THE LIBERALISATION OF BANKING AND INSURANCE IN THE EEC IN THE 1980S

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ABSTRACT

The purpose of this present study is to identify and evaluate obstacles in the way of liberalising banking and insurance services in the EC area. Two countries are used as cases for this purpose: the UK and Greece.

The UK cases represent the barriers to freedom of financial services in the developed EC countries while the Greek cases represent those of the developing EC countries. The distinction between developed and developing countries is considered as necessary since the rationales that exist for erecting barriers to freedom of financial services seem to vary according to the level of development. In the developed countries protectionist measures are imposed to safeguard the interests of the consumers, while in the developing countries the placing of strict barriers to trade in international financial services is used mainly as support for protection of the domestic financial sector and financial protectionism.

In the UK case studies barriers in the way of liberalising banking and insurance services are identified and evaluated in the light of the divergence of supervisory philosophies and practices between the UK and the continental European countries. The UK

authorities have adopted a flexible supervisory system which is considered by the other European countries as one that moves in a direction inconsistent with the objective of preserving the integrity of the financial system. In the Greek case studies the analysis suggests that the unification of the European financial sectors would have detrimental effects not only on the domestic financial sector but also on the whole economy. The authorities would find it very difficult to accept a measure which would bring about complete freedom of competition, particularly within the timescale set by the EC Commission - ie the end of 1992.

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<u>DIAGRAMS</u>

ABBREVIATION

ABI	Association of British Insurers
bop	Balance of Payments
DTI	Department of Trade and Industry
LOA	Life Offices Association
JCMS	Journal of Common Market Studies
ELR	European Law Review
CMLR	Common Market Law Review
OJ	Official Journal

I N T R O D U C T I O N

The present study is concerned with the attempts of the Member States of the EC to achieve their declared aim of a Common Market in financial services by the end of 1992. Its scope is to identify and evaluate protective barriers to intra-EC trade in financial services -banking and insurance - and examine the potential for their elimination in the foreseeable future. The study explores the obstacles to be overcome in the search for financial integration, the conditions necessary to enable progress towards it to be made, and the strengths and weaknesses of different types of strategies intended to hasten its achievement.

The subject of financial services has been given attention from the early years of European integration. Interest in this subject has been renewed recently after the Member States were assigned the task of creating one Common Market for financial services from the current twelve separate national ones. The Commission's White Paper published in 1985 commits the Community to realizing by 1992 a truly single market not only for goods but also for services including services of financial institutions. The financial industry is vast and immensely important in terms of the services it provides, the funds it makes available for investment, the people it employs and the general impact it has on economies. It is one of the largest industries in the world.

The study is divided into two parts. Part 1 refers to banking and Part 2 to insurance; and both follow the same form. The first chapters of both parts give general surveys of the moves towards a Common Market in banking and insurance respectively. The Community is developing a strategy based on the Treaty of Rome and the White Paper for the completion of the internal market. The aim of these chapters is to outline the Commission's strategy for the banking and insurance sectors and highlight their philosophy shaping its actions. Whether this strategy will be successful is discussed with reference to two EC countries: the UK and Greece.

Obviously, the obstacles to freedom of financial services relate to the conditions under which a financial organization can conduct business in a given country or with residents of the country concerned. These conditions are determined by a host of elements such as regulatory provisions and administrative practices relating to the conduct of business. Accordingly, in the first sections of the case studies the analysis focuses on existing restraints arising from government regulations, policies and administrative practices, on assessing the relative importance of such impediments and on providing the rationales for their existence.

The analysis of the rationales that exist for instituting protectionist measures against the entry, establishment and market access of financial institutions, indicates that these vary considerably from country to country. In the developed countries restrictions are imposed in the light of prudential considerations - ie. to protect domestic consumers from the consequences of a "bad buy". In the developing countries the placing of strict limits mainly stems from the desire to protect the domestic capital market, the sophistication and development of which lags behind. The choice of the two countries is therefore not haphazard. The UK case demonstrates the barriers to freedom of financial services in the developed EC countries while the Greek case presents those of the developing EC countries. Each has, however, unique elements.

In the UK case studies special sections are devoted to the impact of financial integration on the British economy in order to anticipate the British attitudes towards the various aspects of the integration process. The discussion is broadened by presenting the difficulties in the way of harmonizing the existing approaches of prudential supervision. Since the completion of the internal market for financial services can take place only through a narrowing of differences in supervisors' policies, barriers to freedom of financial services are identified and evaluated in the light of the divergence of supervisory philosophies and practices between the UK and the continental European countries. Another objective emerged when assessing the large difference in practical and philosophical approaches to prudential supervision, namely the need to identify factors behind its existence. These factors relate to the various political forces and pressure groups policies which would possible affect the integration process.

In the Greek case studies the objective has been to identify the point where a country strikes a balance of costs and benefits of an open-door policy in the financial sector. Indigenous financial organizations may be seen as not being sufficiently equipped to withstand competition from more sophisticated foreign institutions. In a developing country the domestic capital market plays a special role in the attainment of national macroeconomic goals and a foreign presence affects the competitive balance in the national financial system, while changes in the latter may not be considered to be desirable.

The study is an attempt to look into the future and discuss the extent that a Common Market in financial services will be attained in the next few years. However, the study is not only concerned with the barriers to freedom of financial services. It is also seen as an opportunity to examine critically the Commission's strategy in the financial field and make some policy recommendations.

The existing literature reveals areas of considerable uncertainty over a wide range of technical matters which are covered by the present study. However, the author found a number of experts to discuss these matters and in many cases he was allowed access to internal working documents.

My indebtedness to those who have in one way or another helped in producing this study is extensive. It includes my supervisors Dr Paul Taylor and Mr Alan Marin, who went through successive drafts of this work with great patience and who made so many useful suggestions for improvement. To all those unnamed officials actively involved in the European and National policy making in Brussels, London and Athens who were kind enough to respond to my questionnaires and who permitted me to interview them in person, I owe many thanks. I also wish to express my warm gratitude to the numerous individual experts in financial institutions who gave some of their valuable time to discuss with me many aspects of the state controls on the financial systems. My special thanks go to Mr John Young, Economic Adviser of Lloyds Bank; Mrs Fiona Brener, Analyst in Bank of England; Mr Dimitris Agelides, Director of the National Bank of Greece and Mr Kindley Doerr, Economic Adviser to Commercial Union Insurance, for the documentation they provided and for their stimulating comments; of course none of them is responsible for the arguments and opinions expressed in this study.

P A R T 1 : <u>B A N K I N G</u>

UNIFYING THE EUROPEAN BANKING SECTORS : EC PROPOSALS FOR DISMANTLING BARRIERS TO THE LIBERALISATION OF BANKING SERVICES

By January 1, 1993 according to the Commission's programme for the completion of the internal market, the EC will have become a single integrated market through which labour, capital and products will flