[39] This situation of mixed competition could be defined as that kind of competition which does not only refers to economic rivalry among firms but also to competition among administrations and regulators. Mixed competition associated to the process of European integration, presupposes then regulatory competition among different national authorities involved in the industry's regulation.

Nevertheless it was not enough with the liberalisation of capitals and other measures contemplated in the First Banking Coordination Directive[40] to achieve an internal market. In 1987, the Commission delivered a communication to the Council[41] on the liberalisation of capital movements. In the Commission's opinion, even though the liberalisation of capital movements was a prerequisite for the creation of a financial area, it also required services to be liberalised. These provisions, despite of representing a

[37].- Vipod, "Financial Services and the Internal Market, in the book, *The State of the European Community*, edited by Hurwitz and Lequesne. Longman 1991, p. 118. Parenthesis added. We will develope this point infra.

[38].- Vipond, P.A. "The liberalisation of capital movements and financial services in the European single market: A case study in regulation", European Journal of Political Research, vol. 19, 1991, p. 236

[39].- Gual and Vives, op. cit. p. 31

[40].- Directive 77/780/EEC of 5 March 1977, OJ. 1977 L 322/30. For a detailed analysis of this provision, see, Clarotti, "The Harmonisation of Legislation Relating to Credit Institutions" Common Market Law Review, vol.19 n. 2, 1982

[41].- COM (87) 650 final

huge step in the process of banking integration, did not *per se* reached the pretended Single Market; every time a bank crossed a national border, it had to comply with the regulation of the host country, which were very far from being harmonised.[42]

The fact that a credit institution was forced to comply with a second banking supervisory structure may be conceived, in itself, disproportionate and thus discriminatory.[43]

The Preamble of the proposal for a Second Banking Directive recognised that the First Directive had still left three obstacles for the full achievement of the freedom of establishment. First, a credit institution wanting to establish a branch in a Member State different of the one of its domicile must obtain an authorisation of the host Member State; second, such branch was subjected to the control of the supervisory authority of the host Member State and its operational scope could be limited by the provisions of that State; third, in most of the States, branches were required to comply with endowment capital levels, as for the case of the creation of a new credit institution.[44]

Using the distinction between establishment and the provision of services, the liberalisation of movement of capitals is more easily included in the latter. The flow of capitals does not need any permanent presence. Conceivable enough the movement of capitals was the first step towards a greater integration. It however proved incomplete to reach the full

[42].- Paolo Clarotti, "Community objectives and plans for banking", in 1992- *The Single European Market*, IFR London, 1989, p. 58. The rationale behind the directive was one of national treatment clause. Member States had to permit the setting up of branches of Community credit institutions, according to the law and procedure applicable to credit institutions established on their territory. "The shortcoming of the chosen approach of the First Banking Directive is perhaps best illustrated by the fact that also after the adoption of the First Banking Directive, banking remained very much a national business. Thus, in most Member States the legislation required 'endowment capital' (or 'own funds') before commencing banking activities from an establishment. The treatment of branches of foreign banks as 'separate banks' meant in effect that branching was unattrcative for most banks for economic reasons" Nielsen, *Services and Establishment in European Community Banking Law*. Copenhagen, 1994, p. 25

[43].- See Public Prosecutor v Alfred Webb, case 27/80 ECR 1981 p. 3305 and Ministère Publique a.o. v Van Wesemael, case 110/78 ECR 1979 p. 48.

[44].- All these restrictions are eliminated by the Second Banking Directive. Oriol Llebot, "El mercado interior del crédito en el ámbito de la CEE", *Revista de Derecho bancario y Bursátil, vol. 38,* 1990, p. 394-395.

integration.[45] Financial integration consequently requires both freedom of movement of capitals and market access for financial services.[46]

Moreover, this first step could also be explanied under the theoretical distinction between negative and positive integration. "In a negative sense, financial integration may be understood simply to be synonymous with free trade in financial assets (capital mobility); that is, with the elimination of all exchange controls on relevant transactions. But given the vast differences in domestic policies applied to financial activity in each country, affecting rights of establishment or operation, integration in this sense alone would be far from sufficient to remove all forms of discrimination between national states. Integration in a positive sense would be required as well."[47]

Evidence has shown that negative integration leads to a principle of non-discrimination of foreign entitites operating in a given national market. Non-discrimination by an EC Member State amounts to offering national treatment to individuals and firms from other member states. Simply removing all the obstacles that are built in reason of the nationality of the undertaking is not enough to create a transnational banking system[48].

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[45].- Usher, "1992 and the Implications for Banking and Finance: an Overview", in the book *The Single Market and the Law of Banking*, edited by Cranston, London 1992, p.3.
[46].- Lewis, Mervyn, "International Financial Deregulation, Trade and Exchange Rates", CATO Journal, vol. 13 n. 2, 1993 p. 245
[47].- Cohen, "European Financial Integration and National Banking Interests", in the book, *The Political Economy of European Integration*, edited by Guerrieri and Padoan, 1989, p. 147. Note that the Treaty itself provides for both forms of integration. Thus, article 3 contemplates both forms of integration: in paragraph (i) it is established that one of the objectives of the Community will be "the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital"(negative integration), while paragraph (h) provides for "approximation of the laws of Member States to the extent required for the proper functioning of the market" (positive integration).
The SEA also implied a shift in the concepts used in order to build a market. "Although the EEC Treaty already provided for the establishment of the common market by 1970, it now (after the passing of the SEA) stipulates that a further integrated area, known as the internal market, should be established by 1992. A definition of the common market is lacking, but it is generally held that the enumeration of Community activities in Article 3 of the EEC Treaty provides its framework. In the area of financial services, abrogation of discrimination and of other obstacles to the interpretation of the markets within the Community was to be pursued, together with convergence of banking rules. However, a radical abolition of internal frontiers was not forseen. That is precisely how the internal market is defined: '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". We see then, the movement from a common market formulation to a internal market one has its relevant implications. Smits, "Banking Regulation in a European Perspective" *Legal Issues of European Integration*, 1989, vol. 3, p.67
[48].- Cordero, Richard, *The Creation of a European Banking System*, New York, 1990, p. 2

It has been observed that "in the field of the freedom to provide services, the application to foreign firms of the same norms applicable to nationals of that State - which had already been submitted to the control and authorisation of their home State - may lead to a material or 'de facto' discrimination which will reproduce the situation analysed in the Cassis de Dijon case"[49]. Therefore, if the European Community had adopted national treatment (through negative integration only) as an approach to financial integration, the result would have been a level playing field for foreign and domestic institutions within each national market. But, even though each country's rules would have been applied on a non-discriminatory basis, twelve separate markets with different rules in each would still have existed.[50] Thus, measures of positive integration were also needed to reach a truly integrated market.

3.3.2. Freedom of establishment.

Free movement of capital between Member States is undoubtedly prerequisite to the Single European Financial Market (SEFM), but this is unlikely to function properly unless financial services can be performed unhindered throughout the Community[51]. It is precisely for this very reason that the process of creation of an internal financial market needed a second pillar: to guarantee the freedom of establishment.

This second goal has required of a more complex construct[52]. "The regulation of financial services is much more complex than that involved in implementing the Capital Movements Directive. The emerging regulatory

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49.- Luzzatto, "La libera prestazione dei servizi bancari nella Cee ed il principio del mutuo riconoscimento degli enti creditizi", Il Foro Italiano, 1990. IV, p. 448.

50.- Key, "Mutual Recognition: Integration of the Financial Sector in the European Community", Federal Reserve Bulletin, vol 75, 9, 1989, p. 601. "The concept of mutual recognition goes well beyond that of national treatment. Under a policy of mutual recognition some member states in effect agree to offer treatment that is more favorable than national treatment to firms from other states". ibidem, p. 602

51.- Nielsen, *Services and Establishment in European Community Banking Law.* Copenhagen, 1994, pp. 72-73

52.- The most relevant normative provision, although not the only one, is the so called Second Banking Directive, "on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-up and Pursuit of the Business of Credit Institutions and amending Directive 77/780/EEC"; Directive 89/646/EEC of 15 December 1989, OJ 1989 n. L 386/1 of 30 December 1989. This Directive, was preceded by Directive 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" of 28 June 1973, Directive 73/183/EEC, OJ 1973, L194/1, and the First Banking Directive, both analysed above.

order is conditioned by the requirements of the single market and by the consideration regarding the need for regulation that enhances competition yet maintains the soundness of the financial system. It is also conditioned by the reality of pre-existing national markets (including national regulatory systems) and the problems of coordinating directives that would govern in some respects these divergent national frameworks. In responding to this complex starting point the EC's emerging regulatory order has sought to create a single market without necessarily creating a unitary market"[53] In that process came together several elements[54] like mutual recognition of entities, prudential control in the hands of the home country, as well as the fixing of a minimum essential harmonisation conducted by the Commission.

The Commission reached this conclusion after the poor and frustrating results obtained in the years of existence of the Community. "The harmonisation of the essential elements of prudential regulations of the mber states includes aspects regarding the soundness and stability of banks d other financial institutions. The harmonisation of such essential elements of the Community's banking regulations now constitutes the long term goal of the Community, because the meticulous harmonisation efforts in the banking field - judged by their results - have proven to be impractical and cumbersome in many respects. This experience and, primarily, the urgency to complete the common market by 1992 has prompted the Commission to shift is policy emphasis and to adopt as its main tool for integration in the financial field the mutual recognition of the supervisory standards"[55]

It is also noticeable that this integration process encompasses a qualitative as well as quantitative change. Before 1985, the main tool for European integration was centralised harmonisation. Thus each EC member state rules were substituted by a uniform Community legislation. The conundrum was that Member States found it extremely difficult to reach complete agreement on any particular matter. The White Paper replaced this

[53].- Vipond, P.A. "The liberalisation of capital movements and financial services in the European single market: A case study in regulation", European Journal of Political Research, vol. 19, 1991, p. 237

[54].- all of them analyzed in more detail infra.

[55].- Paolo Clarotti, "Community objectives ...", op. cit. p. 59. The same author also underlines the importance of this new approach for the necessary dynamism of banking regulation "Ia A harmonisation of bank's permissible operations had been sought, this exercise would have taken very long even if an agreement had been reached, and some more recent financial transactions that have reached the market through innovation would have been ruled out, thus leaving the issue unsolved. A wise decision then was, in my view, to refrain from seeking any such harmonisation, and to let the market determine what bank will eventually prevail in the unified banking market place" Clarotti, "The Regulatory Framework of Economic y"op. cit. note p. 119.

concept with that of mutual recognition which means there will be no attempt to impose Community-wide rules beyond a core essential regulations and standards. Instead, the EC Member States will be required to recognise the validity of each other's rules and regulations. Mutual recognition will not be an end in itself; the assumption is that mutual recognition will lead to regulatory convergence.[56]

The abandonment of a strategy based on regulatory centralisation as harmonisation tool of the different domestic laws in the financial field, implies one of the most significant steps in the design on a European Union based on a new legal approach. "In recent years, the most successful instrument of economic legislation of the European Commission has been the promotion of competition among national regulations. By forcing the different countries to lower their barriers to foreign entry and by adopting the principle of mandatory mutual recognition of regulatory standards, all companies are authorised to operate abroad on the basis of their home country rules."[57]

However, "considering that capital movements are fully liberalized, it is assumed that the Treaty provisions (article 52) on establishment apply fully to the banking sector. It might therefore be argued that, after the adoption of the Second Banking Directive, the right of establishment for credit institutions will be fully governed by this directive. This is unfortunately not the case. The Second Banking Directive merely covers secondary establishment, and has even so a limited coverage, as it merely includes rules on the establishment of branches. As a consequence of this approach, primary establishment and the setting up of subsidiaries will remain fully governed by the basic Treaty provisions on establishment"[58]

56.- Golembe and Holland, "Banking and Securities", in the book *Europe 1992*, edited by G.C. Hufbauer, Brookings, 1990, p. 68.

57.- F. Modigliani and E. Perotti, "The reforms are overdue", op. cit.. See also Vipond who expresses himself with these words, "the degree to which EC member States have been prepared to accept a new regulatory order, including the free movement of capital, is the clearest indicator possible of the degree to which they have abandoned traditional interventionist industrial policy and also accepted the non-viability of independent national macroeconomic policy making. Subject to the constraints of investor protection and the stability of the financial system, the aim has been to re-regulate to promote competition", Vipond, "Financial Services and the Internal Market, in the book, *The State of the European Community*, edited by Hurwitz and Lequesne. Longman 1991, p. 116

58.- Nielsen, *Services and Establishment in European Community Banking Law.* Copenhagen, 1994, p. 129-130. Cfr. also, Pardon, Jean, "La libre circuation des services financiers: à la recherche de la doctrine de la Cour de Justice à propos des établissements financiers", in Castello -Branco et Pelkmans, (ed.), *Le Marché Interieur des services financiers,* Institut Européen d'Administration Publique. Dcument de Travail, 1987, p. 45

3.3.3 the freedom to provide cross-border services

Financial entities can circulate within the Community, either by establishing subsidiaries, branches, or by providing services. The rights attached to the freedom to provide services and the right of establishment are not necessarily identical. The right of establishment refers to the provision of activities performed from a more or less permanent place of business, while the freedom to provide cross-border banking activities refers to the fact that the provider is located in a different State from where the service is performed[59].

It should be remembered that banking services were excluded from the scope of Treaty provisions on services[60] and that the lack of liberalization of capitals movements made it impossible on practical terms. The Second Banking Directive reverses that situation completely, mainly adopting the policy change announced in the White Paper of the Commission:

> "... some comparison can be made between the approach followed by the Commission after the 'Cassis de Dijon' judgements with regard to industrial and agricultural products and what now has to be done for insurance policies, home-ownership savings contracts, consumer credit, participation in collective investment schemes, etc. The Commission considers that it should be possible to facilitate the exchange of such financial products at a Community level using a minimal coordination of rules (especially on such matters as authorisation, financial supervision and reorganization, winding up, etc) as the basis for mutual recognition by Member States of what each does to safeguard the interests of the public"[61]

59.- This explain the distinct existence of articles 52 and 59 respectively. Cfr. case-law of the ECJ, in Insurance cases: Cases 220/83 Commission v. France 1986 ECR 3663; 252/83 Commission v. Denmark 1986 ECR 3713; 205/84 Commission v. Germany 1986 ECR 3755; and 206/84 Commission v. Ireland 1986 ECR 3817.

60.- For a recent interpretation of the free provision of services, see case 278/92 Schindler 1994 ECR I-1039.

61.- Completing the Internal Market. COM(85) 310 Final. para. 102. Despite the wording of the White paper, there exist some dissimilarities in respect to the conceptual framework for the free movement of goods and for services. As Van Gerven has noticed, "The case-law of the Court on the free movement of persons, services and goods, is undoubtely most developed as regards goods. Conceived at the outset as a freedom prohibiting Member States from adopting measures which discriminated against goods from other Member States, it was rapidly transformed by the Court of Justice into a prohibition of any obstacle imposed by law, regulation or administrative action on trade between Member States. By contrast, the case-law of the Court on freedom of establishment has remained a case-law based essentially on the idea of non-discrimination on the ground of the nationality of the person wishing to set up in a host Member State" Van Gerven, "The Second Banking Directive and the Case-law of the Court of Justice" 10

Thus, although acknowledging some differences between the procedures to obtain mutual recognition for branching and for provision of services activities[62], we will analyze both under the general scheme of the Second Banking Directive.

YEL, 1990, p. 61 . See also Commission Communication concerning the freedom to provide cross-border services, 1993 O.J. C334/03.

[62].- For instance, "While the basic aim of the provisions on freedom of establishment may be to achieve equal treatment for those establishing themselves in a particular Member State, the aim of freedom to provide services is the removal of obstacles to the provision of services rather than equal treatment", Usher, "1992 and the implications for banking and finance: an overview" in Cranston, *The Singe Market and the Law of Banking*, London 1991, p. 5

3.4. The normative basis. The Second Banking Directive.[63]

One might say that the main or core normative instrument trough which the new approach is implemented is the Second Banking Directive of 1989.[64] The culmination of the views expressed in the White Paper of the Commission has been possible thanks to the abandonment of the traditional method, based on the progressive harmonisation of national legislations, and with the adoption of a new strategy consisting in the mutual recognition of equivalent regulations of other States.

"The fundamental aim of the Second Directive is to create a single Community-wide banking market with no internal barriers to movement of banking services and the establishment of branches within the Community. The instruments for attaining this banking market include the creation of a 'single banking license' through 'mutual recognition' and the guarantee of minimum Community standards on prudential supervision."[65] For our purpose, we will concentrate only on three aspects of this complex legislation:

63.- Second Banking Directive, "on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-up and Pursuit of the Business of Credit Institutions and amending Directive 77/780/EEC"; Directive 89/646/EEC of 15 December 1989, OJ 1989 n. L 386/1 of 30 December 1989. More complete studies of the Directive can be found in: Oriol Llebot, "El mercado interior del crédito en el ámbito de la CEE", *Revista de Derecho bancario y Bursátil, vol. 38*, 1990, p. 373; Ebeling, "The proposed second banking coordination directive", *European Law Review*, Feb. 1990; Van Gerven, "The Second Banking Directive and the Case-law of the Court of Justice", *10 Yearbook of European Law*, 1990; Gruson and Feuring, "A European Community Banking Law: The Second Banking and Related Directives"; and Dassese, "Retail Banking Services in 1992", both in *The Single Market and the Law of Banking*, edited by Ross Cranston, 1991; Katz, "The Second Banking Directive" *12 Yearbook of European Law*, 1992; Paolo Mengozzi, "La seconda direttiva bancaria, il mutuo riconoscimento e la tutela dell'interesse generale degli stati membri", *Rivista de Diritto Europeo, n.3*, Luglio-Settembre 1993

64.- Other normative provision that determine the regulatory framework for the integration of the European Banking system are the Directive on Consolidated supervision of 13 June 1983, 83/350/EEC, OJ 1983 L193/18; the Solvency Ratio Directive, of 18 December 1989, 89/648/EEC, OJ 1989 L386/14; and the Own Funds Directive of 17 April 1989, 89/299/EEC, OJ 1989 124/16.

65.- Gruson and Feuring, "A European Community Banking Law: The Second Banking and Related Directives" in *The Single Market and the Law of Banking*, edited by Ross Cranston, 1991, p.20. Also, Strivens, "The liberalisation of banking services in the Community", *Common Market Law Review*, vol 29, 2, 1992. It has been stressed that "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 wil 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". Fraser and Mortimer-Lee, "The EC single market in financial services", Bank of England Quarterly Bulletin, vol. 33 n.1, 1993, p. 92.

the formulation of the principle of mutual recognition; the attribution to the home state of the function of control; and finally, the fixing of minimum requirements through community legislation.

3.4.1. mutual recognition

The principle of mutual recognition basically supposes that a financial entity created in accordance with the regulations of one of the Member States of the Community will be able to freely entry and offer services in any of the other States, and being recognised as a domestic entity[66]."As a rule, any bank validly established in one member state (the 'home country') will have the right to offer its services in another member state (the 'host country'), without having to be established in the host country and without having to modify its banking products in order to make them conform with the local regulations in force in the host country. This is the case in so far as the services in question are those included in the relevant list of qualifying banking activities which is annexed to the Directive. In addition, the bank must be authorised to provide such services in its 'home' country"[67]. Intuitively, the benefits for the liberalisation process are tremendous.

The previous is applicable to the right of establishment through branches (secondary establishment). Under the Directive, a Member State may not require a credit institution already authorised in another Member State to obtain a licence to branch in its territory. The only requirement which is

66.- The principle is formulated in article 18(1) of the Directive: "The Member States shall provide that the activities listed in the Annex may be carried on within their territories, in accordance with articles 19 to 21, either by the establishment of a branch or by way of the provision of services, by any credit institution authorised and supervised by the competent authorities of another member state, in accordance with this Directive, provided that such activities are covered by the authorisation". Hence, "The concept of mutual recognition is the cornerstone of the Second BAnking Directive. Once a credit institution authorized in another Member State to perform banking services within its territory, either through a branch or by way of the provision of services". Nielsen, *Services and Establishment in European Community Banking Law*. Copenhagen, 1994, p. 196

67.- Maitre Marc Dassesse, "Implementation of the new banking Directive - constraints and opportunities", in the book *1992- The Single European Market*. IFR London, 1989, p. 73. Recall however that this mutual recognition of activities which a financial entity is authorised is only applicable to the activities listed in Annex (Annex containing the list of activities subject to mutual recognition) or to those activities which not being listed in the Annex are not submitted to authorisation in the host state. It is widely recognised that the Annex is quite close to the universal banking model, which means a full range of activities, from, acceptance of deposits and lending to money broking and participation in securities issues.
There is a contrasting elements in the formulation of the directive. While a credit institutions is defined very narrowly, the range of activities it can perform and tremendously wide. The directive has opted for a functional (or pragmatic) definition of its scope, instead of an institutional classification.

established is the duty to inform the Home authority of the intention to open a branch in the Host State. Recall that the only authority empowered to deny that right of establishment is the home authority and not the host one. "The only measure that can be taken against the establishment of the branch is a refusal by the Home Member State authorities to inform the Host Member State. This measure may be taken if the Home Member State authorities have reason to doubt the adequacy of the credit institution's organisational structure or its financial situation. The Home Member State must give reasons for such refusal which is subject to a right of appeal to the courts of the Home Member State"[68]

However, the principle of mutual recognition does not apply to expansion through subsidiaries: "the Second banking Directive would appear to favor expansion through branches rather than through subsidiaries by eliminating economic inefficiencies associated with territorial expansion through the use of subsidiaries. This policy choice is significant for two reasons. First, subsidiaries are separate legal entities formed under laws foreign or external to the Home state. Thus, the preference for branching has the effect of eliminating potentially thorny conflicts of laws between the national corporate laws under which a bank's subsidiary has been organized and the banking regulations of the Home state as harmonized by the EC. However, the Second Banking Directive eliminates this conflict of laws problem at the expense of the regulatory authority of the host state. Second, the policy preference for expansion by branching, when combined with the efforts in the EC to consolidate accounting and supervision reflects the adaptation of the 'economic unit theory'."[69]

Nevertheless, we argue that the distinction is not a capricious one. The different treatment of branches and subsidiaries permits a double edged operation of regulatory competition. On the contrary, if home country

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68.- The distinction between branches and subsidiaries is not fruitless. As Dassesse has stressed, the bulk of benefits coming from the new banking regulation system in Europe will be appreciated when using branching for expansion. "It is generally accepted that the liberalisation of financial services in the EC presents considerable opportunities for those operating in the financial markets of the Community. However, it is not so widely appreciated that such opportunities will be most effectively realised by the setting up of branches in, or the provision of cross-border services to other Member States rather than by the establishment of subsidiaries or joint ventures there." Dassesse, "Financial Services and 1992: Significance of Branching and Cross-Border Selling", European Trends, 1989/3, p.74. Gruson and Feuring, "A European Community Banking Law: The Second Banking and Related Directives" in *The Single Market and the Law of Banking*, edited by Ross Cranston, 1991, p. 26

69.- Matthews, Barbara, "The Second Banking Directive: Conflicts, Choices and Long-Term Goals", Duke Journal of Comparative & International Law, vol. 2 n.1, 1992 p. 102-103

principle was to be applied in any case, there will be no mechanism for pressing domestic regulators, apart of entry of foreign institutions.

Instead, the possibiity of exiting a national regulatory regime by means of a subsidiary implies the possibility of benefiting from a more attractive regulatory regime. Thus, the different treatment of branches and subsidiares adds the exit mechanism to regulatory competition. Firms are able to open a subsidiary abroad and thus scape the stricter domestic regulatory regime. "A conceivable strategic response by financial sevices firms to the home country rules is therefore for parent companies to select the regulatory regime in that country with the lowest net regulatory burden and open a subsidiary (and not a branch)"[70]

Thus, regulators will be forced to take into account both the external pressure exerted by means of entry of foreign branches accompanined by their legal regime (home country), and that of domestic firms that establish subsidiaries abroad (host country) and benefit from a more convinient legal regime. "Locational advantages are a relative concept which arise from the specific relation between home and host-country characteristics. They may induce cross-border entry if the host country has certain locational advantages compared to the home country or, alternatively, they may provide a competitive edge if the home country confers certain locational advantages to the entering firm in the host market. Thus, it is not necessarily the case that the host market needs to have 'attractive' locational characteristics to induce cross-border entry. However, it is equally plausible that an entering firm transfers locational advantages from its home market into the host market and thus gains a competitive edge. Thus, locational factors can give the firm a disadvantage in the domestic market and induce foreign expansion, for example, by gaining access to cheaper funds abroad or circumventing a more stringent home country regulatory regime"[71] Finally, it is easy to forsee that firms located in attractive regulatory regimes will choose branching as a way of expansion while, on the contrary, subsidiaries will be used by those registered under a more strict system.

Unlike harmonisation, mutual recognition does not involve the total transfer of powers to the Community but, at most, it restricts the freedom of action of Member States[72]. By the same token, the need of according

70.- Hoschka, T. "Cross-Border Entry in European Retail Financial Services", PhD Thesis EUI, 1992. p. 57, parenthesis added.

71.- Hoschka, T. "Cross-Border Entry in European Retail Financial Services", PhD Thesis EUI, 1992. p. 95

72.- Carosio has also clearly pointed in the same direction when analysing the principle of mutual recognition: "not only does it imply a surrender of national sovereignity, but because

normative instruments among Member States with different legal traditions and regulatory systems is avoided. Last, the new approach creates a competition among national regulators which, like competition among producers of good and services, should provide an efficient way of assessing the costs and benefits of different methods of regulation and increase the range of choice available to consumers[73] Therefore, mutual recognition is an ingenious mechanism to speed harmonization of EC financial services regulation by avoding lenghty negotiations

Also, professor Neven underlines the competition among rules effect of the principle: "by emphasizing trade liberalisation and (effectively, if not formally) adopting the principles of mutual recognition and subsidiarity, the Commission and the Council of Ministers have induced competition among rules and regulators. Previously, the emphasis was put on ensuring the rights of establishments of foreign (EC) firms in domestic markets and harmonisation of national rules. Decisions on principles instituting the framework for competition among rules have proved easier than decisions on detailed plans for harmonisation. In addition, the prospect of competition among rules has encouraged member states to push through new EC regulations in those areas where they anticipate national gains. For example, banking regulation has been championed by the United Kingdom, whereas Germany has been a strong advocate of new regulations on standards for industrial products"[74]

Mutual recognition implies the existence of a multiple set of norms applicable for the same territorial scope[75]. Then, different credit institutions

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power is surrendered not to some overriding federal authority, but to other 'sister' regulators, it also gives rise to competition among regulations", Carosio, G. "Financial Regulation in Europe", London School of Economics (LSE) Financial Markets Group, Special Paper n. 34, 1995, p. 2

[73].- Majone, "Regulatory federalism in the European Community" *Government and Policy, vol. 10,* 1992 p. 308. Parenthesis added. In what relates the improvement of consumer position, it has been pointed that, "unlike in the case of the Common Agricultural Policy (an extreme case of trade diversion) which benefits producers, the main beneficiary of financial market integration will be the European consumer. Either he gains directly as a borrower or as a saver, or he gains indirectly by purchasing services produced with a lower financial cost", Steinherr, Alfred and Gilibert, Pier-Luigi, "The Impact of Financial Market Integration on the European Banking Industry", Centre for European Policy Studies, *CEPS Financial Markets Unit Research Report* n. 1, 1989, p. 37

[74].- Neven, "Regulatory Reform in the European Community, *The American Economic Review. Papers and Proceedings, vol. 82,* 1992, p. 98

[75].- Note the clear ressemblance of the principle of mutual recognition and that of extraterritorial applicability of domestic laws. This is also the so-called 'regulatory pluralism', Padoa-Schioppa, T. "Towards a European Banking Regulatory Framework", Banca d'Italia Economic Bulletin, Feb. 1988.

operating in a same market will be governed by different sets of norms[76] and regulatory authorities and law, will become a decissive element in shaping the competitive position of a banking undertaking. The national regulator who insists on the maintenance of inefficient norms will lead their financial entities to a competitive disadvantage in comparison with other actors governed by a more adequate regulation[77].

This fact produces a competitive pressure that forces regulators to study and adopt innovative policies. As it is illustrated by the OECD report on banks, "although it has not yet been fully clarified what these two principles (mutual recognition and home-country responsibility and control) mean for the establishment in EC countries with different regulatory frameworks, it is conceivable that banks from countries with high-grade universal banking systems will be able to conduct in a host country with a low-grade universal banking system all activities that are permissible under home-country regulation. This would mean, for example, that a bank which is a member of a stock exchange in its home country, would have to be given access to stock exchange membership in all other EC countries including those with traditional stock exchange monopolies. Thus, banks from countries with high-grade universal banking systems would obtain 'better than national treatment' in any host country with a low-grade universal banking system, and 'home-country national treatment' for all operations in the unified market."[78]. Then

76.- Nicosia, Benito, *L'Unificazione del Mercato Bancario Europeo*, 1988, p. 40

77.- "Where harmonisation will not be provided for, one may expect the markets to lead to further convergence of regulatory systems. It will be difficult in a fully integrated economic area to maintain idiosyncracies and particularities that may put the economic operators from within the region at a disadvantage in their competition with economic operators from elsewhere in the common market", Smits, "Banking Regulation ..." op. cit. p. 81.

78.- G. Broker, *Competition in Banking*. OECD Series on Trends in Banking Structure and Regulation in OECD Countries. Paris, 1989, p. 95. Also Llebot, "El Mercado Interior ..." op. cit. p. 380. "As a consequence, any credit institution authorised as such in its Home Member State may exercise in the Host Member State activities that meet such criteria even if the same activities are not permitted to similar credit institutions of the Host Member State. For instance, if a bank is authorised by its Home Member State to participate in securities issues, it is permitted to do so anywhere in the Community, since participation in securities issues is an activity listed in the Annex. On the other hand, if the Home Member State licence does not authorise participation in securities issues, a credit institution may not engage in this activity in a Host Member State even if credit institutions licensed in the Host Member State are entitled to engage in this activity. If the Home Member State license permits travel agency services, a credit institution still cannot conduct this activity in a Host Member State by virtue of the Second Directive, because travel agency services are not included in the Annex." Gruson and Feuring, "A European Community Banking Law: The Second Banking and Related Directives" in *The Single Market and the Law of Banking*, edited by Ross Cranston, 1991, p.24

"The European position is that permiting bank participation in the securities industry secures bank earnings when traditional banking business is less profitable because of increased securitization and stronger competition for deposits. And admitting banks to the securities

harmonisation and convergence will occur in the self interest of Member States.

One of the most illustrative examples is provided by mortgage market. Belgian consumer was deprived of variable-interest mortgage, since these transactions were not permited by Belgian legislation. Since these mortgages are to be considered as a lending activity contemplated in the Annex of the Second Banking Directive, a United Kingdom bank (where variable-interest mortgages are an extended lending practice, specialy through building societies) was allowed to sell these products to Belgian consumer. As a result, the Belgian legislation soon authorised their banks this kind of financial product[79].

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markets adds depth and liquidity to them. In Europe, banks are the only institutions strong enough to provide the capital necessary for a modern securities market. The Community does not have nonbank securities houses comparable in size to those of the United States or Japan. Thus the adoption of the universal banking model will improve the Community's competitive position on the global marketplace", Zavvos, "Banking Integration and 1992: Legal Issues and Policy Implications", Harvard International Law Journal, vol. 31, 2, 1990, p. 481. See also for a more skeptical vision, Steinherr and Huveneers, "Institutional competition and innovation: Universal Banking in the Single European Market", in Mullineux (ed.) *European Banking*. Blackwell, Cambdrige, 1992, p. 130 and ff. and; Clarotti, "The Regulatory Framework of Economic Community", *Annals of Public and Cooperative Economics. Espečial issue on What Bank Model for Europe?*, vol 64 nº1, 1993, pp. 113-121.

[79].-Neven, "Regulatory Reform in the European Community, *The American Economic Review. Papers and Proceedings, vol. 82*, 1992, p. 100. However, this fact does not mean that the mortgage market is a good example of the convergence effects of regulatory competition. On the contrary, it has been stressed that, "The demand for mortgage finance is influenced by, among others, demographic factors, the availability of rented accomodation, the level of disposable income, mortgage interest rates, the tax regime, house prices, expectations of house price inflation and so on. " All these factors are not going to be removed by the abolition of legal restrictions to mortgage market. Thus, the resulting competition will be imperfect and this could limit the benefits of a fully integrated market. Despite of these, general tendencies as the convergence of cost of provision of mortgage financing , as well as changes in the quality and quantity of mortgage products, are observable". For an exhaustive study see, Holmes, Mark, J. "The European Market for Mortgage Finance and 1992" in A. Mullineux, *European Banking*, Oxford, 1992, pp. 148-168. "The arguments that 1992 will provide considerable opportunities and benefits presumes that institutions can provide mortgage credit across borders without too much hindrance. Many EC members are likely to guard many facets of their tax an legal structures jealously. Furthermore, social an cultural considerations are likely to mean that consumers will prefer to transact with institutions that have an indigenous identification. The implication of this is that the mortgage market across the EC may still remain fragmented with supply dominated by local institutions. If in a given country, restrictions on the market for mortgage are eased, it is more likely that existing established commercial banks are better placed to increase their supply. They already have a branch network with an established identity. These barriers to entry (can) constitute a crucial advantage over potential newcomers". Holmes. op. cit. p. 164-165.

In this case, the Belgian supervisor was forced to choose between offering more favourable treatment to financial institutions of other member states than to their own national institutions or granting the latter the same powers. Hence, the principle of reverse discrimination[80] (in the sense of confering their own nationals less powers than those of the foreigners) acts as a tremendously powerful instrument for policy integration.

However, the Directive does not clearly determine the extent of mutual recognition in relation to the activities listed in the Annex. The discussion thus appears as to whether mutual recognition applies to the way the service is provided to the consumer (the financial techniques used or the home country contractual law).[81]

According to the Preamble of Commission's original proposal for the Second Banking Directive, Member States were obliged to ensure that there were to be "no obstacles to the activities benefiting from mutual recognition being undertaken using the *financial techniques* of the home Member State". The final version adopted by the Council substituted the term financial techniques for *in the same manner*. It has been argued that the modification has no practical effects. Thus, mutual recognition would also be extended to the private law of financial instruments[82]. If, on the contrary, the opposite interpretation prevails, it is submmitted that it would mark only a limited advance for the liberalisation of the provision of financial services, particularly in the area of retail banking.[83]

In addition, the Economic and Social Committee expressed in its Opinion in relation to the issue in the drafting of the Directive that the host country would retain the right to require compliance by a foreign bank with all national legislation aimed to promote consumer protection. "While it is true that the legal provisions of contract law which bind the contracting parties with a view of protecting the interests of the weaker, or less well informed party, may amount to an obstacle to the freedom to provide services, the relevant interests in question, however, require that these substantive

80.- Schneider, Uwe H. "The harmonization of EC banking laws: the euro-passport to profitability and international competitiveness of financial institutions", Law & Policy in International Business, vol. 22, 1991, p. 270. See infra.

81.- On the importance of unharmonized contract law and its repercussion of consumer protection, see infra.

82.- Vasseur, "Des Aspects Juridiques de l'Europe Financiere et, plus particulierment, bancaire", Revue de Droit des Affaires, 1991

83.- Dassese, "Retail Banking Services in 1992", in Cranston, The Single Market and the Law of Banking. London, 1991. p. 65.

national legal provisions of the Member States designed to ensure the binding protection for the parties remain in force"[84]

This however does not mean that the whole of 'financial techniques' will be subject to host regulation but only those aspects aimed at consumer protection as mandatory legal rules. The problem, nevertheless, remains in determining whether a given regulation is aimed at consumer protection or not.

In sum, we argue that mutual recognition applied to the banking system will have two direct consequences: first it will be a measure to nullify the restrictions based on different regulatory approaches and practices which exist in the Community[85]; second, this principle will lead to regulatory convergence through the competitive interaction of the different regulatory models[86].

Finally, "Once banks are able through a combination of subsidiaries incorporated in different states and direct branching abroad, to choose the most favourable regulatory framework even for single lines of business, the element of monopoly inherent in government regulation will have all but vanished. With some exaggeration one might say that competition between regulators will engender a tendency towards the privatization of regulation[87]. Private forms of regulation already exist and can be quite useful; examples are the services provided by rating agencies, auditing firms, associations for accounting standards or for professional ethics, and the like. These arrangements are workable even in the absence of enforcement powers, because to banks and other firms reputation has value in selling products, and independent 'watchdogs' can help to provide reputation"[88]

84.- Opinion of the Economic and Social Committee, ESC 287/88/final para. 1.6.4.3

85.- With less restriction to intra Community flows, there will be an increase of competition among banking entities. On this point, see the results in Neven and Roller, "Competition in the European Banking Industry: An Aggragate Structural Model of Competition", 1994 mimeo

86.- "It is clear that in comparison with leaving conditions for admittance of foreign banks to the member states, 'mutual recognition' is a formidable accelerator of convergence and integration", Carosio, G. "Financial Regulation in Europe", London School of Economics (LSE) Financial Markets Group, Special Paper n. 34, 1995, p. 3

87.- See more generally the discussion on self-regulation and soft law in the globalization chapter.

88.- Carosio, G. "Financial Regulation in Europe", London School of Economics (LSE) Financial Markets Group, Special Paper n. 34, 1995, p. 4-5.

3.4.2. Home Country Control

It could be said that the Home Country Control principle is the counterpart of mutual recognition. With the introduction of the principle of mutual recognition, it is achieved what has been called the 'single license', that is, a single banking authorisation granted by one State will be enough to allow the entity to operate or establish throughout the Community. The scenario defined in the Second Banking Directive[89], according to which, from January 1993 onwards supervision of financial institutions will be undertaken by the Member State where they are incorporated and according to which, a bank, once created will be able to freely branch through the Community, constitutes a significant step to force States radically change the procedure traditionally used to supervise those institutions. Instead of applying for a previous authorisation in order to allow banks established in a Member State to branch in another Member State, Member States must accept that those branches operate without any kind of previous authorisation[90].

Moreover, what is most highlighting of the functioning of this principle in the financial field is the fact that the foreign entity operating in another market different from the one where it is incorporated, will be governed the norm of its country of origin (home country). A recent example involves the Bank of England and the Dutch ABN Amro Bank. An individual suing the Dutch bank addressed to the Bank of England, who responded to him in the following terms: "As a matter of law, the Bank's power to intervene in ABN Amro Bank's affairs have been considerably reduced ... and do not extend to questions of the fitness and properness of the managers. It follows that your concerns about ABN Amro Bank's conduct and management should in the future be directed to the Nederlandsche Bank (the Dutch central bank) as the relevant home supervisory authority"[91]

Mutual recognition combined with home-state control principle constitutes a far-reaching legal innovation. "The Treaty provides that Member States must accord national treatment to companies established in the other Member States. After the introduction of the home-state control principle,

[89].- Singularly, article 13(1) provides for, "The prudential supervision of a credit institution, including that of the activities it carries on in accordance with article 18, shall be the responsibility of the competent authorities of the home Member State, without prejudice to those provisions of this Directive which give responsibility to the authorities of the host Member State".

[90].- Paolo Clarotti, "Estructura marco ...", op. cit. p. 15

[91].- Peston, "Bank of England concern over EU supervision directive" Financial Times, 21 January 1994.

Member States may be obliged to grant better than national treatment to branches of other Community banks than they do to their own"[92]

It is interesting to note that while discrimination is no longer permitted reverse discrimination is. In other words, a national authority can insists in maintaining a peculiar regulation applicable to their home credit institutions but cannot force others (which already comply with home country standards) to do so. In reaction to that situation, national industry will lobby regulators to avoid anticompetitive positions. Thus reverse discrimination is a much powerful harmonisation and integrative instrument than the simple no discrimination and national treatment principles.[93] "This possibility of reverse discrimination against the home states own credit institutions is entirely compatible with EEC law, as it stands at present. Expressed otherwise, it is left to the national legal systems to decide whether credit institutions of the home state shall be placed at a competitive disadvantage in comparison with credit institutions of other Member States"[94]

Again, this fact leads to a competitive pressure on the national regulators in order to avoid that its domestic entities are disadvantaged because of an improper or anticompetitive regulation. "Within the Community such reverse discrimination is essentially a strategy to produce harmonisation and is predicated on political agreement of goals for convergence of national regulatory systems"[95] This fact begins to be perceived by the industry itself as it is proved by the writing of Amusátegui, president of the Spanish Banco Central-Hispano: Diversity of regulations passed by the several States constitutes the second element that determines the degree of competitiveness of different banking systems. The Single Financial Market does not imply harmonisation of regulations of Member States but simply the adoption of what could be called a minimum regulation, leaving room to the States to configure their regulatory systems, with the only condition of respect

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92.- Zavvos, Banking Integration and 1992: Legal Issues and Policy Implications", Harvard International Law Journal, vol. 31, 2, 1990, p. 473

93.- The fact that autorisation and supervision is in hands of the home country "means that some member states will in some cases have to offer more favourable treatment to financial institutions from other member states than to their own financial institutions", Lannoo, Karel, "The Internal Market For Financial Services. What has been achieved and what remains to be done", Centre for European Policy Studies, CEPS Research Report n. 10, 1992 p. 10. Cfr. Shaw, "annotation on case 41/90, Höfner v. Macroton, judgement of 23 April 1991. ELRev, 1991 p. 503; Greenwood, "Nationality and the Limits of Free Movement of Persons in Community Law", YEL, 1987, p. 185; Poiares, "We the Court " PhD Thesis. EUI, 1996.

94.- Nielsen, *Services and Establishment in European Community Banking Law.* Copenhagen, 1994, p. 200 and notes accompaining text.

95.- Key, S.J. and Scott, H.S. "International Trade in Banking Services: A Conceptual Framework", *Group of Thirty Ocassional Papers* n. 35, 1991, p. 9

to the limits fixed in the minimum regulation. Thus, different banks would be forced to compete in Europe under regulation of its country of origin. By this means, the competitive struggle is reallocated, to a great extent, from the strictly commercial and private field to the legislative field.[96] It is then perceived the huge importance of regulation for the competitive capacity of private banks. This capacity will be largely modelled by the regulatory quality of the legal environment where banks are incorporated.

Nevertheless, the principle of home country control does not expressely apply in three cases[97]:

1. supervision of liquidity of institutions; (article 14(2) where the host state is responsible for it in cooperation with home authorities).
2. measures applicable in relation to domestic monetary policy; (article 14(2))
3. supervision of risk arising out of open positions on financial markets outside the Home Member State. (article 14(3), jointly with home country authorities).[98]

These exceptions are all related to the creation of a single currency area. This is particularly visible if we take into account that the funding of a branch in another Member State may largely take place in that other State's currency. By the same token, a foreign bank branch's lending operations may have an impact on that State's money supply by increasing the monetary mass. "As long as the Community does not form one single currency area, liquidity supervision and monetary control will have to be entrusted to the authorities of the Member State in whose currency or in whose area the transactions are effected"[99]. Nevertheless, the areas of liquidity supervision and monetary policy present an opportunity to restrict not only free movement of capital but the free provision of services as well. In both respects, restrictions will be carried out primarily by means of banking regulation.[100] "Invariably these types of interventions are taken in response to economic disturbance, but their effects can be a distortion of market forces and impedence of competition. It

[96].- José Maria de Amusátegui, "Exigencias de un marco de competencia para la banca española ante el Mercado Unico Europeo", *Boletín del Círculo de Empresarios, 56,* segundo semestre 1992. p. 99. Cfr. also, Lubochinsky C. and Metais, J. "La Banque a Géométrie Variable: un Nouveau Facteur de Compétitivité", in Fair and De Boissieu, Financial Institutions in Europe under New Competitive Conditions. Kluwer, 1990.

[97].- COM(87) 751 final.

[98].- After the passage of the Capital Adequacy Directive, 93/6/EEC of 15 March 1993, the question of market risk incurred by firms and banks is subject to harmonization and this does not leave much room for the hist state to regulate this area.

[99].- Smits, "Banking Regulation in a European Perspective", LIEI vol. 1989/1, p. 71

[100].- vide for instance our discussion on reserve requirements.

would be interesting if the Court were ever in the position to consider whether these monetary policy interventions were appropriate, proportional or effective under standards of Cassis de Dijon"[101]

1. The General Good Clause

The regime of mutual recognition and home country control contemplated in the Second Banking Directive can further be exceptioned in application of the general good clause, i.e. a State can make use of a restrictive measure when considering that reasons of public policy, public security or protection of consumers - among others - are at stake. The activities of a credit institution's branches in a Host Member State will be supervised by the authorities of the Home Member State. Despite of that, those branches still have to comply with the legal provisions in force in the Host Member State which have been adopted in the interest of the general good. It remains to be seen whether Member States will use this provision to make inroads against the rule of Home Member State supervision[102]

"Under article 21(5) a Member State may apply its own rules, adopted in the interest of the general good, even if, in doing so, it prevents a bank authorized in another Member State from acting in a way that would be allowed in its home country. A host Member State may therefore apply its own conduct of business rules to banks authorized in other Member States. Thus, Member State A, which applies stringent conduct of business rules to banks which enter into transactions in its territory, may deprive banks authorized in State B, a state with relatively relaxed rules, of the competitive advantage they would otherwise have over banks authorized in state A. The ability of host states to

101.- Rossini, Christine, "Cross-Border banking in the EC: Host Country powers under the Second Banking Directive", European Review of Private Law, vol. 4, 1995 p. 581. Cfr. also Matthews, Barbara, "The Second Banking Directive: Conflicts, Choices and Long-Term Goals", Duke Journal of Comparative & International Law, vol. 2 n.1, 1992 p. 116 and ff.

102.- Gruson and Feuring, "A European Community Banking Law: The Second Banking and Related Directives" in *The Single Market and the Law of Banking*, edited by Ross Cranston, 1991, p.26. As expressed by the DGXV itself, "We need to be on guard that the home-country principe of the Directives is not made ineffective through a broad interpretation of the rules of conduct clause by Member States", in Hoschka, T. "Cross-Border Entry in European Retail Financial Services", PhD Thesis EUI, 1992. p. 50
However, the use of the general good clause by Member States in order to justify further restrictions to the principle of Home Country Control is, with no doubt, subject to close scrutiny by the ECJ. For a detailed account of the role of the general good clause in the Directive, see, Katz, "The Second Banking Directive" *12 Yearbook of European Law,* 1992. See also Key, "Mutual Recognition: Integration of the Financial Sector in the European Community", Federal Reserve Bulletin, vol 75, 9, 1989, "The European Court of Justice has already played a major role in establishing a public interest test for host-country regulation and in determining whether that criterion has been met, and it will undoubtely continue to do so". ibidem p. 602

apply their own conduct of business rules to banks authorized in other Member States limits the opportunity for a competition between regulatory regimes within the Community. It may, therefore, require future harmonization to clear the way for competiton between regulatory regimes. Indeed, the Commission has already expressed its intention to achieve the harmonization of conduct business rules"[103]

However, the delimitation of this general good has to be interpreted at the light of the Community Law. The ECJ cas law[104] has traced some guidelines for the definition of the general good in relation to the freedom to provide services:

- the exception cannot refer to areas already harmonised by Community legislation
- it cannot duplicate similar provisions which are already in force in the home State which is penetrating the local market. That is, if Germany already has legislation protecting the consumers, a host state cannot invoke consumer protection as a general good clause to exception the free provision of German services.
- the exception has to be applicable in a non-discriminatory way. That is, the exception has to be appicable both to domestic and foreign institutions or providers of services. However, this national treatment limit does not prevent per se discrimination. A State can ban products offered only by foreign banks, as long as home banks are subject to the same rule provided the general good argument is convincing.
- the measure has to be necessary to protect the interest at stake and proportinal to the end.

The wide variety of consumer protection issues relating to banking and financial service products in general could lead to repeated ECJ approval of Member State restrictive measures and hence, to erode the Single Market Objectives of the harmonisation Programme. Thus, the ECJ has to balance in

103.- Bradley, Caroline, "1992: The Case of Financial Services", Northwestern Journal of International Law & Business, vol. 12 n.1, 1991 p. 148-149. Cfr. also Explanatory Memorandum to the Proposal for a Council Directive on Investment Services in the Securities Field. COM (88) 778-SYN 176 32 O.J. C-43.

104.- On December 1, 1989, Sir Leon Brittan, Commissioner responsible for banking answered a parliamentary question on the meaning of general good referred to in the draft of the Second Banking Directive. In doing so, he made reference to the Court of Justice rulings and in special the German Insurance Case (Case 205/84 Commission v Germany ECR 1986, 3775). O.J. 139/14, answer given by Sir Leon Brittan on behalf of the Commission, 24/01/1990.

any case the interests of the general good and the goals of the Single Market Programme.[105]

This is reflected in the 16th Recital of the Preamble of the Second Banking Directive when establishes that:

> "Whereas the Member States must ensure that there are no obstacles to carrying on activities receiving mutual recognition in the same manner as in the home Member State, as long as the latter do not conflict with legal provisions protecting the general good in the host Member State".

This wording suggests the general good will play an important role in determining the permissible limits of mutual recognition of financial techniques for conducting the activities listed in the Annex.[106]

Van Gerven[107] proposes an interesting way of limiting the broadness of the general good clause: the combined reading of arts. 19(4) and 25 (5) of the Directive. Article 19 establishes that the host Member State has to notify the national provisions which may be applied to branches. The combined reading would mean a restriction of the general good clause only for those matters already notified. The advantages of this interpretation are fourfold:

- there is no need to comunicate all the legislation with which the branches will have to comply. Only provisions considered to be in the interest of the general good need be communicated. This does assist the credit institutions in so far as they will no longer have to study legal systems with which they are not familiar to discover the provisions their branch will have to comply in carrying on its specific activity.
- the scheme set up by the directive also implies that in the event of disputes the onus will be on the competent authority of the host Member State to stablish that the application of the contested provision is in fact justified on grounds of the general good.
- the competent authorities of the host Member State must satisfy the obligation within a specific period, namely within two months of the date on which the competent authority of the home Member State notifies them that a credit institution wishes to open a branch

105.- Molyneux, Phil, "Europe's single banking market and the role of State autonomy", IEF. University College of North Wales. Research Papers in Banking and Finance, n. 94/10.
106.- Katz, Sherman, "The Second Banking Directive" 12 YEL, 1992 p. 259
107.- Van Gerven, "The Second Banking Directive and the Case-law of the Court of Justice", 10 YEL, 1990; idem, "La deuxième directive bancaire et la jurisprudence de la Cour de Justice" Droit Bancaire et Financier, 1/1991.

- the method chosen is likely to put in a train the harmonisation of the national provisions concerned. It may well be that the competent authorities will draw up one or more lists of national provisions adopted in the interest of the general good which will be used as models for individual communications to be made to credit institutions wishing to establish a branch. It is not unlikely that the Commission will endeavour to organize consultation between competent authorities with a view to clarify and harmonize the Member States' criteria contained in such lists for identifying provisions adopted in the general good.

In any case, however, these proposals seem to be foreclosed by the Draft Commission Communication on 'the freedom to provide services and the interest of the general good in the Second Banking Directive'.[108]

In one way or another, the Second Directive leaves considerable room to Member States to establish conditions in the interest of the general good under which credit institutions from other EC Members must carry on their activities. "At the same time, the references to the general good in the Directive and the available legislative history indicate that the Commission and Council intended national derogation for reasons of the general good to be the exception rather than the rule. This would be consistent with the practice of the European Court in earlier service cases regarding the general good. The Court will play a decissive role in determining which national measures qualify as exceptions to the goals of the Second Directive. The Directive specifically contemplates that national rules adopted for the general good will affect advertising and efforts by credit institutions to carry on their activities in the same manner in which they conduct them at home. Member States will remain free to adopt general good restrictions on credit institutions and activities not qualifying for mutual recognition under the Directive"[109]

The role of the ECJ corresponds perfectly to one of arbiter in a process of regulatory competition. There will be efforts by the States to characterize its regulation as falling within the criteria of the protection of the general good, while the State wanting to enter the local market will present evidence of the contrary. The resemblance with the balancing of interests in the combination of art. 30 and 36 of the Treaty in relation to free movement of goods is clear. Hence, the ECJ will be the supra-parties instance entrusted with the protection of the fairness of the competitive process.

108.- 95/C 291/06 OJ No C 291/7 of 4. 11. 1995

109.- Katz, Sherman, "The Second Banking Directive" 12 YEL, 1992 p. 264.

Recently, the ECJ has had the opportunity to apply this concept in case 384/93 Alpine Investment BV[110].

The case deals with an article 177 reference where the questions raised by Alpine Investment BV(a Dutch undertaking) challenged the restriction imposed on it by the Dutch Ministery of Finance prohibiting it from contacting individuals by telephone without their prior consent (cold calling).

Thus, the prohibition at issue is imposed by the Member State in which the provider is established (Home state) against a domestic firm, which, nevertheless offers corss-border services. As stated in paragraph 38 "A prohibition such as that at issue is imposed by the Member State in which the provider of services is established and affects not only offers made by him to addressees who are established in that State or move there in order to receive services but also offers made to potential recipients in another Member State. It therefore directly affects access to the market in services in the other Member States and is thus capable of hindering intra-Community trade in services".

The Court upheld the restrictive measure, not based on the protection of the consumers (in any case the protection of non-national consumers is not a matter for the Dutch authorities) but on the maintenance of the good reputation of the national financial sector.

As a result, "the ECJ has now generally conceded that the maintenance of the good reputation of national financial markets can be a mandatory requirement to protect the general good which justifies restrictions on the free provisions of financial products."[111]

Undoubtely, this is a pretty wide form of conceptualizing the 'general good' clause which in turn means that the ECJ is prepared to admit a great deal of restrictions to the movement of banking institutions and services.[112] Moreover, the concept of 'reputation of financial markets' is highly subjective and will include cultural assumptions about the property of certain activities. Therefore, the previously mentioned balance between market integration and

110.- Judgement of 10 May 1995, ECR 1995, I-1141

111.- Knobl, Peter F. "A Milestone in European Banking and Investment Services Law as well as in the Scope of the Freedom to Provide Services in the EU", Maastricht Journal of European and Comparative Law. vol. 2 n.3, 1995 p. 313.

112.- However, it has to be recalled that in the present case, the general good clause is not adopted by the Host State in order to prevent the provision of a cross-border service in its national territory. On the contrary, it is the Home State itself who imposes a restriction which has effects on intra-Community free circulation of services. Finally, one must guess if the result had been the same in a case where the cold-calling prohibition had been alleged by the Host State.

national interests seems to be decided in favour of the latter, in clear detriment of market integration through regulatory competition.

Consequentely, although the directive adopt the rethoric of home state control, both a close reading and the jurisprudence of the ECJ seems to indicate that there will be a substantial level of host state control.[113] This implies the existence of considerable scope for the individual action of Member States which in turn interfere with the development of the SEFM.

However, things may be seen under a different point of view. One could consider that this dynamic distribution of supervisory functions between the home and the host country, characterizes a system of imperfect mutual recognition in European banking, where both the traditional principle of mutual recognition and the possibility of intervention for the host state in order to regulate certain aspects, are combined.

Then it results that: "The EC has not been able to implement pure mutual recognition for financial services. Credit institutions and investment firms providing services in a Member State that is not their home Member State, still have to comply with some domestic regulations of the host market. A good example of imperfection is provided by rules of conduct. Host Member States retain the power to enact specific conduct of business principles and to enforce them against domestic as well as non-domestic financial intermediaries. However, such an imperfection does not result in higher barriers to entry than under national treatment or pure mutual recognition, especially considering that the EC will move toward the latter as soon as uncertainty and compliance costs are significantly increased by imperfect mutual recognition. Imperfect mutual recognition is not likely to bring significant additional costs, as financial intermediaries are already used to grasping and obeying multiple sets of rules of conduct. On the other hand, imperfect mutual recognition should allow better competition among rules of conduct because of the higher freedom in the mix of liberal/severe requirements, which in turn should increase the efficiency of the system. Consequently, the inability of EC Member States to agree upon an essential requirements in the financial services area should not be seen as a failure. On the contrary, as they have succeeded in providing a European passport, they should probably be commended for having accepted a certain level of imperfection."[114]

113.- Bradley, Caroline, "1992: The Case of Financial Services", Northwestern Journal of International Law & Business, vol. 12 n.1, p. 150

114.- Hertig, "Imperfect mutual recognition for EC financial services", International Review of Law and Economics, vol. 14, 1994, p. 185-186. It has also been stressed that since contract law is far from being harmonised, different rules of conduct would persist: "According to others, the

2. Home Country control and the fear to a race to laxity

In this framework, it can result, as has been warned by one of the most eminent experts of this field that "for instance, the operation of the country of origin principle to the solvency, supervision an initial authorisation of financial entities, together with the host country principle for the deposit insurance system, might offer incentives to national regulators to be extremely liberals when fixing standards with the objective of conferring its banks a competitive advantage abroad (particularly if a significant part of their operations are developed in other states). According to this, if a national bank has problems abroad, the deposit insurance scheme of the host country will bear the costs. In the case of the insolvency of the Bank of Credit and Commerce International (BCCI), the vast majority of its clients were not residents in the country where the bank was incorporated (Luxembourg), and thus, the costs of the insolvency were placed on the shoulders of foreign clients or their insurance systems"[115] We will see however that the regulatory response in the case of deposit insurance forecloses this possibility.

White Book standards cannot possibly be equally applied to the banking industry because financial techniques or products, unlike industrial products, cannot, at least not at all times, be separated from the underlying legal relationship, usually a contract. The (mutual) recognition of that financial techniques would, in fact, result in the application of other than national regulations within one and the same system", Clarotti, "The Regulatory Framework of Economic Community", op. cit. note p. 115.

115.- Vives "Desregulacion y reforma ...", op. cit. p. 10. In the same direction, Dermine points that "the possibility of competitive deregulation raises immediately the question of the need to harmonise regulations at the international level. This issue is particularly relevant in Europe since, according to the home country principle, nationals from one particular country will be offered services from institutions supervised in another country" Dermine, EC Banking Regulation, op. cit. p. 18. As a result of the experience of the BCCI some modifications are proposed to the First and the Second Banking Directives in the line of do not "grant a banking licence where the bank belongs to a group structure, unless the structure is sufficiently transparent to allow for effective supervision of the credit institution. Any material change in the conditions under which the competent authorities have granted a licence will have to be reported. The authorities are to have the power to withdraw the licence when transparency is reduced to such an extent that the bank can no longer be supervised effectively. Another requirement is that a bank's head office is to be located in the same State as that of incorporation. Confidentiality requirements are lifted in order to enhance co-operation between banking supervisors and other authorities in the investigation of banks. Finally, external auditors will be required to report relevant information to the banking supervisor". Adenas, Current Developments: European Community Law. *International and Comparative Law Quarterly vol. 43 part 3,* 1994, p.731. See also, Quinn, Morgenthau y Bingham, "Banking supervision after BCCI", *LSE Financial Markets Group, Special Paper n. 54,* August 1993.

Moreover, in our view competition among European financial markets will not trigger a deregulatory free-for-all. The main impact of the new EC directives will be the dismantling of entry barriers; and thus the reduction of rents enjoyed by the more inefficient and protected financial institutions. In addition, the EC legislation has applied the principle of subsidiarity (delegation of legislative prerogatives to the national level) for financial regulation of markets, implicitly encouraging competition among legal-regulatory codes to provide a sound and reliable financial environment.[116]

The fear of a competitive deregulation or 'race to the bottom' deserves some closer attention. First it has to be recognised that the operation of the principle of mutual recognition can be restricted by the Host State. The existence of the 'general good' clause means that a Host State can insist in the respect of its national legislation when, otherwise, reasons of public policy would be at stake. Then, when a Host State may invoke restrictions on banking activities adopted in the interest of the general good, we are in front of a powerful brake on an hypothetical race to the bottom.

Second, the Directive itself, concious of the possibility of dangerous lowering of regulatory standards, forsees the possibility for a Home State to deny authorisation in the cases where it is evident that the bank is registered in one Member State with the only end of avoiding stricter standards[117]. Thus, Recital 8 of the Preamble states that:

> "the principles of mutual recognition and home Member State control require the competent authorites of each Member State not to grant authorisation or to withdraw it where factors such as the activities programme, the geographical distribution or the activities actually carried on, make quite clear that a credit institution has opted for the

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116.- F. Modigliani y E. Perotti, "Reforms are overdue" op. cit..

117.- The European Court of Justice, in its interpretation of the fundamental freedoms of establishment and services (e.g. case 205/84 Commission v Germany (1986) ECR 3755 and case 33/74 van Binsbergen (1974) ECR 1299) and indeed, the free movement of goods (case 229/83 Leclerc (1985) ECR 1), has made clear that such freedoms may not be used (or abused) simpy to evade or circumvent those rules in force in another Member State that would otherwise be applicable to them. This balancing of the right to exercise the fundamental freedoms with what are essentially public policy considerations is deemed necessary in the light of the current levels of harmonization in the Community. Thus, the inclusion of such an approach in Recital 8 may well reflect future interpretations by the ECJ which could hold by analogy that such limitations are applicable to the estabishment of companies in the Community", Dassese, Marc, "Retail Banking Services in 1992" in Cranston, *The Single Market and the Law of Banking*, London, 1991 p. 70.

legal system of one Member State for the purpose of evading the stricter standards in force in another Member State"[118].

For the same reasons, it is required that the head office of a bank and the registered office be situated in the same Member State.

As a consequence, and product of the fear of the race to the bottom, the possibility of forum shopping is curtailed. Instead we argue that forum shopping or, more neutrally, regulatory arbitrage should be seen as a normal circumstance in the operation of regulatory competition and as an adequate instrument to discipline the regulatory administrations. As expressed by Lannoo, "Member states are required to recognise the validity of the laws and regulations in force in other member states and agree not to exploit the differences between regulatory systems to protect their national markets"[119] Therefore, more than fearing an unlikely competition in laxity, the provision should be blamed for hindering one of the intrinsic elements of the new regulatory model.

Finally, the very existence of fixed minimum standards[120] at Community level prevents the development of a 'race to the bottom' dynamic. Since the harmonisation Directives set out the lower limit for a process of regulatory competition - which is not equivalent to that existent in

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118.- As Key illustrates, "In theory, a Greek bank could establish a subsidiary bank in London and the London subsidiary could branch into Greece under home-country (that is UK) control. The Greek branch of the London subsidiary of a Greek bank might thus have broader powers to conduct activities in Greece than would its parent bank". Key, "Mutual Recognition: Integration of the Financial Sector in the European Community", Federal Reserve Bulletin, vol 75, 9, 1989, p. 603. This is precisely the kind of forum-shopping than the Directive tries to prevent. In any case, the potential existence of this complicated organisational structures will increase the pressure for regulatory convergence. Moreover, as Bradley has pointed, "the Recital expresses no more than a pious hope, because the operative provisions of the Directive do nothing to force the supervisory authorities in the Member States to turn away banks applying for authorisation" Bradley, "Competitive Deregulation of Financial Services Activity in Europe after 1992", *Oxford Journal of Political Studies*, vol. 11 n. 4, 1991

119.- Lannoo, Karel, "The Internal Market for Financial Services", Centre for European Policy Studies (CEPS) Research Report n. 10, Brussels, 1992, p. 4

120.- On the top of that, it has to be noticed that minimum standards can be highered by Member States in respect to their financial institutions. As stated in Recital 9 of the Preamble, "the home Member States may alow establish rules strciter than those laid down in articles 4, 5, 11, 12 and 16 for institutions authorised by its competent authorities". Moreover, it is arguable that since the regultory floor is fixed in the Directives, the only way for regulators to compete with other jurisdictions will be to impose higher standards, leading to a race to the top and not a race to the bottom.

the less protective regulatory order - a race to the bottom, understood as the lowest common denominator, is legally impossible.[121]

Moreover, the new legal framework for banking regulation should not be characterised as a simple deregulation but instead a deregulation accompained by a re-regulation[122]. "Deregulation refers to the opening up or liberalisation of financial markets to compete more freely. This environment factor may be labelled as structural deregulation. At the same time, banking supervision (or prudential regulation) is growing and becoming more formalized or re-regulated. The evolving single financial space is characterized by the twin regulatory forces of structural deregulation and supervisory (and investor protection and conduct business rules) re-regulation".[123] Therefore, "regulatory reform is a better description than deregulation which implies the complete abandonment of regulation instead of selective removal and a shifting emphasis. Much of what passes for deregulation consists of a change from regulatory to market actions and within the category of regulatory actions, from structural controls to conduct and protective measures"[124]

As pointed out by Woolcock, "While deregulation may be a means of attracting more international investments and business, the experience of the early deregulation innitiatives in the 1980s showed that investors are also concerned about the protection of their investment and are reluctant to place funds in a capital market which cannot provide sufficient protection for the investment. Therefore regulation to ensure the prudential security of financial institutions becomes a means of attracting investment (race to the top)"[125]

The fear of a deterioration of standards through a competitive race could be interepreted as a debate about the real limits of necessary regulation. Finding a core element in the definition of a regulation prevents some of the actors of fearing an unfair deviation of it. "Problems would be less likely to arise the greater the theoretical agreement among the member states as to the line between liberalisation and laxity - that is the distinction between national

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121.- Nielsen, *Services and Establishment in European Community Banking Law.* Copenhagen, 1994, p. 51. "The process is interactive: mutual recognition requires initial harmonisation, and additional harmonisation results from mutual recognition. In adopting the approach of mutual recognition in the financial area, the Community is in effect using trade in financial services as a lever to arbitrage the regulatory policies of the member states". Key, op. cit. p. 604

122.- Majone, *Deregulation or Re-regulation. London,* 1992; Button, K. and Swann, D. *The Age of Regulatory Reform,* Oxford, 1989.

123.- Gardener, E.P.M. "Banking Strategies and 1992" in Mullineux (ed) European Banking. Oxford 1992, p. 114. 252

124.- Lewis, Mervyn, "International Financial Deregulation, Trade and Exchange Rates", CATO Journal, vol. 13 n.2, 1993 p.

125.- Woolcock, "The Single European Market ..." . op. cit. p. 41. Parenthesis added.

rules that have primarily the effect of imposing barriers to trade in services and national rules that are necessary for prudential purposes or for consumer protection. For example, a consensus exists within the Community that permiting all forms of securities activities to be conducted in a bank or its subsidiary is a positive, liberalising measure"[126]

However, some areas of application of the home country principle can be seen as excessive or dangerous for a smooth functioning of supervisory rationalisation. For instance, there are some areas of supervision reserved primarily for host state control, while responsibility for enforcement remains primarily with the home State authorities (art. 21(2) to (4) lays down a procedure for enforcement in those areas). On noticing a breach, the host state authorities must first require the institution concerned to put an end to that irregular situation. If this does not result in compliance, the host State authorites must inform the home State authorities who shall, take the appropriate measures to ensure that the institution concerned puts an end to that irregular situation. The host State authorities shall be informed of the measures adopted. It is only when these measures fail and non-compliance persists that the host State may take appropriate measures to prevent or tu punish further irregularities. The effectiveness of these procedures may be questioned. It is suggested that they represent an attempt to apply the home State control principle in a manner which is unjustified, goes further than is envisaged in the White Paper and is likely to result in inefficient and ineffective enforcement in host States[127]

To sum up, "the method of coordination which the Community has adopted will not inevitably result in competitive deregulation. It is possible that some institutions would consider the investor and depositor confidence which would result from regulation under a strict system could outweigh the competitive advantage provided by regulation under a relaxed system. A Member State could market its regulatory system as a system of tough effective regulation designed to promote investor confidence. This phenomenon is the 'struggle to the top'. Some Member States apply rules stricter than those of the relevant EC Directives and there are signs of a reluctance to weaken these rules"[128] This is specially important since "the comparative advantage of a

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[126].- Key, op. cit. p. 605. This is similar to the approach of the ECJ in the wood-working machines. Case 188/84, Commission v France, Rec. 1986, p. 436

[127].- Strivens, Robert, "The liberalization of Banking Services in the Community" CMLRev. vol. 29 n. 2, 1992, p.

[128].- Bradley, Caroline, "1992: The Case of Financial Services", Northwestern Journal of International Law & Business, vol. 12 n.1, p. 159. As ponted out by Chick and Dow, "financial institutions are based on confidence of their lenders and quite detailed knowledge of their borrowers. Confidence is based on continuity of reputation, long to built and easy to lose.", Chick V. and Dow S.C., "Competittion and the future of the European Banking and Financial System",

bank, much more than in industry, is not primarily embodied in a particular product or production process, but in reputation, confidence and customer proximity. As a result, bank clients not only find it difficult to compare effective prices but they also are unlikely to react elastically to any changes"[129]

3.4.3. Minimum standards

Even recognising that the principle of mutual recognition, in its wide formulation might imply risks, this fact by itself does not invalidate the model of competition among rules. On the contrary, what is required is to adapt the rest of the regulatory framework to this new reality. It would be misleading to characterize the new approach as one granting *carte blanche* to Member States.

Therefore, the Community has opted for a system of restricted mutual recognition, that is the introduction by the Community institutions of minimum or essential standards that make feasible the operation of this system of equivalence among legislations[130]. On the other hand, Member States must change the procedure through which foreign financial entities were traditionally supervised. Instead of requiring previous authorisation to all banks established in the EC which wanted to enter its national market, Member States have to accept that those banks will operate without any previous authorisation. In order to adapt to this new scenario, it was necessary to guarantee that the supervisors knew they were implementing the same minimum standards that their supervisory colleagues in other Member States. Any credit institution established in a Member States has to comply with some pre-conditions before being authorised to operate in the whole Community territory.[131]

University College of London. Discussion Papers in Economics 94/16, 1994. See, Vogel and the discussion of the California effect, where regulators compete with foreigners by raising than lowering standards. Vogel, David, *Trading Up: Consumer and Environmental Regulation in a Global Economy*. Harvard University Press. Cambridge 1995.

[129].- Steinherr, Alfred and Gilibert, Pier-Luigi, "The Impact of Financial Market Integration on the European Banking Industry", Centre for European Policy Studies, *CEPS Financial Markets Unit Research Report* n. 1, 1989, p. 16-17.

[130].- Mutual recognition cannot simply be decreed among a group of countries with widely divergent legal systems, statutory provisions, and regulatory and supervisory practices. Mutual recognition of rules that differ as to what a country regards as essential elements and characteristics would be politically unacceptable. As a result, a crucial prerequisite for mutual recognition is the harmonisation of essential rules. If a member state consider certain rules essential but cannot reach agreement on initial harmonisation, they may agree explicitly to exclude such rules from mutual recognition and home-country control until agreement can be reached". Key, "Mutual Recognition: Integration of the Financial Sector in the European Community", Federal Reserve Bulletin, vol 75, 9, 1989, p. 602

[131].- Paolo Clarotti, "Estructura marco ...", op. cit. p.15

In this way, it can be observed how a system of regulatory competition forces a increase of cooperation among regulators. Banking regulators, in our case, must increase the mutual exchange of information concerning activities of the banks they supervise in order to be able to carry out an effective control of them.

The fixing of these common elements takes place by means of the following elements:

• minimum capital requirements to create and run a bank, fixed in 5 million ECUs[132].

Note that this capital requirement is only established as a minimum. Nothing prevents Members States to impose their own banks a reserve requirements higher to that provided for in the Directive. Nevertheless, "a number of existing credit institutions, especially smaller banks in Germany, Italy and Spain will be totally incapable of meeting this requirement, because their local orientation has resulted in only minor financial capacity. As they are already licensed, they do not need to meet the new special requirements, but the Second Banking Coordination Directive Article 8 will require them to own funds totalling up to 5 million ECU by 1997. This quite severe obligation is imposed on these banks with the aim of a free common banking market, that they propably never wanted. These banks are tipically interested in local servicing and will face fierce competition from international banks whose operations do benefit from the Second Banking Coordination Directive"[133]

• disclosure requirements for effective supervisory control on the main shareholders.

132.- Article 4(1) of the Second Banking Directive establishes that: "The competent authorities shall not grant authorisation in cases where initial capital is less than ECU 5 million".

133.- Ebeling, J.W. "Freedom of establishment and freedom to provide services. The proposed Second Banking Coordination Directive" ELR, Feb. 1990, p. 65. This element may be interpreted as another manifestation of the complex phenomenon of regulatory competition, i.e. the competition among regulatory models to be adopted as the basis for harmonization strategy within the Community. "Member States engage in a regulatory contest to shape European Policy, to champion their interests and push through their policy concepts. All member states are interested to a greater or lesser degree in putting their stamp on Community policy (...) The motivation has been to minimize the cost of adjusting to European legislation and to avoid the regulatory costs harming the competitive position of domestic industry", Heritier, Knill and Mingers. Ringing the Changes in Europe. Regulatory Competition and the Transformation of the State. Walter de Gruyter, Berlin, 1996, p. 331

By virtue of article 5 of the Second Banking Directive, it is a compulsory requisite for the granting of authorisation, the disclosure of the identities of the shareholders or members, whether direct or indirect, natural or legal that have qualifying holdings, and of the amounts of those holdings. The Council also adopted Directive 92/30/CEE on the Supervision of Credit Institutions on a Consolidated Basis.[134]

- adequacy of capital in relation to the risk[135].

"In essence, the Solvency Directive will set minimum capital requirements to support different types of banking assets. As these requirements are generally more strict than current EC norms, the effect is to increase banks costs. Just how the banking industry will respond tactically to this increase of costs is not yet clear, but there must be additional pressure to raise spreads and charge fees to reflect increased capital requirements, Of course demand for traditional banking services may fall as a consequence and there may be a further trend towards disintermediation. There are also competitive business development implications. While banks in all EC and BIS signatory nations' will be subject to roughly similar requirements, they are not all starting from the same position. Among the major European banks, the British and the Swiss are already comfortably meet or exceed the capital adequacy minimum and will therefore not have to curtail their business development activities. However, most French and German banks will need to raise new capital and/or disclose their hidden reserves. The capital adequacy rules clearly bias competitive advantage in favour of the well capitalised banks."[136]

134.- OJ L110 of 6 April 1992.

135.- Directive on the "Own Funds for Credit Institutions" of 17 April 1989, 89/299/EEC, OJ L 124/16, of 5 May 1989; and Directive on a "Solvency Ratio for Credit Institutions" of 18 December 1989, 89/647/EEC OJ L 386/14 of 30 December 1989. For a criticism of the system of adequacy capital-risk, see Davis, where it is argued that the system is to rigid, requiring the same percentage regardless of the size and leverage of the firm. Davis, "Problems of Banking Regulation",LSE Financial Markets Group, Special Paper n. 59, 1993 p. 17. See also, Kane who holds that "such international agreements (the Basle agreement on capita adequacy) are inherently suspect, since regulators are under a shorter time horizon than taxpayers, and are see as seeking to extend or defend their share of the market for regulatory services in the face of disturbances in economic environment, subject to bureaucratic , market and technological constraints. As such, the Basle agreement is seen as a form of cartel imposing costs on financial firms which they cannot escape by switching to other regimes. A similar critique could be made of EC proposals more generally, to the extent they entail harmonisation and not competition between regulators" Kane, "Incentive conflict in the international regulatory agreement on risk-based capital" NBER Working Paper n. 3308, 1990.

136.- Norrington, H. "Strategies for competitive advantage - banking", Reestructuring Europe's Financial Services. 1992 and Beyond. The Economist Conference Unit, 1989, p. 60-61

• limits to the concentration of credits.[137]

The Commission initially choosed the Recommendation as normative instrument in order to permit the banking system to adjust more flexibly to the changing environment of the credit markets. Also, since a Recommendation is not a binding instrument it would allow some degree of diversity among Member States.

• control of the significant investments of banks in non-banking sectors.

Although the banking model advocated for in the Second Banking Directive is that of universal banking, there are some restrictions to the participation of banks in non-credit institutions[138]. This participation is subject to a double limit: no credit institution may have a qualifying holding of more than 15% of its own funds in a single undertaking; and the total amount of participation in non-banking sectors cannot exceed 60% of its own funds. (article 12(1) and 12(2) respectively).[139]

• existence of deposit insurance systems which cover all financial institutions in the Community [140]

• the obligation of branches regarding the pubication of annual accounting documents (Directive 89/117/EEC)[141] and consolidated accounts (Directive 86/635/EEC)[142]. The prupose of these Directives is to make it

[137].- Commission Recommendation on Monitoring and Controlling Large Exposures of Credit Institutions, 87/62/EEC, OJ L 33/10 of 24 February 1987; Draft Large Exposure Directive COM XV/286/89, Rev.1.

[138].- It is difficult to justify these restrictions taking into account that the bank by itself can engage in securities transactions as one of the elements listed in the Annex of activities. The Commission has justified those restrictions in the name of the protection of liquidity and stability of banking institutions. See COM (87) 715 final pp. 9 and ff.

[139].- However, this restrictions may not be applicable for banking participation in the insurance sector. Moreover, the Directive provides for a transitional period of 10 years to allow the banks that exceed those limits to bring into line with them.

[140].- Although there is no strong reason to advocate to a uniform condition of insurance schemes throughout the Community, it is aknowledged that a minimum should be set. The proposal for a Directive on deposit insurance was delivered in june 1992. COM(92)188, OJ C 163 of 30.6.1992. A final agreement has been reached and the proposal has been enacted by the Council and the European Parliamente as Directive 94/19EEC of 30 May 1994. OJ L 135 of 31.5.1994.. Because of the crucial significance of the deposit insurance issue, it would require a study by itself. See infra.

[141].- O.J. 1989 L 44/40

[142].- O.J. 1986 L 372/1

possible for creditors, borrowers and shareholders, as well as the public to compare the accounts of credit institutions[143].

The combination of these two elements - mutual recognition and the fixing of minimum standards - has been characterised by Davis as a compromise between to extreme positions: "competition between regulators under a passport principle may be stimulated either by desire of regulators to retain business in their own markets (banks always have the option of setting up subsidiaries under rules of other countries), or from pressure by market participants to remove obstacles to level playing fields. Competition between regulators has a more general advantage over negotiation of not leading to protection being given to entrenched interests. Nevertheless, harmonisation may be seen as better in cases where there are externalities across borders (e.g. systemic risk), given the risk that competition will lead to an outturn with excessively low standards. The EC approach of setting minimum harmonised standards may be seen as a compromise between these approaches, in that competition between regulators will determine the precise level at which standards will be set in relation to the minimum. Even in an integrated market, the case for harmonisation is again less clear cut for conduct of business rules, which concern information asymmetries more than externalities, and where competition between regulators may still leave regulation at acceptable levels"[144]

Also, it is interesting to note the discrepancy among countries in respect to the need of having harmonized rules before the effective adoption of mutual recognition or, on the contrary, the more liberal approach defending that the Second Banking Directive was enough. Finally, the winning approach was the former and the legal force of the Directive was delayed till 1st January 1993.[145]

143.- Closely related to the disclosure requirements there must also exist some harmonisation in the accounting methods of the banking authorities to permit the comparison of different banks' performance and position. Among the recommendation for action of the BIS, on has to mention; "to alleviate problems associated with reduced transparency in financial markets, market participants and centrals banks should encourage efforts aimed at improving and achieving some harmonisation of accounting and reporting practices with respect to off-balance-sheet instruments. To the extent possible, development of accounting guidelines should be done in an internationally coordinated manner. Ways of making public disclosure of financial institutions more meaningful should also be undertaken", Bank for International Settelments, "Recent developments in international interbank relations", Basle, 1992, p. 4

144.- Davis, "Problems of banking regulation - an EC perspective", London School of Economics Financial Markets Group. Especial Paper n. 59, Dec. 1993, p. 14

145.- There was a quite visible division of opinions between countries with more liberal approach and those with a more interventionist tradition. Nicosia, Benito, *L'Unificazione del Mercato Bancario Europeo*, 1988, p. 38.

Mutual recognition and minimum harmonisation should not be perceived as two contradictory concepts. "Mutual recognition can only be applied fully provided that the most essential rules on, for example, supervision and requirements on own funds are harmonised. There is therefore a crucial link between harmonisation on the one hand, and liberalisation on the other. If the level of harmonisation is not satisfactorily high, then mutual recognition does not work in practice"[146] The same argument has been used in a similar way to reconcile competition among banking industries and their regulation. Since competiton increases the risk of bad bank practices, regulation is to be seen as a complementary element of competition, contradicting the normal characterisation of the debate in terms of competition versus regulation[147]

"These concepts do not exhaust the range of possibilities, but merely rank the two ends of a spectrum encompassing a number of intermediate points. Full (or detailed) harmonisation implies an advanced approximation of national laws. Mutual recognition, on the other hand, implies that the result reached by one member State by its internal procedure will be recognized in other Member States as valid"[148]

However, the passage of the Second Banking Directive dates back to 1989 and States were concious of the future implications of mututal recognition and regulatory competition. This fact gave a huge impetus in agreeing further harmonization measures, singularly, the Own Funds Directive and the

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146.- Nielsen, *Services and Establishment in European Community Banking Law.* Copenhagen, 1994, p. 38. Also Majone has underlined that, the new approach implies a double approximation to the question of harmonisation. On the one hand, the principle of mutual recognition supposes a deregulation since reduces the scope for community norms. But, on the other, supposes a re-regulation, that is a change in the kind of regulatory activity of the Community which will concentrate on the elaboration of minimum laws on the harmonisation of essential requirements. Therefore, we have to have in mind this double aspect of the new approach to understand its functioning. Majone, G. "Regulatory federalism in the European Community" *Government and Policy, vol. 10,* 1992. Minimum harmonisation then is an essential element for the operation of the mutual recognition system. As Dehousse has pointed, "The advocates of the race to the bottom theory also appear to have over-estimated the risks inherent in the mutual recognition strategy. What they failed to understand is that mutual recognition cannot operate in a vacuum: for the system to be operational, its basic premise (the equivalence of national provisions) must reflect reality. Where the objectives pursued by the Member States or their methods diverge, mutual recognition is of no help". Dehousse, "Integration v. Regulation? Social Regulation in the European Community". *EUI Working Papers Law,* 92/23 p. 17.

147.- Revell, "The Complementary Nature of Competition and Regulation in the Financial Sector" in *UK Banking Supervision,* edited by Edward Gardener. London, 1986, p. 160

148.- Zavvos, Banking Integration and 1992: Legal Issues and Policy Implications", Harvard International Law Journal, vol. 31, 2, 1990, p. 471

Solvency Ratio Diretive. Moreover, article 24 establishes that Member States shall bring into force at the latest by January 1993, the necessary provisions to comply with the above mentioned Directives. Thus, the operation of the principles of mutual recognition and home country control were made contingent of the adoption of harmonisation measures.[149]

Moreover, and contrary to what is customarily believed, "harmonisation in the banking sector has been, and is envisaged to be, extensive. It is questionable whether the amount of harmonization that has already taken place could properly be described as 'minimal', certainly when taken together with the harmonisation which is proposed for the future. It is difficult to imagine that a policy of uniform Community regulation, as was envisaged at the time of the adoption of the First Directive, would have involved a very much greater degree of harmonisation that has in fact taken place under the Commission's new 'minimal harmonisation' approach"[150]

It may be wondered whether harmonized banking supervision in the EC on the basis of a number of minimum requirements might lead to a minimal and hence weakened supervision. We argue that the so called minimum requirements are not minimal but ambitious, constituting a well structured supervisory system. Consequently, "supervisors do not expect that banks will transfer their head offices to those Member States where they hope to find the lightest supervisory regime. If, in some cases, banks were to contemplate such a move, they might be restrained by the predictable reactions of (potential) creditors and rating agencies"[151]

The remaining differences in regulation and supervisory vigilance will not lead to a significant encouragement of regulatory arbitrage in the post-1992 European banking market for several reasons.[152]

First, the Second Banking Directive specifically states that regulatory arbitrage is a permissible basis for denying or withdrawing bank authorisation. However, most established credit institutions are unlikely to move their state

149.- Bisignano, J., "Banking in the European Economic Community: Structure, Competition and Public Policy", in Kaufman, G.G. *Banking Structures in Major Countries.* Kluwer, 1992, p. 197

150.- Strivens, R. "The liberalization of banking services in the Community" CMLRev. vol 29 n. 2, 1992, p.301

151.- Cornet, Peter, "Issues in Banking supervision and regulation from the perspective of a banking supervisor", in Fair and De Boissieu, Financial Institutions in Europe under New Competitive Conditions, Kluwer, 1990, p. 281. Cfr. Norman, Richard, "Regulation of Banking in the Member States. The EEC and its Impact on the Location of Banking Institutions in Europe post 1992", Price Watehouse, London, 1989.

152.- Matthews, Barbara, "The Second Banking Directive: Conflicts, Choices and Long-Term Goals", Duke Journal of Comparative & International Law, vol. 2 n.1, 1992 p. 108-109.

of domicile due to differences in reporting requirements or bank secrecy laws. It is difficult to imagine an scenario where domestic EC institutions would relinquish decades of accumulated administrative and political voice in their home state for anticipated benefits from other jurisdictions.

Second, harmonizing key aspects of banking regulation in concert with other financial services legislation makes regulatory arbitrage less economically attractive.

Third, the consolidating of reporting requirements and supervisory authority in one Home state will serve to deny some credit institutions the benefits derived from their corporate structures.

This fact has lead the OCDE to warn that, "while harmonisation of prudential standards is aimed at levelling the playing field, in the sense that it eradicates competitive inequalities by reducing the scope for regulatory arbitrage, it could also eliminate the competitive edges that would normally promote market development"[153]

[153].- OCDE, Banks under Stress, 1992, p. 71.

3.5. Banking supervision and the division of powers between the Community and Member States.

3.5.1. Regulatory competition and administrative cooperation

The regulatory techniques expresed in the Second Banking and related directives evidence a complex distribution of regulatory and supervisory functions between Community and Member States' level of government. The legal approach which inspires the Second Banking Directive constitutes a radical change in legal methodology: we move from harmonization by means of Directives to harmonization as a result of the market forces, even though it should be noticed that in practice mutual recognition is unworkable in the absence of minimum harmonization.[1]

The assessment of a system based on horizontal regulatory competition has to be premised by no absolute pressence of community instruments which preempt any possible state initiative. As we will see in the analysis of the US system, the rival coexistence of both levels of administration is a question of delicate balance. Community rules have to be limited to ensure the soundness and stability of financial system, allowing enough room for diversity and flexibility. On the other side, states must have their autonomy limited somehow to prevent externalities and destructive competition."The Commission's role has not been to set itself up as a second tier regulator, or to deal with specific cross-border issues. Rather, it has sought to establish and enforce a set of rules aimed at opening national markets, allowing cross-border financial transfers and promoting uniform standards in a limited number of key areas such as capital adequacy, accounting, and the listing of stock exchange prospectus. This is most commonly put in terms of the twin principles of harmonisation in few areas and mutual recognition of national regulations in others. From this position, it is logical to argue that 'home' countries should authorise financial institutions, but that the 'host' countries in which they operate should have some power over the application of the rules under which the institution works within that national market"[2]

1.- Nielsen, *Services and Establishment in European Community Banking Law.* Copenhagen, 1994 p. 343.

2.- Vipond, "Financial Services and the Internal Market, in Hurwitz and Lequesne (eds), *The State of the European Community*, . Longman 1991, p.117. In fact, the Second Banking Directive does not create a 'Community' banking licence but it decrees that each Member State's banking licence shall be valid throughout the Community. Gruson and Feuring, "A European Community Banking Law: The Second Banking and Related Directives" in *The Single Market and the Law of Banking*, edited by Ross Cranston, 1991, p.23

The European model has therefore rejected the idea of having an euro-regulator for european banks, and specific set of rules for those entities whose operations extend further the mere domestic markets. There is nothing similar to the idea of creating a 'societas europaea' which is proposed in the field of corporate law, for financial markets, or the whole idea of a banking incorporation at european level.

Instead, the regulatory system is based on a minimum Community intervention to guarantee and discipline a fair regulatory competition at horizontal (state) level. One has to recall that EC banking law finds its relation to the convergence process largely through article 100 of the EC Treaty, which provides for the aproximation of such legislative and administrative provisions of the Member States in so far as they affect the establishment or functioning of the common market. It becomes thus clear that the EC Treaty does not envision transplanting national banking laws and practices but instead envisions that the national systems will continue to exist.[3] Although this fact can be perceived as a weakness of the european approach to financial integration[4], we argue constitutes of its major achievements.

This view is also shared by Dermine. "As concerns banking and financial services, a major issue arises as to whether regulation and supervision must be handled by a unique European authority, or whether it can be delegated to independent national central banks and supervisory bodies. After trying in vain to harmonise national banking regulations over twenty years, the European Commission adopted the principle of the single banking license, the home country control, and the opening of borders with minimal harmonisation of regulations. Each country will recognise the competence of foreign authorities to regulate and supervise their own banks. The Treaty of

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3.- Norton, "The EC Banking Directives and International Banking Regulation", in Cranston (ed.) The Single Market and the Law of Banking, London, 1991, p. 161

4.- Such a critical vision is expressed by Bradley; "EC legisaltive provisions do lay down minimum standards, but there are weaknesses in the EC mechanisms for ensuring compliance by member states with their EC obligations, and for ensuring comparable interpretations of provisions of EC legislation in different Member States. The introduction of an EC supervisory authority with responsibilities in the financial services sphere would help to ensure that rules would be applied in the same way in all Member States, but the creation of such a body would entail extensive amendment of EC's financial services legislation, and it is therefore unlikely that a Euro-regulator for financial services wil be set up in the near future", Bradley, "Competitive Deregulation of Financial Services Activity in Europe after 1992", *Oxford Journal of Political Studies*, vol. 11 n. 4, 1991.

the European Union, which became law on November 1, 1993 recognises explicitly the principle of decentralisation of regulation and supervision"[5]

As the relation between the principles of mutual recognition and home country control shows, the key relationship involves EC member states' banking regulators, with no automatic need to involve the Comission at all. "The Commission has not been established as a regulator either of the EC banking industry or of the national banking supervisors, and there is no evidence that it has tried to attain any of these goals. The Commission's role will not put it in competition with national banking supervisors, far less establish it as a second order supervisor. Rather its purpose in producing new regulations is to establish a genuine and stable EC-wide market in financial services and capital. This analysis certainly shows that national soverignity is maintained - albeit within a framework of rules that is agreed at the EC level and then made binding"[6] This hypothesis reinforces the perception of european financial integration as a process mainly based on negative integration.

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 responsability 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 major shareholders. On the other hand, the conduct of a firm's business with customers is largely responsibility of the autorities of 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).[7]

As a manifestation of these mechanisms which provide for a global European treatment of banks, the Council passed the Directive on the Supervision of Credit Institutions on a Consolidated Basis[8]. This directive expands consolidated supervision by including financial holdings companies and mixed-activity holding companies . Thus the Council has taken significant precautionary measures to ensure that banks are monitored, not only as

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5.- Dermine, "EC Banking Regulation: centralisation or national autonomy". *INSEAD Working Papers Series,* April 1994, p. 1.

6.- Vipond, P.A. "The liberalisation of capital movements and financial services in the European single market: A case study in regulation", European Journal of Political Research, vol. 19, 1991, p. 240. This hypothesis, however, neglects the existence of some degree of vertical regulatory competition that, although less poweful, it does exist. See aour discussion infra.

7.- Fraser and Mortimer-Lee, "The EC single market in financial services" Bank of England quarterly Bulletin, vol 33 n.1, 1993, p. 93

8.- OJ L110 of 6 April 1992. See also its predecent, Directive 83/359 EEC of 1983.

regards territorial expansion but also as regards products offered by financial conglomerates.[9]

Thus, interestingly enough, it has to be stressed how the process of regulatory competition increases **horizontal cooperation.** Somehow in response to the BCCI fraud, which in part was due to the lack of co-operation among responsible supervisors, the Basle Committee has been acting to strengthen the arrangements for international supervisory co-operation. These arragements are designed to increase the exchange of information between home and host countries and to improve supervision. "The (new) regulatory structure requires coordination and consultation between national supervisory authorities regarding issues previously considered as purely domestic. This could build a critical precedent for intergovernmental cooperation"[10]

"The completion of a single market implies that banks conducting their business throughout the Community should be subject to efficient supervisory control. Traditionally, national supervisory authorities have jurisdiction only within their national territory. Pursuant to this territorial approach, various parts of banks which are located in another (host) state fall under the latter's supervisory regime. Retention of this traditional scheme would be inconsistent with the concept of a single market, for banks would have to abide by different supervisory regimes applicable in the various host Member States. Centralizing prudential control in a single supervisory authority proved infeasible since, unlike a federal state, the Community does not yet possess one"[11]

Thus, under the Second Banking Directive, the home state is responsible for supervision of all its branches (article 13). The host state, however, still has specific rights such as verifying the authorisation and requesting any necesary information. It also may monitor liquidity and monetary policies. As a result, a credit institution may be supervised by more than one Member State.

For instance, it is illuminating to turn to the example of subsidiaries of foreign banks in financial difficulties: "In the EC the host country is primarily responsible for the supervision of foreign subsidiaries, as the home country concept only applies to branches[12]. In so far as supervision of foreign

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[9].- Rodriguez, S. "Are Banks Within the European Community Adequately Supervised", Boston College International and Comparative Law Review, vol. 17 n. 1, 1994.
[10].- Matthews, Barbara, "The Second Banking Directive: Conflicts, Choices and Long-Term Goals", Duke Journal of Comparative & International Law, vol. 2 n.1, 1992 p. 92
[11].- Zavvos, Banking Integration and 1992: Legal Issues and Policy Implications", Harvard International Law Journal, vol. 31, 2, 1990, p. 475
[12].- see supra.

subsidiaries is based on national treatment (host country) deposit insurance should accordingly be based on national treatment. This approach is a limited application of the principle of consolidation which is laid down in the revised Basle Concordat of 1983. Consolidated supervision enables the home supervisior to assess the risk of the entire banking group. We therefore argue that not only for foreign branches but also for foreign subsidiaries there is surely a role for the home supervisor. The closing decision should then be regarded as a coordinated action of the home and host supervisors"[13]

Therefore, we assist to a growth of an increasingly important institutionalzed framework for inter-state cooperation within the EC. These could be some examples of it:

a) The Groupe de Contact

The need for supervisory co-operation which was felt among G 10 authorities in the early seventies, also lead to the formation of an informal contact group among Community supervisory authorities. This Groupe de Contact has organized exchanges of views among its members on policy matters and individual cases. It has developed into a well-established practice that the Groupe meets four times a year in one of the Member States. The central banks and other supervisory authorities first meet inter se and then continue their discussions in the presence of a representative of the Commission's Banking Directorate.

The Groupe de Contact has organized compilations of banking regulations on a host of issues and has also helped pave the way for the adoption of harmonized standards or the introduction of new policies. The Groupe de Contact existence is merely acknowledged by the final recital of the preamble to the First Banking Direcitve; there is no further formal legislation in relation to its existence or functioning.

b) The Banking Advisory Committee. (BAC)

When the Community adopted the First Banking Directive in 1977, the activities for the harmonisation of supervisory rules were to be furthered by a committee consisting of representatives of the authorities and relevant departments in the Member States (intergovernmental structure). It consists of representatives of central banks and other supervisory authorities, representatives of the finance departments and of the Commission.

13.- Schoenmaker, "Home Country Deposit Insurance?", LSE Financial Markets Group, Special Papers Series, n° 43, 1992, p. 9

The main tasks of the BAC are:

- advising and guiding the direction of banking supervision harmonisation in the Community
- assisting the preparation of certain decisions to be taken under the First and Second Banking Directives
- preparing common banking standards for solvency, liquidity and profitability
- give advice to the Commission and help it preparing new banking legislation for the common market
- assist the Commission in making technical amendments to banking directives adopted (through a regulatory committee. Implementing measures or technical adaptations which the Commission proposes, become law once the regulatory committee has given green light - comitology)
- act in a similar capacity concerning the adoption of reciprocity measures

c) bilateral agreements

Apart from the formal or informal groupings of EC supervisory authorities, there is a lot of bilateral co-operation. For the implementation in day-to-day practice of the regime of supervisory responsibilities instituted by the Second Banking Directive, Memoranda of Understanding (MU) have been signed between pairs of supervisory authorities across the Community. The co-operation called for by the internal market legislation for the financial sector implies mutual information and decision-making with cross border effects. A credit institution licensed in its home Member State may operate branches and provide cross-border services without host State authorisation. Instead it is to notify its home State supervisor on the intention to establish a branch or provide a service. Thus decisions by the Home State authorities have effects in other jurisdictions[14].

Note that there is no formal hierarchy among the supervisory fora that function within the Community and most of their tasks overlap. Their membership is not exclusive and there is a continuous mutual information which ensures a workable, though informal division of labour.

In respect to implementation of supervisory measures, the aim of EC-wide rules is to have a common core of principles governing regulation, with complementary national regulations. Within these boundaries Member States

14.- Louis, J.V. (Chairman of the Working Group of the ECU Institute), Banking Supervision in the European Community. Institut d'Etudes Européennes. Université de Bruxelles, 1995 p. 39

will keep the primary role in the implementation of regulation and in the supervision of financial institutions[15].

There are plausible grounds for believing that international networks - understood as epistemic communities - will develop, and co-operation between national authorities should represent a palliative to the allocation of powers to a central authority. In any case, the allocation of powers to a Community authority will have to conform with the principle of subsidiarity, that is with the double test of comparative efficiency and value superiority.

3.5.2. vertical regulatory competition and the pressures for centralisation

Arguably, problems of co-ordination will provoke some pressure for centralisation of supervision. Therefore there will also exist in some degree vertical regulatory competition among the central (EU) institutions and the supervisory authorities of each Member State.

The subsidiarity principle established in the TEU, although rarely stressed, does not represent in itself an indication for the distribution of competenes. Subsidiarity means that things are to be done where it is more efficient. Thus, the clause is bi-directional in the sense that can also function as an instrument of assumption of competences by central institutions. We envisage a subsidiarity ascendent clause for problems of failure to co-ordinate.

"In the context of the historically unprecedented levels of interpenetration that the Single Market is expected to provoke, its regulatory framework could lead to considerable problems of co-ordination when banking difficulties arise, because both the home supervisor and hosts in up to 11 (14) countries would need to be involved. Also host supervisors have no right to withdraw the licence from a bank that transgresses business rules (they can only stop it trading temporarily). Some commentators suggest that such difficulties require establishment of an EC-wide co-ordination agency, or even centralisation of supervision"[16]

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[15].- The same reasoning is also applied to the functional supervision of credit institutions. Given the increasing expansion of bank powers, it will be necessary to find cooperative mechanisms to enhance supervision. "More generally, the view is increasingly gaining ground that, though securities firms and other capital market institutions need not necessarily be fully integrated into the supervisory system for credit institutions, more effective cooperation between the supervisors that are responsible for the different parts of the financial sector is desiderable, or indeed, indispensable", Blommestein, "Structural Changes in Financial Markets: Overview of Trends and Prospects" in OECD, The New Financial Landscape, Paris, 1995.p. 27

[16].- Davis, op. cit. p. 19. See WilKinson, "Financial Regulation in Europe", LSE Financial Markets Group Special Paper n. 34, 1995

With the begining of the first stage of the EMU, the ground rules relating to the Committee of Governors of EC central banks were modified. Under this new charter, the Committee of Central Banks Governors was to

> "hold consultations concerning (...) issues falling within the competence of the central banks and affecting the stability of financial institutions and markets"[17]

To this end, the Banking Supervisory Subcommittee was created. Since the begining of the second stage of the EMU, the Committee of governors was replaced by the EMI. The Banking Supervisory Subcommittee has continued to function under the aegis of the EMI. It prepares the supervisory functions of a co-ordinating and advisory nature which the EMI is to fulfil and which the ECB will later assume.

Although prudential supervision does not formally count among the tasks of the ESCB[18], there are some related questions assigned to the it:

- contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system (art. 105(5) EC Treaty and 3.3. of the Statute of the ESCB and the ECB.
- the ECB is called to give advice on draft legislation in areas which are within its field of competence. Prudential regulation is thus made the subject of prior consultation of the ECB. Art. 25.1. of the Statute of the ESCB and the ECB, establishes that :

> "The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the member States on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system".

Apart from the supervision-related tasks of the ESCB which may be performed immediately from the start of the third stage, the ECB may have a

17.- art. 109F(2) TEU.

18.- The four basic tasks are: conduct of Community's monetary policy; carrying out of foreign exchange operations; management of the official foreign reserves of the Member States; and the promotion of the smooth operation of payment systems. Cfr. Smits, R. "The European Central Bank: Institutional Aspects", International and Comparative Law Quarterly, vol. 45. n. 2, 1996, p. 330.

further task in this area if so entrusted by the Council. According to article 105(6) of the EC Treaty and art. 25.2. of the Statute,

> "The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the EP, confer upon the ECB specific tasks concerning policies relating to the supervision of credit institutions and other financial institutions with the exception of insurance undertakings".

The Belgian Association of Bankers has already interpreted article 25.2 of the Statute, as laying down a very demanding procedure for the conferment on the ECB of specific tasks concerning policies relating to prudential supervision of credit institutions. This could represent a safety valve enabling the Community to respond quickly to the future developments without the need for a revision of the Treaty and could provide for a embrionary form of direct Europe-wide supervision of financial institutions.

The case for the involvement of a supranational supervisor rests on there being advantages in the centralised formulation and implementation of supervisory policy. Among the key arguments for centralisation there are:[19]

- the need for speed of action where the obligation to consult members of a supervisory college might delay a response;
- the existence of externalities (such as threats to financial intermediaries outside the Member State or contagion from outside) in an increasingly integrated financial market that can only be fully appreciated centrally;
- possible gaps in the information available to national supervisory authority and a supranational Lender of Last Resort provider.

Assuring stability is one of the designated roles of the ECB and ESCB alike, so that it is logical that both should be involved in prudential supervision to guard agaisnt systemic risk[20]. However, because supervision is a highly specialised activity, pragmatic rather than conceptual considerations

[19].- Louis, J.V. (Chairman of the Working Group of the ECU Institute), Banking Supervision in the European Community. Institut d'Etudes Européennes. Université de Bruxelles, 1995 p. 30

[20].- As argued by Baltensperger and Dermine,supervisory measures directed at preventing systemic risk are best placed in a supranational authority. Although the principle of home state makes sense from the point of view of investor protection, makes host countries more vulnerable to systemic risk. Therefore, in the absence of a supranational authority, this regulation should be in the hands of the host country. This suggests that although the home state control philosophy makes sense from the perspective of competition objectives, it needs to be complemented by the involvement of the EC tier in ensuring systemic stability. Baltensperger E. and Dermine J. "European Banking: Prudential and Regulatory issues", in Dermine, J. European Banking in the 1990s. Oxofrd, 1990.

probably need to be the foremost in allocating tasks. It is consequently, likely that national supervisory bodies will continue to possess advantages in the efficient exercise of prudential control. (regulators with local knowledge will be best equiped to understand the character of the financial institution).

Also it has been suggested that there is a need for a double set of rules and supervisory practices depending on whether the financial institution is invoved in cross-border activity or not. This, however, contradicts the principle of a single license for the whole European market. Moreover, the different treatment of these two kinds of institutions would call for a centralised level of authorisation, creating a federal authorisation for a given type of banks and breaking the system into two tiers (state and federal), similar to the US system. This result could be seen as contrary to the EC design based on a single license and regulatory cooperation among states.

On balance, the Recommendations of the Working Group of the ECU institute are mixed: there should be neither total centralisation nor total decentralisation of prudential supervision: "Some authors consider that a new supranational body is unatractive from either political or a practical standpoint; they fear that a supranational body would be a recipe for further regulation, with damaging effects for the competitiveness of the European financial services; nevertheless, they consider that it is important to strengthen the practical co-operation between regulators in different Member States and to raise standards of regulatory power. (...) There is not a compelling need for such centralisation within the Community. The experience gained by the Community is unique, and is not such that it needs to follow precisely the same course as that taken within federal states."[21] In fact, we argue that such compelling need would be largely determined by the results of horizontal regulatory competition and co-operation. As we previously argued, the relation between horizontal and vertical competition is a reverse one: the better functions it at horizontal level, the fewer will be the perceived need for centralization.

To sum up, the Community regulatory structure is emerging as a kind of co-operative structure to allow the network of national supervisors to operate properly. The Community is then to be viewed as a kind of network adjusting mechanism. Community legislation will be organized as a system of elementary rules governing co-ordination among different Member State and

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21.- Louis, J.V. (Chairman of the Working Group of the ECU Institute), Banking Supervision in the European Community. Institut d'Etudes Européennes. Université de Bruxelles, 1995 p. 52

functional authorities. This may involve a transition from a system based on co-operation to a system based on co-ordination[22].

3.5.3. The role of the states in financial integration

In line with the precedent discussion, we argue that it would be misleading to consider the new approach and the financial services revolution only as a deregulatory phenomenon - in the sense of conferring to the market all tasks previously held by States. Indeed, it can be argued that the position of the state has been reinforced. "Economic accounts have produced the misleading depiction of the process as deregulation. It is certainly true that in some spheres deregulation has indeed happened. Yet at the heart of any theory of regulation must be an account of the role of the state, the most important actor in the design of regulatory systems. Economic accounts of the financial services revolution largely ignore the state or, in the simple image of deregulation, suggest that the story of the last few years is one of state retreat. The reality is otherwise. The state has not retreated"[23]

Therefore, the process of liberalisation of capitals has taken the form it has in part because national sovereignity retains the role it does within EC policymaking. "The EC's capacity to act as a corporate actor is reduced, though not altogether vitiated, by the practical reality of this power, despite some of the rethoric about integration. Reference to the single market programme and the nature of regulation are not enough to explain these matters on their own; the enduring significance of national power in shaping the regulatory framework for capital in the single market cannot be overlooked"[24]

Also, the designed structure of Community Law permits states to retain some degree of autonomy in the implementation phase. This can be specially important as regards the creation of a SEFM. We have seen that States still are powerful actors in deciding the extent of the protection of their general interest

22.- Co-operation mechanisms (networks of agreements, creation of committees, notification of decisions, gentelmen's agreements, exchanges of information, mutual assistance ...) are indeed useful for especific objectives like discussion and issuing of recommandations or as a contribution to the smooth functioning of the control and effectiveness of administrative action; nevertheless, the rather informal character of those mechanisms, prevent them to be an effective administrative instrument.

23.- Moran, "The State and the Financial Services Revolution: a comparative Analysis" *West European Politics*, vol. 73 n. 3, 1994, p. 176.

24.- Vipond, P.A. "The liberalisation of capital movements and financial services in the European single market: A case study in regulation", European Journal of Political Research, vol. 19, 1991, p. 242

and consequently, the openess of their banking systems. On the top of that, the potential differences in the national implementations of directives is considerable and this way provide states with certain degree of autonomy.[25]

Again, as we argued in the first part of this work, there is no reason to characterise the process of regulatory competition as one where markets and states occupy different spheres. It is not accurate to define markets as unrestrained processes that marginalise political - state or interstate - interests. Politics, through state decision making, continue to determine the pattern of development of competition and internationalisation of markets.

This is clearly manifested in the case of the management of an international monetary regime created as a consequence of globalisation. In this field, the development of co-operative interstate efforts has had even more relevance than unrestricted operation of markets. We will examine this point in the last chapter. "The trend towards international economic integration, encouraged by state policies, requires international political cooperation if it is to continue. Thus not only have states had to iron out conflicts of interest among themselves, but they also had to muster the political resources to legitimate the agreements at home. Politics, far from being absent in the process of international market development, is both present and greatly complicated"[26]

"Whatever the changing role of the State in this situation, markets are not managers. Politics fills this gap, and the dominant political interests are tied to market development.[27] The crux of the matter is that in the financial domain states are consistently opting for market solutions to the allocation of resources at the same time as market power increasingly becomes a source of political power"[28]

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[25].- Molyneux, P. "Europe's Single Banking Market and the Role of State Autonomy", Institute of European Finance. University College of North Wales. Research Papers in Banking and Finance, n. 94/10, 1994.

[26].- Underhill, "Markets beyond politics?. The state and the internationalisation of financial markets", European Journal of Political Research, vol. 19 , 1991. p. 201

[27].- For an interesting account of the influence of financial institutions as political actors within the EC decision making process, cfr. Moreiro Gonzalez, C.J. *Banking in Europe after 1992* Aldershot, 1993.

[28].- Underhill, "Markets beyond politics?. The state and the internationalisation of financial markets", European Journal of Political Research, vol. 19 , 1991. p. 222.

3.6. The case of the deposit insurance scheme

The debates around the deposit insurance scheme could be seen as an illustrative example of the evolution of the new regulatory environment and of the need of a comprehensive response to the new challenges.

In contrast with the home country principle we have examined, the initial proposal for deposit insurance was based on the host country principle (national treatment, as established in the Deposit Guarantee Recommendation of 1987[29]). However, home deposit insurance can offer home country supervisors an incentive for sound supervision since they would be faced with the costs when any of the banks under their supervision fails.[30]

In fact, it is clear that an increasingly important amount of transactions is developing through foreign establishments. The host country principle for deposit insurance would mean that home countries would reap the benefits of them but will contribute very little to the costs in cases of insolvency, provoking thus a externality problem. In this way, home country supervision together with host country deposit insurance did nothing but reinforce competition through laxity or race to the bottom between supervisory regimes. "The purpose of adopting the home country principle for deposit insurance is to correct this, as the home country supervisor will then face the cost of the results of its supervision , and hence will have a very powerful incentive to strengthen its supervision"[31]

It is no secret that the experience with the failure of the BCCI had an influence in the shaping of the new directive. In fact, the BCCI was a bank registered in Luxembourg while its administrative headquarters were in London. The Bank of England considered that the main place of business was Luxembourg and requested the authorities of that country (Commissariat au Controle des Banques) to verify whether the bank had the necessary conditions for authorisation. The ambiguity between the place of registration and the head office was fundamental in this game of passing the buck. As far as savers were concerned, the problems caused for intervention by the deposit guarantee schemes by the different regulations in force in the various countries (host

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29.- Commission Recommendation concerning the Introduction of Deposit Guarantee Schemes in the Community, 87/63/EEC, OJ L 33/16 , 2/1987.
30.- Schoenmaker, "Home Country Deposit Insurance?", LSE Financial Markets Group, Special Papers Series, n° 43, 1992
31.- idem p. 6

country principle) and even the absence of such schemes in some states, immediately became obvious.[32]

After having recommended voluntary schemes in 1986, the EC has recently passed a binding directive[33]. The directive thus imposes the compulsory membership of credit institutions to redress schemes, based on mutual recognition of already existing systems in the Member States. This will bring deposit insurance fully in line with the supervisory regime of the Second Banking Directive which applies home country authorisation and supervision. Harmonisation, however, shall be achieved as to the limits of redress. Henceforth, the minimum of cover funds will have to amount to 20.000 ECU per each single deposit. Article 4(2) provide for an optional right of credit institutions to become member in the host country redress schemes. The deviation of the country control principle is in this respect only a minor one since the covering by the home country and therefore the control will be upheld.[34]

Two comments should be made on the establishment of this quite low limit of protection. First, the minimum level of coverage should not be too high in order to avoid the moral hazard problem.[35] Again, the Directive places more emphasis in the protection of the (small) depositor than in the soundness and stability of the financial system as a whole which is supposed to be guaranteed through adequate supervision. The protection offered in case of redress is quite limited and there is no provision relating to the way of funding the insurance scheme. This represent the adoption of the UK view on the issue. In philosophy, the Deposit Guarantee Directive is closest to the current UK scheme, than to the German or Italian one.

Second, this minimum would leave outside protection most of wholesale operations whose clients are supposed to be able to monitor by

32.- Gualandri and Vella, "The Post-BCCI EC Directive", Revue de la Banque, 4/1995, p. 203. See also, Quin, Morgenthau and Bingham, "Banking Supervision after BCCI", LSE Financial Markets Group, Special Paper n° 54, Aug. 1993.

33.-Directive 94/19/EEC of 30 May 1994. OJ L 135 of 31.5.1994. Incidentally, we observe that this is a common way of action of Community institutions in this field. proposals are initially entered in the form of non-binding recommendation or even codes of conduct ellaborated by self-regulatory bodies. This creates a climate of consensus building that latter allows to move to the passage of hard law instruments. Then, the relation between soft law and hard law is one of progression n this field.

34.- van Aken, J.C. "Community Regulation on Banking Services" in Reich and van Aken, "The Evolution of Community Law on Financial Services", Zentrum für Europäische rechtspolitik. Universität Bremen, ZEPR Diskussionspapier 1/94, p. 125-128.

35.- This implies that banks have an incentive to engage is riskier activitities since they have the protection of the insurance system. Conversely, depositors have no incentive to monitor or to be aware of the bank's financial soundness.

themselves the riskiness of one operation. Then, there is a strong stimulus for the depositors to monitor the system (or to rating agencies to do it) which can be seen as an element fostering regulatory artitrage[36].

Apart from these general considerations, it is interesting to examine the provision of the Directive in relation to regulatory arbitrage. Two different scenarios can be contemplated: in the first, the Home State of an institution penetrating a foreign market has a lower level of deposit insurance than that of the host country; the second possibility is, however, that the foreing institution benefits from a higher level of protection.

Where a Member State wants to uphold a higher level of protection this may not lead to a restriction of market access of institutions coming from other Member States. A credit institution intending to operate in another Member State has solely to indicate the membership to a scheme in the home country.

In second paragraph of article 2 it is stated that a branch of a bank authorized in another Member State may apply to join voluntarily the scheme in the host state in order to supplement the guarantee which its depositors already enjoy by virtue of their obligatory coverage by the home country scheme. Moreover, objective conditions relating to membership of these branches shall be part of all deposit guarantee schemes. While objective criteria are important for accepting branches from other member state in the host country scheme, it is crucial that the financing be commercially fair. This means that these branches from other member states should get a proper discount for that part of the deposits which are already guaranteed by the home country scheme.

However, this topping-up provision is subject to several critics: Firstly, if the topping-up would be compulsory, this would mean a complete elemination of the competitive stimulus for regulatory competition. Secondly, it protects inefficient and too large deposit insurance schemes. The funding of these schemes is effectuated through premiums that banks have to pay and this represents a burden. (e.g. Italy). Thirdly, although host countries might have some power in refusing branches from another member states to join their scheme, they would not have any supervisory power after they have

36.- On the top of that, the Directive allows a small option for co-responsability in the insurance scheme between the insurer and the depositor. In other words, depending upon impementation by each country, depositors may have to co-insure 10% of the deposits themselves (since are not going to be covered by the deposit insurance scheme). Again, then, there is a strong incentive for depositors to monitor bank's solvency.

admited them.[37] This breaks the principle of no deposit insurance without countervailing supervisory powers. Finally, problems would arise in dealing with the closure of banks subject to two deposit schemes. One of them may be prone to close the bank and the other to reorganise it.

Moreover, "it should be noted that the host country topping-up is only a half way solution to the problem of competitive distortions. If the home country scheme is higher than the host country scheme, no adjustment is provided. British banks, for example, with protection of up to 21.500 ECU per depositor, will face competition in their domestic market of Italian branches with a protection of up to 520.000 ECU per depositor. This might in principle start a race in which levels of deposit protection are raised by authorities under pressure from domestic banks, for competitive reasons rather for intrinsic reasons of banking regulation"[38]

It is this kind of reasoning which has lead to the exception of the principle of home country control where the depositor's guaranteed protection is higher in the home country than in the host one (second scenario). In other words, a credit institution attached to a scheme in its home country which confers a higher protection cannot export its standards into the host country whilst the access of banks who do just comply with the minimum standard is not restricted at all. This solution as amended in a common position of the Council would mean a remarkable deviation from the concept of mutual recognition in favour of a bottom-down-policy. (in so far as prevents the exportation of regulatory models as we argued in the distinction between branches and subsidiaries).[39] We argue that although this provision is said to avoid competitive disadvantages, is in itself anticompetitive.

There is no need to equalise the conditions of a deposit insurance schemes which vary greatly from State to State. Despite of that, and coherently with a twin system of mutual recognition and minimum harmonisation, a European minimum should be set. "Let it be clear that from a market based regulatory point of view, deposit insurance does not mean that a bank will never be allowed to fail. It is only the adverse consequences for the small saver which are to be avoided so that, first, an important social function of government is properly exercised and, second, a banking failure will not be

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37.- This kind of reasoning is the one which have been present when Germany filed a complaint before the ECJ in August 1994. Cfr. Case 233/94 of 18.8.1994

38.- Schoenmaker, "A Note on the Proposal for Council Directive on Deposit Guarantee Schemes", LSE Financial Markets Group, Special Papers Series, nº 48, 1992, p. 6

39.- Article 4(1) establishes that: "Until 31 December 1999 neither the level nor the scope, including the percentage, of cover provided shall exceed the maximum level or scope of cover offered by the corresponding guarantee scheme within the terrirtory of the host Member State"

likely to cause a ripple effect through the retreat of money from the banking system"[40]

On the other side, from the point of view of the depositor, uniform deposit insurance makes all deposits equally attractive, independent of the bank's insolvency risk. The establishment of a uniform deposit protection scheme in Europe will remove the necessity for the depositor to distinguish between different quality types of banks and - in case such differences are perceived by the depositor - for the bank to include a bank-specific risk premium in the rate of interest paid to the depositor.[41]

In article 6 of the Directive the Commission requires Member States to ensure that banks will provide depositors with the necessary information regarding the relevant deposit guarantee scheme and its level of protection. However, at present, depositors throughout the EC are almost totally ignorant of the existence of deposit guarantee schemes. The Commission might therefore be slightly optimistic in their reliance on the provision of information, in particular when it comes to the explanation of the host country topping-up. Article 6 states that the information 'shall be indicated in a readily-comprehensible manner'. Since deposit protection might become a tool of competition between banks, it may be expected that the information will be provided in a customer friendly way and will not disappear in the 'small print'. [42]

However, the Directive contradictorily establishes that this information may not be used as an advertising strategy to achieve a competitive advantage over the rival bank having an inferior guarantee scheme, (art. 9.3.) provision which seems difficult to reconcile with the obligation to provide information and the fostering of regulatory evaluation by the depositors.[43] The reasoning is the same as in the previous case of Home States offering a higher deposit protection, i.e. to prevent starting a race where the levels of protection are increased only due to competitive reasons.

Finally, two other points must be raised: the first is the issue of multiple regulators intervening in a failed bank and the problem of the lender of last resort; the second refers to the way the deposit insurance scheme is funded.

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[40].- Smits, "Banking Regulation in a European Perspective", LIEI vol 1989/1, p. 80

[41].- Baltensperger, "The economic theory of banking regulation" Center for the Study of the New Institutional Economics. Universität des Saarlandes, Occasional Papers vol. 2, Winter 1989/90, p. 7

[42].- idem, p. 12

[43].- Jordan, J.L. "A Market Approach to Banking Regulation" CATO Journal, vol. 13 n. 3, 1994, who preceisely argues that one of the ways of improving deposit insurance schemes is by providing more information to depositors.

There are two mechanism of reactive regulation for the protection of the investor. One is the institution of lender of last resort which operates in cases of massive withdrawal of funds from a bank that is solvent. The lender of last resot faces only a problem of liquidity of a safe bank. On the other hand, the deposit insurance scheme we are analizying is design for solvency problems, i.e. to protect the depositor of the economic harm of an insolvent bank. When deposit insurance is designed according to the home country principle, the incentive structure for investor protection changes completely. "The host country faced only with the costs of the lender of last resort support will in doubtful cases be more in favour of closing banks (insolvency option). This can be a desirable policy, especially for countering the 'too big to fail' concept. However, it may involve the closure of banks which are solvent. In that case the social costs will be higher than the benfits"[44]. Then, there is a powerful reason for arguing in favor of the allocation of the lender of last resort mechanism in a super-partes institution, i.e. the ECB.

Finally, it is worth referring to the way the deposit insurance schemes are funded. The Directive makes no reference to this point but it should be discussed in the light of the moral hazard problem. There are two basic systems of funding a insurance system: flat fees or risk-related premia. "Economist almost invariably have expresed a preference for risk-related premia. An efficiently organized insurer would graduate the insurance premia according to the bank's risk of insolvency, and consequently according to the risk of the banks' asset portfolio and the adequacy of its capital holdings. Such a system would minimize the danger of adverse incentive effects which may otherwise result form deposit insurance. Under such a system, the individual bank bears the consequences of higher risk portfolio or a lower capital-deposti ratio in the form of higher insurance fee. Is this is not the case, banks have an incentive to hold higher risk."[45]

"A country may be sovereign in the sense that it sets its own regulations subject to EU minimum standards, but that in fact it has no independence if partner countries have adopted less restrictive regulations. In such an environment it is impossible for a smaller unit to operate more effectively as an independent agent than a larger grouping that has harmonized its procedures. It is this conjecture that we examine in the case of deposit insurance. Even though there will exist differences in coverage in national

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44.- Schoenmaker, "Home Country Deposit Insurance?", LSE Financial Markets Group, Special Papers Series, n° 43, 1992, p. 10

45.- Baltensperger, E. "The Economic Theory of Banking Regulation, Center for the Study of New Institutional Economics, Universität des Saarlandes, Occasional papers vol. 2, Winter 1989/90, p. 8

banking systems governed by the home country principle, there will be the incentive for all regulatory systems to converge. But to what level? To the extent that the regulatory authorities are fully independent of political pressure and the banking industry itself, then the expectation would be that the goals of competition and safety will be pursued"[46]

[46].- McKenzie and Khalidi, "The EU Directive on Deposit Insurance: A Critical Evaluation", Journal of Common Maret Studies, vol 32, n. 2, 1994, p. 186. However, the authors continue warning about the effects the lack of independence could provoke and the fact that the Directive does not take into account the possibility of competition in laxity.

3.7. The process of regulatory competition

3.7.1 General

The new regulatory scenario described, entails a significant increase of competition among financial entities, as well as, although not enough stressed, among national legal systems. In Vives opinion, "the main effect of integration will be to change the focal point of the strategies of banks from collusion and regulatory capture to competition. Nevertheless, competition will be imperfect owing to the presence of important economic barriers to entry, yielding an upper bound for the integration benefits lower than the competitive benchmark. (...) In any case, the institutional and regulatory framework in many countries seems to have fostered a cooperative attitude and consolidated a tradition of understanding among banks. Once regulation is harmonised and kept to its prudential role, the possibilities of regulatory capture diminish dramatically. At the same time, the incentives to deviate from a collusive agreement increase since there is no longer an official sanction to individual bank's decision. The deregulation and integration process will move the focus towards non-cooperative behaviour, thus destroying the anchor to which restrictive practices are bound"[47]

We have asserted that the re-regulation of European banking keeps as its primary goal the maintenance of systemic stability trough the harmonisation of structural regulations. Neither the Second Banking Directive nor the Investment Services Directive[48] do harmonize conduct of business rules because Member States could not agree on what such rules should cover. Those directives allow host states to regulate the conduct of business. The Commission idea is to expect future convergence of conduct business rules as a consequence of regulatory competition and emulation. Until that happens the conduct of business rules which currently apply in the host Member State as a matter of national law or industry practice will apply, and investment firms which carry on business in more than one Member State will probably need to comply with a different set of rules in each state.[49] Therefore, depending on

[47].- Vives, "Banking competition and European integration", in European *Financial Integration*, edited by Alberto Giovannini and Colin Mayer, CEPR, 1992, pp. 512-513. Cooperative practices among institutions might still exist but are going to be scrutinized by competition law. See, Reich, "Transborder Banking in the EEC. Competition Law and the Consumer Interest", in Stauder, Bernd (ed.) *Liberalization and Regulatory Reform in the Field of Banking Services in Europe: The Swiss Consumer's Point of View.* Zurich, 1989, pp. 45-65.

[48].- Directive 93/22/EEC, OJ nº L141/27 of 11 June, 1993

[49].- Bradley, Caroline, "Competitive Deregulation of Financial Services Activity in Europe after 1992" Oxford Journal of Legal Studies vol 11 n. 4, 1991, p. 552.

the domestic rigidity in the field of conduct rules, that convergence will be speeded or slowed. A high degree of autonomy is left to the Member States to control that process.

In any case, there is a ground distinction between the market failure a given regulation tries to redress and the suitability of regulatory competition. In the case of systemic stability, regulation tries to correct an externality problem. Taking into account this fact, it is quite obvious that devolving to the market the regulation that tried to avoid externalities will do nothing but to return to the initial point, or even aggravate it. On the contrary, conduct regulation primarily responds to a asymetric information type of market failure. In this case, regulatory competition can help to demonstrate the false existence of that market failure, or when accompained with adequate disclosure requirement, to overcome it.

Moreover, one has to recall that apart from the establishment of minimum requirements, the consumer must have the possibility and the capacity to compare two different banking regulations and their risks[50]. If this is not the case, we will confront a similar case to the pharmaceutical products, where the impossibility for the consumer to technically evaluate the medicines makes necessary the existence of a authority substituting their choice. As Dermine affirms, "competition among national regulators or private clubs is desirable whenever the parties can evaluate the quality of the regulatory systems. For instance, competition among regulators in Tokyo, Paris, Frankfurt, London and New York will shape the developments of local stock exchanges and the outcomes will be optimal if participants can discriminate among different regulatory systems. Harmonisation of rules to ensure minimal quality would be necessary only if the market cannot discriminate. This suggests that the degree of international harmonisation would vary for different activities and classes of investors, the 'informed' and the 'non-informed'[51]. [52]

50.- It has been emphasized that, "Under EC banking structure, Community consumers should be provided with a greater choice in the range of bank products and services, while at the same time they should be as well protected and safe in their dealings with financial institutions in other Member States as they would be in their Home State", Norton, "The EC Banking Directives and International Banking Regulation", in Cranston (ed.) The Single Market and the Law of Banking, London, 1991, p. 159

51.- "There is no need for special protection for professional, wholesale investors, and such investors, and those markets on which they dominate should not be subject to regulation by the investor protection arm", Goodhart, "Some Regulatory Concerns", LSE Financial Markets Group Special Paper n. 79, 1995 p. 10

52.- Dermine, "EC Banking Regulation: centralisation or national autonomy". op. cit. p. 18-19. See note 43 above.

In the same direction Davis has stressed that, "Interpenetration differs widely between retail and wholesale financial markets. This is due to the greater importance of sunk costs barries to entry in the former than in the latter. The necessity for common standards in the latter is acordingly less and the rules hence run the risk of unnecessarily imposing harmonisation where interpenetration is unlikely to occur. As information asymmetries have no implications for other firms, there is no case for harmonisation of conduct of business rules"[53]

This is also the view of the ECJ in its case law. The extent to which member states should be allowed to restrict the free choice of the consumer, in favour of establishing minimum safeguards, depends on the economic level at which one activity is carried out.[54] In the case of insurance the ECJ discriminated between insurance and co-insurance products.[55] For the first type of activities, it allowed the imposition of the German rules to other member states services. On the contrary, in the case of co-insurance, the ECJ stated that: "Co-insurance arises in the context of insurance taken out only by large undertakings or groups of undertakings which are in a position to asses and negotiate insurance policies proposed to them". This distinction has been followed by the Second Insurance Directive[56].

Therefore, the role of central institutions should actively foster information mechanisms to allow regulatory competition to work in a convergent direction. The paradox is that the more European institutions succeed in pursuing this goal the fewer will be their regulatory parcel. An alternative to both allowing regulatory competition mechanisms and the total harmonisation of prudential regulations is to grant some supervisory powers to the host state, whenever it is felt that investors are not adequately protected by foreign regulation on supervision. This is precisely the approach adopted by

53.- Davis, E.P. "Problems of Banking Regulation - An EC Perspective", LSE Financial Markets Group, Special Paper n. 59, 1993, p. 13. "Competition needs to be constructed and can take a variety of forms. The dimensions of competition and the degree of competition attained can and does vary. Generally where financial products are used by individuals (as opposed to corporate users), the EC has been less inclined to force through competitive reregulation" Vipond, "Financial Services and the Internal Market" in Hurwotz ad Lequesne, The State of the European Community. Essex, 1991, p. 116 . The Cecchini report argues that more than 50% of the output of the financial sector is for intermediate purposes while only 20 is consumed directly by households. This should imply that the bulk of the financial market is that sector which will be expossed to regulatory competition. The other part 20%, constitutes the households needs that are not going to be subject to this kind of competition since consumers cannot evaluate properly the characteristics and quality of a financial product.

54.- This is the case in Ministere Public v Van Waesemel, cases 110 and 111/78 (1979) ECR 35.

55.- Commission v Germany, case 205/84, (1986) ECR 3755.

56.- Directive 88/357, OJ 1988 L172/1.

the European Commission which leaves to each host country the right to control foreign branches for reason of 'public interest'.

As a consequence, restrictions to convergence will exist, then, but it would be wrong to believe that continual national differences invariable reflect barriers to the functioning of a free market. Instead, they may reflect the realtively slower path of deregulation where consumer products are involved. Also such restrictions may simply reflect national habits and customs. Such differences are not barriers to a freely functioning market but a reflection of different preferences within a single market.[57]

Hence, for our study, it exists a clear difference between structural rules and conduct rules, as well as between wholesale banking and retail banking. It is arguable that the effects of regulatory convergence in the field of structural regulation would be much more important while conduct rules are less affected by this process.[58] At the same time, wholesale banking practices will experience a much greater harmonisation since the actors are credit institutions capable of evaluating different legal environments. The consumer, on the other side, has less technical information of the type required to evaluate by himslef the soundness of different banking conducts in retail business. Some kind of two tiered system is likely to emerge. As expressed by Hawawini and Rajendra, "As European markets in financial services integrate, we may witness the development of a two tiered market structure: one, more centralized (in the sense of harmonized) market, revolving around the largest corporate and institutional clients and the other, more decentralized (less harmonized) focusing on smaller national corporations and retail clients"[59]

This description, however, must not make us believe that competition - where appropriate - will be the perfect substitute of the traditional cartelization. As we have pointed out, the imperfect mutual recognition will

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57.- Vipond, P.A. "The liberalisation of capital movements and financial services in the European single market: A case study in regulation", European Journal of Political Research, vol. 19, 1991, p. 238

58.- Recall that the concept of regulatory convergence is used in this context. It is a much wider formulation than that of regulatory competition and location arbitrage. Thus, regulatory convergence will include several mechanisms like, emulation, threat of exit, forced international co-operation, regulatory arbitrage itself and even some degree of centralised harmonization. Despite this fact we recognise the concept can only give a partial picture of this highly complex process.

59.- Hawawini, Gabriel and Rajendra, Eric, "The Transformation of the European Financial Services Industry: From Fragmentation to Integration", Salomon Brothers Center for the Study of Financial Institutions. Monograph Series in Finace and Economics n. 4, 1989, p. 70. Parenthesis added.

also create an imperfect competition system, where cooperation will still be a crucial element. Cooperation will be necessary to maintain competition and to obtain satisfactory results; at the same time, competition will constitute a powerful incentive to avoid self interest policies or policies protecting domestic structures.

For this reason it is not contradictory to affirm that the new competitive framework will lead to a significant increase in cooperation among different national supervisory authorities; "in fact, there are a number of areas in financial systems and markets in which co-operation is a better approach to efficiency than reliance on competition and market forces. This raises the question for financial policy to what extent co-operation should be allowed to play a role in efforts towards improving efficiency and how such co-operation should be organised"[60].

There are examples, like the protection of the payment system or the flow of information among different national supervisors, where cooperative attitudes are essential[61]. But differing from the traditional era, cooperation will not be a suspicious element but a real need created by the competitive system itself. Moreover, being before an interrelational system highly dynamic and flexible, has to permit to define in every situation what will be the right combination of cooperation and competition in order to achieve a given goal.

In the light of the previous observations, one could conclude that the idea that the single-market programme tried to reach a unitary market is misleading. Instead, the final scenario will consist of fifteen sets of national rules for many financial services. However, all national orders will have been modified in order to facilitate the establishment and to allow cross-border selling for some financial products, and will be constrained by the pressure of regulatory behaviour of other Member States.

"It must be acknowledged that language, custom and geographical pressence will continue to play a role even in the days of electronic money. The countries of Europe differ in the extent of use of cash as opposed to deposits, giro and even more modern payment devices; in the extent of branching or development of regional banks; in the international involvement of its major banks; and, as often noted, in their place along the

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60.- G. Broker, *Competition in Banking*. op. cit. p. 78

61.- It has been stressed that, "The staff at Directorate-General (DG) XV who deal with these matters are few (less than 100) and already fully occupied. Therefore a complex regulatory situation has emerged where regulatory power is divided". Vipond "Financial Services and the Internal Market, in the book, *The State of the European Community*, edited by Hurwitz and Lequesne. Longman 1991, pp. 116-117.

continuum limited by Germany and Britain at the extremes of market-based and bank-based systems of long term finance.[62] All these factors influence the competitive potential of existing European banks and thus the probable shape of the post-1992 financial system"[63]

The European context will focus, in principle, in a horizontal (interstate) competition although some degree of vertical regulatory competition will also be present. This competitive need to adopt efficient norms will at the same time lead to a sort of harmonisation of the different regulations. At the end of the process the norm that has proved its efficacy will be adopted. It is then necessary to underline two aspects of the new approach: first, regulatory competition that is inherent to the principle of mutual recognition force the passing of more efficient norms[64]; second, this competitive process based on the comparability of different norms will homogenise the regulations that govern the financial sector.

The pressence of the federal intervention in this kind of regulatory competition systems can be explained by the interest involved in banking regulation; "because of the substantial public policy interest involving macroeconomic policy, safety and soudness, and stability of markets that are inherent in the financial sector, in addition to consumer protection, a greater degree of harmonisation than is necessary in the nonfinancial sector may be required to make mutual recognition and home country control acceptable to member states"[65] At the same time, central institutions have both a proactive and disciplining role in the process of competition.

3.7.2 some trends in the regulatory convergence process

62.- Hodges and Woolcock, "Atlantic versus Rhineland Capitalism in the European Community", *West European Politics* vol. 16 n. 3, 1993.
63.- Chick, V. and Dow. S.C. "Competition and the future of the european banking and financial system", University College of London Discussion Papers in Economics, 94/16, 1994, p. 3
64.- But the difficult question arises when trying to defne an efficient norm. In Llewellyn opinion's, "in the final analysis regulation is either redundant (to the extent that it prescribes behavious that the regulated would choose anyway) or acts as a tax in that it forces porfolios and behaviour away from a desired position. If it is redundant, the real resource cost of regulation, supervision and monitoring can be high. If it acts as a tax, it increases the cost of supplying financial intermediation services, and this is in some sense optimal (in that it gives the consumer the correct balance of advantage of regulation and competition) then the net effect of regulation is to produce correct pricing signals incorporating externalities. Either way the consumer pays for the implications, and such costs must be set agaisnt the benefits of regulation", Llewellyn, D.T., "Competition and the Regulatory Mix", National Westminister Bank Quarterly Review, August 1987, p. 5.
65.- Key, "Mutual Recognition: Integration of the Financial Sector in the European Community", Federal Reserve Bulletin, vol 75, n. 9, 1989, p. 605

These might be some lines of evolution along the process of regulatory competition in the European banking sector: 1.- increased banking merger activity; 2.- de-mutualization (reduction of public participation in banking) and privatisation; 3.- universalization; 4.- increased entry of foreign institutions; 5.- other elements.

1.- increased banking merger activity

In the new regulatory environment, one tends to assume an increasing pressence of foreign banks in domestic markets and the creation of a truly single banking market. There are three basic strategic responses of banks to the need for a pan-european presence:[66]

1. The green field approach.

This entails setting up branches in most of the major European cities from a well established base in one o more countries. The most obvious problem with this strategy are the demands on time and resources.

2. Acquisition approach.

The acquisition approach is favoured by various prominent German and French banks and has many advantages, namely: it is quick; you buy an established customer base; you may also get a relatively cheap retail funding base. However, this also has a major disadvantage: cost. European banks cannot be obtained without paying a substantial premium on book value. In addition, one is probably buying a bank with a different management culture and incompatible systems which will be difficult to integrate into a truly pan european business.

"It is accepted wisdom that selling bank products to retail will require a local physical presence near to the customer. The customer's caution with the asset side of his balance sheet is understandable, so there is a clear and substantial brand value to an established and respected physical distribution system"[67]

Nevertheless, one has also to take into account the distinction between product orientation and distribution orientation. An increasing number of

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[66].- Norrington, H. "Strategies for competitive advantage - banking", Reestructuring Europe's Financial Services. 1992 and Beyond. The Economist Conference Unit, 1989, p. 60-61
[67].- Bishop, Graham. "The progress to date - banking" Reestructuring Europe's Financial Services. 1992 and Beyond. The Economist Conference Unit, 1989, p. 39

financial institutions which are specialised in the production of financial products and services see themselves faced with the question of how to find access to appropriate distribution networks, notably in foreign countries. The larger banks with nationwide distribution networks generally have the capability, resource-wise of generating a wide range of products and services that lend themselves to distribution through the network of an in-house basis or via specialised subsidiaries. On the other hand, smaller retail banking institutions such as local saving banks and credit co-operatives wishing to compete with larger banks in this field are bound to buy a number of such products and services from outside producers.

But banks and financial institutions that wish to expand their retail banking operations into foreign markets see themsleves faced with the problem of how to gain access to the distribution networks of their host countries. They usually follow one or the other of the two basic strategies:
- they try to acquire an existing retail banking organisation operating in the target country
- they conclude co-operation agreements with local institutions.

3. Mergers and Co-operation:

If carefully considered, this approach has many merits. For example, in Spain, the late 80s wave of banking mergers is clearly inspired by the need to rationalise the domestic base of Spanish banks in order to withstand the competitive shock that opening up of the Spanish market will inevitably bring. However, most of the theoretical synergies in cros-border alliances will, in practice be difficult to realise. Strategic alliances have a dreadful track record but there is a need for co-operation between independent banks on infrastructure.

We have to add to the difficulty of cross-border mergers the fact that economic theory suggests that mergers should occur among institutions operating on the same territory and either competing with each other (and thus with the possibility of extensive rationalization) or offering mutually integrating product lines (and thus creating the opportunity of reaping economies of diversification). Mergers between banks located in distant markets and each having imperfect knowledge of the respective strenghs and weaknesses are likely to make the essential management decisions the merged bank has to face more difficult to reach. This should make intra-national mergers more frequent than cross-border.[68]

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[68].- Steinherr, Alfred and Gilibert, Pier-Luigi, "The Impact of Financial Market Integration on the European Banking Industry", Centre for European Policy Studies, *CEPS Financial Markets Unit Research Report* n. 1, 1989, p. 53

The creation of competitive financial products is forcing banks to reduce their costly branch networks. This is often achieved by domestic mergers between the largest banks. However, "while official statements of both regulators and public authorities cite economic efficiency as the main rationale for increasing domestic concentration, an equally pausible economic interpretation is that domestic authorities attempt to raise barriers to cross-border entry activities by foreign banks. Such entry barriers may result from the fact that a more concentrated oligopoly is able to coordinate strategies. Alternatively, regulators may merge banks which are particularly 'vulnerable' to foreign takeovers into bigger institutions which are more difficult to acquire"[69]

Therefore, if one wants to predict the future structure of European banks, one has to take into account this double set of conditions: first, the need to enhance cost efficiency has lead banks to merge, thereby reducing they total number. Second, the announced opening of borders for banking services and establishment, has also stimulated this domestic mergers trend. Banks that used to be large on their home markets, found themselves to be much smaller and vulnerable in an international context when national borders disappeared. Therefore, banks have merged with banks in their own countries rather than cross-border. Sometimes this has involved mergers between banks that were already very large in their home markets (elephant weddings). Lower bank profitability continues to suggest the existence of overcapacity in the banking market, or, in other words, that there is still a degree of overbanking.[70]

This poses the debate of the real existence of economies of scale in banks. Although economic literature is anything but conclusive, we assume that "the general conclusion appears to be that, on average, economies of scale in banking are at best elusive, limited, and seem to be exhausted at a fairly low size of bank. In other words, a bank that is moderate in size should not be at a significant cost disadvantage relative to a large bank. Size does not appear to be a prerequisite for profitability"[71]

69.- Hoschka, T. "Cross-Border Entry in European Retail Financial Services", PhD Thesis EUI, 1992. p.137

70.- OCDE, Banks under Stress, 1992, p. 12

71.- Hawawini, Gabriel and Rajendra, Eric, "The Transformation of the European Financial Services Industry: From Fragmentation to Integration", Salomon Brothers Center for the Study of Financial Institutions. Monograph Series in Finace and Economics n. 4, 1989, p. 21. On the correlation between size and profitability, see, Steinherr and Gilibert, "The Impact of Financial Market Integration on the European Banking Industry". Brussels, CEPS, 1989. This opens the debate of the existence of positive economies of scale

As a consequence, the justification for domestic bank mergers seems to respond to the second cause: to maintain a robust national oligopoly which will defend market share of home institutions and will prevent cross-border takeovers. Therefore, there is a clear role to be played by competition authorities in preventing the balcanization of markets under the false image of economic restructuring.

Finally, the issue of bank merger activity raises the question of regional inequalities. "Increased competition is predicted to restructure European banking in such a way as to reduce the local monopoly power of small local banks, but increase the market power of the large money centre banks. As a result, while the banking system as a whole will be more unconstrained in its power to create credit, some constraints on credit availability to certain classes of borrower will be preserved, and additional constraints introduced. These classes include small firms, particularly in peripheral regions, with the consequence of promoting increased divergence in the regional pattern of economic growth in Europe"[72]

"To the extent that central and peripheral economies are financially integrated, centre capital will be made available to periphery to finance investment. But a weakening in economic conditions in the periphery, which generally involves weakening exports, will be accompained by a withdrawal of capital. Unless there is a mechanism for redistribution, or access to preferential public sources of finance, the only recourse is downward income adjustment in periphery to reduce imports. The greater the degree of financial integration, the greater the dependence of periphery on outside sources of capital, given the financial dominance of the centre"[73]

As known, a paradigm of regulatory competition is inappropriate for regional distributive goals. We submit the need for accompaining the policy embodied in the Second Banking Directive with some kind of regional policy through permissible views from competition policy in those cases. On the

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72.- Chick, V. and Dow. S.C. "Competition and the future of the european banking and financial system", University College of London Discussion Papers in Economics, 94/16, 1994.

73.- Chick, V. and Dow. S.C. "Competition and the future of the european banking and financial system", University College of London Discussion Papers in Economics, 94/16, 1994, p. 25. The same point is exemplified by Zevin refering to interest rates: "If domestic financial assets are perfect substitutes for foreign financial assets, then domestic policy-makers can only exert influence over the effective stock or price of those assets to the extent that the domestic share of the relevant total world is large. Thus, for a relatively small country, control over domestic interest rates or money supply might be lost, and with it control over ultimate targets such as investment, real growth and inflation", Zevin, "Are world financial markets more open? If so, why and with what effects?", in Banuri and Schor, Financial Openness and National Autonomy, New York, 1992, p. 45

other hand, competition policy should be used to prevent that the new European banking system be more concentrated and more centralised. The increased concentration might just supplant one type of monopoly - national or local - for another - power and size.[74]

In all these cases, there is a strong need for an active competition policy in order to be able to benefit from an undistorted process of regulatory arbitrage.

2.- de-mutualization (reduction of public participation in banking) and privatisation

In comparison with other financial markets, the European one represents a major state involvement in Banking. In 1989, among the 162 largests European banks, 67 (roughly 40%) were public[75]. It is frequently argued that publicly owned banks enjoy cheaper funding costs and other regulatory advantages over their privately owned competitors since their liabilities are explicity guaranteed by government and they have acces to government borrowing.

"Among the top four countries, the UK banking sector is most 'private' whereas in France and Italy government ownership is paramount among the top commercial banks and in Germany the relatively powerful regional Landesbanken are owned by the local state governments. In terms of their comparative financial positions, European state-owned banks are somewhat smaller in asset size, are less profitable and are less well capitalized. (Thus), large government-owned banks will find it harder to compete with private and cooperative banks of the same size league. The presure to de-nationalize and to publicly float these giant banks in France and Italy hence may become stronger, both from within the bank's management and from cash-strapped governments"[76]

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[74].- For the discussion of the application of EC competition polivy to financial services, see, Lannoo, Karel, "The Internal Market for Financial Services", Centre for European Policy Studies (CEPS) Research Report n. 10, Brussels, 1992 . Cfr. also, Dassesse, "Application du droit communautaire de la concurrence aux activités bancaires: l'arret Züchner et ses suites", 18 Cahiers du Droit Européen, 1982;

[75].- Bisignano, J., "Banking in the European Economic Community: Structure, Competition and Public Policy", in Kaufman, G.G. *Banking Structures in Major Countries.* Kluwer, 1992; Molyneux, P. "An Analysis of the Structure and Performance Characteristics of Top EC Banks and Strategic Implications for 1992', Revue de la Banque, June 1989.

[76].- Hawawini, Gabriel and Rajendra, Eric, "The Transformation of the European Financial Services Industry: From Fragmentation to Integration", Salomon Brothers Center for the Study of Financial Institutions. Monograph Series in Finace and Economics n. 4, 1989, p. 13

3. universalisation

Since the Second Banking Directive configures a bank model quite close to universal banking, there is an increasing tendency towards regulatory convergence in that direction.[77] "The endorsement of the concept of mutual recognition linked with the single banking licence and the agreed list of banking activities (Annex to the Second Banking Directive) will contribute to the widespread acceptance of a 'universal type' of banking." [78] The idea at the root of the universal bank system is "that the clientele relation has a distribution cost and a value (client loyalty or inertia) and therefore, the broadening of the range of services offered to each client is more profitable than the separate offer of each service"[79]

Therefore, we argue that there are more reasons to argue in favour or economies of scope rather than for economies of scale. National banking systems are seen as developing from being bank orientated, to the so called securitized phase. The broad feature of change in moving through these phases is that the open capital markets increase their role in credit intermediation (so called market based intermediation) at the expense of the banks and other financial intermediaries (institution based intermediation). The overall tendency is that of creation of financial 'supermarkets'[80]

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[77].- See, Gardener, "Banking Strategies and 1992", in Mullineux (ed), European Banking, Oxford, 1992; Steinherr and Huveneers, "Institutional Competition and Innovation: Universal Banking in the Single European Market", in in Mullineux (ed), European Banking, Oxford, 1992; idem, "Universal Banks: The Prototype of Successful Banks in the Integrated European Market?", Centre for European Policy Studies. Financial Markets Unit Research Report. Brussels, 1989; Kregel, "Universal Banking, US Banking Reform and Financial Competition in the EEC", Banca Nazionale del Lavoro, Quarterly Review, 1992.

[78].- Zavvos, "Towards a European Banking Act", CMLRev. vol. 25, 1988, p. 276. As explained by Hawawini and Rajendra, this will chnage the charcater of product fragmentation (specialization) of European banks. Instead of havinf 10.000 banks with broad traditional categories of specialization we will have 10.000 banks effectuating similar activities. Hawawini, Gabriel and Rajendra, Eric, "The Transformation of the European Financial Services Industry: From Fragmentation to Integration", Salomon Brothers Center for the Study of Financial Institutions. Monograph Series in Finace and Economics n. 4, 1989, p. 11. Cfr also, Steinherr, alfred and Huverneers, Christian, "Universal Banks: The Prototype of Successful banks in the Integrated European Market", Centre for European Policy Studies, CEPS Financial Markets Unit Reseacrh Report, n. 2, 1990; Kregel, J.A. "Universal Banking, US Banking Reform and Financial Competition in the EEC", BNL Quarterly Review, n. 182, 1992.

[79].- Levy-Lang, André, "Banking Strategies for the 1990s", in Fair and De Boissieu, Financial Institutions in Europe under New Competitive Conditions, Kluwer, 1990, p. 44.

[80].- Gardener, "Banking strategies and 1992" in Mullineux (ed) European Banking . Oxford 1992, p. 109. See also, Rybczynski, ""The UK financial system in transition", National Westminister Bank Quarterly Review, 1984.

There are currently three broad types of financial structures in the Community: the traditional universal banking system found in Germany[81] and Netherlands whereby banks are licensed to engage in a full range of financial activites, including securites; the hybrid system, like that found in the UK after the big bang, France, and Greece; the Belgian model whereby the banks are subject to strict limitations against involvement in the securities business. "The new regulatory framework will affect the strategy not only of banks, but of Member States too, specially those that have maintained segregated banking systems. Banks from universal systems will, on the basis of mutual recognition, be able to provide the full range of their services in other Member State, even though that state's own domestic institutions cannot do the same"[82]

However, universal banking should not be confused with the regulatory possibility of operating unrestricted banking. The Annex of the Second Directive provides for unrestricted banking. Whether this possibility will evolve towards a universal structure of financial institutions is mainly a question of corporate organization."Regulatory convergence is particularly likely to occur with regard to bank powers because the Community has reached a theoretical consensus on what activities are permissible for banks. In effect, the Member States have agreed upon a goal for regulatory convergence. Banks permitted by their home country to engage in any of the activities listed in the Second Banking Directive are specifically permitted to engage in such activities anywhere in the Community through a branch o through cross-border provision of services. As a result, although the Community has not required governments to give their banks the powers on the list, it has created a situation in which regulatory convergence toward the EC list of activities as a result of market forces seems almost inevitable"[83]

4.- increased entry of foreign institutions[84]

81.- Baums, T. and Gruson, M. "The German Banking System - System of the Future?, Brooklyin Journal of International Law, vol. 19, n. 1, 1993.

82.- Zavvos, Banking Integration and 1992: Legal Issues and Policy Implications", Harvard International Law Journal, vol. 31, 2, 1990, p. 481

83.- Key, "Mutual Recognition: Integration of the Financial Sector in the European Community", Federal Reserve Bulletin, vol 75, 9, 1989, p. 604, For a detalied analysis on how this trend has been experienced in national legal order see, OECD *Banks under Stress*, 1992, where recent regulatory developments affecting the specialization of banks.

84.- Hoschka, T. "Cross-Border Entry in European Retail Financial Services", PhD Thesis EUI, 1992.

Foreign penetration of banking in Europe is a comparatively recent phenomenon. Regulatory competition has had a much greater effect on the structure and performance of national banking markets than on the effective penetration of those markets by foreign institutions. [85]

In order to predict whether or not cross-border entry will take place, we need to analyse both expected costs and benefits of the entry opportunities. However, while entry for sole regulatory purposes plays a significant role in wholesale financial services, it is unlikely to be a sufficient explanation for cross-border entry in retail financial services.[86]

A possible strategy for banks is to enter a profitabe but highly inefficient market. Collussion among domestic firms may reduce the level of efficieny but still market attractiveness remain. Whether the strategy of entry is successful, depends crucially on the reaction of domestic firms. For example, "in merchant banking, skills and strengh acquired over time through actual deals in, say, mergers and acquisitions, produce a track record which may be the most important asset of a merchant bank and hence, virtually by definition, generates economies of scale. British merchant banks are generally considered as more experienced and skillful than their continental counterparts. The large continental market is attractive to British merchant banks and they can be expected to use their competitive advantage to enter continental markets. Continental banks dispose of two major defensive strategies: one is to benefit from their universal banking structure, the other is to cross-subsidise merchant banking ativity. In answer to this, the newcomers may initially price their services at a marginal cost which, if economies of scale are important, may be substantially below average costs. Hence there would be price discrimination and a form of dumping: British customers would pay full costs and continental customers less than full costs. This opens a second possibility of retailiation: some continental banks with large capital resources may enter into merchant banking in the UK and apply their marginal cost strategy there. This entails massive risks of corporate warfare, conflicts with national authorities, overbuilding of capacity and creating high barriers."[87]

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[85].- Dermine, "EC Banking Regulation. Centralization or National Autonomy", INSEAD Working Paper Series, 93/13/FIN/EPS. Fontainebleau, 1994 p. 5-6.

[86].- Hoschka, T. "Cross-Border Entry in European Retail Financial Services", PhD Thesis EUI, 1992. p. 96

[87].- Steinherr, Alfred and Gilibert, Pier-Luigi, "The Impact of Financial Market Integration on the European Banking Industry", Centre for European Policy Studies, *CEPS Financial Markets Unit Research Report* n. 1, 1989, p. 42. As explained by Kane, it is useful to distinguish between active and passive movements of regulators. "Passive movements occur when regulatees gain or lose market share on their own, unrelated to prior or concurrent adjustments that may be carried out by their traditional regulators. Active movements are those brought about by regulator's effort to realign the operative regulatory structure. In turn, active adjustments may be either

It also has to be taken into account that financial-asset prices can change to incorporate new information before any new transactions take place, or can eliminate the profit of arbitrage before any arbitrageurs have traded.[88] This is in line with our argumentation that the process of regulatory competition can take place without any real movement of entities. Just the threat of exit is an enough powerful mechanims to provoke regulatory (or price) adjustments. As explained by Steinherr and Gilibert, "once foreign banks have the right of entry this right does not need to be exercised to reduce margins in the protected banking industry. Oligopolists faced with the potential threat of entry will behave like competitive firms."[89]

Liberalisation measures have opened borders for foreign banks around the globe and cross-border capital flows and financial services have increased. However, multinational banking establisment has not grown to the extent that might originally have been imaginated. "In the discussion of competitive relocation of banking activities and expansion of the branch network it is usually assumed that supply needs to move closer to consumers to satisfy their demand. This view neglects the rapid advances in technology which allow demand to move to distant supply centres and render geographical specialization possible. In fact, with modern technology, demand for corporate and private banking has already become highly mobile, even beyond national boundaries"[90]

"In designing their competitive strategy for the 90s with a view to meeting the challenges of intensifying competition, banks have a certain choice between consolidating their home market positions and competing more vigorously abroad and extending their international presence accordingly. In practice, most institutions follow either line of action. But there are indicators that in case of a conflict between the two objectives, priority is given to strengthening the institutions' competitiveness on the home front against an expected onslaught from foreign newcomers"[91]

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aggressive or defensive in intent". Kane, "Competitive financial reregulation: an international perspective", in Portes, R. and Swoboda, A.K., *Threats to International Financial Stability.* Cambridge U. Press, 1987, p. 114.

88.- Zevin, "Are world financial markets more open? If so, why and with what effects?", in Banuri and Schor, Financial Openness and National Autonomy, New York, 1992, p. 43

89.- The threat of foreign entry in a liberalised European financial market has by itself sufficed to induce a restructuring in the Spanish banking market. Vives, "Deregulation and Competition in Spanish Banking", European Economic Review, vol. 34, 1990.

90.- Steinherr, Alfred and Gilibert, Pier-Luigi, "The Impact of Financial Market Integration on the European Banking Industry", Centre for European Policy Studies, *CEPS Financial Markets Unit Research Report* n. 1, 1989, p. 25

91.- OECD, Banks under Stress, 1992, p. 22

5. Other elements

a) convergence on interest rates paid on retail deposits

Traditionally banks have benefited from regulation or 'gentelmen's agreements' on interest rates paid on retail deposits. However, the transition from competition based on client relationships to price-based competition demonstrates both the dismantling of collusive practices in some countries and the demand for services based on price and quality (market rates).[92] The changing competitive nature of the industry makes no longer possible the maintenance of such artificial limits.

In France, for instance, a 1967 law prohibits the payment of interests on current accounts. Under the home-country rule, foreign banks will be able to offer interest on such accounts and these prohibitive regulations are going to be contested by domestic institutions.[93]

Interestingly enough, in the more recent period 1987-1992, one observes a clear pattern of convergence. Interest rate margins are going down in Belgium, France, Denmark and Spain, but they are going up in the Netherlands and Germany. The convergence of spreads is a direct effect of the convergence of short term interest rates brought on by the EMS and the abolition of controls on capital flows. [94]

b) convergence of taxation of financial products

Another area that has been indetified as potentially under the effects of regulatory competition is the taxation of interest rate earnings.[95] With the possibility of cross-border transfers, consumer can select that country with a lower level of taxation.

Depositors may be highly sensitive to differences in taxation principles. Let us examine two examples:

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[92].- Canals, Competitive Strategies in European Banking, Oxford, 1993, p. 195

[93].- Except considering that the prohibition is founded on grounds of monetary policy. In that case, home-country principle is not applicable.

[94].- Dermine, "EC Banking Regulation. Centralization or National Autonomy", INSEAD Working Paper Series, 93/13/FIN/EPS. Fontainebleau, 1994 p. 4

[95].- Giovannini and Hines, "Capital Flight and Tax Competition: Are There Vaible Solutions to Both Problems?" in Giovannini and Mayer,(eds) European Financial Integration, Cambridge, 1991.

Banks in Belgium used to tax differently the savings deposits (tax-free) in front of other financial instruments (25%). In April 1991, the Minister of Finance lowered the tax rate on interest income to 10% to reduce capital outflows to the neighboring country of Luxembourg. As a result a tax differential between savings deposits and other instruments was reduced and Belgian banks have seen the percentage of savings deposits in the composition of their liabilities fall from 48% (1986) to 34%(1992).

"In Germany the introduction of a witholding tax of 25% in 1988 resulted in a capital flight of more than DM 70 billion, forcing the German government to quickly abandon this tax.[96] This example illustrates that economic agents respond quickly to differences in taxation. A significant proportion of the capital was transferred to Luxembourg where domestic and German banks offered special investment funds which were regulated under Luxembourg law and thus exempt from German witholding tax"[97]

Free movement together with taxation differences will exert pressure to reach some kind of rate convergence. However, the optimal taxation has also to take into account the possibility for capital in a global economy to move to off-shore centers or to tax-heavens. At the end of the day, it has to be some balancing between taxation and the quality of regulatory settelment offered (for instance some trade-off between quality of regulation and supervision enhancing financial stability and tax reduction).[98]

c) convergence in reserve requirements

Minimum reserve requirements represent a percentage of deposits a bank has to hold at the central bank. Depending on the remuneration of these reserves, they can effectively function as a tax levied on banks.

Different reserve requirements on banks can produce competitive distortions since the monetary mass able to be used in lending activities is not equal. Thus, a credit institution subject to a zero reserve requirement (Luxembourg) branching in Portugal (15% reserve), will enjoy a competitive advantage.

96.- Cfr. Genschel and Plümper, "International Cooperation in the Shadow of Regulatory Competition" mimeo. p. 17 and ff.

97.- Hoscka, Cross-Border entry of European Retail Financial Services. PhD Thesis, EUI, 1992 p. 66

98.- Dermine, "EC Banking Regulation. Centralization or National Autonomy", INSEAD Working Paper Series, 93/13/FIN/EPS. Fontainebleau, 1994 . Cfr, also Genschel and Plümper, "International Cooperation in the Shadow of Regulatory Competition" mimeo. p. 15

"So far, reserve requirements have been considered a monetary policy instrument by the EC Commission and are therefore exempt from the home-country rule. Nevertheles, international capital mobility may lead to a situation where banks from a system with high reserve requiremens are disadvantaged due to higher funding costs. This is likely to lead to pressure on the domestic central bank to relax reserve requirements. Such a process could already be observed in France where minimum reserve requirements were reduced in May 1992 from 4.1 % on current accounts to 1 % and from 2% to 1% on savings accounts. A similar development has taken place in Spain where reserve requirements were reduced in March 1990"[99]

3.7.3 . Conduct regulation and the question of unharmonized contract law.

The principle of mutual recognition of authorisation and supervision of banks has however a further issue which deserves closer atention. Mutual recognition means that the activities of a bank are going to be subject to the home state law in the host state. Thus, it is easily arguable that regulatory competition could be extended beyond institutional regulation to functional regulation, concerning banking activities and contractual law for financial products.

"There has already been great progress in the harmonisation of the banking supervisory law. The contrary is true, however, for the law of bank transactions. The contract laws, securities laws, consumer laws and procedural laws of the Member States differ widely. For example, in the Netherlands and France, the maximum interest rates for consumer credit are fixed. In Great Britain, the double of the market interest rate is lawful"[100]

Is the operation of this plurality of different legal orders subject to the principles of conflicts of laws? In absence of harmonised contract law, which is the applicable law?

In this situation, the conflictual-like technique based on private international law has to be applied, at least as guidance. The problem is to determine if the minimum harmonisation pressumed in the principle of

[99].- Hoscka, *Cross-Border entry of European Retail Financial Services.* PhD Thesis, EUI, 1992 p. 62

[100].- Schneider, "The harmonisation of EC banking laws: the euro-passport to profitability and international competitiveness of financial institutions", *Law and Policy in International Business,* vol. 22, 1991, p. 276

mutual recognition should also extent to the field of contract law regarding the activities under mutual recognition[101].

This is for instance the case in the insurance sector[102], where the Community has in certain way balanced the need to protect the policy holder by adquate contract law and the functioning of regulatory competition. "There is an inevitable conflict between an open market and protection of the consumers' interests. National laws designed to protect the consumers by stipulating the conditions under which services may be provided, constitute barriers to trade in services. Moreover, the variation of the levels of the consumer protection of the Member States might make it more costly for the supplier to operate throughout the Community if all national requirements on consumer protection shall be complied with"[103]. Thus, contract law is imposed through conflict of rules system.

One means of harmonising contract law in the field of banking is the establishment of minimum levels of protection and common rules of private international law[104]. This is the case in the Rome Convention (which entered into force in April 1991). Article 5 of the Rome Convention confers protection to the 'passive consumer' by the mandatory requirements of the law of his country of residence, regardless of the law applicable to the bank operating in the domestic market. This means that a German resident opening a savings account in a Greek bank in Germany is allowed to the protection of german law regardless that the activities of the foreign bank are subject to greek law.

"Another means consists in establishing harmonised rules with regard to the permissible contents of contract for services. It is here that Community legislation in found particularly lacking. Community legislation has confined itself to adopting some minimum rules in relation to consumer credit in

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101.- Luzatto, Riccardo, "La libera prestazione dei servizi bancari nella Cee ed il principio del mutuo riconoscimento degli enti creditizi", *Il Foro Italiano,* 1990, IV, p. 451

102.- Connor, J.T. "Deadlines and Dangers EC 1992: The Single License Regime for Insurance, Banking and Financial Services", Boston University International Law Journal, vol. 9 n. 2, 1991, where it is stated that " insurance poses special problems to the single license regime because harmonization and investment liberalization may be incompatible with home Member State protection of consumer interests", in op. cit. p. 203. Cfr. also, Everson, M. Laws in Conflict. A Rationally Integrated European Insurance Market?", PhD Thesis, EUI, 1993.

103.- Nielsen, *Services and Establishment in European Community Banking Law,* Conpenhagen, 1994 p. 253, quoting Bourgoignie and Trubeck, *Consumer Law, Common Markets and Federalism in Europe and the United States*. Berlin, 1987.

104.- Koch, Harald, "Private International Law: a 'soft' alternative to the harmonization of private law?", paper delivered at the *Workshop on The Impact of European Integration on Private Law: The Case of the Directive on Unfair Terms in Consumer Contracts*. EUI, Florence, September 1994.

Directive 87/102/EEC[105]. For other financial services, there exist only recommendations as instruments of soft law"[106]

In this respect is worth signaling at least three examples of this kind of minimum norms for contract law or for substantial harmonisation of banking contracts:

1. Recommendation 88/590/EEC[107].

This recommendation deals with protective rules for consumers, most notably in the case of loss or abuse of a credit card, providing that a consumer be protected against abuse if he or she has notified a central network of the loss of the card. Before notification, the liability of the consumer should be limited to a celining of the equivalent to 150 ECU per case unless he or she is proven to have acted with extreme negligence or fraudulently. The recommendation, even though it is binding still has some legal effects because Member State courts are under an obligation to take account of them in a litigation concerning the interpretation of implementing State or Community legislation.[108]

On the top of that, the implementation of the Recommendation by German credit institutions also provides an example of the relative need of complete uniformity in consumer protection. Private banks have implemented the Recommendation by limiting the liability of consumer to 10% of loss while savings banks do the equivalent by fixing an lump sum of 6000 DM. Thus, diverse solutions achieve a similar protective result and show the importance of agreeing in the substance of consumer protection policies while leaving the means to different institutions (or governments). The market and consumer arbitrage can in the long run determine the peferred form of protection once a policy goal has been established.

105.- OJ L 42/48 of 12.2.1987, as ammended by Directive 90/88/EEC (OJ L61/14 , 1990). Cfr, generally, Mitchell, J. *Banker's Racket or Consumer Benefit. A consumer view of the Single European Market for Financial Services.* London, 1991; Chombrugghe, N. "Consumer protection and fredd movement of financial services' in Campbell D. and Moore, M. *Financial Services in the New Europen Community.* CILS, London, 1992.

106.- Reich, Norbert "The Evolution of Community Law on Services, with especial reference to financial services and consumer protection", Zentrum Für Europaïsche Rechtspolitik Discussionspapier 1/94, p. 3. See for instance, Rec. 88/590/EEC on electronic means of payment, OJ L 315/55 of 24.12.1988 and Rec. 90/109/EEC concerning transparency of applicable charges in cross-frontier banking operations, OJ L 67/39 of 15.3. 1990.

107.- OJ L 317/55 of 24.11.1988. See also , Commission Recommendation of 8/12/1987 on a European Code of Conduct relating to Electronic Payment. OJ L365/72 of 24/12/1987.

108.- Reich, Norbert "The Evolution of Community Law on Services, with especial reference to financial services and consumer protection", Zentrum Für Europaïsche Rechtspolitik Discussionspapier 1/94, p. 28

2. Directive 87/102/EEC on the aproximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit[109].

Aware of the fact that differing Member State legislation in the field of consumer credit may provoke competitive distortions among producers, the Council adopted the present Directive. Thus, although not directly invoking consumer protection grounds, the Directive underlines the right of the consumer to receive adequate information on the conditions and costs of the credit. (annual percentage rate). The directive also contains certain provisions on unfair credit terms without making clear its scope and philosophy. However, the process of implementation of the directive has been very slow and irregular and the directive is not enough precise as to consider its direct effect.

Despite of these shortcomings, the Directive represents a valuable indicator of the new direction to be taken in the field of consumer protection, i.e. empowering consumer to exercise a responsible choice through the provision of information. Providing more information to consumers means diminishing the asymetric information market failure which both justifies regulation and hampers the functioning of regulatory competition.

3. Directive 93/13/EEC on unfair terms on consumer contracts[110].

"The need to harmonize insurance contract law is indirectly spelled out in the new Community proposal on a directive against unfair terms in consumer contracts. Article 5(1) contains a general clause that "in case of contracts where all or certain terms offered to the consumer are in writing, these terms must always be drafted in plain, intelligible language". Such a drafting on a Community level will require considerable efforts on the side of the insurers and consumer organizations alike. If successful it may one day supersede conflict of law solutions and thereby shift competition of legal orders from procedure to substance"[111]

There is an observable tendency which partly explains this lack of Community legislation. Liberalisation measures repeal much of unjustified state regulation for financial services. This repeal is not however

[109].- OJ L 42/48 of 17.2.1987

[110].- OJ L 95/29.

[111].- Reich, Norbert, "Competition between legal orders: a new paradigm of EC law?", CMLRev, vol 29 n.5, 1992 p. 877.

accompainned, in the field of contract law by a corresponding harmonisation. That means that for instance, German law was much confident in supervision and authorisation as a means of control of insurance policies. The weakening of this instrument through mutual recognition is not paralleled by a much rigid contract law which remains mainly unharmonised at Community level.

Instead, the trend is to allow the onw industry to self regulate those conditions. This is the case of Regulation 1534/91[112] where the Council limits itself to allowing self regulation by the insurers, who may conclude agreements "on the establishment of standard policy conditions". This is also the case of the proposed directive on uniform standards in cases of loss or abuse of a bank card. The Commission initially proposed a directive which the banks prevented becoming law. Instead, it issued a recomendation[113] which has been the base for two Codes of Conduct of European Banks on payment cards.

It is clear that consumer protection has not been subject to wide harmonization measures. Instead, much of the convergence is expected to occur through regulatory competition since information asymetries will less and less justify regulatory intervention. On the other side, and paradoxically, retail banking, the field where to play this regulatory competition will be and remain quite fragmented because of the structure of the market itslef and of the existence of barriers such as the deeply rooted character of domestic banking traditions, reputation and switching costs.

As affirmed by an eminent expert, "the main protection against a bank failure must be internal management's own risk controls. It is increasingly doubtful whether regulators can effectively aim to second-guess management by direct supervision on the basis of private information. Placing more weight on pubic disclosure, though not likely to be any better in preventing insolvencies, may be a more realistic approach"[114]

"The deregulation of State law is supplemented by agreements between suppliers. It is not yet sure whether the insurance companies will implement this strategy; they are under no obligation to do so. If they do, it remains to be

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112.- OJ L 143/1 of 7.6.1991.

113.- Recommendation 88/590/EEC, of 17.11.1988; OJ L 317/55 of 24.11.1988

114.- , Goodhart, C.A.E. , "Some Regulatory Concers", LSE Financial Markets Group, Special Paper n. 79, 1995, p. 6. This is in fact exemplified by the Barings Bank failure. That was not a case of failure to supervise but of the impossibility of evaluate risks with current regulatory techniques (occasional snap-shots of balance sheets). Nowadays, a banks' risk can dramatically shift overnight by a single trader or operator as was the case in the Barings affaire.

seen of what happens to the consumer interest being, as it is, a diffuse one without a professional organisation"[115]

This is also shared by Carosio, who suggests that competition between regulators in the EC will have the side effect of increased privatisation of regulation in that institutions such as rating agencies auditing firms and associations for accounting standards will have an increased role vis-à-vis government agencies. [116]

This kind of two tier regulation or privatisation of regulatory powers till now in the hands of governments has also is repercussions in competition law. This form of cooperation among bankers is exempted of antitrust scrutiny by virute of Commission Regulation 3932/92.[117] Again, the strategy of regulatory competition leads to an increase of cooperative devices among the industry.

Moreover, there are also some effects of regulatory competition in private law. Since regulatory models are put under pressure, this also implies some convergence of private law. However, to argue mutual recognition of different forms of contract law in the filed of banking seems to be outside the scope of the Second Banking Directive. It has been noted that the amenmend of recital 16th changing mutual recognition of 'financial techniques of the home Member State' for 'activities receiving mutual recognition in the same manner as in the home Member State', precisely indicates a will of the European legislator not to foster regulatory competition among different forms of banking contractual differences[118]. However it might be, the detailed research on this point goes beyond the ambitions of this work.

3.7.4 Regulatory competition: a balanced evaluation.

115.- Reich, Norbert "The Evolution of Community Law on Services, with especial reference to financial services and consumer protection", Zentrum Für Europaïsche Rechtspolitik Discussionspapier 1/94, p. 21

116.- Carosio, G, "Financial Regulation in Europe", LSE Financial Markets Group, Special Paper n. 43, 1990. On the role of rating agencies, see, Jordan, J.L. "A Market Approach to Banking Regulation" CATO Journal, vol. 13 n. 3, 1994

117.- OJ L 398 of 31.12.1992. Art. 5 of the regulation exempts agreements which have as their object the establishment and distribution of standard policy conditions for direct insurance as well as common models illustrating the future benefits of a life insurance policy.

118.- van Aken, "The Evolution of Community Law on Services. Community Regulation on Banking Services", Zentrum Für Europaïsche Rechtspolitik Discussionspapier 1/94, p

Traditional theories of banking regulation have assumed a certain trade-off between systemic risk and systemic efficiency. In order to secure a stable financial system some measure of efficiency ought to be sacrificed. If regulators overemphasise the need to prevent grave disruptions of the financial system by stringent regulation of financial institutions, they run the risk of unduly stifling competition and thereby removing these institutions' incentives to outdo their competitors' efficiency. An over-reliance on unrestrained competitive forces may promote efficiency, but exposes the financial sector to the risk of breakdowns, which may in the end cause a general loss of confidence in the financial system. But this trade-off is not an absolute one. A financial system requires a stable and credible legal framework to retain the public confidence that is essential for its functioning. So it is not surprising that the financial deregulation in the 80s has been accompanied by certian forms of reregulation, in particular a strengthening and harmonisation of prudential standards.[119]

This deregulation, in the sense of removing obstacles for establishment and services and of non-interference in the price mechanism, has been quite pervasive during the last decade. Controls on interest rates and the price of financial services, which were still fairly widespread around 1980, have now virtually disappeared. The right of establishment for both foreign banks and branches of domestic banks have been considerably liberalised

In sum, legislators and other regulators have re-oriented themselves towards a greater reliance on measures that are compatible with free competition. Curiously enough, regulation of the financial sector has traditionally been anti-competitive in nature due to the goal of preventing excessive risk taking by the financial institutions. While the consumer may demand benefits of regulation (more stable system) may also demand the benefits of a more efficient services performed under competitive market conditions. The issue is then how much regulation is necessary to balance these interests or how much competitive regulation could be used to satisfy both concerns (stability and efficiency). There is thus a clear changing perception as to the effectiveness of restricting market forces. The existence of 'grey' financial markets and specialised institutions that were less strictly regulated than banks gave rise to disintermediation, while competition from the euro-capital market and other foreign markets increased the pressure for liberalisation.

The new regulatory approach destroys this false dilema between efficiency and system stability. "Designing financial structures that work with

119.- Cfr. Blommestein, "Structural Changes in Financial Markets: Overview of Trends and Prospects" in OECD, The New Financial Landscape, Paris, 1995.

rather than against efficient adaptation by clients provides the best chance of achieving society's long run regulatory goals".[120] Moreover, it is assumed that the more efficient a banking system will be, the fewer the probabilities of bank failures and of system disruptions.

Another factor that may explain the shift out of restrictive measures is that such measures do not merely promote the financial system's stability. In addition to enhancing the scope for a more efficient allocation of capital, free competition does not necessarily promote the accumulation of risks by financial institutions; it also induces them to maintain sufficient strength to be able to withstand the competition from others. Conversely, it may well have been anti-competitive regulation itself that has caused the financial weakness of some institutions.

But the shift towards other forms of regulation - singularly competitive regulation - does not mean that concerns about the degree of competitive freedom are no longer relevant. It may in fact well gain relevance as further harmonisation of regulatory standards is achieved. Harmonisation, combined with a general raising of prudential standards, could dilute the competitive edges that are driving force for progress and market development. Harmonisation involves often cumbersome negotiations, in which countries are inclined to defend their own system in the first place , and the result may be a compromise by which some countries end up with more stringent regulation than they would consider reasonably justified . While the merits of harmonisation are obvious, an elimination of the possibilities for regulatory arbitrage would remove an important means of preventing over-regulation.

Historically, the purpose of maintaining stability and soudness has been approached from two different angles. First by restriction of market forces, which seeks to shield the financial sector from the supposedly disruptive forces of unrestrained competition. We have already argued the ill-oriented formulation of this dilema. Regulations of this category, representing obstacles to free competition in financial services, have been removed on a broad front. Secondly, stability and soundness was also pursued by means prudential regulation. Prudential regulation sets standards for prudent management of financial institutions but does not directly interfere with the price mechanism, nor prohibits the rendering of financial services. At the same time, prudential regulations have generally been strengthened and adapted to the new competitive environment[121]. Therefore structural deregulation and

120.- Kane, E.J. "How Market Forces Influence the Structure of Financial Regulation" in Haraf and Kushmeider, Restructuring Banking & Financial Services in America, American Enterprise Institute, Washington, 1988, p. 380

121.- OCDE, Banks under Stress, 1992, p. 32

prudential re-regulation are twin forces observed in the process of regulatory competition.

In the years immediately following the Second World War, government regulation of the financial sector used to take the form of restrictions on competition between financial institutions. All OECD member countries regulated bank deposit rates, lending rates or both or tolerated cartel agreements among banks to curtail interest rate competition. After 1960, and increasingly so from the late 70s onwards, government regulation of the financial sector shifted from the restriction of market forces to more market oriented systems.

Moreover, what has emerged is that two basic trends in regulation are currently operating in opposite directions: the process of various forms of de-regulation is enabling financial institutions across the border to widen their range of services while at the same time the authorities are imposing a more stringent regulatory environment with respect to the conduct of each of their particular areas of activity.[122] Again, a double process of more or less harmonised structure rules and competitive convergence in the field of conduct rules has been detected.

Finally, we argue that the results of regulatory competition will greatly differ depending on the type of financial product and client involved. Thus, while competitive convergence has already progresed in wholesale banking, retail banking is lagging behind. This might be explained by the fact that retail institutions have to face deeply rooted consumer preferences for home produts. This implies reputation and switching costs which are not alleviated by a process of regulatory competition.

It is very difficult to predict a fixed banking regulatory structure in the EU, since, by design, the system is expected to evolve toward a competitive equilibrium. A component of this structure will include some harmonised regulations and agreements that are organised cooperatively among banking regulators. The other component will largely depend on how Member States respond to competition that may place their banks at a competitive disadvantage within their home markets.[123] In any case, the new regulatory

122.- Llewellyn, D.T., "Competition and the Regulatory Mix", National Westminister Bank Quarterly Review, August 1987, p. 9
123.- Bisignano, J., "Banking in the European Economic Community: Structure, Competition and Public Policy", in Kaufman, G.G. *Banking Structures in Major Countries*. Kluwer, 1992, p. 199-200.

technique will lead to a banking system more diversified both geographically and by activity.[124]

Member nations with less developed banking systems should expect to see an acceleration in their stage of banking development as a result of financial integration. The common regulatory framework will reflect the practices of the most advanced banks. Rapid adjustment can be expected to be painful and will dislocate the real economy as well as financial institutions. However, attemps to delay adjustment would encourage takeover by outside banks[125] Generally speaking, potential economic gains are largest for the most distorted markets, that is those markets subject to a more rigid interventionist system.

"1992 certainly does not mean an overnight revolution; it does not mean that the Commission or anyone else will pull a switch on 31st December 1992 and the scenery of the promised land will suddenly appear. The programme is a continuous process of change which has already begun and which will no doubt continue beyond 1992. We will certainly not achieve (even if we considered desirable which is not) completely uniformity of market conditions by 1st January 1993. For example, we will still have (at least to a considerable extent) twelve different laws of contract, twelve different sets of company law, twelve different tax regimes and different consumer protection regimes. Some of these differences will present obstacles to free trade in financial services which may have to be removed after 1992, either by eroding forces of competition or by actions before the Court or by further harmonisation"[126]

124.- Capie, F.H. and Wood, G.E. "Banking Structure and Banking Stability after 1992" in Fair and De Boissieu, Fair and De Boissieu, Financial Institutions in Europe under New Competitive Conditions, Kluwer, 1990, p. 317

125.- Chick, V. and Dow. S.C. "Competition and the future of the european banking and financial system", University College of London Discussion Papers in Economics, 94/16, 1994. p. 26

126.- Fitchew, Geoffrey, "The Progess to Date - an EC Perspective", Reestructuring Europe's Financial Services. 1992 and Beyond. The Economist Conference Unit, 1989, p. 24

CHAPTER IV

THE US 'DUAL BANKING SYSTEM': RISE AND FALL OF A MODEL OF REGULATORY COMPETITION.

> "I do believe that [the 'dual banking system'] has been a rather important means of keeping vibrant a banking system that might otherwise become stagnant or lifeless because of mindless, bureaucratic regulation. This is not because of what dual banking does in a positive sense, but largely because it offers options and alternatives."
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> Carter H. Golembe, "Are the States still part of the Dual Banking System?" Banking Policy Report, vol 13 n°8, April 18, 1994, p. 4

4.1 Introduction

Traditionally, the 'dual banking system', the model of banking sector's public regulation in the US, has been considered a paradigmatic example of competition among norms and regulatory administrations. In plain language, one could say that under this system, the chartering of a bank as well as its supervision might opt between the federal or the state level of government. Banks can select which level of government will be their primary regulator.

The possibility of choice between these two regulatory options - the federal and the state one - supposes a competitive pressure on both systems since they are compelled to offer adequate norms in order to avoid financial institutions to move from one regulatory sphere to another[1].

As Hill states, "regulatory competition, which is one of three components of the current dual system, was evident by 1865. The powers of

[1].- One could find, among the main reasons why the regulators are interested in compete for the maintaining of banks within their jurisdiction: the fees and taxes they collect, jobs provided by the banking industry, and capital generated by the resident banks.

state-chartered banks were determined by their legislatures, and state banks were accountable to their chartering agencies. The powers of national banks were defined by the Congress, and national banks were answerable to their chartering authority - the Office of the Comptroller of the Currency (OCC), part of the US. Department of Treasury. Regulatory competition between state and federal authorities first appeared in reaction to congressional restrictions on both state-chartered banks and federally chartered banks"[2]

The very existence of regulatory competition between the state and federal authorities, did not suppose that Congress could not dictate norms which could globally restrict both systems, basing its action under the Commerce Clause. This position of superiority, however, had not been used till recently, since it was recognised that a system based on regulatory competition offered undeniable advantages, which the federal regulation, with uniform intention, would have eliminated.

However, it can be readily perceived that this equilibrium among different regulatory authorities is unstable by nature, constantly evolving and giving rise to different roles of the respective authorities and regulatory agencies. Activities of nationally chartered institutions are subject to and constrained by State law; conversely, state banks are subject to, an ever growing extent to federal legislation.[3] At the same time, the role of regulatory competition in different contexts will vary. Along this section, we will analyse, in a descriptive manner, two stages in the characterisation of the 'dual banking system' and the role of regulatory competition in each.

Surprisingly, it is unanimously recognised, that the existence of the dual banking system is fruit of a historic accident instead of the firm determination of the legislators to establish a dual system based on a free choice principle[4].

2.- Hill, "The savings and loan debacle and erosion of the dual system of bank regulation", *Publius* n. 21, 1991, p. 30.

3.- Huber, S.K. "The Dual Banking System: Interaction of Federal and State Law in the Regulation of Banking", Consumer Finance Law Quarterly Report, vol. 42 n.2, 1988.

4.- According to Butler and Macey,"The existence of the dual banking system is an historical accident in the truest sense of the word", Butler and Macey, "The of Competition in the Dual Banking System", *Cornell Law Review*, vol. 73, 1988, p. 681. It is also stated by Golembe and Holland that, "In 1963, the American Bankers Association celebrated the hundred anniversary of the 'dual banking system', i.e., a system offering the option of chartering and supervision by federal or by state authorities. It is doubtful, however, that anyone in 1863 was conscious of the fact that such a system had been created. If anything, the two banking systems were at war, with each seeking the extermination of the other". Golembe and Holland, *Federal Regulation of Banking. 1983-84.* 1983, p7.

The banking system, regulated initially only at state level[5], tried to be replaced by a federal system during the Civil War, but state resistance gave rise to the superposition of both systems, situation that has lasted till nowadays[6].

National banks were first authorised by Congress in 1863[7]. After the short experiences of the First and Second National Banks, the National Bank Act permitted the chartering of national banks by the Comptroller of the Currency. These national banks where subject to strict lending restrictions - they could not lend more than 10 % of their capital stocks to any one borrower - and they could only issue notes to the extent of 90% of the value of the United States bonds they held. "The purposes of this legislation were to provide the nation with a stable currency, to replace the existing chaotic system of notes issued by state banks[8], and to help finance the Civil War by creating a market for US government bonds.[9] It is quite clear that the spirit of this legislation was antithetical to the dual banking system as it subsequently developed. The framers of the National Bank Act hoped that the option of a federal charter would prove so attractive to the existing state chartered banks that all would convert in a short time, thus replacing the system of state-chartered banks with one of federally-chartered banks."[10]

However, because the national regulation was stricter than those of the states[11] and because the Comptroller of the Currency enjoyed a great range of

[5].- "For the first 75 years after the adoption of the Constitution, the regulation of banking was almost entirely a state matter. In that period of the nation's history the federal government's major involvement with banking was limited to the two Banks of the United States, each chartered for a 20-year period". Golembe and Holland, *Federal Regulation of Banking. 1983-84.*, op.cit p. 4

[6].- It has been recognized that politically, the dispute between Federalists and Anti-Federalists factions led to a bank chartering authority at both state and federal levels. Symons, E. and White J. Banking Law, 1984, quoted by Cane and Barclay, "Competitive Inequality: American Banking In The International Arena", Boston College International and Comparative Law Review, vol 13 n.2, 1990.

[7].- By the National Currency Act of 1863, supplanted in part by the National Bank Act of 1864.

[8].- It is a remarkable fact that until Congress authorised the Treasury to issue paper currency in 1862, the United States had no national paper currency, but instead 7,000 different kinds of notes issued by 1,600 state banks (!!!). Galbraith, *Money: Whence It Came, Where It Went*. Penguin 1975, quoted by Litan, *What Should Banks Do?*, Washington 1987, p. 20

[9].- In fact, it has also been argued that "the creation of a national banking system can be seen as an attempt of the federal government to extent its control of the banking business, as it can be used to finance its debt", Schneider, F. "Regulating the Banking Sector", EUI Thesis, 1989, p. 133

[10].- Geoffrey P. Miller, "The future of the dual banking system", *Brooklyn Law Review, vol. 53, n.1, 1987*, p. 13

[11].- "State bank Charters were widely regarded as preferable to national charters because of lower minimum capitalization, more easily met reserve requirements and generally less stringent

discretion in granting or not the national charter, most banks continued to operate according to state charters. In sum, although the new national legislation, state banks continued to have more advantages such as easier charter requirements, lower reserve requirements, fewer regulations and more liberal branching provisions. "When state banks did not cooperate, Congress attempted to destroy the state banks outright by imposing a punitive tax on state bank notes, a measure that failed only because of the development of checking accounts as effective substitutes for bank notes. The creators of the dual banking system, in short, were hardly bent on establishing the overlapping scheme of state and federal chartering that we observe today"[12]

In fact, and despite hardly noticed, one may argue that this historic accident is instead a consequence of the plural structure of division of powers existing in the federal system of the United States. It is not casual to find among the arguments for mistrusting the new system of national chartering the fact that the Comptroller of the Currency accumulated the entire power to charter or not a new bank. Such a discretion is normally rare in pluralistic structures. Having in mind those premises, the 'dual banking system' may be considered as a foreseeable or natural result in a system of fragmentation and duality of powers like the American one, more than a simple accident. [13]

In developing this section we will focus on three stages of the US banking system. Firstly, we will characterise the 'dual banking system' as a regulatory model based on regulatory competition. Secondly, and according to a more recent and critical vision, we will analyse the effects of the passage of relevant federal legislation on the real functioning of the system. Under this latter approach, the traditional division between States and Federation in the field of banking regulation has been altered due mainly to a gradual transfer of competencies in favour of the Federation and consequently to the detriment of the States. Finally, we study the revolutionary transformation of the banking system and specially, the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

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regulation", Huber, S.K. "The Dual Banking System: Interaction of Federal and State Law in the Regulation of Banking", Consumer Finance Law Quarterly Report, vol. 42 n.2, 1988.p. 52

[12].- Geoffrey P. Miller, "The future of the dual banking system", op. cit. , p. 13-14, quoting Swanson, *The establishment of the national banking system.* 1910, and Hammond, *Banks and politics in America from the revolution to the Civil War.* Princeton University Press 1957. It has been stressed that "although it was the intent of Congress, in enacting the National Bank Act, to eliminate state banks, the act ultimately led to the creation of a dual banking system", Lash, *Banking Laws and Regulations,* 1987, p.7-8; and it is in that sense that the dual system has to be seen as an historical accident.

[13].- England, C. "Two Cheers for the Banking Reform Bill Introduction", Heritage Foundation Report, June 3, 1994. Available on LEXIS.

With the findings of those periods we do not pretend to reach a definitive conclusion about the actual functioning of the banking regulatory structure. On the contrary, these studies should instrumentally serve us in order to understand the debate about regulatory competition which is the core of our work. In any case, a detailed and exhaustive investigation on the banking regulatory system would require further research and empirical data that clearly escape the ambition of this study.

4.2 The 'dual banking system' as a regulatory model based on regulatory competition[14]

As we have advanced, the traditional model of regulation for the banking sector in the US discriminates between banks incorporated under federal jurisdiction and those under State norms. Moreover, financial institutions are also regulated at two levels:

At a first level we find the administration that authorises the creation of a bank: the chartering authority. This might be on the one side the state regulator (who will apply state regulations) if the bank is a state bank, or, on the other side, the Comptroller of the Currency or the Federal Home Loan Bank Board if the bank is a federal one (correspondingly applying federal regulation). This first level determines the activities that the entity can undertake and the investing activities that can carry. There are then 51 regulatory models corresponding to 50 States, plus the federal model. However, due to the fact that a bank can only operate in the State where it is incorporated, the array of available options when choosing a regulator ('chartering authority') is reduced to two: federal or state regulator[15].

Overlapping this first level of regulation, there is a second level of regulation and supervision, only federal in its origin and much more detailed.

14.- We mainly rely on Scott's contribution, which has been considered the seminal work in this field. Scott, "The Dual Banking System: a Model of Competition in Regulation", Stanford Law Review, vol. 30 n.1, 1977.

15.- State bank regulators do not compete among them for bank charters because banks must obtain a charter from the jurisdiction in they do business. Moreover, this geographic restrictions are also applicable to national banks, meaning that the fact that a bank is federally chartered does not suppose it can freely branch throughout the national territory. "The dual banking system limits direct competition between the regulation of national banks and the regulation of state banks to the geographic territory of the state in which either a bank is chartered or granted permission to operate. Thus a firm seeking to enter the banking industry in any state is limited to two chartering options and an existing firm has only one choice for charter conversion when dissatisfied with the other regulators", Butler and Macey, "The Myth of Competition in the Dual Banking System", op. cit. p. 684

To be a member of the Federal Reserve[16] (FED), for instance, makes the banks to yield to the reserve requirements, maximum interests as well as periods of deposit. Members of the FED are at the same time insured by the Federal Deposit Insurance Corporation (FDIC). For State banks, to be member of the FED also represents to be subject, in these aspects, to its supervisory powers. Moreover, State banks are subject to the prohibitions and restrictions set up in the Federal Reserve Act and the National Bank Act. For banks which are not members of the FDIC, the weight of the federal control is significantly softer.

This second level of regulation, as the previous, is also governed by the principle of free choice with two exceptions: some form of federal intervention will be always present and it is considered banks not insured by the FDIC have to face a competitive disadvantage practically insurmountable since they have to insure their deposits in a private insurance company.

Mixing both forms of intervention, we will be in front of four possible banking models:

- federal banks, authorised by the Comptroller of the Currency which are automatically members FED and insured by the FDIC.
- state banks which are also FED members and insured by the FDIC.
- state banks insured by the FDIC which are not members of the FED[17].
- state banks which operate outside the federal insurance system.

Therefore, commercial banks can choose between state and federal chartering, but can also select different federal routes to deposit insurance. The different banking institutions therefore represent the structure of the 'dual system' to different degrees.

4.2.1 Regulatory instances

At the federal level, there are three main regulatory instances which have different degrees of intervention depending on the type of institution -

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[16].- The Federal Reserve act was passed in 1913 and represented an attempt to prevent liquidity crisis experienced the previous years. For that goal, the FED would act as a lender of last resort and with time it will become a new regulatory authority superimposed to the chartering authority already existing at federal level (Office of the Comptroller of the Currency).

[17].- Recall that membership of the FED is not a compulsory requisite. In Golembe and Holland's words, "the Federal Reserve Act (1913) superimposed on the then existing banking system the authority of a new federal banking agency, with the objective of bringing state banks within the ambit of federal regulation. Unfortunately, from the point of view of those who sought such an end, the attempt was not very successful. Since membership in the Federal Reserve System was required only of national banks and was voluntary for state banks, the extension of federal regulation could occur only to the extent that state banks elected to join the Federal Reserve System", Golembe and Holland, *Federal Regulation of Banking. 1983-84.* op. cit. p. 8

except for a small portion represented by those state banks outside FDIC, which are only dependent on the state chartering authority[18]:

a) The Office of the Comptroller of the Currency (OCC):

It was created in 1863 by the National Bank Act. Although formally depends on the Treasury, enjoys a high degree of autonomy from federal government. Apart from the granting of charters for national banks, it has regulatory responsibilities for interstate branch office applications and merger applications when the resulting bank would be a national bank.

b) The Federal Reserve Board (FED):

It was established in 1913 and it is entrusted with ensuring stability of the financial system. Among other functions, it sets reserve requirements, approves acquisitions of banks by bank holding companies, regulates US banking organisations' overseas activities and foreign banks non-banking activities in the US, and it is responsible for examining state member banks as well as approving mergers in which the surviving institution is a state member bank.

c) The Federal Deposit Insurance Corporation (FDIC):

It was set up in 1933 to prevent the spread of bank failures by insuring deposits at commercial and mutual saving banks. "It is involved in the examination and supervision of FDIC-insured state non-member banks. Although not directly involved in the chartering of banks, the FDIC nevertheless strongly influences the process through its deliberation on banks' applications for deposit insurance"[19]

According to this rough description, the 'dual banking system' is based on the principle of free choice, that is, a financial entity can choose which regulation - federal or state- will govern its activities, and who will be entrusted with its supervision - the Comptroller of the Currency or state regulatory authority -. At the same time, it is at the discretion of the bank to pertain or not to the FED as well as the way of insuring the deposits, either through the FDIC or through another system (private one).

18.- We only analyse the three main regulatory instances at the federal level, following the exposition of Hall, *Banking Regulation and Supervision. A comparative Study of the UK, USA and Japan*. Aldershot, 1993 p. 53

19.- ibid..

Once decided the system and operating in accordance to it, an entity can also shift from one to another, without requiring authorisation of the authority being abandoned. Initially, it was necessary the consent of the affected authority when the bank wanted to leave the federal jurisdiction and turn to the state one, consent which was overturned after certain legal and jurisprudential modifications[20]. The resulting legal structure permits financial institutions to choose the chartering authority at any time, even with the objection or resistance of the one being left.[21] Thus, the DBS is regulated mainly by 'consumers' of regulation including the regulated industry.[22] This competitive dynamic among the several state and federal administrations has generated the benefits of the dual banking system.

A study of the American Bankers Association specifies that: "the historic value of dual banking lies in its ability to provide an escape valve from arbitrary or discriminatory chartering and regulatory policies at either the state or federal level. One of the historic objectives of dual banking has been to provide alternative supervisory frameworks under which commercial banks may choose to operate, thereby safeguarding against the extension of harsh, oppressive, and discriminatory supervision to institutions without recourse to alternative arrangements"[23] In the same direction Litan has pointed out that, "competition between chartering authorities at the two levels of government resulted in a regulatory dialectic: certain states would give their banks broader powers, which the federal government would eventually be forced to match to preserve the national banking system. One early illustration of this process is the congressional decision in 1913 to allow national banks to engage in real state lending and to act as trustees, powers that many states had long authorized for their state banks"[24]

20.- Hopkins Federal Savings & Loan Association v Cleary. 296 US. 315 (1935) and Federal Conversion Statute, of August 17th 1950, ch. 729,64 statute 455 . Cod. as amended at 12 U.S.C. § 214-214c (1982)

21.- Scott, "The Dual Banking System: a Model of Competition in Regulation" op. cit. p. 11. This fact, however, should not induce us to believe that banks move entirely free and costless. As Frankel recalls us, "It should be noted that even though the ability of banks to move to another jurisdiction puts pressure on the regulators, that pressure should not be exaggerated. It is expensive for a bank to move to another state. Moreover, states offer benefits other than their particular regulatory schemes. A wealthy population, which includes money-center activities and facilities, may induce a bank to remain in a state despite strict regulation" Frankel, "The dual State-Federal regulation of financial institutions - a policy proposal", *Brooklyn Law Review, vol. 53 n.1*, 1987 p.56

22.- Tamar Frankel, "The dual State-Federal regulation of financial institutions - a policy proposal", op. cit. p. 55

23.- W. Brown, *The dual banking system in the United States*, 1968.

24.- Litan, *What Should banks do?* , op. cit. p. 22

The effects of a plural structure have also been explained under the economic theory of the firm. At the end of the day, a bank is also a firm and as any other enterprise, tries to maximise the value of the firm. In order to calculate this value, one has to take into account of the future earnings estimation, which is heavily influenced by the investment opportunities and the legal environment. "If the differences in regulatory options available to a bank create significant differences in estimates of future earnings, the model predicts that banks will choose to convert to the most profitable option if the costs of conversion are less than an increase in present value generated by it"[25]

4.2.2 differences in the functioning of banks

Formulated the structural basis of the 'dual banking system' and the several options for the constitution of a financial institution, one must also observe the differences in the functioning between state and federal banks. It is the existence of these differences what offers the banking industry different opportunities and different models of banking operation, being at the end the measure for the true dynamism of US banking system. These differences can basically come from three normative sources:

a) The Federal Constitution.

In certain areas, like state taxation or the jurisdiction of courts, it is said that federal banks benefit from advantages in comparison with state banks since the Supremacy Clause is applicable. It implies that state law can be preempted by Congress legislation, placing national banks in a privileged position.

In practice, however, courts have created a single and limited set of federal norms applicable to banks and have left the bulk of the control on banking operation on state regulators. The result is summarised by the Supreme Court in 1944: "national banks are subject to state laws, unless those laws infringe the national banking laws or impose an undue burden on the performance of the bank's functions"[26]

"The federal instrumentality doctrine, then, remains a source of somewhat uncertain dimensions for differences between the state and national banking systems. Although it has some constitutional and statutory foundations, much of it rests in the hands of the courts and so is dependent

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25.- Scott, op. cit. p. 13

26.- Anderson National Bank v Luckett, 321 US. 233, 248 (1944)

primarily upon judicial inferences about what is necessary to achieve legislative objectives"[27]

b) legislative peculiarities.

Together with the differences which can result from the constitutional doctrine, there is a more obvious source of differences resulting from the different statutory provisions governing the banking system. These statutory differences, contrary to those analysed previously, do not automatically favour federal banks.

The very fact that the states are empowered to regulate bank activity according to their own policy criteria, supposes the potential creation of statutory differences between national and state banks and among themselves. Therefore, the major source of diversity among the models is to be found in the fact that they are governed by different statutes and regulations. On the contrary, these differences will be reduced to the extent that federal regulation determines uniform criteria for all entities, regardless of the chartering authority. When confronting the question of the applicable law to a particular issue, one could have the temptation to answer that it solely depends on the chartering authority. However, the reality is not that simple. Federally chartered banking institutions are subject to state laws and conversely, state chartered institutions are also subject in some aspects to federal law, in those fields where preemption of state law has taken place. As we will see, the balance between uniformity and diversity is a delicate one.

For instance, the reserve requirements were a perfect example of this diversity originated by different statutory provisions. Nevertheless, the passing by the Congress of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) in 1980, vanished that difference when imposed the federal reserve requirements not only to national banks but to all banking firms. On the contrary, in the field of credit concentration, different regulations may establish different maximum lending amounts to a single customer, resulting that the total amount of money a bank can lend to a single client is different depending on whether the bank is a state or federally chartered bank.

c) administrative discretion.

Finally, when statutory language explicitly confers a range of discretion to the corresponding authorities, it is conceivable that different policies and

27.- Scott, op. cit. p. 17

different implementations will appear, depending on whether the administration is the federal or state one.

In order to illustrate the effects this diversity and plurality of normative options can have on the behaviour of financial entities, it is interesting to focus on the effects the policy of James Saxon - a Comptroller of the Currency during the years 1962-1966 - had on the functioning of the banking system. Saxon initiated during his mandate many new and more liberal policies; he extended the operations allowed to national banks and the industry saw him as a champion of the federal system and as a quite flexible person in what relates authorisation policies. The conversion index from state to federal banks during the sixties it was considered very high and even alarming[28].

These movements of financial institutions from one regulatory jurisdiction to another produce adjustments in the policies of the different administrations involved. Since the attractiveness of one legal order increases, financial entities are induced to change and to operate under this new regulatory model. The clearest example is provided by the shift that took place in 1968, involving the Wells Fargo Bank and the Chase Manhattan Bank. These two banks were the most important banks incorporated in California and New York respectively, and shifted from the State to the federal jurisdiction. "State bank supervisors attributed these conversions to the inducements created by the policies and interpretations of the Comptroller and to the constraints imposed by the FED upon its member state banks"[29]

"Regulatory competition between national and state-chartered banks has been a part of the DBS since its birth in 1864. From 1864 to 1900, many national banks converted to state charters in order to participate in the greater lending powers of state banks and the fewer restrictions on reserves. The Congress responded in 1913 by authorising national banks to participate in real estate lending. This was the beginning of the federal/state regulatory competition that continues today. Typically, the OCC who regulates national banks, will grant new powers to national banks and state regulators will respond by granting similar powers to state banks and vice versa"[30]

4.2.3 the virtues of the DBS

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[28].- See FDIC statistics, *Changes Among Operating Banks and Branches, 1961-1982.* 1982

[29].- Scott, op. cit. p. 31

[30].- McGray, Sandra B. "The Dual Banking System: Evolution and Current Status", in ACIR, *State and Federal Regulation of Banking,* 1988 p. 1.

For the reasons enumerated above, the dual banking system can be interpreted as a legal structure where the several regulatory authorities, which produce different sets of norms, compete among them in order to attract the greatest share of the market. In short, the dual 'banking system' prevents the formation of a banking superpower, governed by the powers and norms of a single administrative agency.

Moreover, it is argued that the dual system diminishes the possibilities of regulatory capture. Among the conclusions of a study sponsored by the Advisory Commission on Intergovernmental Relations, it is underlined that "the dual banking has also encouraged competition between federal and state regulators and, thereby, competition within the banking industry as well. Such competition reduces the ability of industry representatives to capture regulatory authorities"[31]

Another aspect of major importance is the fact that the duality of legal orders in competition, forces the different public administrations involved to be dynamic, since they are bound to promote new innovative tools and techniques for the organisation and control of the banking sector, while at the same time these tools and techniques have to meet the requirements of adequate discipline of the financial system. As Hill has stated, "many of the innovations common to banking today were begun as experiments allowed by state regulatory authorities, and were often opposed by federal regulators. Rivalry between state and federal regulators has allowed institutions to innovate in response to new conditions in the credit markets"[32]. Then, this fact evidences several of the values and principles inherent in a pluralistic legal order - diversity, rivalry, experimentation and innovation -, which in combination result in effects that are largely more positive than those offered by regulatory models based on bureaucratic centralism and regulatory rigidity.

Hence, the traditional analysis of the dual banking is based in the premise of the existence of competition among regulators. According to this, the dual banking system produces more efficient regulations since competition limits the possibility of imposition of unnecessarily harsh regulations, controls the abuse of administrative discretion that the regulators enjoy, and promotes the development of more liberal banking undertakings, without prejudice of safety and soundness of the banking system.

In this same line of argumentation, Tamar Frankel carries out an examination of the most significant pros and cons of the dual system, which is

31.- *State Regulation of Banks in an Era of Deregulation.* ACIR, A-110, September 1988, p. 6.
32.- Hill, op. cit. p. 32

interesting to refer[33]. According to this author, among the reasons in favour of this system excel two: firstly, it provides a system of checks and balances to governmental activity, and; secondly promotes a better, more efficient and innovative regulation.

First, one of the principal arguments in favour of the dual banking system is that it provides mechanism for the self-control of the government power to direct the formation and concentration of money[34]. The dual system breaks up the power. The regulatory power is shared not only between the federal and state administrations but also among four different federal administrative agencies. Moreover, the different branches of government of which those agencies are accountable are also different. The 'Office of the Comptroller of the Currency' depends of the Treasury. The 'Securities and Exchange Commission' depends of the Congress. The 'Federal Deposit Insurance Corporation' also depends of the Congress but in less extent in what concerns its budget. Finally, the Federal Reserve Board regulates privately hold banks and obtains its owns revenues through charging for its services and from the reserve requirements and thus is the less politicised and more independent agency among all which control banks[35]. This set of regulatory authorities, sometimes with deliberately ambiguous boundaries, serve as a mechanism of checks and balances to regulatory activity.[36]

Secondly, the 'dual banking' fosters innovative regulation and the improvement of regulatory quality. Competition can lead to better, more

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[33].- Tamar Frankel, "The dual State-Federal regulation of financial institutions - a policy proposal", op. cit. pp.. 53-69.

[34].- "One of the most important issues during the "Bank War" of the 1830s was the public hostility toward banks and banking concentration, whether in public or in private hands. Indeed, hostility was so intense that banking was outlawed in a few states; but such extreme animosity soon vanished. However, a significant residual of the concern over concentration was the adoption of the so-called free banking laws, establishing a system that survives today", Golembe and Holland, op. cit. p. 5

[35].- It has also been underlined how each administrative agency pursues different mandates and has its idiosynratic preferences. Thus, the FDIC will look at the financial health of the deposit insurance system; the FED is concerned with the overall stability and security of the banking system; and finally, the OCC views banking reforms under the perspective of the competitiveness of national banks. Coordinating these preferences becomes crucial in defining strategies of action for financial services. Coleman, W.D. *Financial Services, Globalization and Domestic Policy Change.* McMillan Press. London, 1996. p. 13

[36].- It is also worth underlying the distinction between the checks and balances of the constitutional system and those of the dual banking system. The role of consumers in the latter bring us one of the main characteristics of the regulatory competition paradigm: consumers are the arbiters of the system. Whereas the constitutional checks and balances are regulated mainly by the courts, the dual banking system is regulated mainly by 'consumers' of regulation, including the regulated industry.

efficient and more effective regulation. Moreover, there are some ways of deregulating and eliminate legal barriers trying to achieve efficiency, without destroying the 'dual banking'. On the other side, in these changing times, when experimentation and innovation are specially valuable, the dual banking system reduces the risk of adverse consequences for the national system, since the dual system limits the experiments to a single State[37].

Conversely, one has to take account of arguments against the dual banking, which are normally invoked by its critics. In their opinion, the dual banking system provokes an irrational design of the system as a whole, it lacks uniformity, coherence and predictability; and it fosters the production of banking standards excessively lax. Let us analyse these critics separately:

In what concerns at the production of an irrational design and the lack of logic, one could argue that a system that has lasted for more than a century, it is likely to be based in a logic structure although this logic perhaps is not a Cartesian one[38].

"Critics argue that efficient regulation is uniform, consistent, and predictable, since these features reduce costs both to the regulators and to the regulated industry. Conflicting and parallel rules are costly to the industry because they produce uncertainty. (...) The dual banking system produces conflicting and overlapping regulation. Since governments want to retain, if not increase, the number of institutions under their jurisdiction, they attract regulated enterprises by differentiating their regulatory 'product' from that of other governments. (...). These criticisms are valid. However, the alternative of one large agency controlling and regulating all banking institutions in this country is not necessarily more efficient. Such a behemoth may generate more regulation than is necessary and may be so bogged down by a large bureaucracy as to become unmanageable. In contrast, small agencies, which resolve problems through informal and informed advice from members of the industry, may be more efficient. In short, lack of uniformity does not justify full preemption of bank regulation"[39]

37.- States are then laboratories of democracy as formulated by Justice Brandeis in his famous dissenting opinion in New State Ice Co. v Liebmman, 285 U.S. 262, 311 (1932).

38.- "The short answer to this criticism is provided by Holmes' characterisation of the life of law as experience, not logic. An organic law grows with the society that give life to it. Therefore, a viable system of law is rational, much as the tree is rational, even though its branches are not symmetrical and its shape is not governed by the rules of geometry". Tamar Frankel, "The dual State-Federal regulation of financial institutions - a policy proposal", op. cit. p. 57

39.- ibid. p. 58.

"There is no doubt that centralization and uniformity would bring some real benefits to the US baking system, including relief from conflicting and duplicative rules, and consistency and order to a system that is now so interconnected as to be truly nationwide, if not international. Yet, there is another, less praiseworthy side to centralization and uniformity. Centralization and uniformity can lead to rigidity, which delays innovation. For example, centralization and uniformity tend to make the introduction of new products, services and methods of delivery deviant behaviour, and therefore act as a constraint on innovation"[40]

Finally, it remains the critic that the dual banking produces a competition among regulatory standards on safety and banking supervision, leading to their establishment below the optimal level. It is the well known 'competition in laxity' or 'race to the bottom'. The critic of the race to the bottom in a banking system with strong geographic restrictions has not much sense, since those who will suffer the adverse consequences of standards excessively low will be banks and citizens of the same State. Moreover, if the fear of the race to the bottom was true, the system would already have moved towards free banking without any restriction, and this is a completely inaccurate description for the actual banking system.[41]

Moreover, courts play an important role in the market for bank regulation by preventing extreme regulatory changes.[42]

4.3 The federalization of banking regulation. A critical vision of the dual banking system.

Recently is has been called into question the traditional conception of the dual banking system in the United States[43]. The proponents of this new vision consider that instead of being in front of a system that encourages competition and diversity, as the dual banking was traditionally characterised, we are before a case where the process of federal centralisation takes preeminence leading to a uniformity in the basic aspects of banking

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40.- "The Dual Banking System: Evolution and Current Status", in ACIR, *State and Federal Regulation of Banking,* 1988 p. 2

41.- On the debate around the free banking model, cfr. Rockoff, "Institutional requirements for stable freebanking", CATO Journal, vol. 6 n. 2, 1986.

42.- See, Investment Co. Inst. v. Camp, 401 US 617 (1971) where the Supreme Court struct down proposals of the Comptroller of the Currency to allow national banks to deal with securities.

43.- According to Miller, "The 'dual banking system' has long been a sacred cow in the American political tradition". Miller, "Banking Regulation. The future of the Dual Banking System", op. cit. p. 1

regulation[44]. Moreover, following these doctrinal claims, the functioning of the dual banking is in no way competitive but cooperative, where the various regulators cooperate in order to maintain a *statu quo* in the banking industry.[45]

The current approach is clearly opposed to the previous vision, in part because of the evolution federal regulation has experimented in recent years, always in a limitative direction of State rights[46]. This new vision can also be explained by the fact that banking regulation is compared with that of corporate law. In the latter, there is not only vertical regulatory competition between federal and state regulation, but mainly, competition at horizontal level, among States' legislations. In the banking industry, a institution which wants to operate in a State different of the one of incorporation, has to face numerous obstacles and to comply with the norms of the host state. There is no principle such as extra-territoriality that exists in corporate law. On the contrary, it exists a legal segmentation of the banking market. This fact supposes that, to some extent, the banking and corporate regulatory models, are incomparable, since they show to different types of regulatory competition.

According to this critical approach, "the regulatory outcomes generated by the dual banking system appear to be cooperative rather than competitive, because Congress has divided up the regulatory turf of the relevant state and federal agencies in the way most beneficial to the groups that the system regulates"[47]

The first characteristic that make us think in the banking system as a cartelised instead of a competitive one is the necessity of obtaining an authorisation to entry the market. "In contrast to the market for charters of general corporations, neither the state bank regulators nor the Comptroller receive the same benefits from attracting additional corporate charter business. And unlike the competition among states for general corporate charters, state bank regulators do not compete against one another for banks charters because banks must obtain a charter from the jurisdiction in which they do

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44.- For instance, Lash does not doubt in asserting that. "Until 1980, most of the major regulatory responses had been to tighten regulation and centralise authority", Lash, *Banking Laws and Regulations*, op. cit. p.1

45.- Macey, J. R. "The Political Science of Regulating Bank Risk", Ohio State Law Journal, vol. 49 , 1989.

46.- Cfr. Rubin, Edward, "Uniformity, Regulation, and Federallization of State Law: Some Lessons from the Payment System", Ohio State Law Journal, vol. 49 n. 5, 1989.

47.- Butler and Macey, "The Myth of Competition in the Dual Banking System", op. cit. p. 679

business."[48]. Despite of this critic, mainly inspired in the comparison of the chartering system for banks with that established for general corporations, it has to be recognised that the chartering of banks is somewhat justified by they especial position in the economic gear[49].

Furthermore, there are at least four elements that hinder the operation of a true regulatory competition in the banking sector:

4.3.1 The Supremacy Clause:

The first element that troubles the theory of regulatory competition is the capacity of the federal government, through the Supremacy Clause to nullify the effectiveness of state regulation, when passing preemptive regulation that involve a uniform implementation.[50] Congress can use its threat of preemption to limit the role of the states in the regulation of banks. As we stated above, both federal and state authorities have powers to regulate the banking industry. Their coexistence is a question of fragile balance between both. Excessive state autonomy in regulating banks might lead to problems for the national economic system. Conversely, excessive powers placed in the federal sphere would destroy state rights and the essence of the dual banking itself.

Federal administration can pass regulations which preempt state norms, instead of accepting the competition coming from the States and to react against a flow of entities that freely 'migrate' to state jurisdiction. This possibility place the federal regulator in a disproportional advantage comparing with state regulators. Over time, the federal government has

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48.- ibid. p. 686. "Bank chartering has been used to prevent entry of a new bank into a market if it would hurt the profitbility of an existing bank". Mishkin, "An Evaluation of the Treasury Plan for Banking Reform", Journal of Economic Perspectives, vol. 6 n. 1, 1992 p. 136

49.- Banks provide for liquidity to the mechanism of economic life and stability to the payment system. For a general account on the specific characteristics that justify the special regulatory treatment of banks, see Corrigan, "Are Banks Special?" *Federal Reserve Bank of Minneapolis. 1982 Annual Report..* 1982; Aspinwall, "On the 'Specialness' of Banking", *7 Issues in Banking Regulation. 16,* 1983.

50.- "Under the Supremacy Clause of the Constitution, nationally chartered depository institutions ca be subjected to whatever constraints Congress believes appropriate, despite contrary state statutory or even constitutional provisions. The 'federal instrumentality doctrine empowers Congress to adopt provisions that assure the effective functioning of federal entities such as national banks. It is less well understood but equally clear that the power to preempt state law can be delegated to administrative agencies". Huber, S.K. "The Dual Banking System: Interaction of Federal and State Law in the Regulation of Banking", Consumer Finance Law Quarterly Report, vol. 42 n.2, 1988. p. 52

passed centralised and uniform legislation[51] in areas as important as the reserve requirements, the separation between commercial and investment banks[52] and the regulation of Bank Holding Companies (BHC)[53].

In the first of the cases, the reserve requirements, it is stated that, "historically, the most significant advantage to being a state non member of the FED bank was freedom from the reserve requirements that the Board of Governors of the Federal Reserve System imposes on its members. (...) But consistent with our preemption model of regulatory delegation, the federal response was to pass the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)[54], which imposed the reserve requirements on all banking firms. With the passage of the Act, federal law now requires all depository institutions offering transaction accounts to maintain reserves with the Federal Reserve System against all transactions accounts and non-personal time deposits. By imposing this rule, Congress eliminated a major dimension of the competition within the dual banking system"[55]

Hence, the very fact that after the DIDMCA all institutions are subject to reserve requirements has practically eliminated the difference between state banks that are members of the FED and those which are not. The main advantage for being a non-member of the FED bank was that you were not subject to those reserve requirements. This extension explains why the

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51.- As Golembe indicates, "There has been a seemingly inexorable transfer of power from the states to the federal government. This transfer rarely takes the form of moving any piece of authority from one party to other, but rather consists of giving to one or several federal agencies the power to override state action or to dictate to the states" Golembe, "Are the States still part of the Dual Banking System?", *Banking Policy Report*, vol. 13 n.8, April 18, 1994 p. 3

52.- This separation between commercial and investment banking was first established by the Glass-Steagall Act of 1933 (12 U.S.C § 461 (1982)) and was only applicable to national banks. In 1987, with the passage of the Competitive Equality Banking Act of 1987 (Pub. L. n. 100-86, 101 stat. 552, 1987), those restrictions were extended also to banks which were not members of the FED, thus generalising them to state chartered banks.

53.- Bank Holding Company Act of 1982. (12 U.S.C. §§ 1841-1850 (1982)). "The Bank Holding Company Act regulates the activities of any company that controls a bank, regardless of whether the subsidiary bank is a national bank, a state member bank, or a state nonmember insured bank. Thus, even though a bank holding company owns only state banks operated within a single state, the Act subjects the holding company to regulation by the FED. This preemption is wholly inconsistent with the competitive principles supposedly underlying the dual banking system and grants the FED complete control over the definition of the activities that a BHC's subsidiary may conduct". Butler and Macey, op. cit. p. 698.

54.- Pub. L. n. 96-221, 94 Stat. 132 (1980), vide Federal Reserve Bank of Chicago, "Leveling the playing field: a review of the DIDMCA of 1980 and the Garn St Germain Act of 1982", *Readings in Economics and Finance*, 1987; Cargill and Garcia, *Financial Deregulation and Monetary Control. Historical Perspective and Impact of the 1980 Act*, Hoover Press Publication, 1982

55.- Butler and Macey, op. cit. p. 694-695

majority of state banks are now also members of the FED, which implies an increased presence of federal regulatory overview in state chartering[56].

The same legislative piece tried to improve the position of thrift institutions by preempting state usury ceilings on residential mortgages. "Although this legislation paid lip service to the dual banking system by giving state legislatures a few years in which to override the federal preemption, it was clear that, given the burden of legislative inertia, this preemption would remain effective in many states. In 1982, Congress went further, in the Garn-St Germain Act[57], by preempting state laws restricting the enforceability of due-on sale clauses. Here the states where given even less ability to override the legislation"[58]

As similar consideration can be made regarding the South Dakota experiment of allowing a bank to conduct insurance activities. The Federal Reserve Board denied the State application in 1985.[59]This fact demonstrate that "federal banking authorities are prepared to asset a superior federal interest with respect to all nonbanking activities."[60]

Thus, it is arguable that the development of preemptive regulation used by the federal administration is contradictory with the competitive principles that characterise the dual banking system, or, in the best of the worlds, it limits its effective functioning. "In summary, the Supremacy Clause, because it allows the federal government to preempt numerous areas of state regulatory law, tends to minimise the principle of choice that Scott thought was so important to the development of efficient laws. In other words, even if banks were free to re-incorporate in any state where they found suitable laws, federal dominance in important aspects of banking regulations would still hamper the forces of jurisdictional competition. As the literature on the jurisdictional competition for corporate charters has long assumed, the existence of any

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56.- By 1989, 5188 banks were members of the FED, accounting for 73% of the domestic deposits of the US commercial banking sector. In addition, the FED may, after consultation with other federal agencies (FDIC, OTS and NCUAB), impose supplementary reserve requirements of up to 4% of transactions accounts if this is deemed 'essential for the conduct of monetary policy'. Hall, *Banking Regulation and Supervision. A comparative Study of the UK, USA and Japan.* op. cit. p. 50

57.- 12 U.S.C. § 1701j-3 (1982)).

58.- Macey and Miller, *Banking Law and Regulation*, Little Brown, 1992, p. 125

59.- Federal Reserve Board Decision denying the application of Citicorp, New York, to acquire American State Bank, Rapid City, South Dakota. August 1, 1985. Federal Banking Law Report (CCH)86,320.

60.- Lybecker, M.E. "The South Dakota Experience and the Bush Task Group's Report: Reconciling Perceived Overlaps in the Dual Regulation of Banking", Brooklyin Law Rev. vo. 53 n.1, 1987

significant role for the federal government is incompatible with competition among federal and state regulators and among the states themselves"[61]

4.3.2 The Deposit Insurance System[62]:

The second element that shows the inadequacy of the competitive model for describing banking regulation is the fact that as a question of competitive need, both federal and state banks have to be covered by a deposit insurance, which is provided by the Federation trough the FDIC[63]. The insurance for banking deposits was initially a state invention[64], and it was transformed into a federal system by the Banking Act of 1933.

The FDIC does not only provide insurance for banks but also supervises the institutions it insures. "The most obvious alternative for would-be bankers unable (or unwilling) to obtain a charter from the Comptroller is to obtain a state bank charter. As a practical matter, however, our banks would have to obtain deposit insurance from the FDIC if they want to be a successful in attracting deposits. Virtually all state-chartered banks have opted to obtain deposit insurance. The factors that the FDIC considers in granting insurance are the same factors that the Comptroller of the Currency uses in considering whether to grant a new national bank charter (!!!)"[65] So, an extension of the

61.- Butler and Macey, op. cit. p. 698-699

62.- We deliberately obviate the debate on the effectiveness and the convenience of the actual deposit insurance system and its possibilities of reform. Some commentators have suggested that the deposit insurance system increases the riskness of banking: Shiers, "Deposit Insurance and Banking System Risk: Some Empirical Evidence" *The Quarterly Review of Economics and Finance, vol. 34 n. 4,* 1994; Thies and Gerlowski, "Deposit Insurance: A History of Failure", *CATO Journal, vol. 8 n.3,* 1989; Fischel, Rosenfield and Stilman, "The Regulation of banks and Banking Holding Companies", *Vanderbilt Law Review, vol. 73,* 1987.

63.- Nowadays, 99,9% of all commercial banks are FDIC insured. Even further, some states require candidates for chartering to apply for FDIC insurance. For instance, "In Florida, if the bank board approves the application, the proposed bank must apply for FDIC insurance within six months of the approval date. This may be done either by applying directly to the FDIC for insurance or by applying to membership in the Federal Reserve System. If a bank does not apply for insurance within the six-month period, or if either the FDIC or the Federal Reserve System deny membership to the new bank, the applicant's Florida bank charter will be revoked and terminated", Malloy, *The Corporate Law of Banks,* 1987, p. 116-117, quoted by Macey and Miller. op. cit.. After the disaster with the deposit insurance schemes of Maryland and Ohio, the possibility of subscribing a private insurance coverage has de facto evaporated.

64.- The first system of banking insurance in the US was New York's state fund created in 1829. From 1908 to 1917, eight states passed deposit guaranty legislation. These included Oklahoma, Kansas, Nebraska, Texas, Mississippi, South Dakota, North Dakota and Washington. Thies and Gerlowski, "Deposit Insurance: A History of Failure", *CATO Journal, vol. 8 n.3,* 1989.

65.- Macey and Miller, Banking Law and Regulation, op. cit. p. 109, parenthesis added.

insurance requirement is always paralleled by an extension of the powers of the federal agency.

This institution requires that the insured banks comply with its uniform regulation without taking into consideration distinct regulations which might exist in the normative corpus of States. In other words, the FDIC has actually the power to supersede state regulation when it thinks that the system of deposit insurance is threatened because of the powers States grant to their banks. These restrictions limit diversity and therefore competition among state regulators.

This element has lead Golembe to affirm that, "entry into banking no longer depends on obtaining a charter, but instead on the receipt of federal deposit insurance, which the states cannot grant. In fact, with the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991(FDICIA), only one agency at the federal level - the FDIC - may make that determination. Many have argued that providing alternative routes of entry into banking, and therefore guarding against bank monopolisation of individual markets, was the most vital part of the dual banking system. Whether it was or not, it was pretty well killed in 1933 with the adoption of federal deposit insurance and came to an end in 1991."[66]

Therefore, what will be really important in order to restore, at least partially, the dual banking system, would be the abrogation of the FDICIA or at least, the elimination of the provision which allows FDIC to preempt state legislation in what refers the possibility to determine the powers of state banks.[67]

In the debate on the FDIC, it is underlying the discussion on where to place the regulatory powers concerned with the system of deposit insurance, either al the federal or state level[68]. Again, as Golembe points, if we can not entrust states the exercise of this responsibility, it has not very much sense to establish a dual banking system, and at the end, a system of plurality of

[66].- C. H. Golembe, "Are the States still part of the Dual Banking System?", op. cit. p. 3

[67].- See England's proposal for fragmenting the deposit insurance system in such a way that each regulatory authority would maintain its own protection scheme. England, C. "Regulatory Restructuring: Resolving the FED's Conflicting Roles", CATO Journal vol. 13 n. 3, 1994.

[68].- vide Scott, "Deposit Insurance - The Appropriate Roles for State and Federal Governments" *Brooklyin Law Review vol 53 n.1*, 1987; Lapidus, "State and Federal Deposit Insurance Schemes", *Brooklyin Law Review vol 53 n.1*, 1987.

administrations shared between States and Federation, which is the very essence of the federal system[69].

4.3.3 interstate banking and branching legislation:

The third element to be taken into account to evaluate the incidence of regulatory competition in the US banking system are the geographical restrictions to interstate banking and branching.

Historically, the US banking system was a system of 'unit banks', i.e. banks operated out of a single office and multi-office banks were unknown. The bank building was the bank. Very soon, the states begun to authorise the expansion of state chartered banks within the state territory. At the federal level, however, prior to the passing of the McFadden Act[70], the National Bank Act did not contained any provision on the possibility of branching for federal banks, possibility that was repelled by several judgements[71]. Under this situation, the McFadden Act was passed to avoid the drain of financial entities under federal regulation who reincorporated to state jurisdiction, since the latter allowed them to branch within the State.

This piece of legislation granted the States the right to control the opening of branches of financial entities in its territory. Although the McFadden Act derogates the existing prohibition for national banks, the opening of branches will be summited to State authorisation. Both national and state banks have to conform with the laws of a given state in order to be able to open offices. This fact has hampered free interstate banking and has lead to the segmentation of the nation into 50 geographically limited markets. As a result of both historical peculiar conditions and the traditional popular hostility to concentration of banking, the US has a highly fragmented banking system.[72]

Thus, it has been stated that, "According to Representative McFadden, the single most important goal of the McFadden Act was to ensure the continued existence of the national banking system by allowing national banks to meet the competition of their state counterparts head on with branch

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69.- much of this debate is also related to the usefulness of state safety and soundness regulations in a competitive banking environment.

70.- Ch 191 § 7c, 44 Stat, 1224,1228 (1927) Cod. 12 U.S.C. § 36(c) (1982)).

71.- First National Bank in St. Louis v. State of Missouri 263 US. 640 (1924), where the possibility for national banks to branch was denied.

72.- Mishkin, "An Evaluation of the Treasury Plan for Banking Reform", Journal of Economic Perspectives, vol. 6 n.1, 1992, p. 134

offices"[73] The first intention of this norm was basically pro-competitive. However, it happened that the possibility for federal banks to branch was made dependent of the existence of the same provision for state banks, in a very similar way of what the competitive equality doctrine advocates[74]. In sum, Congress gave to state legislatives the power to control the expansion of branches of all kind of banks, included those chartered under federal law.

In comparison to the unit banking situation, this was a huge improvement. Nevertheless, the fact of having restrictions imposed by state legislation was still an inconvenience for banking expansion. In order to avoid this restriction, banks started to use the so called Bank Holding Companies, that is, a network of different banks located in different states but under the control of a single firm. With the same spirit of the McFadden Act, the Douglas Amendment introduced to the Bank Holding Company Act[75], prohibits 'interstate banking' without specific authorisation of the States involved.

This two norms - the McFadden Act and the Douglas Amendment to the Bank Holding Company Act - reveal that Congress permitted the States to prohibit banks to branch outside the state borders[76]. Hence, since both norms respect the state power to control a substantial part of the banking operation, are in full syntony with the regulatory philosophy of the dual banking system. In fact, the McFadden Act 'compensated' the states for the presence of national banks within their territory, with the power to regulate their branching. This kind of compromise between two opposite solutions is no doubt a consequence of the division of authority which inspired the dual system.

Therefore, the segmentation of the banking market product of these norms is not a signal of the erosion of the dual banking as proposed by Butler and Macey but all the contrary, a characteristic of this regulatory model, since it maintains important regulatory powers for the States, one of the pillars of the dual model. Instead, it can be said that what represents an erosion of the

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[73].- Joann Senzel Nestor, "Interstate branch banking reform: preserving the policies underlying the McFadden Act", *Boston University Law Review, vol. 72,* 1992, p. 611.

[74].- This doctrine roughly means the automatic rank of state and federal banks. For further explanation, see below.

[75].- 12 U.S.C. 1842(d) (1982).

[76].- A more detailed account of the evolution of interstate banking restrictions in the US would escape the introductory character of this study. Thus, we refer to Report of the Senate Banking Committee, "A history of Interstate Banking in the US", summarily compiled in *Banking Policy Report, 5 Sept. 1994, vol. 13 n.16.* See also Macey and Miller, *Banking Law and Regulation,* op. cit. pp. 387-490.

system is the abandonment of State delimitation and the adoption of a system that starts challenging those borders.[77]

In relation to that, it can be said that nowadays most of the States (except Hawaii) have legislated allowing interstate banking activities, that is allowing the acquisition by a Bank Holding Company of a State bank, subject to some restrictions, significantly, reciprocity with other States[78]. It is also worth underlying the passing of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)[79], which permits a bank that has acquired a failed savings association, to operate with the branches of the failed institutions as if they were its own branches. Thus, through the acquisition of a savings association with financial troubles, the restrictions to interstate banking can also be surmounted.

This statute represents a further step in the process of federalization of regulation. "Although FIRREA does not change the rules affecting regulatory competition between state and federal banks, the act does override state restrictions on branch banking."[80] We will analyse how the very fact of the erosion of the geographic restrictions in the US banking system has extremely profound consequences for the issue of regulatory competition.

4.3.4 The competitive equality doctrine and the 'wild card' statutes

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77.- See infra.

78.- See for instance New York's case analysed by Robert G. Ballen and Joseph P. Savage in "Interstate branching: are the walls starting to crumble?, *The Banking Law Journal, vol. III, n. 2,* 1994, pp. 171-172. This reciprocity has led into the so called 'regional banking'.

79.- For a detailed analysis of the complex aspects of this piece of legislation, Wallace, "Life in the boardroom after FIRREA: a revisionist approach" *University of Miami Law Review, vol. 46 n. 5,* 1992; Gail, "The changing face of bank regulation and supervision in the United States: a period of superisory reregulation" in Norton, *Bank Regulation and Supervision in the 1990's.* London, 1991, p.33 and ff. "FIRREA's changes to the BHC Act provide significant opportunities for bank holding companies to expand their business on an interstate basis. In addition, these opportunities are not subject to the restrictions on interstate expansion contained in the Douglas Amen mend to the Act. The Douglas Amendment forbids interstate acquisitions of banks except where such acquisitions are specifically permitted under the laws of the state of the bank being acquired. Normally, this provision prevents a bank holding company from acquiring a bank in any state that does not specifically permit the acquisition. However, acquisitions of savings associations are not subject to the Douglas Amendment because savings associations are not considered banks and therefore are not subject to its provisions. This liberalisation of banks' ability to acquire savings associations is one of the FIRREA's more important regulatory changes" Macey and Miller, *Banking Law and Regulation,* op. cit. p. 326

80.- Sandra B. McCray, "Federal Preemption of State Branch Banking Laws under FIRREA" *Intergovernmental Perspective,* Summer 1990, p.. 8

The fourth factor that should be mentioned is the competitive equality doctrine that requires federal banks to respect state law when establishing branches. This fact allows state regulators to maintain its local cartels and restrict competition among banks in certain geographic areas. "The competitive equality doctrine prohibits the Comptroller of the Currency from enlarging the scope of certain activities of national banks -which would otherwise be permissible under federal law- beyond the precise limits state allows for that state's chartered banks. (...) The greatest impact of the competitive equality doctrine is its restrictions on the ability of national banks to branch. In addition to federal restrictions on national bank interstate branching, and despite the commerce clause, national banks are subject to state law regarding the extent to which they may branch within the state in which they operate"[81]

Finally, one has to remember the existence of regulations passed by the vast majority of State under the label of the so called 'wild card statutes'. They establish that the same powers and privileges enjoyed by federal banks will automatically be applicable to state banks. The objective is to protect state institutions form suffering a competitive disadvantage. Like the competitive equality doctrine, these state wild card statutes appear at first sight to represent the ideal of competition, because states immediately respond to innovations at the federal level. However, as with the competitive equality doctrine, the competition is more apparent than real[82]. Wild card statutes eliminate any state incentives to compete with the federal level to obtain bank powers, since these are automatically given to he national banks. Together, these two forces inhibit regulatory innovation through dual system competition because they reduce the political support for innovation.

"The expansion of the federal role has taken the form of increased regulation of existing state depository institutions rather than the placement of constraints on the chartering of new ones. This approach reflects a policy choice rather than a lack of federal power. Congress would seem to have the legal authority , but not the political support, to eliminate state chartering and to require national charters for all depository institutions. The issue is of little practical consequence because, even if the states are entitled to charter banks, the federal government has plenary authority to regulate every facet of their existence"[83]

81.- Butler and Macey, op. cit. p. 701-702

82.- Indeed, wild card statutes create a mirror image of the competitive equality doctrine

83.- Huber, S.K. "The Dual Banking System: Interaction of Federal and State Law in the Regulation of Banking", Consumer Finance Law Quarterly Report, vol. 42 n.2, 1988. p. 53

In sum, it is argued that the principal beneficiaries of the present regulatory system, are banks themselves. On the top of that, federal regulators do not regulate competitively. Instead federal regulators, use their constitutional and statutory powers to determine the amount of regulatory control they delegate to the state regulators. "In general, the structure of banking regulation suggests that federal regulators have determined that regulations with purely local effects, such as the location of bank branches, are best settled by referring to state law, while regulations with national effects are best determined by considering their national political implications.(...) Instead of duplicating regulatory efforts, which one would expect to occur in a competitive system under the current dual system, state and federal regulators have divided up the task of regulating banks"[84]

However, it has to be emphasised that although this critical vision brings us a more updated narrative of the dual banking system, which confirms a decrease of the system of regulatory competition, this decrease does not mean that the model has been definitively abandoned because it was considered as inefficient. Explicitly, it has been stated that the "intention of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) was to limit regulatory competition which has provoked excesses of some financial institutions in Texas, California and Florida. The conundrum faced by Washington is how to preserve the benefits of regulatory competition while deterring the social costs incurred by improper regulation of state-chartered institutions"[85]

4.4. Understanding the transformations of the dual banking system.[86]

All these shakes suffered by the US regulatory model can be explained when analysing the changes the financial market itself has experienced.[87] Internationalisation and telecommunications technological revolution are

[84].- Butler and Macey, op. cit. p. 707-708. An opposite critique is also raised: "the concept of the dual banking has been utilized by state bankers and regulators to constrain the potential competitive advantage of federaly chartered institutions inherent in their being instrumentalities of the federal government" Ginsberg, E. "An Idea for a Modified Dual Banking System", Brooklyin Law Review, vol. 53 n.1, 1987, p. 23. However, a completely different evaluation of overlapping and competition among banking regulators is provided by Coleman. Cfr. Coleman, *Financial Services, Globalisation and Domestic Policy Change.* McMillan, London, 1996 pp. 49-53.

[85].- Hill. op. cit. p. 29

[86].- Berger, Kashyap and Scalise, "The Transformation of the US Banking Industry: What a Long Strange Trip It's Been", Brookings Papers on Economic Activity n. 2, 1995.

[87].- Todd, W.F. "The Evolving Legal Framework for Financial Services", CATO Journal, vol. 13 n. 2, 1993.

some of the elements that could help us in questioning the adequacy of the existing legislation to current times. While the market and the entrepreneurial spirit were alert and energetic, Congress was fast asleep.[88]

Many scholars attribute the restructuring of banking regulatory model to changes in economic conditions and technological innovations. Among these causes, one could find: "regulatory agencies had been protecting inefficient firms in the industry. The purpose of deregulation in the commercial banking industry was to move away from protecting inefficient firms in the industry in order to create a more competitive environment for commercial banks. The second explanation for regulatory change dealt with the increased competitive pressures for financial services facing the commercial banking industry due to technological change during the 1970's. Finally, poor general macroeconomic conditions during the 1970's also contributed to industry instability and ensuing regulatory change"[89]

As Miller explains, "dual banking (in its classical characterisation) functioned effectively in an era of competitively restricted and geographically limited banking; but the introduction of intense competition and interstate banking has dramatically altered the ground rules. It is doubtful that the dual banking system can survive in its present form as the financial services marketplace undergoes this rapid transformation. Eventually, we may see banking develop towards the pattern that is familiar to other industries: chartering by the states, not by federal government; high mobility by firms in terms of choosing where to charter; and regulation by the federal government to the extent necessary to protect the federal interest"[90]

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[88].- Heimann, John, "Market-Driven Deregulation of Financial Services", Federal Reserve Bank of Atlanta Economic Review, December 1984, p. 37

[89].- Krause, "Economics, Politics and Policy Change. Examining the Consequences of Deregulation in the Banking Industry", *American Politics Quarterly, vol. 22 n. 2*, 1994, p. 224. However, the study conducted by Krause concludes that the instability in the banking industry does reflect politics more than economics, that is, it has been largely due to a combination of new ideas and changing ideological composition of Senate's banking subcommittee members more than to economic and technological transformations.

[90].- Geoffrey P. Miller, "Banking Regulation. The future of the Dual Banking System", op. cit. p. 2. Parenthesis added. A contrary opinion is expressed by Ginsberg, "An Idea for a Modified Dual Banking System", *Brooklyn Law Review, vol. 53 n.1*, 1987, p. 23-25. In the same direction, it has been stressed that, the "alternative to the present system is to eliminate completely the preemptive role of the federal government, thereby allowing for state competition in the provision of banking laws and regulation. This approach would require several radical alterations in current banking structure, including the imposition of risk-adjusted deposit insurance and the repeal of the McFadden Act's interstate branching restictions. Under such a system no real need for federal chartering would exist because state banks would be allowed to branch regardless of geopolitical boundaries. This would lead to the development of a truly national market for banking laws which would exhibit all of the benefical aspects of the current

Indeed, one has to distinguish two scenarios of the banking sector, corresponding to two different historical periods.

The first, the so called cartel banking era, is characterised by existence of restrictions to the interests banks could pay for its deposits, fixed by the famous Regulation Q[91], as well as restrictions to the types of operations banks could undertake in comparison with other financial entities, and finally, by the geographic restrictions that resulted in the balkanization of financial entities. "The effect of cartel banking was to create a banking structure that was stable and profitable, but also unimaginative and inefficient"[92].

In this cartel banking scenario, there was a vivid need for vertical regulatory competition between the federal and the state level. If we assume that the main goal of the dual system was to offer financial entities alternative chartering and supervising frameworks, there was no other alternative but to choose between federal and state regulations. The very existence of geographic restrictions prevented banks from finding that alternative regulation in other States. If banking would have been similar to any other industry[93], there would have been no need to engage in vertical competition since the same goal could have been achieved trough simple reincorporation in some other state offering less onerous regulations.

The same observation can be applied to the functional restrictions imposed to banks. Without the possibility of engaging in securities or investment transactions, any expansion of bank activities had to come from vertical regulatory competition.

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robust jurisdictional competition in the market for corporate charters", Butler and Macey, op. cit. p. 713-714.

91.- "Regulation Q was the means by which the Federal Reserve Board implemented the provisions of the Banking Act of 1933 which prohibited the payment of interests on demand deposits by member banks and limited the rates of interest they could pay on time and savings deposits. The restrictions reflected the then prevailing view that destructive interest risk competition had contributed to the bank failures of the 1920s and early 1930s." Hall, *Banking Regulation and Supervision. A comparative Study of the UK, USA and Japan.* op. cit. p. 49

92.- Geoffrey P. Miller, "Banking Regulation. The future of the Dual Banking System", op. cit. p. 4

93.- Because of the specialness of banks we have seen above, banking industry reveals a strong pressence of federal chartering activity. "Virtually all private business enterprises, other than depository institutions are chartered at the state level. Federal chartering is generally reserved for enterprises that are primarily or wholly devoted to serving a governmental interest. Yet in banking we see a very different pattern, one of federal charterning of institutions that are both privately owned and devoted to the pursuit of profit for the owners." Macey and Miller, Banking Law and Regulation, op. cit. p. 121.

Nevertheless, the second scenario, - which generally speaking can be said to be the actual one - differs completely of the former and it has been labelled as the competitive banking era. In this new situation, the restrictions to the amount of interest payable are withdrawn, allowing banks to compete with money market funds which are not regulated[94]. Although the regulatory response to the financial crisis had always been an increase of regulatory controls[95], for the first time in 1980, Congress reversed that tendency. "In response to serious financial difficulties, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). It was the most significant financial act since the banking acts of the Depression and one of the most important in the nation's history. This complex act was designed to tighten monetary control in one move. It reduced regulation by eliminating state usury ceilings, passing out Regulation Q by 1986, empowering thrift institutions to make, on a limited basis, consumer and student loans, and allowing thrift institutions to offer checking-type NOW accounts"[96] Also, the division of the financial market between depository institutions- banks- an other financial entities has started to crumble, and the same could be said of geographic restrictions, practically abolished in the last decade. However, financial innovations, improved information in the marketplace and increased competition, decreased the profitability of certain commercial banks activities and forced them to engage in more risky operations (the resulting formula is then less profit and more risk, altogether backed by the 'moral hazard' character of deposit insurance).

As Miller affirms, "what is surprising is not that cartel banking has broken down, but that has taken so long to do so."[97] Under this new legal and economic environment, banks can find alternative regulatory structures shopping around for more favourable regulatory environments. Consequently, banks are less trapped within their chartering state. We then assist to a transformation of the type of regulatory competition in the banking regulation and not to its abandonment.

In addition, and far from considering regulatory competition the cause of the problems of the system, doctrinal voices start raising the idea that some

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[94].-leading to what is known as disintermediation. For a complete review of the role of intermediation in the US system, vide, Litan, *What Should Banks do?*. op. cit.; Litan, *The Revolution in US Finance. Washington* 1991.

[95].- Cfr. Macey, J.R. "The Myth of "Reregulation": The Interest Group Dymanics of Regulatory Change in the Financial Services Industry", Washington and Lee Law Review, vol. 45, 1988, p. 1275.

[96].- Lash, op. cit. p. 17.

[97].- Miller, op. cit. p. 7

of the financial troubles suffered by the American system during the 80's - the Savings & Loans crisis and the failure of some small local banks- had their origin in the state segmentation of market[98]. Thus, a leading expert in banking regulation does not doubt in stating that "broader geographic and product-line authority for banks during the 1980s would have improved overall performance, modestly lowering the number of failures and improving the presently precarious condition of some of our larger banks. If nationwide banking, in particular, had been authorised many decades before, it is likely that substantially fewer bank failures would have plagued the nation during the past decade."[99]

Therefore, what is becoming really troublesome is the mismatch existing between the socio-economic reality and the regulatory structures.[100] It

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98.- However, the crisis had mainly devastating effects on Savings and Loan institutions, which paradoxically are those whose regulation is more federalised and consequently out of the system of regulatory competition. On this particular see, White, "The S&L Debacle: How It Happened and Why Further Reforms are Needed". *Regulation,* Winter 1990, p. 11; England, "Lessons from the Savings and Loan Debacle. The Case for Further Financial Deregulation", *Regulation,* Summer 1992, p.36. "The S&L experience yields three important lessons. First, excessive regulation was the initial cause of the industry's problems. Second, federal deposit insurance was ultimately responsible for the high costs of the debacle. Finally, government-sponsored efforts to protect the industry only inivited abuses and increased the ultimate cost of restructuring", England, op. cit. p. 36; and also Scott, "Never Again: The S&L Bailout Bill", in *The Economics and Law of Banking Regulation,* edited by Furubotn and Richter. Center for the Study of New Institutional Economics. Universitat des Saarlandes. Occasional Papers vol. 2 Winter 1989/90.

99.- Litan, "Interstate banking and product-line freedom: would broader powers have helped de banks?" Yale Journal on Regulation, vol. 9 n.2, 1992 p. 540. "When banks are prohibited from entering certain locations, their balance sheets tend to have less geographic and industry diversification, which reduces its soudness and profitability. Similarly, when banks are prohibited from entering certain activities, banks have less product diversification, which also reduces their soundness and their profitability", Jordan, J.L. "A Market Approach to Banking Regulation", CATO Journal, vol. 13 n. 3, 1994 p. 320. In the same direction, it has been argued that the very existence of the FED was a factor that aggravated the financial crisis of 1929: "were it not for the existence of the FED, the crisis would have been less severe. Bank runs such as those of 1907 were cut short when banks refused to allow conversion of deposits into currency. In the 1930s, however, banks did not turn to this time-tested procedure because they erroneously believed that the existence of the FED eliminated the need for such drastic behaviour", Friedman and Schwartz, *A Monetary History of the United States: 1867-1960.* Princeton University Press, 1967, quoted by Lash, op. cit. p.11.

100.- As expressed by England, "banking law in the US is out of step with market realities", England, C. "The Uncertain Future of US Banking" in idem (ed.), *Governing Banking's future: markets vs. regulation.* Kluwer, 1991, p. 2. Going even further, it has been stated that policy change embodied in the DIDMCA and the Garn-StGermain Act and more generally pursued by the Reagan administration has had a major adverse impact on the stability of commercial banks, agravating the technological and economic factors. Thus, policy change has been more responsible for recent commercial banking system instability than economic conditions. Krause,

is crucial for the safety and soundness of American banks to evolve to a new type of regulatory competition suggested here. We will confirm this preliminary hypothesis in Section 5.

Robert Hawkins, President of the US. Advisory Commission on Intergovernmental Relations (ACIR), in occasion of the presentation of an study on the evolution of regulation in the banking sector has stated that "as a result of this study, the Commission reaches several findings with respect to the intergovernmental status of bank regulation in the US. and concludes that not only has the dual banking system generally led to a system whereby the goals of institutional stability and soundness are responsibly balanced with the need to encourage innovation and experimentation in the provision of financial services, but also that recent proposals for a greater concentration of regulatory authority by the federal government poses significant risks of stagnation and of a further erosion of the balance of power in the federal system"[101]. And in the same way are extremely illustrative the recommendations with which the ACIR report concludes: "the Commission finds that the nation's dual banking system has many benefits for citizens, states, and local communities. That system has been conducive to state experimentation, banking innovation, regulatory competition, and vitality in both banking regulation and banking activity. Although there are problems in the nation's banking system, currently proposed measures for federal preemption do not address those problems, Many State regulators have used their authority responsibly in extending new powers pertaining to insurance, real state, and securities to their state banks. The Commission recommends therefore, that the Congress not enact proposed legislation and that the Federal Reserve Board not to promulgate proposed rules that would substantially preempt state regulatory authority over state nonmember bank activities in the fields of insurance, real state and securities"[102]

So we should keep in mind the lessons regulatory uniformity has brought in last times to the US system, which undoubtedly have important consequences for the future of banking regulation in Europe. Indeed, regulatory measures fostering centralisation, hampering the possibility of experimentation and offering new and innovative services to clients, together with the structural changes of banking worldwide market, has been one of the elements that has provoked the extension of financial crises. We can even

G.A., "Economics, Politics and Policy Change. Examining the Consequences of Deregulation in the Banking Industry", American Politics Quarterly, April, 1994.

101.- Robert B. Hawkins Jr, Preface to the Commission Report "State Regulation of Banks in an Era of Deregulation" op. cit. p. IV.

102.- Advisory Commission on Intergovernmental Relations "State Regulation of banks in a era of deregulation", op. cit, p. 3

dare to suggest that had been an effective regulatory competition among States, restricting the amount on central regulation, and adapting with more flexibility to the new reality presented by financial markets, would have prevented the domino effect of the crisis. European legal development should try to avoid this 'too little, too late' story.

4.5. The Interstate Banking and Branching Efficiency Act of 1994.[103]

The US banking system has experienced a truly revolution during 1994. There has been a modification of the grounds on which classical banking regulation was based, namely, the territorial delimitation of banking markets and the relevance of vertical regulatory competition between state and federal norms.

Geographical restrictions to banking, which were presented as a factor limiting competition among regulators, will be left behind as a consequence of the current legislative reform. Nowadays, the observer can see a panorama which is significantly different and which, as a consequence, will imply deep changes in regulatory policy.[104]

In sum, in 1994, the so called Riegle-Neal Act is passed. We will devote the next pages to its analysis. Our approach, as is a constant in the whole work, will be centred in the aspects of the new legislation which will have effects on the model of regulatory competition. Thus, it has no intention of becoming a treatise on the legislation itself.

103.- Riegle-Neal Interstate Banking and Branching Efficiency Act de 1994, Pub. L.No. 103-328, 108 Stat. 2338 (1994), signed by President Clinton on september 29, 1994.

104.- Robyn Meredith has no doubt in labelling the new legislation as the begining of a modern banking system for the US. R. Meredith, "Comptroller Vows Close Watch on Local Needs Under Interstate Banking Law", The American Banker, 29.09.1994, p. 2. It has also been affirmed that "Now , Congress is about to adopt new federal legislation not only permitting banks acquisitions across state lines anywhere in the nation, regardless of state laws, but allowing bank holding companies to consolidate offices of their out-of-state banks into interstate branch networks. Enactment of such legislation wil mark one of the most dramatic chapters in American banking history, a major step away from the Depression-era laws that have severely limited the competitive capacity of expansion-minded banking organizations.", Editorial, Banking Policy Report, vol 13 n. 10, 1994

4.5.1 Geographic restrictions in American banking history.[105]

The issue of the restriction to interstate banking in the United States is a complex topic which has experienced several administrative and legislative vicissitudes. Let us describe a brief historical account in order to understand the importance of the Riegle-Neal Act.

In 1924[106], 60 years after the National Bank Act had established the competence of the Federation to authorise banks, the Supreme Court of the United States was confronted with deciding whether federal banks were authorised to open branches throughout the national territory, as was argued by banks' supporters. The answer of the Court in First National Bank in St. Louis v. Missouri[107] was negative. The open of branches was not included within the normal banking operation to which the federal banks were authorised. Therefore, the present judicial interpretation of the National Bank Act meant the first imposition of geographical restrictions to banking activity.

Under this state of affairs, it resulted that state banks benefited from a competitive advantage in respect to federal ones, since the former could open branches within its territory (intrastate branching) while federal banks were still relegated to the 'unit bank' model.[108] This competitive advantage provoked the abandonment of banks from the national to incorporate under the state system and also forced the federal response to stop the fugue of banks leaving the federal jurisdiction.

This response was materialised through the McFadden Act of 1927. The McFadden Act, three years after the Supreme Court decision, established the possibility for federal banks to branch within the city they were headquartered, provided that state banks were also recognised that opportunity. Adopting this formulation, what the McFadden Act did was to confer to the States the power to decide on the issue of branching, both for its own banks and for federal banks.

105.- Cfr., "A History of Interstate Banking in the US", Banking Policy Report, vol. 13 n. 16, 1994; Mulloy and Lasker, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Responding to Global Competition", Notre Dame Journal of Legislation, vol. 21, 1995; England, C. "Two Cheers for the Banking Reform Bill Introduction", Heritage Foundation Report, June 3, 1994. Available on LEXIS.

106.- Generaly speaking, the whole period before 1924 constitutes the so called 'unit banking system', where both for economic reasons and for convinction, banks had no more then its central office.

107.- 263 US 640 (1924)

108.- However, it is true that certain States completely excluded the possibility of branching within its territory, regardless the bank was federally or state chartered. More liberal states allowed their banks to run a branch network limited within its territory.

In 1933, after the Great Depression, the Banking Act, subsequently modified the McFadden Act in such a way to allow federal banks to branch state-wide provided that the same possibility existed for state banks. Therefore, in 1933, practically half of US States allowed the opening of branches within its territory, (intrastate branching) for both federally and state chartered banks.

However, its has to be stressed that no bank could operate interstate. Federal banks, despite of their name, had the headquarter in one State, and were allowed to branch, at most, in that given State. Hence, under the scope of the McFadden Act and the Banking Act, no bank, neither federal nor state had the opportunity of escape state lines.[109]

Thanks to the creation of Bank Holding Companies (BHC), banks started, for the first time in history, to challenge the prohibition of operating in more than one State. The legal trick was quite simple. The McFadden Act prohibited banks from operating in more than one state. The solution was to create a holding which grouped several banks of several States, which, nevertheless, kept their formally independent identity. This was the first primitive form of interstate branching.[110]

In 1956, Congress passed the Bank Holding Company Act which required that the approval of the Federal Reserve Board before the acquisition of a bank by a BHC. In accordance with the Douglas Amendment to the BHC Act, States can adopt legislation allowing or restricting the acquisition of a home bank by an out-of state holding. Thus, "while the purpose of the Bank Holding Company Act was to ban the formation of interstate networks by BHCs, the effect on the Douglas Amendment was to give the states the power to lift such a ban if they so chose".[111]

109.- Stritzel, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Progress Toward a New Era in Financial Services Regulation", Syracusse Law Review, vol 46, 1995, p. 169

110.- "To achieve the effect of interstate branching without violating the prohibition against it, a abking organization could simply use the BHC format to cross state lines. It had long been the rule that a BHC could acquire banks in more than one state and, so long as it held them as subsidiaries, legally independent of one another, operate them under a common management strategy. The BHC format first became popular in the 1920s, and by the 1950s, use of the BHC as a device for interstate expansion had become so widespread that community bankers began aggressively to seek protection agaisnt the competitive threat that multistate BHCs posed.", Rollinger, "Interstate Banking and Branching under the Riegle-Neal Act of 1994", Harvard Journal on Legislation, vol. 33, 1996, p. 192-193. Cfr. also in the same work the enumeration of the several techniques used to deceive geographic restrictions.

111.- Stritzel, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Progress Toward a New Era in Financial Services Regulation", Syracusse Law Review, vol 46, 1995, p. 171

But it was only 19 years after the passage of the Douglas Amendment, that a State (Maine) for the first time in history adopted an statute which allowed a BHC to acquire a home bank in conditions of reciprocity (i.e. whenever the home state of the BHC also allowed the same operation regarding banks located in its jurisdiction). This principle of reciprocity led to the so called 'regional banking', by virtue of which, some states, normally neighbouring states o pertaining to the same regional area, permit their BHC to acquire banks of other States.

In 1994, when the Riegle-Neal Act was passed, all States except Hawaii allowed some form of interstate banking.

In what concerns the possibility of out-state branching, it has to be pointed that it has been nearly non-existent in the American banking system. "Only a small number of states had authorized state-chartered banks to branch interstate, and no large state non-member bank has done so to date. On the federal level, it was only earlier this year that the Comptroller finally exercised authority under the National Bank Act to authorise an interstate branch network; such a transaction is accomplished by a bank relocating its head office no more than thirty miles but across state lines, merging with an affiliated bank in the new state, and retaining branches in both states"[112]

Finally, we argue that, the history of geographic restrictions to banking in the United States has been a constant struggle for the equilibrium between federal and state jurisdictions to control banking expansion.

4.5.2 The content of the Riegle-Neal Act.

a) Interstate banking. The acquisition of out-of-state banks.

We have seen that till the passage of the Riegle-Neal Act, the only way for a bank to operate in various states was the creation of a BHC and acquisition through it of other out-of-states banks in States where allowing legislation was available (Douglas Amendment).

112.- Indick and Kini, "The Interstate Banking and Branching Efficiency Act: New Options, New Problems", The Banking Law Journal, vol. 112, n. 2, 1995, p. 108 . However, the decision has been challenged before the US District Court for the Northern District of Texas and the judgement has reversed the OCC decision (Ghiglieri v. Ludwig, May 12, 1996) See, "Court Attacks OCC Policy on Relocating Bank Main Offices", Banking Policy Report, vol. 15 n. 12, June 17, 1996.

The Riegle Neal Act (Section 101) allows BHC to acquire banks of other States regardless of State legislation. This step implies an important liberalization of the State's capacity to restrict interstate expansion and at the same time a remarkable federalization of this regulatory field. [113]. The Riegle-Neal Act, thus preempts State legislation over interstate bank acquisitions.

The concrete impact of this provision will vary depending on the States. Those States which already permitted free interstate acquisition, will not be affected. On the contrary, those which required a reciprocal treatment will loose that possibility. Evidently, the State which most dramatically will suffer the consequences of section 101 will be Hawaii which till now did not allowed any kind of interstate acquisition. In reality, it has been pointed out that the statute does nothing else than to codify an existing practice, specially after the judgement in Northeast Bancorp Inc. v Board of Governors of the Federal Reserve System de 1985.[114]

The acquisition of out-of-state banks which will integrate the structure of the BHC are, however, subject to four conditions: the acquiring BHC must be adequately capitalized and adequately managed; state age laws, requiring that the bank had been in existence for at least 5 years, will be preserved. However, all state age laws which provide a minimum existence period in excess of five years will be preempted; acquisitions are also subject to concentration limits (the resulting institution cannot control more than 10% of the total amount of insured deposits of the US or more than 30% of deposits at State level); finally, the BHC has to comply with the Community Reinvestment Act provisions.[115]

Hence, the Riegle-Neal Act, tries to carefully respect States' interests and their sphere of influence. In what regards interstate banking, although the statute does allow a State to abandon the federal framework - does not include the possibility of opt-out - confers to them the fixing of the terms in which the acquisition can take place.

113.- Recall that who, at the end of the day, authorises the acquisition of an out-of-state bank by a BHC is a federal authority: the Federal Reserve Board.

114.- 472 US 159 (1985). Vide Indick and Kini, "The Interstate Banking and Branching Efficiency Act: New Options, New Problems", The Banking Law Journal, vol. 112, n. 2, 1995

115.- The Riegle-Neal Act fosters the acquisition of troubled banks by healthy BHC. Therefore, the four requirements mentioned may be exceptioned in such cases. On the issue of deposit limits cfr. Rappaport, A. "State and Federal Deposit Caps", Banking Law Journal. vol. 112, Oct. 1995 p. 900.

b. Interstate branching. The possibility of opening branches of a bank in another State.

"Perhaps the interstate law's greatest contribution is the express federal authorization of interstate branching, subject to various important conditions. Unlike interstate banking, which had become widespread over the past decade, interstate branching was considerably more difficult to achieve given the quilt of relevant federal and state banking laws".[116]

From June 1st, 1997[117], the Riegle-Neal Act allows the formation of interstate branch networks. This interstate branching can take two forms:

b.1. consolidation of branches of affiliated banks.

By virtue of the Riegle-Neal Act, a BHC can transform branches of a subsidiary in branches of the resulting bank. The same can be said of a federal bank which acquires a State bank. "A banking organization wishing to operate in multiple states will no longer be required to utilise the BHC structure, whereby it must maintain separately incorporated banks in its different states of operation, all of them unified under the umbrella of a common BHC. Instead, for the first time in American history, it will be possible for a single national bank headquartered in one state, having only one charter, to open branches in other states, whether nearby or distant. In this respect, the Riegle-Neal Act is revolutionary."[118]

However, and differing of interstate banking regulation, the creation of interstate branch networks is conditioned to States' will. The Statute contemplates the possibility for States to negate interstate branching facilities through the exercise of an 'opt-out' clause[119]. Therefore, States retain full control over branch consolidation.

In the case of opposing to federal legislation on interstate branching, States, are forced not only to prohibit interstate branch consolidation, but have also to extend such prohibition to any kind of interstate banking merger.[120] An

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116.- Indick and Kini, "The Interstate Banking and Branching Efficiency Act: New Options, New Problems", The Banking Law Journal, vol. 112, n. 2, 1995, p. 108

117.- Section 102, allows the possibility of shortening the existing periods through the so called 'opt-in clause', by virute of which, States expressely manifest their authorisation to interstate branch from the dictate of the corresponding legislation.

118.- Rollinger, "Interstate Banking and Branching under the Riegle-Neal Act of 1994", Harvard Journal on Legislation, vol. 33, 1996, p. 186

119.- In 1995, Texas had already exercised such an opt-out provision.

120.- "If a state 'opt-out' of interstate branching, not only would banks from outside the state be prevented from merging with instate banks, but also banks in the home state would be prevented

interstate merger implies the birth of a new credit institution which would have branches in more than one State and thus will constitute a form of interstate branching. In conclusion, the consequences of exercising the opt-out clause are the complete foreclosure of the home market and therefore implies a high cost for those State deciding to exercise it.[121]

"The decision to forward the branching question to the states means that the Riegle-Neal Act is really only a political compromise. Congress has not spoken definitively or authoritatively on the issue of interstate branching. Rather, it has shifted the deregulation debate from Washington DC to state capitals across the country."[122]

The perceived tendency till now has been for the States to accept the possibility of interstate branching established in Section 102 of the Riegle-Neal Act.[123] At the first quarter of 1996, 27 States had already expressed their assent with the new legislation.[124] "While the section 102 opt-out represents a potentially problematic provision, it appears that the early opt-in, rather than section 102 opt-out is clearly the preferred choice of many states. If the trend toward early opt-in continues, one can expect that interstate branching will be a reality throughout the United States."[125]

b.2. 'ex novo' opening of branches

In addition to consolidation of branches pertaining to subsidiaries under the umbrella of a BHC and interstate mergers, the new legislation also contemplates the 'ex novo' opening of branches. This simply implies the

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from acquiring out-of-state counterparties. It is not difficult to predict intense warfare in some state legislatures, with smaller banks asking the legislature to 'opt-out' and larger banks asking the legislature at the least no to do so". Indick and Kini, "The Interstate Banking and Branching Efficiency Act: New Options, New Problems", The Banking Law Journal, vol. 112, n. 2, 1995, p. 110

121.- At the begining of 1996, only Texas exercised the opt-out provision by including a sunset provision that will cancel the provision on 1999.

122.- Rollinger, "Interstate Banking and Branching under the Riegle-Neal Act of 1994", Harvard Journal on Legislation, vol. 33, 1996, p.250

123.- Mitchell, "Preparations in the States for Interstate Activities", New York Law Journal, 16.08.1995. Cfr. "More States are Opting in Early on Interstate Branching than Opting Out", Banking Policy Report, vol 14 n. 8, May 15, 1995.

124.- For a detailed account of State-by-State indications, cfr. "Majority of States Pass Laws Approving Interstate Branching", Banking Policy Report, vol. 15 n. 7 April, 1 , 1996.

125.- Stritzel, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Progress Toward a New Era in Financial Services Regulation", Syracusse Law Review, vol 46, 1995, p. 210

opening of a branch in a different State where the bank has its central office, without the need of acquiring a pre-existing institution.

In this case, however, the Riegle-Neal Act requires that States have deliberatedly manifested their consent to this operations. Unlike the consolidation hypothesis, where states could block interstate expansion while exercising the 'opt-out' clause, Section 103 requires express legislation allowing the 'ex-novo' opening. ('opt-in'). We see thus, the gradual empowering of state authorities depending on the kind of strategy used to branch over state lines. (from expressly requiring an 'opt-out' clause in the case of consolidation to requiring an 'opt-in' clause in 'ex-novo' establishment.

"The 'de novo' branching privilege is an extremely valuable provision for out-of-state banks as it allows a bank to branch interstate without having to make the great capital expenditures necessary to acquire an existing institution. De novo branching authorisation therefore may work to free up and encourage some banks to branch interstate that may not have been able to do so otherwise. As such, the gateway to de novo branching has been left within the exclusive control of the individual states by virtue of section 103's opt-in provision."[126]

To conclude, the Riegle-Neal Act is greatly innovative in two aspects:

- permits free interstate banking acquisition, that is, without requiring conformity of State legislation.
- allow the States to authorise the opening or consolidation of branch networks across State lines. (interstate branching). In order to achieve this second goal, Congress has expressly repealed the McFadden Act[127].

4.5.3 The Riegle-Neal Act's impact.

a) in the banking industry itself.

It has been said that the major impact of the Riegle-Neal Act will be the creation of a more efficient and economic banking system. Certain, the differences between the existing praxis and the new legislation are not enormous. However, the old interstate banking system based on BHC forced

126.- Stritzel, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Progress Toward a New Era in Financial Services Regulation", Syracusse Law Review, vol 46, 1995, p.183.
127.- Graham, "Relaxed banking rules due for early passage" Financial Times, 28.4.1994 .

institutions to maintain different management boards and different accounting for each subsidiary together with different processing systems, which made the system quite complicated and costly.[128]

Moreover, one of the causes of the precedent banking crisis in the United States has been the impossibility of portfolio diversification which suffered banks limited to one given state territory. With all investments concentrated in one State, banks were highly vulnerable to local economic conditions. Thus, increased geographical freedom will enhance diversification and stability.

On the other side, it seems somehow over dimensioned the prediction that industry will concentrate in few huge nationwide bank conglomerates. Even recognising that a recent wage of mergers has taken place[129], the challenge of the future will be efficient management more than bank's size. States like California or New York, with few branching restrictions have maintained within their respective jurisdictions both big banks and small networks of local banks which serve small savers and investors[130].

Such interstate mergers are extremely unlikely to produce positive social benefits. While bankers once believed that competition was contrary to the interest of the industry, they now recognise that competition is an important positive force and that mergers in order to attain a competitive size should be allowed.[131] (in order to face both the challenge of international competition and of competition from non-bank institutions).[132]

128.- Senator Dodd, argues that: "full interstate branching will streamline the administration, improve bank efficiencies, ease regional economic slumps, boost consumer convenience, ameliorate the impact of future credit crunches and I think enhance the safety and soudness of the banking industry overall" Congressional Record. Senate. 103rd Congress, 2nd Session, April 26, 1994, 140 Cong. Rec. S. 4796.

129.- The FED has already approved two mega-mergers that will alter the national and worldwide rankings of banking organizations. The FED okayed the merger of the New York based Chemical Bank Corporation and the New York based Chase Manhattan Corporation to create the largest banking organization in the nation with $300 billion in assets. It also approved San Francico based Wells Fargo & Company's acquisition of Los Angeles based First Interstate Bancorp. Banking Policy Report, vol. 15 n. 9, May 6, 1996. See also in the same issue a list of state-by-state mergers applications.

130.- Miller, G.P. "Legal Restrictions on Bank Consolidation: An Economic Analysis", Iowa Law Review, vol. 77 n. 3, 1992; Rose, P.S. "Interstate banking: performance, market share, and market concentration issues", The Antitrust Bulletin, vol. 37 n. 3, 1992. See also ABA President's Position in "After interstate: 8 banks or 8.000?", ABA Journal. Sept. 1994 p. 17.

131.- Carstensen, Peter C. "Public Policy Toward Interstate Bank Mergers: The Case for Concern", Ohio State Law Journal, vol. 49 n.5, 1989.

132.- "Mergermania", The Banker, n. 38, 1994.

However, as we argued in the European case, size should not be confused with profitability. There are few economic reasons to argue in favour of economies of scale in banking. On the top of that, one has also to take into account the existence of limits to the total amount of deposits owned by a single institution.

In what concerns the structure of the industry, it has been said that the passage of the interstate banking legislation could signal the end of Bank Holding Companies. "Because Bank Holding Companies for the most part evolved in response to legislation that regulated banks but not the companies that owned them, and the retained their usefulness as necessary vehicles for geographic expansion because of the ban on direct interstate branching, interstate banking may spell the end of the Bank Holding Company"[133]

b) in regulatory authorities and in supervisory policy.

According to Section 105, the State's authority of the place where a branch is located (regardless of where the parent bank is headquartered), will be competent to examine whether that branch complies with State law in aspects such as Community Reinvestment, consumer protection or the conditions established in the Fair Lending Act[134]. The rest of regulation will be in the hands of the home authority.

Thus, it is clear that the new complex distribution of supervisory powers will require a greater cooperation and coordination among supervisory authorities, both because a bank might have branches located in different States (horizontal interstate co-operation) or because the applicable law will be federal or state law depending on the issue (vertical co-operation).

Towards that end, the Conference of State Bank Supervisors (CSBS) has developed guidelines under which state-chartered banks, like national banks, will be subject to only one regulator if they engage in interstate branching. Such guidelines divide between home state (where the bank is chartered) and host state (where the bank operates branches.) They are designed to rationalise supervisory issues, conduct joint examinations and coordination among regulators.[135] "Under the framework, the home-state supervisor will be the

[133].- Clyde Mitchell, "Legislation Affecting Interstate Activity", New York Law Journal, Sept. 21, 1994.
[134].- Buerstetta y Runck, "Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994", Annual Review of Banking Law, vol. 14, 1995, p. 11
[135].- "CSBS Outlines State Initiatives to Implement Interstate Branching Law", Banking Policy Report, vol. 13 n. 21, 1994; "CSBS Guidelines Aim to Ease State Supervision of Interstate Branching", Banking Policy Report, vol. 14, n. 11, June 5, 1995.

primary regulator and the main contact for state-chartered banks. Home-state law will govern a bank's corporate structure, its capital requirements and its limits on lending and investments. Host-state law will apply to out-of-state branches in a number of respects - intrastate branching, antitrust laws and deposit concentration limits, community reinvestment, consumer protection, fair lending, and equal credit opportunity"[136]

The passage of the Riegle-Neal Act and the possibility of interstate operation, has also opened the debate about the future of the Dual Banking System. It is argued that, in the new scenario, banks will simply prefer federal jurisdiction in order to be subjected to a single regulatory authority. Therefore, "in conjunction with the Conference of State Bank Supervisors (CSBS), many states are now re-examining their regulatory systems and developing ways to make their charters more attractive to multistate banking organizations. A state charter may be desirable for several reasons: state supervision is less costly to banks than OCC supervision, state banks are often afforded a wider range of powers than national banks, and the state regulatory environment may be more accommodating. In addition, the advent of interstate branching will provide the states with an incentive to improve interstate cooperation in bank examination and supervision, to ensure that the regulatory burden associated with a state charter will be no greater than for a national charter".[137]

Following this argumentation, it is also argued that it will be much more advantageous for a bank contemplating a future expansion to operate under federal jurisdiction enjoying just a set of norms concerning issues as supervisory policy and taxation instead of being under different and overlapping regimes[138]. However, we argue that this not need to be the case. First, state regulators will be forced to co-operate in order to adapt certain kind of policies applied to a credit institution authorised in one State and operating in a different one. Thus, competition will force regulatory co-operation. As an example of this, one could cite plans of elaboration of common guidelines under the auspices of the Conference of State Bankers Supervisors in the field of interstate banking supervision for state chartered banks[139].

136.- "Regulators Strive to Simplify Interstate Supervision", Banking Policy Report, vol. 15 n. 12, June 17, 1996.

137.- Rollinger, "Interstate Banking and Branching under the Riegle-Neal Act of 1994", Harvard Journal on Legislation, vol. 33, 1996, p.267;

138.- Douglas, "The Interstate Banking Act creates new incentives to obtain national charters, threatening the relevance of the dual state-federal system", *The National Law Journal* vol. 17 n.30, 1995.

139.- Cfr. Bureau of National Affairs (BNA) Banking Report, "State regulators to unveil guidelines for interstate bank branch supervision", vol 64 n.19, 1995.

Second, it is unanimously recognised that the Riegle-Neal Act is a norm that is respectful with States' rights. Instead of completely federalizing the regulation of interstate operations, States hold important regulatory powers. This is for instance the case of applicable 'age laws', antitrust legislation or provision referring to community reinvestment obligations. Equally, in the case of 'ex-novo' branching States have the possibility of exercising the 'opt-out' provision. Hence, it is undeniable that the statute assigns important powers to States and that some kind of horizontal regulatory competition is foreseeable.[140]

In our view the liberalization of geographical restrictions can be presented as a manifestation of the erosion of the 'dual banking' in its traditional sense but not a suppression of regulatory competition. With a paradigm of quasi-free interstate banking operation the core element will be moved from vertical regulatory competition between States and federal level to horizontal regulatory competition among the latter, in a similar way as is experienced in US corporate law and EU banking legislation.[141]

Therefore, the surmounting of geographical restrictions will not necessarily impede continuing characterizing US banking system as a model of regulatory competition. The new situation will, no doubt, present new problems as the possibility of a race to the bottom since a bank will be free to incorporate in one State and mainly operate in another. The consequences of a excessively lax regulatory policy may harm out-of-State clients. It will have to be included in future regulatory agenda how the deposit insurance system will have to adapt to this new regulatory environment and how minimum federal legislation is used to avoid destructive competition (although as we argue, the US banking system is already quite federalized).

Interstate competition is not however a completely unknown phenomenon in American banking. Some areas which were not subject to federal legislation had already experienced some form of interstate competition. This is for instance the case of usury ceilings on consumer contracts and more concretely on credit card transactions. In 1980, South Dakota relaxed such restrictions and allowed out-of-state banks to open a subsidiary in its territory and direct their operations nation wide.[142] Delaware

140.- Indick y Kini, "The Interstate Banking and Branching Efficiency Act: New Options , New Problems", The Banking Law Journal, vol 112, n.2, 1995.

141.- However, the degree fo federalization or centralization of the US system is significantly higher.

142.- By virtue of the Marquette National Bank v. First of Ohama Service Corporation decision, ***** the US Supreme Court established that a bank has the right to charge out-of-

did a similar thing a year latter. A process of horizontal regulatory competition could be observed after these two states had enacted their more permissible banking rules. "Near-by states felt the need to relax if not match the new regulations since banking institutions either threatened or actually moved operations abroad. Only seven months after the South Dakota legislation took effect, New York emulated its moves by also eliminating usury interest rate ceilings as well as allowing annual fees. Nevertheless, the legislation came too late to prevent Citibank from changing its plans to move to South Dakota"[143] This can serve as a clear indication of future direction of the regulatory competition process in the US.

Thus, we argue that there will be no more incentives to charter under federal jurisdiction added to the already existing ones. In practice, state law will continue to have an important impact on banking organizations. On the contrary, what is truly remarkable is the inversion in the functioning of regulatory competition. Returning to the initial argumentation, the DBS was justified by the need of guaranteeing escape valves against excessively harsh and oppressive regulations. In a system were the market was segmented, the only possibility which a financial institution had was to make recourse to other level of government. Nowadays, with the possibility of finding this escape valve in the same State level, the need of an alternative federal regulation will be reduced. Therefore, a possible scenario is a future banking system where state chartering will prevail and federal authorities will function as arbiters and will discipline horizontal interstate competition.

Despite the transformation of the original Dual Banking Structure experienced recently we have to recall that a high degree of jurisdictional competition still exists. "This competitive dynamic has generated the benefits of the dual banking system, and it still exists, although the federal government is reining it in."[144]

4.6 The separation of banking and securities and the current debate on the future of the Glass-Steagall Act.

state customers at the rate which it charges in its home state. This means that a bank could apply its fees nationwide.

143.- Hoschka, Tobias, "Cross-Border Entry in European Retail Financial Services", Phd Thesis EUI, 1992 p. 283-284.

144.- Hill, "The savings and loan debacle and erosion of the dual system of bank regulation", *Publius* n. 21, 1991, p. 31

The wage of reforms of the US banking system will not finish with the abolition of geographic restrictions effectuated by the Riegle-Neal Act. We argue that also product restrictions will follow a similar pattern. It is not our intention to offer a comprehensive study of this issue and of its crucial consequences for regulatory competition. Therefore we present rather sketchy ideas for further reflection.[145]

The Glass-Steagall Act was passed in response to the financial crisis of the 1930s. It was believed at that time that the stock market crash and the subsequent failures of thousands of banks were caused by fraud and other abuses by the securities affiliates of banks. As a result of the Glass-Steagall Act commercial banks were prohibited from engaging in most securities activities. As the basic nature of many important bank lending and deposit taking activities is changing, and traditional markets are changing for banks, they are precluded by law and regulation from participating in these emerging markets.[146]

The 1991 Treasury Plan for Banking Reform already recommended the improvement of the competitiveness of American banks through two sets of reforms: creating a nationwide banking system and allowing banks to expand their product lines and becoming diversified financial services firms.[147]

In fact it has been recognised that the pressures for repealing the Glass-Steagall Act come form the same industry which in the past was a strong advocate of them. Nowadays, industry perceive those product restrictions as a major competitive obstacle since they have to compete in the market with powerful non-banking institutions.[148] In the opinion of the Chairman of the FDIC, the US "can no longer afford the luxury of such restrictions if its financial institutions are to remain competitive in global financial markets"[149]

145.- Cfr. The symposium on comparative bank regulation , "Global Trends Toward Universal Banking", Brooklyin Journal of International Law, vol. 19 n. 1, 1993; "Regulatory Reform in Transition: The Dismantling of the Glass-Steagall Act", Administrative Law Review, vol. 47, Fall 1995, p. 545.

146.- Chessen, J. "The Dual Banking System: Expanding Roles in the Financial System", in ACIR, *State and Federal Regulation of Banking*, 1988 p. 13

147.-US Treasury, Modernizing the Financial System: Recommendations for Safer Nore Competitive Banks. of 5.2.1991. Cfr. also, Lewis, J.B. "Treasury's Vehicle for Bank Reform", Bank Management March/April, 1995.

148.- Macey, J.R. "The Myth of "Reregulation": The Interest Group Dynamics of Regulatory Change in the Financial Services Industry", Washington and Lee Law Review, vol. 45, 1988.

149.- "1992 poses competitive threat to US banks", Banking Policy Report vol. 53 n. 13, October 2, 1989.

Inaction of Congress before the changing need of the banking industry has led to the expansion of banking powers through BHC and through a liberal interpretation by the Federal Reserve. One the of latest episodes is the Mellon Bank order where the FED allowed a bank to enter in the mutual funds business by acquiring a mutual funds institution. This way, the Glass-Steagall Act has lost much of its effectiveness.[150] Similarly, the Supreme Court has recently held in Barnett Bank of Marion County, N.A. v Nelson, that federal law preempts state laws prohibiting banks sales of insurance products.[151]

Congress is finally reacting to the marketplace reality and is considering the repeal of the this expired legislation by the introduction into the House of Representatives of the Financial Services Competitiveness and Regulatory Relief Bill of 1995.[152] The bill would allow well-capitalized and well-managed banks and securities firms to affiliate under a holding company structure.

It remains however the problem of the extension of the safety net (deposit insurance) to the new activities. It has been warned that the model of universal banking with the actual deposit protection could set up a time bomb. The safety bet would be expanded to the entire financial system and not just to the banking sector. Having this in mind, the proposals consider the possibility of engaging in securities activities only through subsidiaries of a BHC. This would permit to establish firewalls to protect the insurance system in case of insolvency. "The FED has recommended that any expanded bank powers be conducted by subsidiaries of the holding company, and that Congress place limits on the transactions between the bank and the security affiliates within that holding company. These institutional firewalls will help to insulate the depository institutions from the risk that is inherent in the securities business."[153]

150.- Zubrow Choen, Jonathan, "The Mellon Bank Order: An Unjustifiable Expansion of Banking Powers", The Administrative Law Journal, vol. 8 n. 2, 1994.

151.- 116 S. Ct. 1103 of 26.3.1996. Cfr. Meyer,P.C. "Supreme Court goes Far to Ratify National Bank Insurance Agency Powers", Banking Policy Report, vol. 15 n. 8, April 15, 1996; Fein, M.L. "Insurance Powers gains of Barnett decision clouded by 7th Circuit", Banking Policy Report, vo. 15 n. 12, June 17, 1996. In general, on the role of the judiciary in interpreting the Glass-Steagall Act, cfr. Langevoort, D.C. "Statutory Obsolencence and the Judicial Process: the Revisionist Role of the Courts in Federal Banking Regulation", Michigan Law Review, vol. 85, 1987.

152.- Financial Services Competitiveness and Regulatory Relief Bill. Cong. Rec. HR. 2520 of Oct. 24, 1995. Section 101 and 102 have the significant titles such as "Anti-Affiliation Provision of the Banking Act of 1933 Repealed" and "Financial Services Holding Companies Authorised to have Securities Affiliates", respectively.

153.- Heller, R. "International Economic Challenges to American Banking", Annual Review of Banking Law, vol. 9, 1990, p. 324.

In any case, it is interesting to note that the United States banking system is headed towards convergence of a continental banking structure, in the sense of increasingly permitting banks to engage in non-bank financial activities, in particular securities underwriting.[154] We emphasise this aspect in next chapter.

[154].- Bisignano, "Banking Trends in Europe" LSE Financial Markets Group Special Paper n. 38 1991, p. 2; Rich, G and Walter, C. "The Future of Universal Banking" CATO Journal vol. 13 n.2, 1993.

CHAPTER V

GLOBALIZATION OF BANKING REGULATION

"All the powers of vested interests and government regulation now have to confront the consequences of a new international mobility of people, capital, enterprise and knowledge. The old order of nation states and national sovereign policies will never be the same again, as the new international mobility is turning into a new historic force"

Kasper, W. The Defeat of Political Power. 1990

5.1. Globalization of financial markets

5.1.1 Definition

Globalization can be defined as the act or state of becoming world-wide in scope or application.[1] In what concerns the effects of this phenomenon to the public law of banks, it is obvious that the increased scope of the market brings into contact various models of authorisation and regulation of credit institutions. This interpenetration of legal orders and cultures due to mobility of the regulated element, leads to a reinforcement of the regulatory competition paradigm at international level. Intuitively, the greater the territorial scope of the market for regulations is, the greater dimension will have regulatory competition.

In other words, with the globalization of financial markets, there is an increasingly high pressure for international regulatory convergence. This regulatory convergence is not achieved (at least not only or mainly) through

1.- Pavel and McElravey, "Globalization in the financial services industry", Economic Perspectives. Federal Reserve Bank of Chicago, vol. 14, 1990 p. 3.

negotiation and political bargain[2]. "The resulting globalization of real and financial markets is often defined as if it were a process of moving together through time to an idealised state in which transnational coordination costs would vanish for private financial and non-financial firms. We might call this utopian state the global village. However, in terms of observable consequences, globalization imposes market discipline on government regulators. This discipline constricts the freedom of financial regulators in different countries to impose or to maintain differences in the rules of financial competition."[3] Instead, "competition, imitation, diffusion of best practice, trade, and capital mobility naturally operate to produce convergence across nations in the structures of production and in the relations among economy, society and state"[4]

Globalization has to be differentiated to related concepts such as internationalization. Internationalization implies a cross-border flow of activities.[5] That is, economy and society are based on national actors and an important role is played by national public authorities. On the contrary, globalization, as defined by McGrew can be considered as:

> "the multiplicity of linkages and interconnections between the states and societies which make up the present world system. It describes the process by which events, decisions, and activities in one part of the world come to have significant consequences for individuals and communities in quite distant parts of the globe."[6]

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[2].- Although there is enough evidence to consider efforts in that direction such as those of the Basle Committee or the GATT. Indeed, it has been argued that the international competitive environment needs a international agreement to discipline competition. See diferent proposals and inconvinients in Hultman, "Regulation of International Banking" *Journal of World Trade,* vol. 26 n. 5, 1992. p. 87. Also, Norton, "The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on International Convergence of Capital measurements and Capital Standards" *International Lawyer,* 245 n. 23, 1989; Hayward, "Prospects for international co-operation by bank supervisors (with background note on the Basle Committee on Banking Supervision)", in Norton (ed.) *Banking Regulation and Supervision in the 1990's.* London, 1991; Zamora, "Regulating the Global Banking Network - What the Role(if any) for the IMF", *Fordham Law Review* vol. 62, n. 7, 1994.

[3].- Kane, E.J. "Incentive Conflict in the International Regulatory Agreement on Risk-Based Capital", NBER Working Paper n. 3308, 1990, p. 2.

[4].- Berger, S. "Introduction", in the book edited by the same author, *Convergence or Diversity? National Models of Production and Distribution in a Global Economy.* MIT, forthcoming, p. 1

[5].- To be precise, "globalisation of finance comprises three sets of phenomena: the growth of international banking and securities markets, the strengthening of the linkages between domestic banking and securities markets, and the deepening of these same domestic markets". Coleman, W.D. *Financial Services, Globalization and Domestic Policy Change.* McMillan Press. London, 1996. p. 5

[6].- McGrew et al. *Globalization and the Nation-states.* Cambridge, 1992, p. 22.

However, the issue of globalization it is not only circumscribed to a question of space. Globalization implies a fundamental change in the perception of law and the classical elements of international relations. Thus, there is a fundamental difference between perceiving the market as an international one or a global one. An international thinker sees the world as a series of national markets. For instance, according to this kind of vision, there is a tendency to assess currency risk as a bilateral phenomenon when in fact is a multilateral one. The interplay and linkages between operating and financial strategies are far more complex in a global world than in an international one. Instead, a global thinker sees the marketplace as an interconnected and integrated space. So, we can define globalization "as the process by which the world's various national financial marketplaces are beginning to act as if they were one single integrated marketplace"[7]

The distinction is not a idle one. There are fundamental shortcomings in international regulation of banking operation due to a lack of understanding of this truly revolutionary paradigm. As has been detected by Scott, the restricted vision of the financial markets as international marketplaces leads to many shortcomings. The most evident one is the use of reciprocity clauses in regulating foreign access to domestic markets. "The basic problem with reciprocity is that they result in an anarchic trading system. Each country adopts its own reciprocity standard based on its own view of what the appropriate rules should be for international banking services. It would be far better to formulate some international standards. Hopefully some progress towards that end will be made in the current Uruguay Round of trade negotiations within the GATT"[8] (and thus conceptualising the financial marketplace as truly global). We will try to discover some of these shortcomings in the following pages.

5.1.2 Causes of Globalization

[7].- Bleeke and Bryan, "The globalization of financial markets", The McKinsey Quartery, Winter 1988, p. 22. "Institutions and markets will continue to be drawn into more complex transnational structures of interaction - in other words structures which cut across and link elements once seen as distinctly domestic with those seen as distinctly international. This distinction now makes little difference to markets". Cerny, P.G. "The dynamics of financial globalization: Technology, market structure and policy response", *Policy Sciences*, vol. 27, 1994, p.335

[8].- Scott, Hal S., "Reciprocity and the Second Banking Directive", in Cranston (ed.) *The Single Market and the Law of Banking*, London, 1991, p. 91.

In what concerns the causes of globalization, it is argued that financial globalization is being driven, among others, by the following factors:[9]

1.- advances in data processing and telecommunications. Taken as a single independent variable, technology represents a crucial factor in understanding the structural significance of financial globalization. One can say that technology has pushed further the changing political context in which globalization is taking place and has led to the huge expansion of transnational market processes (and capital mobility). Thus, in order to understand financial globalization, the changing technological infrastructure underlying an economic-institutional system, is pivotal. The expansion and globalization of the financial services industry in recent years has been virtually synonymous with the rapid development of electronic computer and communications technology which transfer money around the world with the tap of a key.[10]

2.- liberalisation of restrictions of cross-border capital flows. Before liberalisation, markets were deliberatedly shielded from international influences by means of capital controls, interest rate ceilings and lending policies. But in the 1980s countries decided to modernise national financial markets and they began to remove exchange controls, eliminate regulations on interest rates, dismantle barriers among different types of financial institutions and open domestic markets to foreigners.[11]

3.- deregulation of domestic capital markets supported by neo-liberal advocates and internationally oriented businesses.[12]

4.- greater competition among domestic markets for a share of the global trading volume. This implies recognising the increasing integration of world-

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[9].- Pavel and McElravey, "Globalization in the financial services industry", *Economic Perspectives*. Federal Reserve Bank of Chicago, vol. 14, 1990 p. 3.

[10].- Cerny, P.G. "The dynamics of financial globalization: Technology, market structure and policy response", Policy Sciences, vol. 27, 1994, p. 325 and 330. See however Zevin, who argues that a high degree of international capital market integration already existed in the gold standard era, regardless of technological revolution. Zevin, "Are world financial markets more open? If so, why and with what effects?", in Banuri and Schor, Financial Openness and National Autonomy, New York, 1992. In the same line of argumentation, undelying the passive role of technology, see Pringle, "Financial Markets versus Governments", in Banuri and Schor, Financial Openness and National Autonomy, New York, 1992, p. 99.

[11].- Spero, J.E. "Guiding Global Finance", Foreign Policy n. 73 Winter 1988-89, p. 115.

[12].- Interestingly, in most countries, this domestic coalition of neo-liberal enthusiats and internationally oriented business groups encountered very little resistance when they called for the abolition of capital controls. The highly technical and seemingly complex nature of international financial issues appeared to give these groups a high degree of autonomy to influence state behaviour in this area. Indeed, it is striking that in none of the liberalization decisions in the 1970s and 1980s was the kind of controversy generated among the general public that regularly emerges concerning liberalization decisions in the trade sector. Helleiner, "Post-Globalization. Is the financial liberalization trend likely to be reversed?", in Boyer and Drache, States against Markets. The Limits of Globalization. London, 1996.p. 194 ;

wide economy. "The last thirty years have seen an unprecedented increase in the internationalisation of banking and securities markets. National domestic markets have had to respond to these changes and, in the process, have themselves become more closely tied together. Social scientist expect that greater economic integration will encourage closer political relationships among the authorities responsible for the economies affected, and possibly convergence in institutional arrangements"[13]

But globalization has not been a process dominated exclusively by the will of markets. Markets are socially constructed and require an institutional framework. On the contrary, there is a growing body of literature in the field of international political economy that argues that financial globalization has also been heavily dependent on state support and encouragement, specially in what refers the lifting of capital controls.[14]

In fact, it has been stated that among the factors that have lead to the internationalisation of banking, the desire to minimise the regulatory burden for domestic firms, is an important one.[15]. The regulatory burden placed on banks is the difference between costs and benefits of their regulation.[16] In an

[13].- Coleman, "Policy convergence in baking: a compartive study", Political Studies, 42, 1991, p. 274 . There are also economic factors that helped fuelling this process of international expansion: the monetary policy pursued by the US; the Foreign Direct Investment Program; and the rise of foreign debt in developing countries. Cfr. Möschel, W. "International Free Trade in Banking Services", Occasional Papers vol.2, 1989/90. Center for the Study of New Institutional Economics. Uniersität des Saarlandes, p. 69-70.

[14].- "It was the political decision to remove capital controls, rather than tachnology per se, that re-created the conditions for truly global integrated markets to re-emerge", Pringle, "Financial Markets versus Governments", in Banuri and Schor, Financial Openness and National Autonomy, New York, 1992, p. 99; Cfr. Helleiner, "Post-Globalization. Is the financial liberalization trend likely to be reversed?", in Boyer and Drache, *States against Markets. The Limits of Globalization*. London, 1996; Idem, *States and the Reemergence of Global Finance: from Bretton Woods to the 1990s*. Ithaca. Cornell Univ. Press, 1994.

[15].- Together with real sector demands and capital flows. Gavin does not doubt in noting that, "on the regulatory side, there is now widespread agreement that escape from domestic regulation was a major force behind the growth of international banking. It was the regulatory bias in the domestic market aginst international banking business that drove many banks abroad. Conversely, the growth of many new banking centres was a function of their more liberal regulatory environment. As governments began to realize that they were losing valuable business to overseas centres, there was a gradual relaxation of controls at home" Gavin, B. "A GATT for International Banking?", Journal of World Trade Law, vol. 19, 1985, p. 123

[16].- To establish a hypothetical point of reference from which to assess the potential gains of regulatory competition in international banking, one has to bear in mind the following existing costs to mobility: costs for foreign and domestic banks to enter or leave any foreign or domestic banking market; costs of converting between home-country and foreign currencies; costs of delivering banking services to and from any office location in the world.

open world economy, banks may attempt to operate in a regulatory framework outside their home country if the regulatory burden is thereby reduced. In evaluating the internationalisation of the US and Japanese banks and the activities of German banks in Luxembourg, there is no doubt that factors such as interest rate controls and restrictions on permitted activities played a crucial role in inducing them to expand their international activities.[17] This opens the debate on the increasing difficulty of maintaining regulatory effectiveness of measures that run against the international trend. Discontinuity between transnational finance and national regulation diminishes the regulatory effectiveness of the latter.[18]

Therefore, we argue, there is a circular relation between internationalisation and regulation. Internationalisation leads to cross-comparison of regulatory models and to a process of regulatory convergence. At the same time, the remaining regulatory burden fosters financial entities to internationalise to escape those restrictions. As stated by Coleman, "growing international banking markets have forced many firms to demand significant domestic market deregulation in order to compete and survive"[19]

In a world with those costs being zero, "national markets would be completely integrated. Production of banking activities would migrate to office locations in the single country whose regulators placed the lightest consolidated net regulatory and tax burden on these activities" Kane, "Competitive financial reregulation: an international perspective", in Portes, R. and Swoboda, A.K., Threats to international financial stability. Cambridge U. Press, 1987, p. 124-125. Although some costs will be aways present, technological imporvements in information management have reduced the overall costs of transaction and increased the contestability of national market for regulatory sercives.

17.- Swary and Topf, Global Financial Deregulation, Blackwell 1992, p. 478. The above point is clearly ilustrated by the growth of the urocurrency market in the US as a response to regulatory restrictions existing in the US market. "The US government imposed severe controls on the movement of capital, which deflected a substantial amount of borrowing demand to the young Eurodollar market. These US capital controls were dismantled in 1974, but the oil crisis of the 1970s helped to fuel the continued growth of the Eurocurrency market, The US oil embargo made oil-exporting countries fearful of placing their funds in domestic branches of US banks. In the late 1970s and early 1980s, high interest rates bolstered the growth of Eurocurency deposits, which are free of interest-rate ceilings and not subject to reserve requirements or deposit insurance premiums. From 1975 to 1980, Eurocurrency deposits grew over threefold (...). The declining importance of Eurodollar deposits can be explained at least partially by the decline in the cost of holding noninterest-bearing reserves against domestic deposits in the US". Pavel and McElravey, "Globalization in the financial services industry", Economic Perspectives. Federal Reserve Bank of Chicago, vol. 14, 1990 p. 6

18.- Trachtman, "Recent initiatives in International financial regulation and goals of competitiveness, effectiveness, consistency and cooperation", Northwestern Journal of International Law and Business, vol 12 n. 2, 1991 p. 244

19.- Coleman, op cit. p. 277. "The regultory dialectic views regulation and regulatee avoidance behaviour as forces linked like the pedals on a bicycle. The alternating rise and fall of associated stresses drives a single process", Kane, "Competitive financial reregulation: an

"Traditional forms of trade protectionism are both easily bypassed and counterproductive. Currency exchange rates and interest rates are set in rapidly globalizing marketplaces, and governments attempt to manipulate them often at their peril. Legal rules are increasingly easily evaded and attempts to extend the legal reach of the national state through the development of extraterritoriality are ineffective and hotly disputed. Finally, forces and actors seeking to evade, counteract or constrain the state are becoming more and more effective. The ability of firms, market actors, and competing parts of the national state apparatus itself to defend and expand their economic and political turf has dramatically increased. Activities such as transnational policy networking and regulatory arbitrage has both undermined the control span of the state from without and fragmented it from within"[20] The increasing openness of systems has generated economic interdependence. Recapturing lost autonomy may be like trying to squeeze toothpaste back into its tube.

This aspect is also related to the increasing organization of enterprise in corporations and particularly multinational corporate groups. These organizational forms allow greater flexibility and fosters business to engage in regulatory arbitrage, seeking to bypass the jurisdiction of national regulators that impose relatively high costs, seeking to enjoy the reduced costs of more efficient or more lax regulation in other jurisdictions. While this process may have positive long term effects as a discipline on national regulation, in the short term, it may diminish the effectiveness of regulation, including but not limited to enforcement. Effectiveness can be restored through enhanced co-operation.

These observations generate certain reflections on the principle of appropriate level of regulation. The design of an appropriate regulatory structure would call for a comparison of different social needs and regulatory techniques in the particular regulatory context. Differences of economic development, legal and political culture and economic institutions, must also be taken into account. In the context of finance of large enterprise, the most efficient level of regulation may be global, insofar as a universal culture of large-scale enterprise has had a homogenising effect on regulatory goals of

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international perspective", in Portes, R. and Swoboda, A.K., Threats to international financial stability. Cambridge U. Press, 1987, p. 114

[20].- Cerny, P.G. "The dynamics of financial globalization: Technology, market structure and policy response", Policy Sciences, vol. 27, 1994, p. 328 . "If regultions are successful in inhibiting changes in financia activity, financial institutions and their customers have incentives to cincumvent the regulatory constraints. The more stringent the constraints, the stronger the incentives for circumvention", Bryant, R.C. International Financial Intermediation. Brookings Institution. Washington, 1987, p. 128

economic efficiency, as well as on possible regulatory techniques. There is already a level of business integration in this area that involves global regulatory arbitrage. Thus, in order for at least some aspects of large-scale financial regulation to be effective, it must be co-ordinated, and perhaps also formulated, on a global basis.[21]

In any case, the presence of those elements has lead to the process of globalization of financial markets and in turn to a convergence of regulatory models. This convergence, we argue is mainly taking place through international regulatory competition, accompanied with elements of global co-ordinated minimum floor. "While in many respects the EC efforts toward convergence or harmonisation of banking standards and practices can be seen as a sui generis phenomenon, the EC efforts also can be viewed appropriately as an integral part (and perhaps as the epicentre for) a broader international convergence process."[22]

In a global legal structure, regulatory decisions taken in one part of the world can have a profound impact in other regulatory systems. We will argue this is the case in financial regulation. At the end of the day, "globalization is inspired by the need to reconcile politics, economics, and social justice by establishing rules, procedures, and institutions of political governance at the same level as that on which the global economy is operating"[23]

The paradigm of globalization implies a fundamental change in the traditional binomy between law and territory. Actions of one regulator can have profound impact beyond the frontiers of its own State. It is no longer the isolated case of extraterritorial enforcement of domestic laws. On the contrary implies a fundamental dissociation of law and institutions from a given territory[24]. The globalization of markets, the ease with which capital can flow

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21.- Trachtman, "Recent initiatives in International financial regulation and goals of competitiveness, effectiveness, consistency and cooperation", Northwestern Journal of International Law and Business, vol 12 n. 2, 1991, p. 245.

22.- Norton, "The EC Banking Directives and International Banking Regulation", in Cranston (ed.) The Single Market and the Law of Banking, London, 1991, p. 152.

23.- Group of Lisbon, Limits to Competition. MIT 1995, p. 121. As stated by Cox, "The existing globalization thrust grounded in the economic logic of markets would have to be countered by a new globalization embedded in society", Cox, "The Global Political Economy and Social Choice", in Drache and Gertler, The New Era of Global Competition. State Policy and Market Power, McGill Univ. Press, Montreal, 1991, p. 350

24.- Aman, "A global perspective on current regulatory reforms: rejection, relocation or reinvention?", Indiana Journa of Global Legal Studies, vol 2 n. 2, 1995, quoting Evan Luard, The globalization of politics: the changed focus of political action in the modern world, 1990. See also, O'Brien, R. *Global Financial Integration: The End of Geography*. Royal Institute of International Affairs, London 1992.

around the world and the mobility of industries to locate or expand production in the most efficient places possible can significantly limit the effectiveness of State-centered regulators. At its turn this has to be seen as a natural increase of international institutions, transnational regulation and policy convergence without an underlying political structure.

The mobility of industries and factors of production means that domestic governments are more concerned with the costs imposed on them. Governments compete among them for attracting or preventing the outflow of these factors, and are also heavily concerned about the competitive position of domestic firms. These clearly fuels a kind of regulatory discourse both in favour of less regulation and of devolution of federal power to states. Thus, there is a self-reinforcing relation between globalization and de-regulation.

However, the relation is not a unidirectional one. This pressure to decentralise and de-regulate has to be accompanied by the necessary maintenance of uniform elements to prevent disgregation and minimum standards to prevent destructive competition among states. Thus, more than subscribing the idea that globalization leads to de-regulation, it is more precise to advocate in favour of the cause-effect elements between globalization and re-regulation. The federal (or multinational) level keeps its important role. Those who see markets as perfectly self-content mechanisms seems to overlook at this element. Strong non-market intervention will be required.

5.1.3 globalization and competition

"Competition between states is no longer simply rivalry over market shares, but a race to participate in the benefits of transnationally interpenetrated and structurally integrated economic processes. In this context, the globalization of finance has played a disproportionate role by cutting across structures of state power in such a way as to channel state power into reinforcing the structural power of private financial markets, thereby increasingly undermining state power itself and institutionalising that of global marketplace."[25]

[25].- Cerny, P.G. "The dynamics of financial globalization: Technology, market structure and policy response", Policy Sciences, vol. 27, 1994, p. 322. For instane, "There is increasing evidence that financial openness has created serious difficulties for national economic management, particularly for expansionary and redistributive policy", Epstein and Schor, "Structural determinants and Economic effects of Capital controls in OECD countries", in Banuri and Schor, Financial Openness and National Autonomy, New York, 1992, p. 157

Does the previous mean that competition has annulled completely the State?. In some way, this is true for a kind of interventionist, strongly nationalistic state. Nevertheless, this is not accurate for describing a total surrender of forms of public regulation. Somehow we could affirm: the State is dead. Long life to the State!.

For the national government to remain a relevant and effective player in the current global era, with simultaneous pulls from bellow (centrifugal forces) and above (centripetal forces), some reassessment of the national government is in order. In the process of globalization, the State itself becomes internationalised acting as an agency for adjusting national economic practices and policies to the global economy.[26]

Globalization, we argue, forces a reinvention of public-private intervention in the economic as well as a reassertion of regulatory roles. The line that once may have existed between global and domestic economic and political forces, as well as the line traditionally drawn between domestic and international law, is, at best, nebulous, and often non-existent. Political and economic global forces are not particularly responsive to national boundaries and thus help produce transnational economic relationships that are not easily regulated by domestic governmental bodies alone. "Market approaches to domestic regulation help to satisfy not only the domestic political demand that regulation be as cost-effective and as unobtrusive as possible but the y provide the kind of flexibility that can more easily speak effectively to global entities who do business in various countries. Particularly when viewed in this larger global context, globalization means that the central question is no longer government versus the market, as if this were an either/or choice"[27]

Therefore, this impressive transformation has not necessarily to be seen as a lost of state power. It has been affirmed that the globalization of trade and finance has tended to weaken the influence of government and to strengthen the influence of the market in determining the policy outcomes.[28] In fact, one could argue that precisely what has taken place is the transformation of the relation between state and market.

26.- Cox, R. "Global Restructuring: Making Sense of the International Political Economy", in Stubbs, R. and Underhill, G. (eds.) *Political Economy and the Changing Global Order*. Toronto, 1994. p. 49 .

27.- Aman, "A global perspective on current regulatory reforms: rejection, relocation or reinvention?", *Indiana Journal of Global Legal Studies*, vol 2 n. 2, 1995, p. 438

28.- Keleher, Robert E. "Policy Responses to Increased Economic Integration", *CATO Journal*, vol. 13 n. 2, 1993.

While traditionally, state and public authority was opposed to market and controlled it both trough regulation and direct intervention, the new paradigm integrates market as one of the instruments available to states to perform its function. In other words, competition among states, and market mechanisms in general permit to dilute the dichotomy between state or market and transforms in market as a regulatory instrument.[29] "States lose much of their general and hierarchical and holistic character in the process of globalization. The central paradox or dilemma facing states in public policy terms in today's world, therefore, is not that states simply lose power to other structures; rather, they undermine and legislate away their own power, confronted by the imperatives of international competitiveness. In this way, state policies have tended to converge on a more liberal, deregulatory approach because of the changing structural character of the international system - its greater structural complexity and interpenetratedness - which in turn transforms the changing position of states themselves within that system"[30]

Increased globalization of markets for financial instruments will reduce the exploitive potential which governments exercised through that hierarchical and holistic position. Somehow, diversity and globalization constitute scape valves against abusive governmental control.[31]

"A range of key economic issues today reflects the differentiation of economic structures both upward to the transnational and global levels and downward to the local level - in turn interacting with each other in multilayered circular or feedback processes - with significant consequences for the structure of the state. The core of this problematic involves the interaction of political and economic structures and the complex fusion of market and hierarchical forms which characterises the way that different patterns materialise"[32]

29.- Going even further this can explain the increasing usefulness of distinguishing between private and public law. This is what the Group of Lisbon calls New Strategic Aliance: "The question is not whether enterprises are running the show, with the states merely playing follow-the-leader and acting like clerks of the court, recording decisions taken by others. The new phenomenon is that owing, inter alia, to globalization, states and enterprises have entered into a new dynamic alliance. The state is not being led. It is still active - indeed, increasingly active in the wolrd's technological and economic spheres". Group of Lisbon, *Limits to Competition*. MIT 1995, p. 65

30.- Cerny, P.G. "The dynamics of financial globalization: Technology, market structure and policy response", *Policy Sciences*, vol. 27, 1994, p. 321

31.- Ninskanen, W.A., "Major Threats to the Financial Services Revolution", *CATO Journal*, vol. 13 n.3, 1994.

32.- Cerny, P.G. "The dynamics of financial globalization: Technology, market structure and policy response", *Policy Sciences*, vol. 27, 1994, p. 327. "International capital can only be mobile to the extent that there is political and governmental intervention into financial markets.

The failure to understand this new paradigm, and the corresponding position of the traditional nation state, leads to a misperception of the different role of the State. As interpreted by Canova, "the liberalization of international capital flows has created a world in which the sovereignty of any one nation is surrendered to the forces of private financial speculation. (...) When speculators vote against a country's economic policies by selling assets denominated in that country's currency, the country's central bank can respond only by raising the domestic rate of interest. This solution often is ineffective in its intended purpose and always damages the country's domestic economy. More than sixty years ago, the world's premier economic mind John Maynard Keynes, warned that nothing less than the democratic experiment in self-government was endangered by the threat of global financial market forces"[33] However, an extreme efficient-market view is of no persuasive value in explaining reality. Neither polar position (market view and governmental intervention view) can withstand careful scrutiny.[34]

In the same direction the Group of Lisbon express its concern of the role of the State: "The states need global enterprises to ensure the continuity of their legitimacy and perpetuation as local political and social entities. Accordingly, the enterprises gradually acquire historical legitimacy and a social role that in many respects approximates the legitimacy and the role appropriate to the state. (...) The enterprise lays claim to a kind of legitimacy based on the fact that it has become globalized. It makes this claim implicitly in that it represents itself as the only organization able to assure the optimal worldwide management of available material and non-material resources. De facto, therefore, the enterprise privatises the role of the state. In the absence of a world public governance it privatises more and more the function of organizing and governing the world economy"[35]

Nonetheless, our proposition tries to overcome the dichotomy between democracy and self-government, on one side, and market mechanisms, on the

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Financial markets in general, and international financial markets especially, require asymmetric power relations and institutional structures of enforcement to operate at all. Hence, the important issue is not whether there can and ought to be state intervention but, rather, what type of intervnetion is desirable. Thus, the nation-sate and capital mobility are not opposites; they go hand in hand". Epstein, "International capital mobility and the scope for national economic management", in Boyer and Drache, *States against markets. The limits of global competition*. London, 1996 p. 212

33.- Canova, T.A. "The transformation of US banking and finance: from regulated competition to free-market receivership", *Brooklyn Law Review*, vol. 60, n. 4, 1995, p. 1352

34.- Bryant, R. C. *International Financial Intermediation*. Brookings Institutions. Washington, 1987. pp. 112-118.

35.- Group of Lisbon, *Limits to Competition*. MIT. 1995, p. 70

other. Democracy in a broader sense has not only to be understood in formalistic terms. Not all forms of societal organization beyond pure electoral representation are undemocratic. The challenge is precisely to transform market mechanism in favour of democratic goals. Thus, market mechanism should not be seen as a goal in itself. Instead it serve to achieve higher societal aspirations. "Reformers who advocate market approaches as a means to collective ends, rather than as ends in themselves are likely to be more receptive to the development of new global legal regimes"[36]

5.2. Globalization and the process of regulatory convergence

We have argued that globalization has also important consequences for legal orders, both in its internal configuration and in the way of matching differences. Globalization of markets will be accompanied by a process of convergence of regulatory models. But, what do we understand by convergence?. Convergence can be defined as the tendency of societies to grow more alike, to develop similarities in structures, processes and performances.[37] Partially following Bennett[38], the process of policy convergence might arise through different channels. We present them ordered from more informal ones to more formalised and structured ones:

1.- emulation, where state officials copy regulatory action taken elsewhere.

2.- elite networking, where convergence results from transnational policy communities.

Convergence results from the existence of shared ideas amongst a relatively coherent and enduring network of elites engaging in regular interaction at the transnational level. This, for instance could be the case of the G7 fora, the OECD or the Conference of Central Bankers. Convergence under this process results from an interaction and consensus amongst an elite that operates, in the first instance, above the fray of domestic politics. Similar

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[36].- Aman, "A global perspective on current regulatory reforms: rejection, relocation or reinvention?", Indiana Journal of Global Legal Studies, vol 2 n. 2, 1995, p. 429

[37].- Kerr, C. The future of Industrial societies: Convergence or Continuing Diversity. Harvard Univ. Press, 1983, p.3. It is important to note the temporal dimension of the process of regulatory convergence.

[38].- Bennett, Colin J. , "What is Policy Convergence and What Causes It?", British Journal of Political Science. vol. 21, 1991 p. 215

responses then emanate from similar states as a result of the presentation and debate of similar evidence. This may take the form of a common pool of scientific knowledge about a technical problem. Domestic processes may differ, but the necessity for some response is widely believed and carries a certain inevitability. A consensus of motivation and concern crystallises at the transnational level. The participants then go forth to 'spread the word' to their respective societies and governments. But the locus of influence remains at the national governmental level. When attention focuses less on national governments and more on international organizations, the convergence process of 'harmonization' is evident"[39]

The increased geographic scope of financial services and markets has both necessitated and facilitated greater international co-operation and co-ordination. With regard to supervision and regulation contacts among national bank regulatory authorities are essential. Such contacts promote both harmonization of rules and supervisory practices and also trust among supervisory authorities, which in the long run becomes an informal network of relationships among supervisory authorities.[40]

3. - convergence as consequences of penetration by external actors tors
and interests.

Entry of foreign actors, and their corresponding home regulations, provoke a process of regulatory competition in the same territorial field. Different firms are subject to different regulatory regimes and consequently, submitted to different regulatory burdens. Each regulators has incentives to open domestic markets since enhances global welfare by integrating economies more closely together.[41] "As the financial services industry and financial markets become more globally integrated, the most efficient and best organized firms will prevail. Also countries with the most efficient - but not necessarily the least - regulation will become the world's major international financial centres"[42]

[39].- Bennett, op. cit. p. 224-225; Haas, "Introduction: epistemic communities and international policy coordination", International Organization, vol. 46 n. 1, 1992; For a more skeptical vision, cfr. Kapstein, E.B. "Between Power and Purpose: Central Bankers and the Politics of Regulatory Convergence", International Organization, vol. 46 n.1, 1992.
[40].- Key, "Is National Treatment Still Viable: US Policy in Theory and Practice", Journal of International Banking Law, vol. 9, 1990, p. 371.
[41].- Thomsen, Stephen, "Integration through Globalisation", National Westminster Bank Quarterly Review, Feb. 1992.
[42].- Pavel and McElravey, "Globalization in the financial services industry", Economic Perspectives. Federal Reserve Bank of Chicago, vol. 14, 1990 p. 17. However, as detected by Möschel, there is a fundamental difference between wholesale and retail markets; "To a large extent, international banking business has always been dominated by wholsesale banking. In

4.- harmonisation through international regimes.

Differing from other forms of convergence, harmonisation not only requires a coherent group of transnational actors, a broad consonance of motivation and regular opportunities for interaction. Harmonisation requires authoritative action by responsible intergovernmental organizations. Under this process, convergence is driven by a bargaining process based on the recognition of interdependence. Also, some degree of trust on others is needed in order to ensure the performance of specific tasks and successful implementation. There is a shared commitment to a set of governing arrangements and to sacrifice some independence.

However, the classification is not a perfect one. Processes are much more complex and it is normal to find elements of each sub-category. The capital adequacy requirement of a bank can serve as an example of regulatory harmonisation due to regulatory competition, through a diffuse structure. It thus combines elements of 2, 3 and 4. Capital ratio tries to assure a minimum level of bank's capital in relation to risk. The function of this regulatory instrument is then to minimise the risk of insolvency. Regulation is then imposed as a means of controlling the risks assumed by banks.

However, the measurement and supervision of the ratio can be different according to national regulatory practices. On the top of that, excessive levels of capital requirements can suppose a burden on financial institutions.[43] In a highly competitive global market imbalances may place at disadvantage banks subject to comparatively stricter capital adequacy rules. On the other side, too lax capital requirements by one country risk the attraction of unsound banks and the initiation of a race to the bottom or competitive deterioration of regulatory standards. Thus international convergence (either co-ordinated or not) becomes vital.

It is important to note that the new regulatory response appears as a necessary adaptation to the new market configuration. Regulatory competition has forced convergence in some essential elements. "The regulators' problem

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terms of business volume, activity in this field is probably divided more or less equally between interbank business on the one hand and business with large corporate clients on the other. Foreign banks play a much smaller role in retail banking", Möschel, W. "International Free Trade in Banking Services", Occasional Papers vol.2, 1989/90. Center for the Study of New Institutional Economics. Uniersität des Saarlandes, p. 70

43.- On the issue of regulations acting as obstacles to international trade cfr. Walter, "Barriers to Trade in Banking and Financial Services", Trade Policy Research Centre, 1985; OECD, International Trade in Services: Banking. Identification and Analysis of Obstacles, 1984.

is compounded because of the temptation for any one country or jurisdiction to regulate more laxly than others in an effort to attract business. The BIS/EEC capital agreement is significant in two respects. First it avoids the trap of re-regulating at the micro level: it does not re-impose the barriers between markets that have been so successfully eroded. Second, it is a major achievement in international co-ordination, overcoming the temptations of competitive deregulation in the interest of global prudence"[44]

It is beyond any doubt that the Basle Accord was motivated by the bank's regulators interest in enhancing banks' capital position, in order to enhance banks' ability to absorb losses due to less developed countries debt and other exposures. However, and it is here where regulatory competition plays a crucial role, regulators saw a need to forestall a possible competition in regulatory laxity in bank capital adequacy requirements, especially at a time when regulators were seeking capital increases.[45] Thus, both system stability and elimination of competitive distortions among firms were present in the harmonisation strategy.

As regard the network elements, it results that the Committee is a quite unstructured organisation. It does not operate by means of hierarchical relationships of authority and decisions are arrived at after a high consensus based process.

As explained in the case of the European Community, "with the extensive harmonisation of capital requirements for banks pursuant to the Basle Accord, mutual recognition for compliance with this requirement is beside the point, except with respect to supervisory responsibility: mutual recognition would indicate that the home country regulator supervises compliance with the harmonized capital rules. With this exception, there is a trade-off between harmonization and mutual recognition: one can replace the other. In addition, as demonstrated by the European Community, minimal or essential harmonization may be the precondition for mutual recognition. Further, it may be expected that a competition in the reduction of regulatory cost spurred by mutual recognition would result in de facto harmonization."[46] Therefore, there is a clear complementarity between the two elements.

[44].- Dean, "Conservative versus Liberal Regulation of International Banking", Journal of World Trade, vol 23, 1, 1989, p. 7

[45].- Hayward, "Prospects for International Co-operation by Bank Supervisors" Int'l Lawyer 24, 1990, p. 789.

[46].- Trachtman, "Recent initiatives in International financial regulation and goals of competitiveness, effectiveness, consistency and cooperation", Northwestern Journal of International Law and Business, vol 12 n. 2, 1991 p.291

How does international banking experienced the regulatory competition process?. With new technologies of information processing and telecommunications, investment opportunities come into increasing contact. This in turn means opportunities to earn additional regulatory profits depending on the selection of frameworks of financial services regulation .[47]

"In a closed domestic context, financial institutions trying to avoid regulations must devise a new financial instrument or discover some other innovation that will allow them to escape the existing regulatory constraint. In an open economy, another, and potentially more powerful alternative exists: a financial institution experiencing stringent regulation can decide to move the regulated activities outside the jurisdiction of national regulators. Unless home authorities can induce their counterparts in other countries to adopt a posture as stringent as theirs, the financial institution may succeed in escaping the home regulations. Alternatively, the national regulators may see that they cannot prevent the relocation of the institution's activities , and may therefore decide to relax their regulations sufficiently to keep the activities at home"[48]

"Every adjustment in applicable regulations engenders at least partially offsetting reactions on the part of regulated and their differentially regulated competitors. In turn, regulatory adjustments are conditioned on past regulated reactions patterns. Individual acts of re-regulation are directed at resolving prior conflicts between attempts to control the behaviour of regulatees and regulatees' effort to avoid (i.e. minimise) the net burdens that regulation ultimately places upon them (...) Dialectical processes are driven in a Hegelian fashion by forces of conflict (a thesis and antithesis) and conflict resolution (a synthesis). When dialectical thinking is used to interpret observed patterns of regulatory and financial innovation, the thesis and antithesis become acts of regulation and avoidance. (...); the third stage synthesis becomes an act of re-regulation"[49]

"Although acts of structural arbitrage incur transactions costs, competition among regulators serves as a kind of social insurance against excessively burdensome regulation. Opportunities for regulatory migration protect financial firms and their customers from having to bear the high

47.- Kane, "Competitive financial reregulation: an international perspective", in Portes, R. and Swoboda, A.K., Threats to international financial stability. Cambridge U. Press, 1987, p. 112

48.- Bryant, R. C. International Financial Intermediation. Brookings Institutions. Washington, 1987. p. 129

49.- Kane, "Competitive financial reregulation: an international perspective", in Portes, R. and Swoboda, A.K., Threats to international financial stability. Cambridge U. Press, 1987, p. 115

regulatory burdens that a perfected cartel or monopoly supplier might be expected to impose"[50]

Taking the pricing mechanisms as an illustrative example, globalization of financial markets implies a process by which domestic financial markets are becoming more closely linked together. In that context, the price of financial instruments in one market is significantly affected by supply and demand of funds in other markets. The strength of global pricing linkages appears to depend significantly on the number and the complexity of the risks influencing the price of a financial instrument.[51] Conversely, investors try to take advantage of pricing discrepancies across markets to secure a lower-cost source of funding. These pricing discrepancies are created by differences in accounting standards, access to information, regulatory constraints, taxation, financial services industry structure, cultural patterns and investor attitudes.

"For example, enormous foreign investment assets have been built up in Switzerland - partly because tax evasion is not a criminal offence there and partly because of Switzerland tough privacy laws which enable investors who avoid their local laws to be protected from detection. These assets create a huge demand for bearer instruments - i.e. unregistered instruments that do not identify the owner, even to tax authorities. Eurodollar bonds by US issuers are in bearer form; in the United States, corporate bonds and equities are registered. US issuers who place their bonds in the Eurobond market, with private clients of Swiss banks, are often able to issue at better rates than they can get in the US because the banks making portfolio decisions for private investors care more about privacy for their clients than obtaining the absolutely highest yield (...) Even more fundamentally, investors are now trading off more and more the yields between bonds issued in their own currency with the yields issued in other's currencies. One of the reasons why Japanese investors, such as the large life insurance companies, have been willing to take the currency risk implicit in investment in US Treasury bonds is the low nominal yield available to them in domestic 10-year Japanese government issues (5%) relative to the nominal yield in 10-year US Treasury issues (8%). The combination of this increasing interdependence due to trading

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50.- Kane, E.J. "Incentive Conflict in the International Regulatory Agreement on Risk-Based Capital", NBER Working Paper n. 3308, 1990, p. 25

51.- Bleeke and Bryan, "The globalization of financial markets", The McKinsey Quartery, Winter 1988, p. 23-24. "What that flexibilization has most dramatically increased is the transnational price sensitivity of those markets, and this new global-level price sensitivity constitutes the main dirving force of the wider structural transformation" Cerny, P.G. "The dynamics of financial globalization: Technology, market structure and policy response", Policy Sciences, vol. 27, 1994, p. 326. Thus, more than lloking and international flows of capital per se, one has to regard at the structure of financial flows and the forms of competition in the financial market.

arbitrage and cross-border, cross-instrument and cross-currency trading is leading to the convergence in bond volatility across the world"[52]

The process can also be explained not form the point of view of the industry but from the regulators' self interest behaviour in keeping a portion of its regulatory field of influence. "New business creates home country regulatory services by expanding to some degree the home's regulator's dominion over this class of activity in foreign markets. On the other hand, displacing business previously conducted domestically in the home country may be described as regulatory-service diversion. Whenever traditionally domestic business is simply displaced to foreign locations, home country regulators are disadvantaged. They lose market share and regulatory revenue, while retaining at least some of the costs of producing confidence-building and co-ordinating services for this activity"[53]

The ability to maintain and apply regulation that is in excess of the regulation of other countries (reverse discrimination for local banks), is increasingly sacrificed to achieve greater competitiveness and greater co-operation with other countries. Scarcely, a single regulatory issue that formerly was viewed solely as a domestic matter can now be intelligently discussed without reference to international flows of funds and the regulatory environments in foreign countries.[54]

"One way through which the ability to achieve the goals of regulation is diminished is through regulatory arbitrage the shifting of assets or operations in a manner designed to minimise the costs or effects of regulation. Regulatory arbitrage is self- conscious structuring of assets or operations. But even without self-conscious structuring, the increasing internationalisation of business makes it harder for a single regulator to apply its rules in a way that is effective to achieve the relevant goals, or to supervise and enforce compliance with its rules. Unless an explicit or implicit dialogue with foreign regulators is maintained, the discipline and ideas that can help form domestic regulation will not be available. Thus, the negotiations toward co-operation can help each regulator to re-examine its own approach in light of the experience of others.

52.- Bleeke and Bryan, "The globalization of financial markets", The McKinsey Quarterly, Winter 1988, p. 26 -30
53.- Kane, op. cit. p. 133
54.- Bryant, R. C. International Financial Intermediation. Brookings Institutions. Washington, 1987. p. 129

In this sense co-operation both facilitates and requires the compromise of idiosyncratic regulatory principles"[55]

To sum up, this phenomenon has to be seen as a structural revolution. Supply and demand forces that were previously confined to national borders are now spilling over and affecting regulation of financial instruments world-wide. [56] It is also interesting to note that the effective capital movement among jurisdiction has not necessarily to take place. It is enough with the potential existence of this flow to make local regulations more vulnerable and thus to increase the need for regulatory convergence. [57]

Finally, it has to be underlined a crucial issue which is the relation of competition within the industry (intra-sector competition as a result of the opening of borders) and the regulatory regime which will be present in that given field. We argue that the presence of atomistic competition among firms will reduce their overall strength in creating a powerful private regime. Regulatory competition prevents the formation of a governing structure highly based on uniform private interests. Instead, we are assisting at the development of global interstate regime. There are indicators that there is no such thing as a private governance that previous sets of mutual understandings between top banks were disrupted by entry of competitors into international banking markets.[58]

In the same line, a multiplicity of independent regulatory regimes could be an inefficient means of social control over increasingly transnational finance. Global homogeneity of regulation is not necessarily optimal either, as finance regulation must mesh with each society's particular circumstances, and as opportunities for variation, and thus for greater innovation and competition, in finance regulation are desirable.[59] Instead, we argue that there appears to be competition among these constellation of international

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[55].- Trachtman, "Recent initiatives in International financial regulation and goals of competitiveness, effectiveness, consistency and cooperation", Northwestern Journal of International Law and Business, vol 12 n. 2, 1991, p. 313-314.
[56].- Bleeke and Bryan, "The globalization of financial markets", The McKinsey Quarterly, Winter 1988, p. 31-34
[57].- Andrews, David M. "Capital mobility and state autonomy: Toward a structural theory of international monetary relations", International Studies Quarterly, vol. 38, 1994.
[58].- Porter, Tony, *States, Markets and Regimes in Global Finance*. New York, 1993 p. 52
[59].- Trachtman, "Recent initiatives in International financial regulation and goals of competitiveness, effectiveness, consistency and cooperation", Northwestern Journal of International Law and Business, vol 12 n. 2, 1991, p. 311

organisations in pursuit of a leading role in the process of regulating global finance.[60]

"Globalization would seem at a first glance to entail the shift of the world economy to an even larger structural scale. This perception of globalization was what misled observers a decade or two ago to misinterpret the significance of multinational corporations which were seen as involving the world-wide integration of specific assets. While some firms in some sectors, and some problems like environmental pollution, do partially approximate this model of a relatively homogeneous 'upward' shift scale, for the most part economic restructuring has involved a more complex process, leading in a very different direction. For the second face of globalization entails the undermining of the public character of public goods and of the specific character of specific assets , i.e. privatisation and marketization of the political-economic structure - of the state as we have known it - itself. These processes, in turn, especially as represented in the globalization of financial markets, will lead to the increased whipsawing of states between structural pressures and organisational levels which they cannot control. Financial markets, not states, represent the closest thing to a new hegemony in the contemporary international system. Polanyi's Great Transformation is over, and a new Great Transformation will be required at a global, supranational level if values other than the establishment of a global self-regulating market are to be realised"[61]

[60].- Sato, Mitsuo, "Financial Regulation in Europe", LSE Financial Markets Group. Special Paper n. 34, 1995.
[61].- Cerny, P.G. "The dynamics of financial globalization: Technology, market structure and policy response", Policy Sciences, vol. 27, 1994, p 339

5.3. Regulation of International Banking

5.3.1. The EC point of view and the issue of reciprocity

The Second Banking Directive is a huge exercise of market liberalisation and an effort to the practical abolition of national barriers to trade in banking services. This new regulatory environment does not only benefit intra-European industry but also credit institutions from third countries. In other words, once a foreign bank is established in one of the Member States of the Community, it will benefit from free circulation throughout Europe and a wide liberalisation of product restrictions.

Having this in mind, it seems then quite plausible the inclusion of a reciprocity clause in the Second Banking Directive. This is also coherent with Toll's opinion about the Community position: "The Community contends that it can impose these stricter standards, because the banking sector currently is not covered by the GATT. While some Member States would prefer to maintain the stricter standards to protect Community firms from outside competition, most Member States want to exploit the Community's position to increase negotiating leverage against non-Community countries and to obtain greater access to foreign markets. European banks will want the Community to trade access to Community markets for access to foreign markets"[62]

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[62].- Toll, "The European Community's Second Banking Directive: Can Antiquated United States Legislation Keep Pace?", Vanderbilt Journal of Transnational Law, vol. 23, 1990, p. 643. This principle is applied in a relaxed way, resulting that an absolute coincidence among the different powers granted to a chartered bank are not required. If the principled had been understood as a perfect correspondence between both countries, US entities would have seen most of their ambitions frustrated, since the regulatory framework of the US is much more restrictive than that of the EC.

However, as observed by Michael Gurson the language of the Second Banking Directive on this issue is broad enough to allow the Community to pass aggressive provisions to third countries if the political climate requires so. Gruson and Nikowitz, "The reciprocity requirement of the Second Banking Directive of the European Economic Community revisited" Fordham International Law Journal, vol. 12, 1989. "The Second Banking Directive may have as profound impact on the evolution of thinking in Europe about the adherence of national governments to directives from Brussels as it did on the thinking of many Americans about 'Fortress Europe'. In August of 1988, shortly after the United States' official and business communities in Washington finished their work on the Omnibus Trade and Competitiveness Act a shot was fired across everyone's desk from the European Community's direction in the form of the reciprocity provisions of the Second Directive. The idea that the European Community might exclude new entry by United States banks into the Common Market because United States law does not accord

Therefore, one has to understand the reciprocity clause in a globalized context. The most common principle governing international trade is that of national treatment. However, there are other principles for governing international trade in financial services that go beyond national treatment, that is, they presuppose national treatment and seek something more. "These principles have been advanced as the basis for requirements imposed by national reciprocity policies or as obligations undertaken in connection with international agreements or supranational regulation. Although these principles, with labels such as mutual recognition and effective market access, are not always precisely defined, they involve explicit or implicit harmonization of national regulatory structures, with concomitant changes in the regulation of domestic as well as foreign banks"[63]

Effective market access has to be understood both as a mechanism to avoid competitive distortions and as a regulatory convergence tool. The principle of national treatment might imply that the costs of adaptation for the foreign institution are so high that market access in denied. Instead, the principle of market access requires some liberalization of the national structure if there is to be a meaningful market entry. The concept of effective market access may be seen as the international equivalent of the regulatory convergence expected to occur through mutual recognition in the European Community.[64]

Therefore, one could say that are two ways of conceptualising free trade in banking services. One is simply to pursue an equilibrium in international trade flows. The other is to push for the dismantling of barriers and try to

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to any banks, domestic or foreign, the same scope of activity as banks enjoy in Europe, coloured American perceptions about European Community intentions in the creation of a single market for a long time to come. Indeed, the criticism of the reciprocity provisions from the United States Government was so severe that they were amended substantially by the European Commission and enacted in the amended form". Katz, "The Second Banking Directive", 12 Yearbook of European Law, 1992, pp. 251-252. Again, the topic by itself would require an entire study. For further reference see, Scott, "Reciprocity and the Second Banking Directive", in the book edited by Cranston, Ross (ed.), *The Single Market and the Law of Banking, London*, 1991; Nielsen, *Services and Establishment in the European Community Banking Law.* DJOF. Copenhagen, 1994. pp.. 285 and ff.

[63].- Key, S.J. and Scott, H.S., "International Trade in Banking Services: A Conceptual Framework", Group of Thirty Ocassional Papers, n. 35, Washington, 1991, p. 2-3.

[64].- Lewis, Mervyn, "International Financial Deregulation, Trade and Exchange Rates", CATO Journal, vol. 13 n.2, 1993 p. 251.

improve the functioning of market forces. If this is the goal to be achieved, some important consequences can be drawn:[65]

•there will be a reduction of national autonomy in regulatory matters. Competition in this sense automatically involves a loss of absolute national control over markets.

• reciprocity does not conform with the objective of trade liberalisation in the sense of seeking to achieve equilibrium in trade balances. The case is different with respect to reciprocity in the sense of exchanging concessions as regards market access and other regulations. This is nothing more than a bargaining instrument. Its use becomes superfluous when liberalisation is understood as improving market forces.

• national treatment in the sense of a formal equality of treatment of domestic service providers and foreign service providers would fall short of the general objective of improving market forces

The Second Banking Directive establishes a double mechanism under the heading of the reciprocity clause established in article nine. The first is indeed the principle of national treatment, meaning that foreign institutions have to be granted the same powers as the domestic institutions. There is, however, a second principle that is the comparable treatment, where the host state has to grant the Community credit institutions comparable treatment as those received by the host state when entering the EC. Thus, what is compared in this second layer of the reciprocity clause is not the regulations governing both domestic and foreign institutions in a host market but the treatment that would receive domestic institutions when entering the market of the foreign firm now present in the domestic market.

"The concept of comparable treatment laid down in article 9(3) of the Second Banking Directive sets as its criterion the comparison of conditions provided in the host state against those offered in the home. Community banks should obtain genuine access to the foreign market and, once established abroad, should be able to carry out the same activities which the banks of the host country may pursue in the EC[66]. Of course, third states need not

[65].- Möschel, W. "International Free Trade in Banking Services", Occasional Papers vol.2, 1989/90. Center for the Study of New Institutional Economics. Uniersität des Saarlandes, p. 83
[66].- In relation to the separation of commercial and investment banking, Heller has rightly pointed that, "as the foreign banks that seek to engage in securities activities in the US through securities affiliates contend, the concerns that create the firewalls, should clearly be the concerns of the home country (EC) and not of the host country (US). Therefore, the foreign banks contend, the firewalls should not be applied to the US operations. However (and this is the

harmonize to EC law or align their financial structure to EC models. Third states may, however, have to give Community banks better treatment than domestic banks (reverse discrimination) if their own banks are to retain access to Community markets."[67] Undoubtedly, this reverse discrimination will fuel lobby by domestic firms in order to align with foreign regulation. In other words, reverse discrimination will lead to regulatory competition.

On the other side, it has to be underlined that the reciprocity clause does only apply to penetration of the European market by way of branching. That means that a foreign banking institution will be able to establish branches in the Community regardless of the treatment the European firms receive in its own territory. In the case of a branch, however, the applicable law will not be neither that of the home country nor the European minimum standards. Instead, the branch will be fully subjected to host country regulation. Nevertheless, this strategy is considerably harsh for foreign institutions. It implies that, there is no possibility of developing a truly European strategy of expansion since the parent bank will need the authorisation of each of the countries where it wants to establish. In other words, the foreign institution penetrating the European market through branches will be forced to comply with fifteen different sets of norms[68].

One has also to recall that a similar EC reciprocity clause has also been used in other jurisdictions, namely, the US. Initially, the International Banking Act of 1978 established the principle of national treatment. There was no element of reciprocal national treatment in this policy; that is, a foreign bank was entitled to the liberal treatment provided for in the IBA regardless of how US banks were treated in the home country. However, the 1988 Trade Bill[69] incorporates US statutory provisions regarding banking services which make reference to reciprocal standards.[70] "In January 1995, the proposed Fair Trade in Financial Services Act was introduced in the House of

crucial element) that would give them a significant competitive advantage against the US banks in the US markets". Heller, Robert, "International Economic Challenges to American Banking", Annual Review of Banking Law, vol. 9, 1990. p. 326, parenthesis added. We can thus add, that the Glass-Steagall Act, when applied to foreign subsidiaries is no more than a protectionist measure.

67.- Zavvos, "Banking Integration and 1992: Legal Issues and Policy Implications", Harvard International Law Journal, vol 31, n. 2, 1990. p. 496

68.- The differentiation between branches and subsidiaries reinforces our previous assertion of the reciprocity issue as a kind of countermeasure for those foreign institutions benefiting european wide liberalization.

69.- Omnibus Trade and Competitiveness Act of 1988, Pub. L. No 100-418, 102 Stat. 1107.

70.- Heller, Robert, "International Economic Challenges to American Banking", Annual Review of Banking Law, vol. 9, 1990. p. 328

Representatives.[71] The Act would require the Secretary of the Treasury to identify those countries that may be denying national treatment to US baking organisations. Federal banking agencies would then be required with limited exceptions, to take such assessments into account in considering applications by the banks of such countries to operate in the United States"[72] The erosion of the principle of unconditional national treatment and its possible replacement by discretionary reciprocal national treatment might be a signal of a less hospitable climate for foreign banks in the US.[73]

Again, it is significant to understand reciprocity clauses as a tool for further international convergence. EC banking law may have significant influence on the international convergence of banking standards on a bilateral basis. The bilateral accomplishments will probably be achieved through the utilisation of the reciprocity concepts embodied in the Second Banking Directive by the EC Commission. Hence, the primary objective behind the inclusion of the reciprocity notion within the EC banking law is to provide the EC Commission with a strong negotiating position in helping to liberalise positions for EC banks operating in more restrictive regulatory regimes abroad[74]. Thus the legal notion of reciprocity encompasses a political and practical application that is designed not to preclude foreign participation in the EC banking and financial services market, but to open up foreign regulatory structures and markets.[75]

[71].- HR, 19, 104th Congress 1st Session (1995).

[72].- Scheer, C.M. "The Second Banking Directive and Deposit Insurance in the European Union: Impications for US Banks", George Washington Journal of International Law and Economics, vol. 28 n. 1, 1994 p. 185

[73].- Crocker, T.E. "Foreign Banks in the US: a political power struggle", International Financial Law Review, January, 1992, p. 24

[74].- "The need for a more liberal international financial system, an important element of the competitiveness of the EC financial industry, prompted the Community to acquire a negotiating lever for use in the GNS. Indeed, the Community is fully committed to these negotiations and sees an important link between its efforts to acomplish the internal market for financial services and the GNS negotiations. Accordingly, the reciprocity clause has a positive liberalization goal, the liberalization of the international financial system as a whole", Zavvos, "Banking Integration and 1992: Legal Issues and Polciy Implications", Harvard International Law Journal, vol 31, n. 2, 1990. p. 492.

[75].- Norton, "The EC Banking Directives and International Banking Regulation", in Cranston (ed.) The Single Market and the Law of Banking, London, 1991, p. 169. "By proposing (the reciprocity) provision of the directive, the Commission attempted to provide the Community with the ability to play a role as the progenitor of the liberalization of financial services on a global scale". Mitchell, "Unified Banking in Europe by 1993", New York Law Journal, vol. 62, 1988 quoted by Toll, "The European Community's Second Banking Directive: Can Antiquated United States Legislation Keep Pace?", Vanderbilt Journal of Transnational Law, vol. 23, 1990, p. 626

It should not be unnoticed that the Commission has the ultimate power to decide on the issue of reciprocity. The internal European financial services market has a unitary translation in its external relations, where the States themselves are no longer to decide on the evaluation of reciprocity but is the Commission who would do it.

A reciprocity provision which can be activated in a particular case of restrictiveness elsewhere may help to bring about more freedom of trade in services, a goal which is pursued internationally in the context of the GATT's Uruguay Round. It should be clear, however, that the EC seeks free entry on the basis of a fair treatment (effective market access). The reciprocity proposal's intention is not to impose, from Brussels, a universal banking system on countries where the banking and securities industries are statutorily separated.[76] Despite of that, the functioning of regulatory competition will place regulators who maintain those kind of restrictions under increasing pressure. Depending on the value placed by both industry and regulators on that type of financial structuring, together with its theoretical justification, will condition the resistance to international pressure or, on the contrary, the awareness of the benefits of the alternative regulation.[77]

"The endorsement of effective market access linked with comparable treatment indicates the Community's intention to advance beyond national treatment. This is certainly the purpose of article 9(3). In this context, market access has far-reaching implications for both market access and the abolition of restrictions on operation that though applied in a non-discriminatory manner, nonetheless restrict the activities of foreign banks. Article 9(3) thus establishes a negotiating objective of maximum liberalisation of financial services world-wide"[78]

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[76].- Smits, René, "Banking regulation in a European Perspective", Legal Issues of European Integration, 1989/1, p. 75. Despite of that, as Scott, points out, measures of this kind tend to be Eurocentric.

[77].- "The globalisation of finance is a nemesis of inefficient regulation. International trade disciplines domestic industry by subjecting it to competition from abroad. On a higher plane, international trade disciplines domestic regulatory regimes. Inefficient regulation imposes costs on domestic industry that are not commensurate with the social benefits obtanied. As more efficient financial regulation is developed in one national jurisdiction that can meet the needs of economic efficiency and stability more effectively or at a lower social cost than other methods, the retention of the other methods imposes unjustified cost on providers and users of finance", Trachtman, "Recent initiatives in International financial regulation and goals of competitiveness, effectiveness, consistency and cooperation", Northwestern Journal of International Law and Business, vol 12 n. 2, 1991, p. 247

[78].- Zavvos, "Banking Integration and 1992: Legal Issues and Polciy Implications", Harvard International Law Journal, vol 31, n. 2, 1990. p. 497

Hence, most of the critics on the reciprocity clause are based on a misunderstanding of the EC financial policy. As pointed out by Zavvos, "several elements of EC policy point toward openness and free trade. First, there is an increasing economic interdependence between the Community and the outside world in terms of trade. Second, the Community has traditionally pursued a liberal financial policy. It is undoubtedly one of the most open financial markets in the world. Hundred of foreign banks and other financial institutions are already established throughout Community territory[79]. Third, the EC regulatory regime governing foreign banks reflects its openness. Under prevailing Community law, Member State subsidiaries of foreign banks are considered Community undertakings from incorporation. They therefore enjoy both the right of establishment and the right to provide services"[80]

5.3.2. The US point of view

5.3.2.1 US banks entering Europe

A US bank can fully benefit from the single license system within the EU only by establishing or acquiring a subsidiary that is licensed to operate as a credit institution by a Member State. On the contrary, a US bank which chooses to branch as a way of penetrating the EU market will not benefit from the single license system and therefore will not be able to branch throughout the Union. "A US owned subsidiary that is chartered as a credit institution by France may branch anywhere in the European Union and engage in all activities listed in the Annex to the Second Banking Directive. If a US chartered bank merely establishes a branch in France, however, the bank's operations would be restricted to France. Should the US bank wish to operate in other Member States, it would have to establish separate branches in each of them"[81]

Therefore, one preliminary reflection is appropriate. The EC model gives freedom to foreign entities to export their regulatory structure. As we

[79].- This fact confirms that in any case, the Japanese and US banks would not be among the most disadvantaged by a 'protectionist' interpretation of the reciprocity clause but the financial entities from newly industrialized countries.

[80].- Zavvos, "Banking Integration and 1992: Legal Issues and Polciy Implications", Harvard International Law Journal, vol 31, n. 2, 1990. p. 492.

[81].- Scheer, C.M. "The Second Banking Directive and Deposit Insurance in the European Union: Impications for US Banks", George Washington Journal of International Law and Economics, vol. 28 n. 1, 1994 p. 177.

analysed in the case of the internal dimension of the Second Banking Directive, credit institutions wanting to operate in a foreign market under their own rules may do so by expanding through branches. On the contrary, subsidiaries represent an implicit acceptance on the superiority of the host country regulatory environment. If we imagine a State A with extremely restrictive regulations, it is easily predictable that foreign institutions will penetrate that market by way of branching (thus exporting the home regulation) and at the same time, domestic institutions will abandon State A by expanding abroad through subsidiaries (thus adapting to the host regulation).

In sum, whether US entities penetrate the EC market in the form of branching or by creating subsidiaries will much depend on their own perception of the strong rationale supporting home regulation.[82]

Having said that, US legislation on permissible business activities of US foreign operations, "empowers the Board of Governors of the Federal Reserve to issue regulations authorising a member bank's foreign branch to exercise such powers as may be usual in connection with the transaction of the business of banking in the places where the foreign branch transacts business."[83]

Therefore, US banking organisations operating abroad are not subject to the same restrictions that apply domestically. "In order to enable US banking organisations to compete more effectively with foreign banking organisations outside the US, Congress gave the Federal Reserve Board the authority to approve certain exemptions for foreign activities that are not available for domestic activities. The tension between internal coherence and external competitiveness of firms is decided in favour of the latter.

Through bank holding companies and Edge corporations, US banking organisations may engage abroad in any of the activities listed in the Board's Regulation K.[84]

For this purpose, Regulation K establishes that:

82.- Leaving aside the fact that EC law strongly favours the subsidiary model as a way of penetrating the home market.

83.- Cane and Barclay, "Competitive Inequality: American Banking In the International Arena" Boston College International and Comparative Law Review, vol 13 n. 2, 1990, p. 283.

84.- Key, "Is National Treatment Still Viable: US Policy in Theory and Practice", Journal of International Banking Law, vol. 9, 1990, p. 374

> (1) The foreign branch may guarantee a debt or otherwise agree to make payments on the happening of a readily ascertainable event. The foreign bank's guarantee or agreement must specify a maximum monetary liability. However, to the extent the guarantee or agreement is not fully secured, its maximum dollar amount may not exceed the lending limits prescribed in 12 U.S.C. 84
> (2) The foreign bank may invest in:
> (i) Securities of the central bank, clearing houses, governmental entities, and government-sponsored development banks of the foreign branch's host country
> (ii) Other debt securities which the host country determines are eligible to meet local reserve requirements, and
> (iii) Shares in organisations like professional societies and schools which are necessary to the branch's business.

However, some recent developments have to be considered. "Specifically, on January 18, 1989, the Board of Governors of the FRS conditionally approved the applications of five US based multinational bank holding companies to allow their affiliates (but not the banks or their branches) to engage in limited underwriting of debt and equity securities".[85]. So, The FED has recommended that the expansion of bank powers should be conducted through subsidiaries of a BHC and that Congress may place limits to the transaction between parent and subsidiary institutions (the so called firewalls). Further in April 1991 and in response to the pressures for maintaining international competitiveness of US banks abroad, the Board revised regulation K to permit Us banks abroad to engage in underwriting and dealing securities.[86] Therefore, the gap existing between home and foreign range of activities has widened.

In banking regulation, nationality was used as a basis to regulate the activities of US banks abroad, while territoriality was used to regulate the activities of foreign banks in the United States.[87]This kind of inconsistency has forced the relaxation of banking rules applied on a nationality basis. As has been said, "US banking organisations have been active in the securities market

[85].- J.P. Morgan and Co. Inc. 75 Fed. Res. Bull. 192, 1989; Cane and Barclay, "Competitive Inequality: American Banking In the International Arena" Boston College International and Comparative Law Review, vol 13 n. 2, 1990, p. 332

[86].- 12 CFR § 211, Docket No R 07033, 56 FR 19549.

[87].- Trachtman, "Recent initiatives in International financial regulation and goals of competitiveness, effectiveness, consistency and cooperation", Northwestern Journal of International Law and Business, vol 12 n. 2, 1991 p.250

overseas as a result of the FED's ruling that the Glass-Steagall Act does not apply to operations outside the US"[88]

As Kane has argued, "the inappropriate emphasis on measures on industry concentration in US antitrust supervision has encouraged large US banks to plant important parts of their capacity for serving the needs of large corporations in foreign locations"[89]

There are, however, examples of US regulations which negatively affect foreign branches of home entities in some manner. These include reserve requirements on foreign branch deposits, limits on foreign branch lending in the host country, as well as the Congress prohibition of insurance of foreign deposits.

In what concerns deposit insurance, there was a prevailing fear that expanded foreign branch activity may, in some way, imperil the US deposit insurance system. Consequently, foreign branch deposits are not insured. However, the Deposit Insurance Directive establishes that a branch of a third country which is underinsured or not insured at all could be required to join the Member State's deposit guarantee scheme. In any case, the foreign branch would be disadvantaged in the sense of having to pay additional premiums to become an insured institution or having to release information to consumers about the bank's lack of deposit protection. [90]

Concerning reserve requirements, it has been pointed out that, "because a foreign branch's liquidity is necessarily a local concern affected by local events, supervision of foreign branch liquidity should be performed by regulators in the host country. Once host countries assume supervision of liquidity, it will be unnecessary to subject US banks' foreign branches to US reserve requirements. The removal of reserve requirements will immediately lower a US bank's foreign branches' operating costs because it will enable such branch to convert a greater percentage of its deposits into interest earning assets rather than requiring them to sit idle. This will allow the US bank's

88.- Boureslan v Arabian American Oil Company. 111 S. Ct. 1227 (1991); Heller, Robert, "International Economic Challenges to American Banking", Annual Review of Baning Law, vol. 9, 1990, p. 325.
89.- Kane, "Competitive financial reregulation: an international perspective", in Portes, R. and Swoboda, A.K., Threats to international financial stability. Cambridge U. Press, 1987, p. 123
90.- Scheer, C.M. "The Second Banking Directive and Deposit Insurance in the European Union: Impications for US Banks", George Washington Journal of International Law and Economics, vol. 28 n. 1, 1994 p. 199

foreign branches to compete more effectively against host country banks which are not subject to US reserve requirements".[91]

"While changing these regulations and attitudes can be accomplished by the United States, such unilateral action is not prudent. Instead, these changes should be undertaken only after US regulators have discussed them with bank regulators in other countries with a view toward harmonizing the international banking regulatory system. Accordingly, further discussion concerning these types of changes should be deferred until after presentation of recent efforts to co-ordinate international banking regulation."[92]

"The difference between foreign and domestic powers of US banks, which results from defining the powers of US banking organisations operating abroad partly on the basis of activities that are permissible in the host country, enables US banks to take advantage of national treatment offered by foreign countries. This difference is a necessary result of the internationalisation of banking, divergent regulatory structures in the United States and abroad and a governing principle that treats each country in the world as a separate playing field with national treatment accorded to foreign banks within each single host-country market"[93]. Thus, the failure to conceptualise the financial marketplace as a global one provokes the inconsistencies which are detected in US policy.

5.3.2.2 EU banks entering the US.

Foreign commercial banks presence in the US has constantly grown and has had a significant competitive impact on domestic banks.[94] In the United States, foreign banks have attained a greater share of the financial services market in recent years. In 1978, 122 foreign banks had $90 billion in assets in the United States. By 1991, 294 foreign banks, with over 700 offices, had assets of $800 billion - nearly 25% of the total amount of bank lending in the United States.[95]

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[91].- Cane and Barclay, "Competitive Inequality: American Banking In the International Arena" Boston College International and Comparative Law Review, vol 13 n. 2, 1990, p. 329

[92].- Cane and Barclay, "Competitive Inequality: American Banking In the International Arena" Boston College International and Comparative Law Review, vol 13 n. 2, 1990, p. 316

[93].- Key, "Is National Treatment Still Viable: US Policy in Theory and Practice", Journal of International Banking Law, vol. 9, 1990, p. 375

[94].- Goldberg, L.G. "The Competitive Impact of Foreign Commercial Banks in the United States" in Gilbert (ed.), The Changing Market in Financial Services, Kluwer, Boston, 1992.

[95].- S. Rep. nº 167 102d Cong. 1st Sess. 113-14 (1991). Quoted by Norton, J.J., "The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on

"Foreign bank activity in the US varies widely by state. Part of this variance is due to the types of laws erected by states either to attract or deter foreign banks but also due to the economic attractiveness of the states to foreign banks. It is not surprising that the top three states, New York, California and Illinois, accounted for 94,6% of the total foreign banks assets in 1988 since these three states contain the major international financial centres in the US"[96]

The most significant piece of legislation regulating foreign banks in the Us is the International Banking Act of 1978. Prior to 1978, many aspects of foreign bank activity were unregulated and domestic banks claimed that foreign banks had unfair competitive advantages. In particular, foreign banks had significant authority to establish offices across state lines, while domestic banks were severely limited. The main purpose of the International Banking Act was to equalise the treatment of foreign and domestic banks. The act limits the multi-state operations of foreign banks by prohibiting them from establishing offices outside their own home state.[97]

Thus the International Banking Act was no more than a legislative reaction to a market movement, i.e. the entering of new entities subject to different legal cultures. The reaction however is not a liberalising one but a protectionist one. Evidently, domestic firms were put in a competitive disadvantage and lobbied the government to pass legislation restricting foreign entities advantages instead of demanding relaxation of their own home rules.

In any case, while US provides 'national treatment' to EU banks, in the sense of granting the same powers as domestic institutions. However, it does not provide 'comparable treatment' for EU banks since US banking laws prohibit banks from engaging in certain bank activities permitted by the Second Banking Directive. There is thus a clear inconsistency in US regulatory policy. While it permits its banks in engaging in securities operation through foreign subsidiaries penetrating European markets, at the same time, restricts the same kind of activities in its home market. Put simply, the US is benefiting from our banking environment while European banks are unable to equally profit from US bańking environment.

'Interntional Convergence of Capital Measurement and Capital Standards", The International Lawyer, vol. 23 n. 1, 1989, p.243

96.- Goldberg, L. "The Competitive Impact of Foreign Commercial Banks in the United States" in Gilbert (ed.) *The Changing Market in Financial Services*, Boston, 1992. p. 167.

97.- Goldberg, L. "The Competitive Impact of Foreign Commercial Banks in the United States" in Gilbert (ed.) *The Changing Market in Financial Services*, Boston, 1992. p.167

Prior to the International Banking Act, the non-banking provisions of the BHCA applied to foreign banks with subsidiary commercial banks in the US. Hence a foreign institution was subject to the same restrictions as a local one, following the national treatment principle. Yet, a 'foreign bank holding company' exemption was provided by the Federal Reserve Board's regulations under the BHCA. In the absence of this exemption a foreign bank with a subsidiary commercial bank in the US would like a domestic bank holding company, have been subject to Board notice or application requirements for investments and activities abroad. The approach adopted by the Congress introduced a new exemption for US activities of controlled foreign non-banking affiliates.[98] In fact, the exemption is the converse of the liberalisation the 1991 revised Regulation K provides for foreign activities of US banks.

"The exemption is available under the Board's regulations for affiliates of 'qualifying foreign bank organisations' QFBO[99]. The benefits of the QFBO exemption for US activities of such an affiliate are considerably greater than those provided by the previous exemption (...) As under the former exemption, a foreign bank meeting the QFBO test may engage in foreign activities without the necessity of application or notice to the Board that would be required for a domestic bank holding company"[100]

Thus, there was a degree of asymmetry to the Board's position insofar as it permitted US banking organizations increased powers in foreign markets, at the same time it continued to deny these powers to foreign banking organizations operating in the United States. As we see, the solution adopted goes beyond the principle of national treatment and incorporates elements of foreign banking organisation's home country rules, in what refers the separation of commercial and investment banking operations.

However, this is not the case in what concerns securities activities. Even if a foreign bank meets the criteria for a QFBO, the rules with regard to US securities activities are the same as those applicable to a US bank holding company. (limited authorisation and maintenance of strict firewalls). The exemption requires foreign institutions to conform to some extent to the activities permissible to US banking undertakings operating abroad (as provided for in the revised version of Regulation K).

"Does this limitation prejudice national treatment? From the US perspective it may not, as it merely provides a special exemption to foreigners

[98].- There is an implicit element of mutual recognition of home state regulation.

[99].- more than half of the banking's business must be located outisde the US.

[100].- Key, "Is National Treatment Still Viable: US Policy in Theory and Practice", Journal of International Banking Law, vol. 9, 1990, p. 376

from some of the normally applicable restrictions under the BHC Act: the US might argue that this is 'better-than-national treatment'. From a foreign perspective, however, it may be viewed as imposing de facto barriers to European Community credit institutions."[101]

Another source of differentiation comes from the different treatment of offshore operations depending on whether the bank is a home or a foreign institution. Thus, it results that "while there were costs savings to both foreign and US-owned banks from booking loans offshore and circumventing US regulations, the cost advantage was larger for the foreign-owned banks, since the FED has discouraged the US banks from putting US business through their foreign branches. On the contrary, no explicit guidelines against booking domestic business offshore has been given to foreign banks. Regulatory arbitrage in this form blurs the onshore-offshore distinction and by all accounts the US branches and agencies of foreign banks were closely involved in the growth of offshore loans to commercial and industrial enterprises. Thus it would seem that trade in financial services is greatly facilitated by the presence of foreign institutions in the domestic market"[102]

There are also considerable differences between home and foreign institutions in what concerns supervisory policy. In 1991 Congress passed the Foreign Bank Supervision Enhancement Act. The FBSEA introduces significant changes in the regulation of foreign banks in the United States. The Federal Reserve is now the primary regulator of foreign banks in the United States.[103]

Under this statute, the dual system of banking license is no longer applicable to foreign banks. A state banking license is no longer sufficient to operate in the United States; a foreign bank must also obtain the prior approval of the FED in order to open any US establishment. "The FBSEA also erodes the unconditional national treatment approach previously adopted by the Congress in the International Banking Act of 1978. While US chartered banks can operate with either state or federal approval, a foreign bank must obtain Federal Reserve approval before it can operate an establishment in the United States. Foreign banks thus are subject to an additional layer of federal supervision that domestic banks can avoid. The new act is designed to prevent

[101].- Trachtman, "Recent initiatives in International financial regulation and goals of competitiveness, effectiveness, consistency and cooperation", Northwestern Journal of International Law and Business, vol 12 n. 2, 1991 p. 271
[102].- Lewis, M.K. "International Financial Deregulation, Trade and Exchange Rates", CATO Journal, vol 13 n.2, 1993 p. 247
[103].- Cfr. General Accounting Office, "International Banking. Strengthening the Framework for Supervising International Banks." GAO/GGD-94-68. March, 1994.

another exploitation of uncoordinated supervision, similar to the fraud of perpetrated by BCCI's managers"[104]

Therefore, the FBSEA appears to have rejected the idea of national treatment. Under the FBSEA foreign banks operating in the US are regulated in a different way from domestic institutions even if both are operating the same market.[105] Moreover, taking into account that the FED has authority to withdraw its authorisation if the bank has engaged in unsound or unsafe banking practices. It is easily predictable that such weapon might be used in the case of dispute about the range of activities a EU institution may develop in the US market.[106]

"Complementing these legislative initiatives are efforts by federal bank supervisors to improve the supervisory environment for foreign banks. These efforts are being directed to streamlining the supervisory process through the implementation of the "Enhanced Framework for Supervising the US Operations of Foreign Banking Organisations", more commonly referred as the FBO program. This program, which is now being put into effect, reflects a shift in emphasis in the supervision of foreign bank activities in the US. Previously, the branches and agencies of foreign banks were reviewed more as a stand-alone entities. Now a more comprehensive approach emphasises the role of these entities as integral components of the foreign banks as a whole"[107]. In sum, before a foreign bank can establish a branch or agency in the United States, the Federal Reserve Board must determine that the foreign bank is subject to comprehensive consolidated supervision by its home country supervisor.

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[104].- Duncan E. Alford, "Basle Committee minimum standards: international regulatory response to the failure of BCCI", George Washington Journal of International Law and Economics, vol. 26 n. 2, 1992, p. 281

[105].- "By abolishing autonomous state approval authority, the FBSEA eliminates for foreign banks an important attribute of the dual banking system. Comparable requirements do not apply to domestic banks, thereby signalling a retreat from the IBA principe of national treatment", Crocker, T.E. "Foreign Banks in the US: a political power struggle", International Financial Law Review, January, 1992, p. 24-25.

[106].- also, the provision could be used as a retaliation mechanism in the case of strict application of reciprocity clause.

[107].- ibidem, p. 3

5.3.3 Reciprocal influence of regulatory measures in the context of the EU-US relations. [108]

The competitive pressure among States at international level has contributed to the liberalisation of European markets and the modernisation of its regulatory system. The financial services revolution at the level of the EU is, no doubt, an important factor. However, it remains insignificant when compared with the context of a wider revolution in the financial markets of the advanced capitalist world. What is more, the engines of financial change have been driven to a substantial extent non-European and where changes has been driven by European forces, those forces have been national in character, and have been shaped by struggles for competitive advantage between national actors. "In short, making sense of the politics of financial change in Europe is not primarily a matter of making sense of Europe at all; it involves understanding the world financial services revolution which reached its climax in the 1980s."[109]

Conversely, the European response to those pressures has had important external consequences[110]. "The Community's policy for the financial sector will achieve a financial integration more far-reaching than that now existing in any federal state or regional groups of states. Its techniques for doing so are the promotion of product and geographical deregulation. This policy opens a vast financial area within which EC banks and other financial institutions may successfully face competition either at home or abroad. At the same time, the policy increases the attractiveness of EC financial centres for international business"[111]

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[108].- Clair and O'Driscoll, "Learning from One Another: The US and European Banking Experience" in Doukas and Mathur (eds) Financial Management in Post-1992 Europe. New York, 1993.

[109].- Moran, "The State and the Financial Services Revolution: A Comparative Analysis", West European Politics, vol. 17, 3, 1994, p. 160. "The advent of a single European banking market has far reaching ramifications for the US, Japanese and European banking systems and may eventually be regarded in the annals of banking history as the single most important banking event of the twentieth century", Hanley, T. , European banking integration in 1992. Salomon Brothers, New York, 1989, p. 1.

[110].- At a macro-policy level, it has been stated that, "as the global economy moves from a state of economic interdependence to one of greater market integration, the existing GATT principes are coming under considerable strain. Success with a competition among rules approach within Europe might therefore have lessons for the wider international community. After all, the objective of acommodating national differences without protectionist measures is common to the European and globa economies" Woolcock, "The European Single Market. Centralization or Competition among Rules?", RIIA, 1994, p. 4

[111].- Zavvos, "Banking Integration and 1992: Legal Issues and Policy Implications", Harvard International Law Journal, vol. 31, 2, 1990, p. 464.

The transformation of the size of the market implies the necessity of reshaping some of the regulatory concerns of administrations. In other words, with the increasing globalization of finance, all industrial nations will be pressed to harmonise fundamental regulatory principles. And it is precisely at this point where the reflections on the creation of a Single European Financial Market emerge as an external dimension. What the EC Commission is attempting to do among the twelve member states and what the Basle Committee has done with respect to risk-based capital regulations reflects the need of an enlarged vision of financial markets. The linkage between EC regulations and developments in the rest of the world will become more important in the future.[112]

This is not to say that the Community model of banking integration would be suitable for the international liberalisation of trade in financial services. "But the mutual recognition upon which the Community program is based requires a minimum degree of harmonization difficult to attain without an international legislative authority (or as we propose an increase in transnational co-operation). Nonetheless, it does seems that an agreement on prudential supervision could be more easily achieved than could one relating to basic financial structures and the range of permissible banking activities. It should not be forgotten that the principal cause of the de facto convergence of regulatory standards has been the globalization of financial markets. And international initiatives of both regional and more international scope have played their part"[113]

In order to understand the mutual influence regulatory models exert among them, take the example of the establishment of an American bank in London. The regulation of European markets, and among them, specially that of UK, is considerably less restrictive than the American one, where banks are prevented of engaging in securities transaction by virtue of the Glass-Steagall Act. Since the applicable law to that established subsidiary in London would be European law, the establishment of American banks in Europe may suppose overriding the restrictions imposed by American legislation[114]. Therefore, the

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112.- Golembe and Holland, "Banking and Securities", op. cit. p. 101

113.- Zavvos, "Banking Integration and 1992: Legal Issues and Polciy Implications", Harvard International Law Journal, vol 31, n. 2, 1990. p. 502. Parenthesis added.

114.- It has been stressed that, " in some sectors, there is a degree of evidence that the location decision has been a factor in regulation decisions - notably financial sevices. For example, to circumvent US regulations excluding US commercial banks from investment banking, the nation's major banks have established overseas investment-banking networks", Smith, Edward, "Regulatory Competition in the 1992 Process", European Interuniversity Press. Brussels, 1995 p. 51-52.

internationalisation increases the permeability of the markets, which by the same token implies that regulatory models are in contact. Following our example, the American restrictive legislation will be put under pressure by the submission of London subsidiary of an American bank to European law.

We have tried to present in the two precedent sections how jurisdictional overlap (foreign activities of US banking institutions and EU banking presence in the US), has put under pressure and somehow discredited a regulatory principle in other jurisdiction. The competitive pressure exercised by international movement of banking institutions has instaurated a process of reciprocal reduction of barriers. The EU has used the twin forces of granting banking licenses under more favourable conditions to US banks and external negotiations with the US to achieve a reasonably free-barrier market in globalised financial services.

In this line of argumentation, there are two aspects which will be specially affected by this kind of pressure:

• first, the restrictions to the kind of transactions a banks can engage under the Glass-Steagall Act. European banking law is much more flexible than US law as can be interpreted analysing the transactions listed in the Annex to the Second Banking Directive. The European Banking model is closer to that of universal banking;

•second geographic restrictions imposed by the McFadden Act. Both restrictions constitute an illustrative example of competitive disadvantage that the US legal order impose to its financial entities[115].

The analysis of the recent reforms of the US system we have already presented is no more than a visible confirmation of this trend. In sum, one of the substantial consequences of Europe 1992 for the US. financial system will undoubtedly be the removal of the present barriers that limit the powers banks may exercise and the form these powers may take over broad geographic areas.

In the long run Europe 1992 would set a stage for 'complete restructuring' of the US. financial system. "The most drastic change would be an acceleration in the bank consolidation movement, already under way in the United States, which would lead to a substantial decline in the number of US. banking organisations and the adoption of the universal banking. (...). In sum,

115.- Zavvos, "Banking Integration and 1992: Legal issues and Policy Implications", Harvard International Law Journal, vol 31 n. 2, 1990, p. 499.

those who argue that one of the most important consequences of Europe 1992 will be a restructuring of the US. financial system seem to us to be correct"[116]

According to Clarotti, "We should perhaps not be surprised by the popularity of the Second Banking Directive. The most highly qualified representatives of the supervisory authorities in the USA, including the Treasury Secretary Brady, have stated before a Congressional hearing that the European Community's Second Banking Directive should be the model followed in the event of any reform of the complex American banking law"[117]

For the first time after a long absence, one could affirm that Europe is again becoming an exporter of a regulatory model.[118]

5.4. New institutions for global regulation

We argue that the economic significance of national boundaries has been reduced by growing interdependence even if their political significance has been enhanced. The effective domains of economic markets coincide less and less well with national governmental institutions.[119] Financial globalization increasingly constraints policy makers and limits the policy capacity of States, traditionally considered. Also, the end of the binomy law-territory may drive to a re-rationalisation of the existing legal mechanisms or societal forms.

"Political management of this process of internationalisation has spilled over into the domain of inter-state relations, and authorities are looking for ways to institutionalise co-operation. Paradoxically, the consequences of

[116].- Golembe and Holland, "Banking and Securities", op. cit. p.. 94 and 97. See also, Ferrara, "International Trends in the Combination of Banking, Securities and Commerce", Cato Journal, vol.10 n.2 1990. Going even further it has been asserted that, "the goal of the (Second Banking) Directive is not only to liberalize the banking market on the continent but also to liberalize the banking systems in countries outside the Community where the pan -European banks hope to do business", Toll, Christopher T. "The European Community's Second Banking Directive: Can Antiquated United States Legislation Keep Pace?", Vanderbilt Journal of Transnational Law, vol. 23 n. 3, 1990, p. 617. Cfr. also, "EC changes wil have mixed effects on fledging global banking", Banking Policy Report, vol. 52 n. 10, March 6, 1989.

[117].- Clarotti, Foreword to the book, *The Single Market and the Law of Banking*, edited by Ross Cranston. London 1991.

[118].- Mattei, U. "Why the Wind Changes." American Journal of Comparative Law , vol. 42 n. 1, 1994.

[119].- Bryant, R.C. *International Financial Intermediation*. Brookings Institution, Washington, 1987. p. 3

market development must be managed by states with a diminished capacity to do so. The result is a growing need for international co-operative agreements to enhance state policy instruments"[120]

At this point, it is necessary to analyse two kind of questions in relation with the new regulatory environment. First, what are the implications for regulatory policy of the new global situation? and; second, which are the emerging institutional structures for the new regulatory era?

5.4.1 Implications for regulatory policy

The answer for the first of the questions might be summarised in the following points:

1.- liberalisation of financial markets has been the result of the turn to market mechanisms in economic decision-making.
2.- Government involvement in economic and allocative decisions has declined and the role of the market in determining price and quantity has increased.
3.- public interference in banking systems has declined
4.- prudential supervision of financial markets as well as consumer protection have retained their high priorities.
5.- since non-bank competitors will be undertaking 'banking' activities, regulation will need to be applied on a functional and product basis rather than by institutional identity.

"In the mid-to-late 1980s, it became increasingly apparent that the nation-state based method of banking regulation, which had been in place from time immemorial, was no longer sufficient to handle what was becoming an increasingly global banking market. In an age which billions of dollars could travel overseas in a nanosecond, it became increasingly important for national regulators of banks to be able to at least sign from the same song sheet. The demand to try to have some sort of international

120.- Underhill, "Markets beyond politics? The state and the internationalisation of financial markets", European Journal of Political Research, vol 19, 1991, p. 222. "The gap is impressive between the powerful porcess of economic globalization at the level of finance and firms and the weakened capability of national public authorities to cope with the explosive nature of most social, economic, environmental, and political problems across countries and regions of the world", Group of Lisbon, Limits to Competition, MIT 1995, p. xv.

coordination in the way in which banking regulation was conducted was the impetus behind the meetings in Basle"[121]

Having this in mind, the problem of the continuing existence of diverging regulations in the individual countries could be solved through three mechanisms:

1. the setting up a kind of supranational supervisory body.

The idea is based on the assumption that market competition alone is self-defeating in a world of competing nations. The same applies to market competition in the context of competing regional blocs. It seems, therefore, that an efficient system of competitive markets requires a cooperative framework among nations at the global level, that is a socially accountable and politically democratic forms of global governance.[122]

"In principle, the invisible hand works at both levels of competition. Rivalry among alternative regulators for clients and budgets should not be viewed as wasteful duplication. In many cases, duplication of regulatory missions across different agencies promotes long-run efficiency in the production and delivery of regulatory services much as duplication of service functions across private institutions promotes efficiency in the provision of financial services. This competition promotes efficiency when, by exploiting and perpetuating impediments in taxpayers' access to information relevant to judging their performance, regulators can extract unintended and economically inappropriate subsidies. As long as taxpayers do not permit inefficiency to be subsidised, inter regulator rivalry protects borrowers, depositors, and investors from the over regulation to which a monopoly supplier or regulatory cartel would tend in the long run. In the financial services industry today, regulatory conflict is in as furious state of turmoil as the conflict between alternative financial services providers."[123]

However, regulation based on centralization could lead to regulatory monopoly which may be worse than he monopolisation of the industry itself.[124]

121.- Lindsey, Lawrence, "Economic Challenges of the 1990s", CATO Journal, vol. 13 n.2, 1993, p. 165

122.- Group of Lisbon, Limits to Competition, MIT 1995, p. xvii.

123.- Kane, "Competitive financial reregulation: an international perspective", in Portes, R. and Swoboda, A.K., Threats to international financial stability. Cambridge U. Press, 1987, p. 119

124.- Dufey, G. and Giddy, A. "Trends in International Banking and Implications for Regulation" in Roussakis (ed) International Banking, 1983, quoted by Hultman.

2. harmonising the different national systems.

The experience of recent times demonstrates that this route is proving to be increasingly successful, at least with respect to prudential supervision.

The present co-operative structure is only reactive a does not prevent the tendency towards financial crisis. A formal legal framework covering the regulation of international banking would be necessary. A formalised arrangement to regulate multinational banks would entail the harmonisation of national regulatory structures through a binding international arrangement.[125]

One of the distinguishing features of the international activity of credit institutions is that joint liability exists. That is to say if a bank runs into financial difficulties or even collapses in a host country then this has repercussions on the parent bank in the home country as, conversely, any difficulties suffered by the parent bank in the home country will not be without their effects on its banking activities abroad.[126] The latest move towards measuring own capital on a consolidated basis is a further reflection of this line of thought.

3. to introduce a kind of principle of appropriate regulation in an international agreement.

This could be supplemented in more concrete terms by a code of conduct or 'club associations'.

Together with these mechanism, we argue that it is increasingly important the use of market instruments to overcome national legislative differences and initiate a process of regulatory convergence. Once or simultaneously established some kind of harmonization, the rest of the job would be left to the process of regulatory convergence.[127] "Experience has

[125].- Dale, Richard, *The Regulation of International Banking*. Prentice Hall, 1984.
[126].- Möschel, W. "International Free Trade in Banking Services", Occasional Papers vol.2, 1989/90. Center for the Study of New Institutional Economics. Uniersität des Saarlandes, p. 84
[127].- Cerny has stated that, "In the absence of a world government, the regulation of transnational financial markets can only be done in one of the three ways: through workable international institutions; through a hegemonic state or group of states working through less formal mechanisms of power and influence; or through the reestablishment of much closer and more direct state control over the markets". Of the three possibilities, it is clear that the last one is an unlikely one. With international capital flows, the reinstauration of structural controls is no longer possible. The conditions which made efective regulation possible in earlier eras no longer exist. Thus, the two remaining possibilities left are the ones to be considered. We will

taught that international economic coordination is best achieved by decentralised rather than centralised decision-making"[128]

Dean, in analysing the problem of international debt and international lending, has arrived to the conclusion that both prudential measures enforced by an international institution (conservative regulation as debt ceilings established by the IMF) and international co-ordination based on ex-post events (liberal regulation) are needed to stabilise international banking. "Conservative and liberal regulatory reforms are therefore not only mutually compatible but absolutely necessary in conjunction"[129]

Thus, there is a kind of necessary combination of both elements present in the modern regulation of banking institutions. "National treatment and the principles that go beyond it can be understood in terms of three basic components that can be applied separately or in combination : (1) host-country rules; (2) home-country rules; and (3) harmonized rules that apply in both countries. For example, national treatment requires the non-discriminatory application of host-country rules to foreign banks. By contrast, mutual recognition involves both harmonization and, in the absence of it, acceptance by the host countries of home-country rules. Even if rules are harmonized, there is the question of who administers them, - the host country, the home country or a supranational entity. (...) The public policy question is what basic principle or combination of principles - host country rules, home-country rules or harmonized rules - should govern international trade in banking services. Our analysis suggests that no single rule is appropriate for the provision of all international banking services. The choice of a rule depends on the interaction between two factors: the manner in which the service is provided and the public policy goals underlying the regulation of banking services"[130]

5.4.2 Institutional settings

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propose them not as mutually exclusive but the contrary. Both international institutions and informal exchange of ideas among advanced states are valid nad useful instruments. Cerny, "The dynamics of financial globalization: Technology, market structure, and policy response", Policy Sciences, vol. 27, 1994, p. 320.

128.- Dorn, J.A.. "Financial Deregulation in a Global Economy" CATO Journal vol. 13 n.2, 1993. p. 161

129.- Dean, "Conservative versus Liberal Regulation of International Banking", Journal of World Trade, vol 23, 1, 1989, p.12, "International banking reform should move simultaneously in the direction of tax-like conservative regulations to forestall es ante oveerlending and subsidy-like liberal provisions to bridge periods of underlending".

130.- Key, S.J. and Scott, H.S., "International Trade in Banking Services: A Conceptual Framework", Group of Thirty Ocassional Papers, n. 35, Washington, 1991, p. 3

"The world is divided into mutually distrustful sovereign states. Instead of fragmentation and chaos, however, there is a surprising degree of regularity and order. Global financial markets are often seen as uncontrollable and plagued by recurring instability. As we shall see, this image is misleading. There are strong sets of social institutions which organise these markets and which themselves display identifiable patterns as they evolve"[131]

On the institutional settings needed for international banking there is normally a tendency to consider the need for regulation of international markets as an extension on the same needs that are present in domestic markets. Instead, international banking has unique factors that make improper this simple translation.[132] In a number of important respects international banking is different from purely domestic banking both in kind and degree:

- country risk is present in international intermediation (cross-currency risk and cross-border risk)
- international banking has been limited largely to wholesale banking and involving large corporations, governments and other banks. To the extent that wholesale market predominates, the argument of a need to protect small, poorly informed depositor is of less importance.
- most international banking is largely limited to a small number of large institutions. Therefore, international banking is oligopolistic by nature and the belief that unregulated global banking will lead to efficiency is misplaced.
- while deposit insurance schemes provide the basis for confidence in domestic systems, this basis is generally lacking in international transactions.

"Foreign banks are regulated insofar as they compete directly with host-country domestic banks, and good arguments can be made that such regulation in response to domestic private interests is sub-optimally high. It is also true that banks are regulated by their parent countries insofar as they are perceived to impinge on the domestic public interest, but what international banking regulation there is largely constitutes a response to such domestic private and public interests. Since it is likely that these involve international externalities, it is also likely that extant regulation is non-optimal. In short, there is too

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131.- Porter, Tony, *States, Markets and Regimes in Global Finance*. New York, 1993 p. 1.
132.- Hultman, "Regulation of international banking", Journal of World Trade, vol. 26, 5, 1992; "In the past two decades banking has become internationalised to such an extent that national supervision over domestic banks no longer provides an adequate framework for regulating bank operations", Hackney , J.V. and Shafer, K.L., "The Regulation of International Banking: An Assessment of International Institutions", *North Carolina Journal of International Law & Commercial Regulation*, vol. 11, 1986, p. 475.

much domestically-based regulation and too little that is internationally-based"[133]

One plausible argument for regulation of international banking is that world financial integration and international banking have increased the possibility of spillovers from disturbances in other markets. Economic interdependence spread the risk of contagion runs among banks. Regulatory policies have to be adapted to these changes including the development of co-operative policies . Co-ordination of national policies is recommended as a method of providing a 'level playing field' and permitting banks from all countries to compete on an equal footing internationally.[134]

Taking together, structural arbitrage and regulatory competition are diminishing regulator's capacity to control events and to prevent financial panics. The counterforce of international regulatory co-operation is lagging, i.e. developing at a slower pace[135]. As put by Streeck, "economic internationalization without corresponding internationalization of state sovereignty results in an integrated economy governed by fragmented sovereignty"[136]

The process of globalization has been paralleled by a development of formal non-governmental organizations and informal groups devoted to the managing of complexity[137]. "Governance is not synonymous of government. Both refer to purposive behaviour, to goal-oriented activities, to systems of rule; but government suggests activities that are backed by formal authority, by police powers to insure the implementation of duly constituted policies, whereas governance refers to activities backed by shared goals that may or may not derive from legal and formally prescribed responsibilities and that do not necessarily rely on police powers to overcome defiance and attain compliance. Governance, in other words, is a more encompassing phenomenon than government. It embraces governmental institutions, but it also subsumes

[133].- Dean, "Conservative versus Liberal Regulation of International Banking", Journal of World Trade, vol 23, 1, 1989, p.8

[134].- Hultman, "Regulation of international banking", Journal of World Trade, vol. 26, 5, 1992, p. 86. However, cooperation should be flexible enough to allow innovation.

[135].- As the former Spanish finance Minister, Carlos Solchaga, pronounced at the 1992 annual meeting of the Board of Governors of the IMF, at the light of the international financial crisis, "these events serve to show that the (present) mechanisms for multilateral coordination of economic policy are partially incapable of dealing with the globalized, decontrolled and liberalized economy that has emerged since the end of the 1980s". IMF Summary Proceedings, p. 85, parenthesis added.

[136].- Streeck, "Public power beyond the Nation-State. The cse of the European Community", in in Boyer and Drache, States against Markets. The Limits of Globalization. London, 1996, p. 301

[137].- The Group of Lisbon, Limits to Competition, MIT 1995.

informal, non-governmental mechanisms (...)"[138] The growing importance of informal social institutions has to be underlined.

Which are the existing international fora for the international governance of banking rules?. An appropriate forum might

(1) include only countries whose levels of development were sufficiently alike that they had similar interests in the liberalization of banking services

(2) include the relevant financial service regulators[139] (including central bankers) and finance ministry officials from such countries

(3) have authority to formulate proposals, monitor their implementation and resolve disputes.[140] Ideally, the forum would be more than a meeting place. It would be an international institution with delegated authority form participating countries that enabled it to reach decisions binding on participants and that permitted it to monitor implementation of its rules and resolve significant disputes about them. However, "one major contribution of the new wage of theorising international relations is to recognise the influence of informal interstate institutions that do not satisfy such conventional criteria of strength as a high degree of centralization, a formalised constitution, and the possession of tangible resources and mechanisms to force states to comply with rules"[141]

1.- The OMC and the GATS

The Uruguay Round of trade negotiations within the General Agreement on Tariffs and Trade that has been under way since 1986, includes discussions on liberalization of trade in services in addition to trade in goods. The inclusion of services for the first time in GATT negotiations reflects the increasing importance of international trade, especially over the last decade. Financial services in general and banking services in particular, are now a

[138].- Rosenau, "Governance, Order and Change in World Politics", in Rosenau and Czempie, Governance without government: order and change in world politics, Cambridge Univ. Press, New York, 1992, p. 4

[139].- If banks are to be permitted to offer a broad range of financial services, the expertise of nonbanking regulators, such as securites and insurance regulators, will also be important in the formulation of international rules.

[140].- Key, S.J. and Scott, H.S., "International Trade in Banking Services: A Conceptual Framework", Group of Thirty Ocassional Papers, n. 35, Washington, 1991, p. 37-38.

[141].- Porter, Tony, *States, Markets and Regimes in Global Finance*. New York, 1993 p. 5

significant component of international trade in services, in part because of the growing interdependence of national financial markets[142]

The extension of international flow of goods into new markets through co-operative intergovernmental action, specifically trade in agriculture and services, was seen as a potential stimulant to growth. While this expansion was mainly conducted through trade, financial structures at home where sufficient. However, with the establishment of multinational enterprises abroad, the need for expanding also finance has dramatically increased (making clearly insufficient the old technique of correspondent banks). Thus there is an important link between the provision of services and merchandise trade and access to competitively-priced producer services. In fact it has been argued that the initial movement in the globalization of finance was due to the need of banks to 'follow' their clients abroad. Financial services are increasingly important in determining the ability of firms to compete at home or abroad.[143]

The Uruguay Round is the principal negotiation front in what concerns services. However, it does not specifically refer to banks but only to trade in services. Moreover, there are some shortcomings in the approach adopted:

• emphasis is laid on the goal of national treatment. Under a policy of national treatment, foreign banks are treated as nearly as possible like domestic banks, insofar as they have the same opportunities for establishment that domestic banks have. They can exercise the same powers in the host country, and they are subject to the same obligations. We have already shown how differences between regulatory and institutional structures in home and host countries can nullify the effectiveness of the principle of national treatment as an instrument to permit foreign entry." Some of the most intractable problems stem from the lack of agreement among the major industrial countries regarding the permissible activities of banks. For example, the European Community finds it difficult to accept US restrictions separating commercial

142.- Key, S.J. and Scott, H.S., "International Trade in Banking Services: A Conceptual Framework", Group of Thirty Ocassional Papers, n. 35, Washington, 1991, p. 1. Such trading has been done in modest amounts for a long time; what is distinctively today is the enormity of the cross-border business. For example, foreign exchange trading is now running at $65 trillion per year - while the total annual amount of world trade in goods is closer to $4 trillion. See Bleeke and Bryan, "The globalization of financial markets", The McKinsey Quarterly, Winter 1988.
143.- Underhill, "Markets beyond politics? The state and the internationalisation of financial markets", European Journal of Political Research, vol 19, 1991, p. 209 . In relation to this point, it has been argued that one important achievement for the financial sector was the recognition contained in the Montreal Agreement that financial services required a commercial presence. Cfr. Footer, "GATT and the Multilteral Regulation of Banking Services", International Lawyer, vo. 27 n. 2 , 1993.

and investment banking in the United States when the Community does not apply such restrictions to the activities of EC banks. Problems also arise in trying to apply to foreign branches capital adequacy and other requirements developed for the domestic banks of a host country. Moreover, national treatment does not address the extent to which multinational co-operation and agreement are necessary to regulate and supervise financial activities conducted internationally"[144] International competition can only develop if it proceeds from a regime of mere nondiscrimination, i.e. national treatment, to setting off a wave of deregulation by combining mutual recognition of home country control with liberal common standards.[145] Unfortunately, this is not the approach under GATS negotiations.

In fact, national treatment suffers from a basic conceptual difficulty: regulatory-egocentrism. National treatment presupposes that the home regulatory system is not only adequate for home institutions but everywhere. The problem becomes evident when the appropriate market for achieving equality of competitive opportunities for multinational banking institutions is broader than that of a single country. "Because multinational banks compete on a global basis, barriers to international trade in banking services may also result from non-discriminatory differences in national rules, such as differences in the permissible activities for banks or differences in the types of products that may be offered. National treatment, which is limited to ensuring the absence of discriminatory barriers, does not address the problem of practical barriers created by the lack of multinational harmonization of regulatory structures.[146]

• safeguards and exceptions are intended to be included in case of agreement. This has been a controversial area from the beginning with the EC insisting on the respect of national policy objectives and regulatory purposes from the end of 1987. This of course included national regulatory frameworks for banking and financial sectors and by implication the more general macroeconomic policy objectives of the negotiating states. The actual agreement under 'Safeguards and Exceptions' specifically mentioned balance

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144.- Key, S.J. and Scott, H.S., "International Trade in Banking Services: A Conceptual Framework", Group of Thirty Ocassional Papers, n. 35, Washington, 1991, p. 2

145.- Meessen. K.M. "Europe en Route to 1992: The Completion of the Internal Market and its Impact on Non-Europeans", International Lawyer, vol. 23, n. 2, 1989 p. 368

146.- Key, "Is National Treatment Still Viable? US Policy in Theory and Practice", Journal of International Banking Law, vol. 9, 1990, p. 366. On the contrary, the EC program goes much further, dismanteling through market mechanisms even the non-discriminatory barriers: "Within the EC the principle of mutual recognition is being used to achieve in interaction with market force, a single, unified regulatory structure. Such a structure involves removing barriers created even by non-discriminatory differences in national rules that do not discriminate between foreign and domestic firms". ibidem, p. 365.

of payments reasons as requiring special provisions for national policy intervention. In relation to that, it has to be noted that government regulations are explicitly recognised (the power to grant exclusive rights in certain sectors, consumer protection purposes and macro-economic policies). Moreover, emphasis is given to the right of countries to introduce new regulations.[147]

"The GATT ministerial gathering in Montreal in December 1988 achieved some form of progress in the issue of the internal rules for trade in services. The report to the ministers by the services negotiating group was initially torn up and a decision made to start afresh. This strategy apparently helped unblock the situation, for there followed an agreement in principle to bring trade in services under international rules and regulations. (...) The Montreal agreement formally adopted in April 1989 in Geneva, was accepted. It was agreed that negotiations on the elaboration of a multilateral framework of principles and rules for trade should proceed expeditiously"[148]

The significance of the willingness to include trade in services under the rules of the GATT should not be underestimated. The obstacles that arise from differing regulatory situations in the member countries would also continue to exist.[149] "The extremely complex nature of the financial industry is typified by the diversity of services and products offered and by the multiplicity of submarkets. Different banking systems, and variations in the way banking products and services are provided, regulated and supervised emerges as an important factor when negotiating on trade in financial services generally and on banking services specifically"[150] On the top of that, the adoption of the principle of national treatment instead of broader liberalization goal fails to match the real globalization of financial markets. National treatment continues to see financial markets as a set of bilateral relations instead of a world-wide one.

One problem of the GATS is that it comprises a large number of economically diverse countries, many of whom have little interest in

147.- This has led Metzger to affirm that, "All future liberalisation will depend on the goodwill of their members, that is, on the specific compromises each member will subscribe", Metzger, "Les services bancaires sous l'accord général sur le commerce des services (GATS)", Revue du Marche Unique Européen, 2/1996, p. 116 (our translation)

148.- Underhill, "Markets beyond politics? The state and the internationalisation of financial markets", European Journal of Political Research, vol 19, 1991, p. 213.

149.- Möschel, W. "International Free Trade in Banking Services", Occasional Papers vol.2, 1989/90. Center for the Study of New Institutional Economics. Uniersität des Saarlandes.

150.- Footer, "GATT and the Multilteral Regulation of Banking Services", International Lawyer, vo. 27 n. 2 , 1993, p. 353

liberalizing rules for financial services. However, in accordance with an approach that has been suggested in the GATS negotiations on financial services, the developed countries are not necessarily at a competitive disadvantage when it comes to the internationalisation of banking.

"Clearly, there is considerable political conflict over the internationalisation of markets and financial services. There is much to lose and much to be gained depending on the outcome. No doubt there will be some sort of agreement at the GATT negotiating table, for there is sufficient consensus among the industrialised countries that some sort of regulated progress towards liberalisation is desirable. Even if this prediction proves overly optimistic, less formal co-operation among the advanced countries of the OECD will lead in the same direction."[151]

A further cloud in the horizon of the GATS is represented by the temporary withdraw of the US at the Marrakech summit in 1994, unsatisfied with the results obtained in the issue of market access to certain Asian locations.

In any case, it has been stated that, "the value of the GATT, and its history has proved it, is that it is also an institution which has produced an evolutionary mechanism within which gradual adjustment of national policies could take place, while allowing maximum scope for market forces"[152]

2.- The OECD

This forum tries to built a kind of intellectual consensus among banking actors. "Some of the most important elements of trade in services are banking, insurance and securities. The OECD has paid considerable attention to these in the past few years through its Committee on Financial Markets. The emphasis has been on promoting liberalisation of national policies with respect to outside involvement in national financial services industries. So far, the effort has been principally focused on studies to identify obstacles to trade in these sectors, where reliable data on any kind is notoriously scarce. This OECD effort

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[151].- Underhill, "Markets beyond politics? The state and the internationalisation of financial markets", European Journal of Political Research, vol 19, 1991, p. 215

[152].- Gavin, B. "A GATT for International Banking?", Journal of World Trade Law, vol. 19, 1985, p. 134. "While many problems remain with GATT agreements, most economists agree that this rule-based form of international policy coordination has achieved considerable success", Keleher, R.E. "Policy Responses to Increased Economic Integration", CATO Journal, vol. 13 n. 2, 1993, p. 283.

was in addition to national studies which where carried out on behalf of the GATT Secretariat."[153]

For some time the OECD has produced studies on trade in services and issued codes of practice on liberalisation for capital movements and transactions. This is the case of the Code of Liberalisation of Current Invisible Operations of 1986 and the Code of Liberalisation of Capital Movements revised in 1989.

In what concerns the production of studies, we argue it represents a form of regulation by information. The expert Banking Group of the OECD is composed by bank regulatory and supervisory officials from the 24 industrialised countries. The Group has prepared a series of studies on differing national supervisory requirements and areas for convergence.

"Although market forces may foster regulatory convergence in the longer run, in the short term removing non-discriminatory barriers among countries[154] may be extremely difficult politically. However, within the EC, where political agreement on goals for regulatory convergence has already been reached, the elimination of non-discriminatory barriers to trade in banking services is a critical element of the internal market program. This liberalization is being carried out in an environment of substantial co-ordination of common obligations established through a supranational structure to which the member states have already transferred a significant degree of sovereignty. By contrast, the OECD Codes of Liberalisation and National Treatment Instrument are concerned only with discriminatory barriers, a limitation that reflects the absence of a comparable political consensus or degree of integration among members of that organization."[155]

"One problem with the OECD is that its members, unlike those in the European Community, have not surrendered any sovereignty to it. Decision making, as in the GATT, must be unanimous. Moreover, although its rules are legally binding, the OECD lacks a strong mechanism for settling disputes. If it were to play the role of the broad forum, its ability to resolve disputes would

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153.- Underhill, "Markets beyond politics? The state and the internationalisation of financial markets", European Journal of Political Research, vol 19, 1991, p. 210

154.- Because international banks operate on a global scale, barriers to international trade in banking services may also result from nondiscriminatory differences in national rules, that is, differences in national rules that do not discriminate between domestic and foreign firms.

155.- Key, S.J. and Scott, H.S., "International Trade in Banking Services: A Conceptual Framework", Group of Thirty Ocassional Papers, n. 35, Washington, 1991, p. 9

have to be greatly strengthened, a move that would involve a major change of style for the organization"[156]

3.- Bank for International Settlements (BIS) and Committee on Banking Regulation and Supervisory Practices (Basle Committee).

The Basle Supervisors' Committee primary aim is to encourage a gradual convergence of bank supervisory practices of the member regulatory institutions by enhancing the scope and effectiveness of supervisory techniques for international banking activities, by studying and making recommendations on specific areas of prudential concern in international banking, and by facilitating the exchange of information among bank supervisors so as to upgrade the quality of international bank supervision.[157] Its work is directed less towards liberalising international banking activities than towards improving and harmonising national banking supervisory legislation.

"Recent goals of the BIS have been to strengthen capital adequacy requirements to arrive at a greater convergence of approaches in different countries and to improve comparability of the definition and measurement of capital adequacy. Differences in accounting conventions and in the assessment of the value risk of assets and liabilities remain very large. These inconsistencies represent a formidable obstacle to the accurate quantitative comparison of banks in different countries. In the early 1980s a process of harmonization was initiated both within the EC and in the broader forum of the Basle Committee on Banking Regulation and Supervisory Practices. After several years of work, the Basle Committee issued in December 1987 an international convergence of capital adequacy standard for commercial banks"[158]

The case of the harmonisation of capital adequacy ratios does not so much relate to political efforts to extend markets into the international domain, but to deal with the political consequences of this extension. Thus we

156.- Key, S.J. and Scott, H.S., "International Trade in Banking Services: A Conceptual Framework", Group of Thirty Ocassional Papers, n. 35, Washington, 1991, p. 43

157.- Norton, J.J., "The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on 'Interntional Convergence of Capital Measurement and Capital Standards", The International Lawyer, vol. 23 n. 1, 1989, p. 249; idem, "Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?", Ohio State Law Journal vol. 49 n.5, 1989.

158.- Swary and Topf, Global Financial Deregulation, Blackwell 1992, p. 408

are in front of reactive regulation instead of proactive[159]. "The express direction of the International Lending Supervision Act[160] for the domestic and international convergence of capital adequacy standards evidenced the inseparability between the domestic and international dimensions of this issue. This interconnection had already been recognised by the bank regulators of the major industrialised nations through the Basle Supervisors Committee which since the late 1970s had begun to foster multilateral efforts to arrive at a convergence of capital adequacy standards among the leading industrialised nations, and which has led to the issuance of the July 1988 Basle Report on bank capital adequacy"[161]

In essence, the Capital Adequacy Agreement of 1988 was a form of international co-operation on the issue of prudential supervision of banking. It represents a clear attempt to initiate international political co-operation where state regulation is almost by definition inadequate, given the internationalised and integrated nature of contemporary financial markets[162]

Multilateral co-operation among central bankers has a long history. For example, the Group of Ten central bankers meet regularly once a month to discuss exchange rate co-operation; there is a standing committee on the Eurocurrency markets; there are groups of experts on payments systems, computer technologies in banking. The committee which dealt with the agreement on capital adequacy is the Committee on Banking Regulations and Supervisory Practices (Cooke Committee). The Committee meets regularly and serves as an informal forum for on-going co-operation on bank prudential

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159.- It is striking the fact that the 1975 Concordat and its modifications aways came after a major disruption in the functioning of the financial system. A series of bank failures is amazingly corresponded by international BIS action: 1974 Herstatt Bank in Germany led to the 1975 Concordat; 1982 crisis of the Italian Banco Ambrosiano led to the 1983 modification of the Concordat, and; 1991 BCCI collapse result in the 1992 reform and the fixing of the so called Minimum Standards for the Supervision of International Banking Groups. This sequence may induce as to be rather skeptical about the effectiveness of these instruments. As Cerny has stated, "With the exception of Basle (referring to the Basle Agreement of Capital Adequacy) most international intergovernmental cooperation has been in the form of crisis management, often following the most egregious regulatory failure, rather than in terms of effective a priori regulatory control" Cerny, P.G. "The dynamics of financial globalization: Technology, market structure and policy response", Policy Sciences, vol. 27, 1994, p. 337

160.- Pub. L. n° 98-181, title IX, 975 Stat. 1278 (1983)

161.- Norton, J.J., "The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on 'Interntional Convergence of Capital Measurement and Capital Standards", The International Lawyer, vol. 23 n. 1, 1989, p. 247. See Basle Supervisors Committee, International Convergence of Capital Measurement and Capital Standards, Basle, Juy 1988. A copy has also been published in 51 BNA Banking Report, 143, July 25, 1988.

162.- Underhill, "Markets beyond politics? The state and the internationalisation of financial markets", European Journal of Political Research, vol 19, 1991, p. 215

supervision matters. Two earlier accords had been negotiated in the same way as the 1988 risk based capital framework:

- the 1975 Basle Concordat, which sets forth general principles regarding the relative roles of home-and-host country supervisors in an effort to ensure that all banking organizations operating in international markets are supervised institutions. Primary responsibility for the supervision of the liquidity and solvency of foreign banking establishments was that of the authority of the host country.[163]
- the 1983 revised Concordat which incorporates the principle of supervision of multinational banking institutions on a consolidated world-wide basis[164].

"Through the 1975 Concordat and its 1983 revised version, the Basle Supervisors Committee had created the basis for reordering the jurisdictional scheme among banking authorities from different jurisdictions dealing with common international banking problems. While no international banking system exists as a formal or legal entity and while the Committee's Concordats were not written as legal documents, the effect has been that the various member countries and others in fact have reformulated their jurisdictional approaches to prudential supervision of international banking activities to align themselves with the principles of the Concordat."[165]

The relative efficiency of the Cooke Committee is probably due to the fact that its work relates to issues of a more technical nature and they are dealt with at the level of experts. The fact is also important that putting them into practice does not necessitate the involvement of the legislature[166]. The

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163.- "The Concordat's proposal that host authorities should have primary responsibilityfor regulating a foreign subsidiary's solvency conflicted with a 1978 recommendation by the Group of Ten that supervision of international banking institutions should be performed on a consolidated basis". Cane and Barclay, "Competitive Inequality: American Banking In the International Arena" Boston College International and Comparative Law Review, vol 13 n. 2, 1990, p.322

164.- The Basle Committee has also produced studies on foreign exchange positions ("Supervision of Banks' foreign exchange positions". 1980); bank secrecy ("Bank secrecy and international co-operation in banking supervision". 1981); country risk analysis (Mangement of banks international lending: country risk analysis and country exposure measurement an control". 1982); off-balance-sheet risks ("The management of banks' off-balance-sheet expenses, a supervisory perspective". 1986) and bank accounting standards (International Federation of Accountants and Basle Committee, "The Audit on International Commercial Banks". 1990).

165.- Norton, J.J., "The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on 'Interntional Convergence of Capital Measurement and Capital Standards", The International LAwyer, vol. 23 n. 1, 1989, p. 251

166.- In an statment delivered by President Cooke in June 21, 1984, it has been stated that, "The committee does not undertake a formal supranational supervisory role; its conclusions do not have, and were never intended to have, legal force. Rather it formulates and recommends broad supervisory principles and guidelines of best practices in the hope and expectation that

unstructured appearance hides a crucial asset of the Committee: its thigh consensus-based process.[167]

This kind of 'soft law' has proved to be much more effective as an harmonization tool.[168] "the agreement is concerned with ultimate objectives and not with details per se. That is to say, provided that the objectives are assured, the Committee was quite content to allow these objectives to be achieved in whatever way individual members felt appropriate. That way the Committee was not obliged to require members to harmonize in detail their methods of supervision. A flexible approach also has the advantage of permitting the agreement to be adapted and interpreted to meet changing circumstances quite quickly. Supervisors need to be able to respond to market developments and a much more rigid agreement would considerably weakened supervisors' ability to ensure that the spirit of the agreement continues to upheld"[169]

The most recent fruit of the work of the Basle Committee has been the issuing of the 'Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments' in June 1992. This is in fact a third revised version of the old 1975/1983 Concordats. In the new standards, the Basle Committee agreed to tighten international bank supervision. Their main features are that:

1.- all international banks and banking groups should be supervised by a 'home-country' regulator.
2.- an international bank should obtain permission of both the host and home regulators before opening a branch or other banking establishment in a foreign nation (the most relevant change)
3.- banking regulators should have the right to gather information from international banks

individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise- which are best suited to their own national systems. In this way the committee encourages some gradual convergence towards a common approach and common standards without attempting far reaching harmonization of member countries supervisory techniques".

167.- Porter, Tony, *States, Markets and Regimes in Global Finance*. New York, 1993, p. 66.

168.- Wellens and Borchardt, "Soft Law in European Community Law", European Law Review, vol. 14, 1989 ; Snyder,F. "Sof Law and Institutional Practice in the EC" in Martin, S. (ed.) The Construction of Europe. Essays in Honour of Emile Noel. 1994.; Gold, "Strengthening the Sof International Law of Exchange Arrangements", American Journal of International Law, vol. 77, 1983.

169.- Hayward, P.C., "Prospects for International Cooperation by Bank Supervisors", International Lawyer, 24 n. 1, 1990, p. 788.

4.- if the minimum standards are not met, a host regulator may impose restrictive measures against the international bank
5.- information exchanges between regulators in different nations should continue to be encouraged[170].

However, one of the shortcomings of the BIS is the fact that does only include bankers. Financial service regulators or finance ministry officials, whose participation would be necessary to reach government-to-government agreements as opposed to understandings among bank regulators, are not present. However, this limitation is somehow corrected by a process of policy diffusion and expansion which has a much more world-wide character. Most countries with international banks have adopted the Capital Adequacy standards regardless of their membership of the Committee. "The result is that there are few banks operating internationally that are not now subject to the same set of minimum standards of capital adequacy. This is an achievement comparable with that of many long-standing international organizations with far more extensive formal powers. Indeed, some have claimed that banking is the only industry subject to effective regulation on a world-wide basis"[171].

Again, this is a phenomenon that has to be considered by classical international law and international institutions. A policy community, although (or because) only partly self-represented has succeeded in conducting a process of policy convergence through mainly market mechanisms, reputation and regulatory mimetism. We argue this is a typical manifestation of a process of globalization of regulation, where decisions taken domestically or regionally have implications elsewhere.

"The BIS could play an extremely useful role in the international regulatory framework as a specialised forum for issues involving safety and soundness and systemic risk. Other countries could be brought into the discussions of these issues after the BIS had formulated preliminary proposals. The proposals of the expanded group of banking officials could then feed into a broader forum that included government officials more attuned to competition and consumer protection considerations. Similar input to the broader forum could also be made by other financial service regulators."[172]

170.- See, Norton, J.J., "The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on 'Interntional Convergence of Capital Measurement and Capital Standards", The International Lawyer, vol. 23 n. 1, 1989, p. 267-274.
171.- Hayward, P.C., "Prospects for International Cooperation by Bank Supervisors", International Lawyer, 24 n. 1, 1990, p. 793
172.- Key, S.J. and Scott, H.S., "International Trade in Banking Services: A Conceptual Framework", Group of Thirty Ocassional Papers, n. 35, Washington, 1991, p. 42

In any case, it would be misleading to consider the Basle Agreement as a mere technical issue and the task of the BIS as of mere numeric analysis. Instead, the question of the capital adequacy standards are a primary political issue. The agreement on capital adequacy relates as much to the notion of a 'level playing field' in international competition, in order to avoid competitive distortions.[173] "Characteristically, the German Bundesbank took the most conservative stance. The German position was essentially that any definition of capital adequacy should only refer to core capital (equity and disclosed reserves), excluding ant forms of supplementary capital. Not surprisingly German banks would have been better off under such an arrangement. (...) At the other extreme was the Japanese position. Japan wanted considerable flexibility in the determination of the capital base, in particular a liberal definition of what could be included as supplementary capital. This is because Japanese banks have operated on international markets with relatively small capital bases. (...) Most other countries fell somewhere in the middle. In the end, the agreement which merged in July 1988 was not substantially different from the original proposals. The German insistence on confining the agreement to core capital, and the Japanese efforts to expand the definition of supplementary capital, went essentially unrecognised."[174]

The same can be explained under the collective action problem perspective in international regulatory activities, where every State is tempted to free-ride on the benefits of a more regulated financial order without complying with them. "The effort to impose common capital adequacy standards was led not by figures seeking to reduce international capital

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173.- This lead to some strong critics in relation with the imposition of standards to Japan: "The G-7 has engaged in acts of political and financial armtwisting eather tahn friendly coordination. From Japan's perspective, it must be seen as if the Group of Seven has transmogrified into the 'Gang of Six' all aligned against Japan and demanding that the Japanese government step up domestic spending to stimulate its economy. A strong Yen is actually good for Japan because it reduces the vaue of its foreign loans and that helps Japanese banks to meet the BIS capital requirements", Shelton, Judy, "Banking and Government: An Unholy Alliance", CATO Journal, vol. 13 n.2, 1993. p. 204-205. Se also Porter, Tony, *States, Markets and Regimes in Global Finance*. New York, 1993, who interprets BIS requirments as an attempt to impose an idiosyncratic approach to regulation on Japan. Porter at p. 70.

174.- Underhill, "Markets beyond politics? The state and the internationalisation of financial markets", European Journal of Political Research, vol 19, 1991, p. 219-220. Despite of this aspect one has to recognize that the relative success of the Capital Adequacy agreement is due to the alarming decline of the quality of banks' assets due to forces of competition and the internationa debt crisis, and the unanimously perceived need to restore bankind soundness. "Indeed it was the overriding nature of this objective that allowed members to commit their authorities to surrender long-held and desirable aspects of their own supervisory systems in the interest of reaching an agreement", Hayward, P.C., "Prospects for International Cooperation by Bank Supervisors", International Lawyer, 24 n. 1, 1990, p. 789

mobility, but rather by US and British central bankers who hoped to minimize the risk of an international banking crisis. If the US and Britain were to impose capital standards unilaterally on their own banks, these banks would be put at a competitive disadvantage in international banking markets. To overcome this problem, US and British officials used their central position in the international financial system to pressure other states to join their initiative. After reaching a bilateral agreement in January 1987, they raised the prospect of foreign banks being excluded from New York and London financial markets unless these banks and their governments went along with the deal. Because no major foreign bank could expect to be successful internationally without operating in New York and London, this threat was significant enough to encourage other G-10 governments to reach and agreement within next year"[175]

The previous confirms the emergence of the BIS not only as a forum of technical discussion of issues of banking regulation and supervision but also as a political forum for debating the policy instruments of major industrialised economies.

"Thus, the Basle Supervisors Committee, although not a formal international organization in an international law context, has taken on the aura and reality of a substantive and permanent international forum that has been a centrifugal force for creating a world-wide network for the exchange of information and the discussion of issues regarding bank prudential supervision. The Committee has created the possibilities and conditions for an evolutionary international convergence of prudential supervisory practices and standards"[176]

4.- The IMF

Regulation of banks has with no doubt important macroeconomic policy consequences as we have already referred. The role of the IMF, which is an institution dealing with central banks and not private banks, has among its goals, the maintenance of exchange rate stability.

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[175].- Helleiner, "Post-Globalization. Is the financial liberalization trend likely to be reversed?", in Boyer and Drache, States against Markets. The Limits of Globalization. London, 1996. p. 202. See also, Kapstein, "Between Power and Purpose: Central Bankers and the Politics of Regulatory Convergence", International Organization, vol. 46, 1992. Cfr. Genschel and Plümper, "International Cooperation in the Shadow of Regulatory Competition" 1996 mimeo. p. 14.

[176].- Norton, J.J., "The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on 'Interntional Convergence of Capital Measurement and Capital Standards", The International Lawyer, vol. 23 n. 1, 1989, p. 252

Initially it would seem that there is no much relation between the IMF function and that of regulation of international banking. However, some authors attribute some of the recent financial crisis, at least in part, to the development of new financial instruments that make difficult the pursue of monetary policies both by national governments and the IMF itself. While the activities of the IMF are not regulatory in nature, they significantly influence international banking lending practices and operations.[177]

"The creation of a low-cost international payments and deposit system promotes international business, but it also makes it easier for companies and individuals to evade taxes and avoid fiscal and monetary controls established by national authorities (...) The IMF should exercise some authority in pressing, within such a forum, for a regime of regulated international capital markets. Free and deregulated markets may be positive goals for allocation of non-banking goods and services, but financial markets, should be highly regulated, within parameters that allow the interplay of markets forces without inflicting on society the abuses that can accompany normal human urge towards unsettling speculation: speculative bubbles, market crashes and the evasion of fiscal and monetary laws"[178]

5.5. Towards a new model of global financial regulation: markets, self-regulation and policy networks.

The web of institutional alternatives presented is very far from giving a satisfactory structuration of proper mechanisms to afford a new era in financial regulation. On the contrary, we tentatively suggest to explore the virtues of the new engagement between states and markets and its potential to achieve that goal.

In first place, it has been argued that a valuable element could be found in bilateral policy coordination. As seen in the past several years, major industrialized countries have had bilateral talks on financial issues. They were directed to facilitate mutual access to financial markets or to liberalize financial activities in either or both of them. The main deficiency of this mechanism is that they are essentially bilateral undertakings and not intended to achieve

[177].- Hackney , J.V. and Shafer, K.L., "The Regulation of International Banking: An Assessment of International Institutions", *North Carolina Journal of International Law & Commercial Regulation*, vol. 11, 1986, p. 476
[178].- Zamora, S. "Regulating the global banking network - What role (if any) for the IMF?", Fordham Law Review, vol 62, n.7, 1994, p. 1971

harmonisation as such. Despite of that, they in effect have had substantial impacts to align financial regulation in these countries.[179]

During 1986 bilateral discussions began between the FED and the Bank of England concerning risk-based capital standards. "The fruit borne of this informal bilateral collaboration was an agreed proposal of the US federal banking supervisory authorities and the Bank of England on 'primary capital and capital adequacy assessment', released on January, 8, 1987. In legal terms, this Accord was a non binding document in any international or domestic sense. While the banking authorities clearly had authority to promulgate equivalent domestic regulations, there was no legal basis, as such, to create a legally binding agreement among the bank supervisory authorities of these nations. In fact, the Accord does not purport to be a legal document at all: it is presented as a consultative paper to serve as a basis for consultation with the banking industry. Looked at strategically, the US/UK Accord appears conceived as a stimulus for prompt agreement on capital adequacy within the Basle Supervisors Committee (and in particular, to pressure recalcitrant countries such as Japan). The fallback position was that the US and the UK would proceed with international convergence on a bilateral basis in the event the Basle Supervisory Committee did not reach prompt agreement"[180]

This leads us to discuss on the merits of both transnational or global regime formation versus intergovernmental policy co-ordination. For those institutional economist who consider capital mobility and jurisdiction competition as a manifestation of inherent efficiency of markets, the institutional structure should be based on a pure co-ordination basis. However, for those who are concerned by how can markets be effectively regulated for the purpose of minimising the risks of economic instability and volatility, the effectiveness of global institutions is much greater than that of pure bilateral arrangements.

In what concerns international self-regulation,[181] it is worth underlying some differences in the behaviour of self-regulatory bodies which could also represent a step towards that international governance mechanism:

179.- Sato, Mitsuo, "Financial Regulation in Europe", LSE Financial Market Group. Special Paper n. 34, 1995.

180.- Norton, J.J., "The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on 'Interntional Convergence of Capital Measurement and Capital Standards", The International Lawyer, vol. 23 n. 1, 1989, p. 256. See also, Mintz, "International Banking: United States - United Kingdom Capital Adequacy Agreement", Harvard Interntional Law Journal, vol. 28, 1987.

181.- Cfr. in general terms, Black, Julia, "Constitutionalizing Self-Regulation", The Modern Law Review, vol. 59, 1996. Cfr, in the case of credit cards and electronic fund transfers, Kaiser, T.

- re-regulation lags (lack of response to a changing situation) are shorter for industry based self-regulatory bodies than for government regulatory agencies
- self-regulatory bodies are also apt to follow strategies that are more proactive than those that typically appeal to government agencies
- incentives to monitor and minimise the costs of producing regulatory services are weaker for government agencies than they are for private producers.

An example of this kind of organisation could be found in the Institute of International Finance which represents the first attempt by the bank industry as a whole to deal cooperatively with sovereign debt issues.[182]

When deciding in favour of a self-regulatory body as opposed to a governmental agency, we are in front of an incentive conflict. "Self-regulators face socially beneficial incentives to minimise certification costs and to promote efficient arrangements for their members on the one hand. However, they face socially harmful incentives to foster cartel pricing on the other. Moreover, over time, cartel pricing encourages the expansion of uncertified firms that operate outside of the aegis of the self-regulatory organization. Hence, under a purely self-regulatory system, market-structure adaptation to undo the effectiveness of cartel pricing tends to expand the market share of unregulated firms. (...) When regulation is supplied by a governmental organization, the nature of incentive compatibility and conflict is reversed. Socially beneficial incentives exist to promote at least the appearance of stability and to restrain cartel pricing, but incentives to minimise certification costs and to produce co-ordinating, guarantee, and other regulatory services efficiently have little force at all. Hence, when regulation is purely governmental, regulatory services tend to be produced at unnecessarily high resource costs and to be employed as an engine of redistribution"[183]

This might be paralleled to the distinction between corporatist self-regulation, where the interest of the industry are concentrated and well structured in a way that shares the exercise of political power and a pluralist network where the state is a kind of *primus inter partes*. Banking networks in France and Germany tend to be strongly corporatist while the US is more close

"Banking practice: self-regulation versus legislation", International Financial Law Review, Oct. 1989, p. 26

182.- Hackney , J.V. and Shafer, K.L., "The Regulation of International Banking: An Assessment of International Institutions", *North Carolina Journal of International Law & Commercial Regulation*, vol. 11, 1986, p. 484

183.- Kane, "Competitive financial reregulation: an international perspective", in Portes, R. and Swoboda, A.K., Threats to international financial stability. Cambridge U. Press, 1987, p. 121

to the pluralist model.[184] Given the diffuse structure of corporate and political actors within international finance, the kind of expected global arrangement could conform to the pluralistic model.

As stated by the Group of Lisbon, "the more national authorities consider it the principal task of the state to ensure that their own multinational companies are or become competitive in international and global markets, the more the state assigns these companies the task of defining and promoting the economic and social well-being of the country. In so doing, such corporations are given the legitimacy needed to ensure the optimal worldwide management of global material and non-material resources. The result is that representative democratic mechanisms do not operate at a global level. The global system is led instead by oligarchical power structures that tend to merge into more efficient and integrated networks, bypassing nation-state governments"[185]

However, the contrary might be also true. The very fact of making financial firms into agencies or quasi-agencies of the State renders their autonomous power weaker in comparison to those firms which continue to operate wholly in the private sector.[186]

Policy networks may be conceived as a particular form of governance in modern political systems.[187]

Policy networks are forms of governance somewhere in between the line traced by two opposites: market and hierarchy. Markets are characterized by the relative absence of structural and fixed linkages between the elements. On the contrary, hierarchical organizations represent strong and fixed relationship. Finally, networking is an alternative to the two extreme positions, with elements of both of them.[188]

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[184].- Coleman, W.D. *Financial Services, Globalization and Domestic Policy Change.* McMillan Press. London, 1996. p. 68

[185].- Group of Lisbon, Limits to Competition. MIT 1995, p. 132

[186].- Coleman, W.D. *Financial Services, Globalization and Domestic Policy Change.* McMillan Press. London, 1996. p. 42

[187].- Heritier, Adrienne, "Policy Network Analysis: A Tool for Comparative Political Research", in Keman, H. *Comparative Politics. New Directions in Theory and Method.* Amsterdam, 1993; Atkinson and Coleman, "Policy Networks, Policy Communities and the Problems of Governance", Governance, vol. 5 n.2 , 1992; Marin and Mayntz, *Policy Networks: Empirical Evidence and Theoretical Considerations.* Campus Verlag. Frankfurt, 1991.

[188].-Powell, "Neither market nor hierarchy: network forms of organization", Research in Organizational Behabiour, vol. 12, 1990, p. 295-336; Bradach, J.L. and Eccles, R.G. "Markets versus Hierarchies: from ideal types to plural forms", Annual Review of Sociology, vol 15, 1989,

We have characterized our competition among rules paradigm as a dynamic process with a generative potential in knowledge. This profoundly differs from the traditional hierarchical idea of the Public Administration as a central institutional applying a rational general law. Instead, "a new procedure, of constructing public interests from a process of experimentation could be based on the assumption that the search process itself should be regarded as operating on the basis of a heterarchical linkage of private and public action and on the hope of finding a productive pattern of self-stabilizing coordination generated from emergent effects of self-organization instead of a top-down rule structuring social complexity"[189] Network forms of organization and horizontal plurality can become the new architecture of complexity.[190]

"Modern governance is characterized by decision systems in which territorial and functional differentiation disaggregate effective problem solving capacity into a collection of sub-systems of actors with specialised tasks and limited competence and resources. The result is functional interdependence of public and private actors in policy-making. Governments have become increasingly dependent upon the cooperation and joint resource mobilization of policy actors outside their hierarchical control."[191]

Thus, the concept of networking is useful to overcome the classical division between public and private spheres in political process. More and more, both elements go hand by hand in all kind of policies, without a clear separation of functions but in a mutual cooperation-competition process.

In order to understand the paradigm of competition among norms, one has to realise that policy emanates, not exclussively from a central authority, be this government or the legislature, but from a multivariate process involving a plurality of both public and private organizations[192]. This implies that the logic division between state and private is very much diluted. In fact it has

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p. 97-118; Thorelli, Hans, "Networks: Between Markets and Hierarchies", Strategic Management Journal, vol. 7, 1986, p. 38.

189.- Ladeur, K.H., "Network as a Legal Concept in Analysis of European Standard-Setting", paper presented at the Conference: *Social Regulation Through Committees: Empirical Research, Institutional Politics, Theoretical Concepts and Legal Developments*. EUI, Florence, December 1996. p. 8

190.- Kenis, Patrick and Schneider, Volker, "Policy Networks and Policy Analysis: Scrutinizing a New Analytical Toolbox", in Marin and Mayntz, *Policy Networks: Empirical Evidence and Theoretical Considerations*. Campus Verlag. Frankfurt, 1991.

191.- Börzel, "Policy Networks - A New Paradigm for European Governance?", Paper presented at the EUI Workshop on European Governance. EUI, 1996. p. 9

192.- Mayntz, "Modernization and the Logic of Intergovernmental Networks", MIPGF Working Paper n. 4, Max-Planck Institut fur Gesellschaftsforschung, 1994

been recognised how the command and control paradigm of regulation has lost much of its consistence due to regulatory arbitrage. "Regulators do not and cannot autonomously 'command and control' the behaviour of the client institutions they regulate. Rather, each regulator's controls are shaped by prior conditioning and ex-post feedback from the parties it regulates. To survive, a control must be voluntarily accepted by regulatees in the long run. Unacceptable controls lead regulatees and their competitors to engage in regulatory arbitrage."[193] This element of voluntariety modifies the traditional formulation of the Law.

In sum, "networks represent a qualitatively distinct type of social structure which is characterized by the combination of elements belonging to the two other basic forms of governance: the existence of a plurality of autonomous agents, typical for markets and the ability to pursue chosen goals through coordinated action, typical for hierarchies. (...) But policy networks are not only the result of the combination of functional differentiation and orgnizational growth. They suppose of a crucial advantage over the two other forms of governance: unlike hierarchies and markets, policy networks do not necessarily have dysfunctional consequences. While hierarchies produce 'losers' who have to bear the costs of a political decision, markets are unable to control the production of negative externalities. By combining the autonomy of actors typical for markets with the ability of hierarchies to pursue selected goals and to control their anticipated consequences, policy networks avoid both dysfunctions. This is because policy networks are able to intentionally produce collective policy outcomes despite diverging interests of their members through voluntary bargaining between private and public actors"[194]

As we have been arguing along the previus pages, competition requires coordination and coordination requires some form of competitive pressure. This makes the network theory specially useful in analysing this new paradigm. As explained by Thorelli, "considering the plethora of internal and external centrifugal and centripetal forces in the interplay among network members and in the network environment interface, it is self-evident that blissful equilibrium is not to be attained. Cooperation is indispensable, and some measure of both intra- and inter-network competition unavoidable"[195]

193.- Kane, Edward, "A Market Perspective on Financial Regulation", CATO Journal, vol. 13 n3. 1994 p. 334.

194.- Börzel, "Policy Networks - A New Paradigm for European Governance?", Paper presented at the EUI Workshop on European Governance. EUI, 1996. p. 11

195.- Thorelli, Hans, "Networks: Between Markets and Hierarchies", Strategic Management Journal, vol. 7, 1986, p. 38. p. 43

It is also important to recall on the unintentional aspects of the policy network system. Polling together the different visions around a problem and the possible solutions helps to find the best common solution. This way, policy networks resembles in some manner Adam smith invisible hand by which the individuals pursuing their own gain achieve a positive overall outcome which initially was no part of their intention.

The concept of policy networks may also be useful to overcome the dichotomy between supranationalist and intergovernmentalist explanations of European integration. Instead, "The EU is treated as a multilevel structure of governance, whereby private and public actors of the supranational, national and subnational level interact within highly complex vertical and horizontal networks". [196] The concept of network allows us to recognise that, in a competitive scenario, European actors refrain to pursue their own interests at the expense of other Member States. In a given policy field, individual units do not exist by themselves but in relation to the other units. It is also this relational-procedural view of social organisation which is particularly interesting to conceptualise the competitive paradigm.

There is also an alternative explanation to the proliferation of market mechanisms to regulate the new global order which we will use in order to overcome the dichotomy between markets and governments. More than blaming the market, some authors concentrate on the idea that the market is taking the place of the states in front of the failure of these to agree on appropriate instruments to cope with the new situation. As explained by Boyer and Drache, "The dominant position of markets may be due to the fact that no supranational authority has the power to discipline transnational markets which increasingly threaten the sovereignty of nations. The reluctance of nation-states to negotiate a transfer of power to supranational bodies to guide and direct the current restructuring process is easy to explain. But, by default, market forces are in command, intent on disciplining national governments who want to hold onto the instruments of national power."[197]

In any case, it becomes evident that future global financial regulation would emerge as a mixed cooperative and competitive game.

"The historical relationships between finance and the state can be analysed as components in a single 'economic system', in which both financial and political services are produced in response to changing consumer tastes

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[196].- Börzel, "Policy Networks - A New Paradigm for European Governance?", Paper presented at the EUI Workshop on European Governance. EUI, 1996. p. 17

[197].- Boyer and Drache, "Introduction" in Boyer and Drache, States against Markets. The Limits of Gobalization. London, 1996, p. 7

driven by social and technological change. The relationship is interdependent, as each branch of this system depends closely on the other and they have grown up together."[198]

In fact, the existence of contrary interests which balance among themselves constitutes one of the inherent lessons of representative democracy. By analogy, it will be less dangerous for the adjustment process to be driven by world-wide competition among differentially regulated private firms pursuing opportunities for diversification and growth than to be led by multilateral cooperative agreements negotiated from time to time by imperfectly accountable national regulatory entities. [199]

"Competition in financial services is taking place not only among private firms, but also among overlapping regulatory systems both nationally and internationally. The effects of regulatory competition have generally been healthy within the United States and can be healthy worldwide, but competition can also have undesirable dimensions to be guarded against. It is beneficial when regulators are pressed into establishing a regulatory climate in which financial services can be efficiently and safely provided. Regulatory competition reduces the risk of adopting narrow and inflexible approaches to problems, fosters experimentation and facilitates timely and efficient adaptation to changing market conditions"[200]

198.- Pringle, "Financial Markets versus Governments", in Banuri and Schor, Financial Openness and National Autonomy, New York, 1992, p. 104-105.
199.- Kane, E.J. "Incentive Conflict in the International Regulatory Agreement on Risk-Based Capital", NBER Working Paper n. 3308, 1990, p. 4
200.- Haraf, W.S. "Principal Policy Conclusions and Recommendations of the Financial Services Regulation Project", in Haraf and Kushmeider, Restructuring Banking & Financial Services in America, American Enterprise Institute, Washington, 1988, p. 438.

CONCLUSIONS

Although the main conclusions do already appear throughout the precedent pages we will now try to order them in a systematic way in order to give coherence to the study and to present the main findings of the research. In order to do that, we divide these remarks into four big subsections: the reformulation of the competitive pardigm; the experience of the banking sector; the globalization of banking regulation; and finally, the normative implications of the overall analysis.

1.- reformulation of the competition among rules paradigm.

We initially stated that the research was originally fuelled as a consequence of the fundamental dissatisfaction with the two polar positions in the debate about regulatory competition. Also, regulatory competition was seen as the application of economic principles into social organization in such a way that some tasks of the legal system were conferred to market mechanisms. However, this picture has become increasingly over-simplistic in order to capture a complex phenomenon such as the dynamic convergence of regulatory systems.

The traditional scheme has centred the analysis in elements such as mobility, constitutional design favouring decentralised State structure, externalities, and so on. Instead, regulatory competition has to be seen as a complex open-ended process where non quantifiable elements play a decisive role.

Firstly, competition among rules is highly shaped regardless the degree of actual mobility of the elements involved in them. Thus, more than examining the actual movement of regulated factors from one jurisdictional sphere to another, one has to value the "contestability" of those jurisdictions, i.e. the possibility of effectuating that mobility. In these cases, the fear of exit could be as powerful as exit itself. The scientific problem is how to measure the degree of contestability of a given jurisdiction, or in other way, the degree in which a jurisdiction responds to a credible threat of exit of part of their constituency.

Closely related to the previous observation, emulation appears to be a powerful transmission belt among regulatory models. This way, regulators do

pay attention to the solutions adopted in other jurisdictions in order to improve the regulatory environment or the institutional setting available at home. Thus, policy makers do not only 'react' to the demands of the population they regulate but they also 'act' in an anticipatory move. With an increasingly interpenetrated world by means of information, people has the opportunity to be exposed to foreign experiences and foreign regulatory solutions and has the opportunity of comparing them. Again, the measurability of anticipatory responses or automatic self-modelling of legal orders is a complex, multidirectional issue.

Secondly, the behaviour of regulators is conditioned by reputational effects, prestige and leadership. A given regulatory model may maintain differences among its neighbour jurisdictions because it ranks higher specific values as elements of its international reputation. This is a powerful break against the fear of a race to the bottom. Regulatory competition does not imply that more stringent standards can be maintained. On the contrary, it implies that the costs of those higher standards have to be accepted by the population as something they are ready to pay for. (environmental standards are a clear example of this). In these cases, a given jurisdiction acquires a reputation which is always something difficult to built and easy to loose.

Also, regulatory reactions are conditioned by 'path dependence' patterns as well as by the dimension variable. (California effect v. Delaware effect). In such cases, a big State which has initiated a kind of regulatory policy has a leadership effect over the rest. This is also related to the explicit or implicit fight within Europe to adopt certain models of regulation as those commonly practised (for instance the adoption of the Bundesbank model for the European Central Bank).

Thirdly, and despite it is normally ignored, regulatory competition is dependent on how culturally rooted is one regulation. Regulations are inserted within a cultural and legal system and it is difficult to respond to a policy change without affecting the coherence and consistency of the whole system. In any case, this implies that legal transplants are not always a feasible alternative and that the complexity of a social organization makes it impossible to substitute just isolated pieces of a complex institutional gear (this is for instance the case of financial regulation and corporate governance in Germany).

These and other elements contribute to explain the insufficiency of the characterization of regulatory competition as a mere market like mechanism.

Reactions of the destinataries of regulation in a complex world cannot be reduced to a model of rational economic actor which seeks maximization of profits in price terms. Moreover, it is impossible to attribute a clear cause-effect relation in examining a policy change. When a high number of factors and different regulatory models influence any outcome, the causation issue is reduced, at best, to a plausible explanation.

Therefore, instead on focusing on these open expressions of the process of regulatory competition, it is more fruitful to redefine it, not as an efficiency searching mechanism but as an integrating element of complex legal structures constituted by a multiplicity of actors under no explicit hierarchy. This way, competition becomes a knowledge discovering mechanism. The most valuable contribution of competition comes from its potential to foster innovation and experimenting. Competition among legal institutions can be a very fruitful strategy as long as it is linked to a conception of law making as a discovery procedure and not just a mere transfer of tasks to the market.

On the top of that, competition as a discovery procedure implies that the process can only be judged 'ex post', that is, after the knowledge has been created. This is a fundamental difference between neoclassic understanding of economics and evolutionary conception of society. Competition does not reveal a knowledge that was hidden but re-creates it. Consequently, making predictions or policy recommendations on the basis of past experience is bluntly to incur in fiction-science.

Regulatory competition's social function is not primarily one of achieving efficiency but of revealing knowledge. In this competitive process, the effects are not unidirectional and flat. On the contrary, there are many unintended or side-effects which demonstrate that norms are the result of spontaneous evolution, social interaction and cultural selection. This open ended process characterised basically by forces of innovation and imitation, might produce unexpected results. This should not be interpreted as a malfunctioning of the system but as a logical consequence of the initial lack of knowledge present at the initial stage. Therefore, it comes as no surprise that regulatory competition processes are difficult to predict due to the partial existence of knowledge and general future reactions.

In this sense, competition is to be described as an open ended process with a high degree of unpredictability. Convergence and harmonisation of different sets of norms are just one extreme possible result of the process. Regulatory competition has to be seen as a way to tentatively match different and changing needs and circumstances with a variety of institutional answers. The so-called 'ex post' harmonization is only one extreme possibility of an

outcome. Even in the cases where this harmonisation takaes place, it is qualitatively different of the classical centralised one. In our paradigm, harmonisation does not petrify the existing norm but remains flexible and open to the innovative potential.

2.- the experience of the banking sector.

Financial entities were tightly regulated before the eighties and the efforts of detailed harmonisation proved to be impractical. Financial markets were no more than strictly domestic markets. This interventionist system allowed governments to maintain an active role in the banking industry and summit the economic machinery to political control. Regulatory capture and concerted action were the norm. The need to create a single market in Europe (SEFM) with inherent freedoms for services and capitals and the internationalisation of financial markets have produced a regulatory reform directed to the achievement of financial integration. Thus, both internal and external forces have been present in the process of regulatory reform. The main effect of integration will be to change the focal point of strategies of banks from collusion and regulatory capture to competition

Freedom of movements of capitals has been a prerequisite to the creation of a SEFM. It has been necessary but not sufficient. This study demonstrates how important are measures of positive integration. Negative integration lead to the principle of non-discrimination or national treatment. This is not enough to liberalise. Positive integration conducted through mutual recognition and home country control has lead to reverse discrimination which has proved to be a much more effective mechanism of integration.

Such positive integration is mainly undertaken by means of the Second Banking Directive's main innovation: the principle of mutual recognition. Mutual recognition does not involve a total transfer of powers to the Community. Instead, the new approach creates competition among national regulators which will have two direct consequences: first it will be a measure to nullify the restrictions based on different regulatory approaches and practices which exist in the Community; second, this principle will lead to regulatory convergence through the competitive interaction of the different regulatory models. The idea that the single market programme tried to reach a unitary market is misleading.

However, reality demonstrates that the effects of regulatory competition do not satisfy the most optimistic previsions. There are some elements explaining the relative effectiveness of regulatory competition in the banking industry:

- prevention of forum shopping: the Second Banking Directive, faced with the fear of dangerous lowering of regulatory standards, foresees the possibility for a Home State to deny authorisation in the cases were it is evident that the bank is registered in one Member State with the only end of avoiding stricter standards. As a consequence, the possibility of forum shopping is excluded, which in fact, had to be seen as a normal circumstance in the operation of regulatory competition and as an adequate instrument to discipline the regulatory administrations. Therefore, more than fearing an highly unlikely competition in laxity, the provision should be blamed for curtailing one of the intrinsic elements of the new regulatory model.

- fixing of generous minimum standards: the Community has opted for a system of restricted mutual recognition. i.e. the introduction by the Community institutions of minimum or essential standards that make feasible the operation of this system of equivalence among institutions. Those minimum standards could be considered as quite extensive. It is questionable whether the amount of harmonization that has already taken place could properly be described as minimal. Minimal requirements are not minimal but very ambitious. As the OECD itself has warned, while harmonisation of prudential standards is aimed at levelling the playing field, in the sense that it eradicates competitive inequalities by reducing the scope for regulatory arbitrage, it could also eliminate the competitive edges that would normally promote market development.

- existence of switching costs in the banking industry: the banking business is culturally rooted and there are reputational elements present. This means that the impact of regulation on competitive reallocation of banks will be quite limited, since the business of retail banking is based on proximity and confidence.

In sum, interprenetration differs widely between retail and wholesale markets. Cross-border provision of financial services as a form of exporting may be conceivable where the services sold through the market do not require personal proximity between customer and supplier . In the retail services, however, there may be significant transaction costs associated with cross-border provision of loans in particular for personal and small corporate

customers. The degree of regulatory competition and convergence would vary for different activities and types of investors : the 'informed' and the 'non-informed'. Therefore, there will be a slower path of regulatory convergence where consumer products are involved. Such differences are not barriers to a freely functioning market but a reflection of different preferences within a single market.

It exists a clear difference between structural regulation and conduct regulation. The effects of regulatory convergence in the field of structural regulation would be much more important while conduct rules are less affected by this process. In general terms, the home state takes responsibility for the prudential supervision (preventive regulation) of a credit institutions as well as the fitness and properness of its controllers and major shareholders. The conduct of an entity's business with customers, on the other hand is largely responsibility of the authorities of the host state. The enduring significance of national power in shaping the regulatory framework for credit institutions in the SEFM cannot be overlooked.

Beyond any doubt, the clearest example of the effects of regulatory competition affecting structural rules is the gradual convergence of banking powers around the mode of universal banking.

The wide variety of consumer protection issues relating to banking and financial services products in general could lead to repeated ECJ approval beginning to erode the Single Market objectives of the harmonisation programme. Thus the ECJ has to balance in any case the interests of the general good and the goals of the Single Market Programme. The general good clause will play an important role in delimiting the extent to which the activities listed in the Annex of the Directives might be performed. There are still doubts concerning whether mutual recognition embraces the financial techniques (conduct regulation) of Member States or instead those are to be considered as under the general good. Generally speaking, the role of the ECJ, and of Law in general, is one of disciplining regulatory conflicts and of transforming them in collective efforts to find the adequate balance between competing interests.

The new banking regulatory environment should not be characterized as a simple deregulation but instead a deregulation accompanied by a re-regulation. The evolving SEFM is characterized by the twin regulatory forces of structural deregulation and supervisory (and investor protection and conduct business rules) re-regulation. In sum, the harmonisation of the SEFM presents a system of imperfect mutual recognition which has balanced in favour of maintaining systemic stability and has destroyed the false opposition between competitive efficiency and systemic stability.

The new regulatory environment does not envisions transplanting national banking laws and practices but instead national systems will continue to exist and be the basis of the functioning of the system. This should not be perceived as a weakness but instead one of its major achievements. The European model has rejected the idea of having an euro-regulator for European banks and specific set of rules for those entities whose operations extend further the mere domestic markets. There is nothing similar to the idea a banking incorporation at European level.

In any case, the experience of the banking sector clearly illustrates illustrates the different consequences of regulatory competition depending on the fied of application. Thus, wholesale banking characterised by higher mobility and informed customers has experienced a significant convergence. On the contrary, retail banking still maintains a quite fragmented panorma. The same could be said in relation to the distinction between structural norms and conduct norms. This somehow permits a variable speed in the process of integration and convergence.

3.- globalization of banking regulation

We argue that regulatory competition is not limited to the European space. On the contrary, mobility of capital and liberalization of international capital markets has produced a kind of global regulatory competition. With the increasing globalization of finance, all industrial nations will be pressed to harmonise fundamental regulatory principles.

Globalization can be defined as the act or state of becoming world-wide in the scope of application. This implies a fundamental change in the way international relations are perceived as well as an end of the association between law and territory. Economic significance of national boundaries has been reduced by growing interdependence. The various national financial marketplaces are being integrated in a single marketplace. The ability of market actors and States to play in this new interdependent economic system has moved from protectionist and interventionist mentalities to forms of transnational policy networking and international regulatory arbitrage.

Internationalisation leads to cross-comparison of regulatory models and to a process of regulatory convergence. At the same time, the remaining regulatory burden fosters financial entities to internationalise to escape those restrictions. Therefore, the growth of international banking markets have

induced many firms to demand significant domestic market deregulation in order to keep pace. The common demand for a 'level playing field' among financial entities is pernicious in so far it reduces the diversity potential which fuels international trade and cross-fertilization. If there is any value in this mobility is because the playing field is not levelled or uniform.

The most visible example can be found in the reform of the US financial system which is currently taking place with the passage of the Interstate Banking and Branching Efficiency Act of 1994 and the debate on the repeal of the Glass-Steagall Act. In the long run, the process of European banking integration would set a stage for complete restructuring of the US financial system. The abolition of geographical restrictions and the possibility of interstate operation will result in the transformation of the classical vertical regulatory competition between federal and state authorities to horizontal regulatory competition among the latter, in a similar way as is experienced in US corporate law or EU banking legislation.

On the other side, structural arbitrage and regulatory competition are diminishing regulator's capacity to control events. The counterforce of international regulatory co-operation is lagging behind. We are in front of economic internationalization without the corresponding political internationalization. In other words, we confront an integrated economy governed by a fragmented sovereignity. However, instead of fragmentation and chaos, there is a surprising degree of order.

In the same line, a multiplicity of independent regulatory regimes could be an efficient means of social control over increasingly transnational finance. Global homogeneity of regulation is not necessarily optimal either, as finance regulation must mesh with each society's particular circumstances, and as opportunities for variation, and thus for greater innovation and competition, in finance regulation are desirable. We argue that there appears to be competition among these constellation of international organisations in pursuit of a leading role in the process of regulating global finance.

The future of global financial regulation emerges as a mixed co-operative and competitive game. Cooperation is needed in order to support some kind of epistemic community around a network of financial operators. On the other side, competition among overlapping regulatory systems both nationally and internationally reduces the risks of adopting narrow approaches to regulation and fosters experimentation and adaptation to changing market conditions. This kind of structure will represent a new engagement of States and markets providing a middle way between hierarchical and holistic structures and complete rendering of regulatory

instruments to industry itself. Therefore, this impressive transformation has not necessarily to be seen as a lost of state power. It has been affirmed that the globalization of trade and finance has tended to weaken the influence of government and to strengthen the influence of the market in determining the policy outcomes. In fact, one could argue that precisely what has taken place is the transformation of the relation between state and market.

4. - normative implications

The debate around regulatory competition seems to have been misdirected. The choice is not between perfect markets and perfect governments but between imperfect combination of both. Regulatory competition has to be seen as a process of social change, relying on both market and non-market mechanisms. To conceptualise regulatory competition as a mere system of efficient allocation of resources means to miss an important part of the picture.

Markets only become truly effective when they are part of a wider social system which collectively agrees to set up market mechanisms. The futurre will probably experience a genuine social and political engagement of markets with networks, associations and communities along with renewed state intervention. It will remain the task of political institutions to determine social priorities. There has been a profound transformation of the post-war or Fordist model of State in favour of a new alternative form of a restructured State. The Fordist model was based of a shared understanding about state intervention in the economy, an elaboration of bureaucratic institutions and a primacy of the public over the invisible hand of the market. Instead, a new restructured state is expanding the role of the individuals and the market (the areas of self-regulation). Restructuring discourse attempts to depoliticize the economy by representing market-driven adjustment as self-regulating and inevitable.

In the same line of argumentation, competition and co-operation are not mutually exclusive elements but all the contrary. Competition lead to regulatory co-operation as demonstrated in the EU banking example. Regulatory competition will force to develop an institutionalized framework for inter-state co-operation. Some elements of this framework are to be found in the Groupe de Contact, the Banking Advisory Committee (BAS) and bilateral agreements (although the latter may rise some critics). There is no

formal hierarchy among the supervisory fora that function within the Community and most of their tasks overlap. Their membership is not exclusive and there is a continuous mutual information which ensures a workable, though informal division of labour.

There are plausible grounds for believing that international groups will develop, and co-operation between national authorities appears to represent a palliative to the allocation of powers to a central authority. However, the allocation of powers to a Community authority will have to conform with the principle of subsidiarity, that is with the double test of comparative efficiency and value superiority. Problems of coordination will provoke the need for centralisation of supervision. There is also a vertical regulatory competition among the new ESCB and Member States' supervisory authorities

Moreover, it has been shown that regulatory competition has a tremendous integrative potential through reverse discrimination. The pursue of a policy of convergence is now in the self-interest of the States which have to avoid placing their industries in a competitive disadvantage. Intergovernmentalism can be transformed into a fruitful rivalry directed to the achievement of a greater level of dynamic integration. Domestic policy can no longer be formulated without taking into account relational elements, or in other words, being anchored in a parochial conception of regulation. States cannot define their policies unilaterally and autonomously. The greater integration will be, the more the importance of international ramification of domestic policies and vice-versa. This can also serve to explain the absence of visible 'race to the bottom' in the studied field.

However, as some critics point out, it remains some tension between democracy and rule of law and the competitive principles. The dimension of this contradiction has also to be lightened. First, the participatory potential of regulatory competition has to be affirmed. In a competitive setting, destinataries of regulation have the opportunity of expressing their dissatisfaction by a double mechanism: voice and exit. The possibility of abandoning jurisdictions reinforces the voice option expressed through the political process and through lobbying. Therefore, competition is, at least, as powerful as democratic channels for participation.

Second, the competitive paradigm places citizens and in general destinataries of regulation in a privileged position since they become the decisive element in judging the properness of regulation. The functioning of the model is based on the constituent's judgement around certain values. It has been demonstrated how reductionist is to believe that those directly

affected by regulation do only care about quantifiable measures. On the contrary, there are strong elements to argue in favour of the maturity of consumer decisions supporting environmental or quality measures and of refraining from adopting paternalistic protection. In other wods, individual states still have the ability of maintaining more restrictive regulatory regimes provided that any such additional regulatory protections are valued by destinataires of regulation. In sum, regulatory competition offers a wide space for democratic expression although on a non-structured basis.

Third, and in any case, the competition among rules paradigm does not imply a surrendering of State capabilities of ordering social life. On the contrary, States are involved in a kind of complex network with participation of market operators and groups. This way, networks represent a *tertium genus* between markets and hierarchies. Networks appear as a qualitatively distinct type of social structure which is characterized by the combination of elements belonging to the two other basic forms of governance: the existence of a plurality of autonomous agents, typical for markets and the ability to pursue chosen goals through coordinated action, typical for hierarchies. Networks are able to intentionally produce collective policy outcomes despite diverging interests of their members through voluntary bargaining between private and public actors. As a corollary, the traditional understanding of law and of its sources has to be reformulated.

Finally, the absence of explicit administrative hierarchy and the open ended character of regulatory competition as a discovery procedure, make predictions highly risky. In any case, we will see a transformation of the model of banking regulation, being more close to the use of market disciplining mechanims and informal international cooperation.

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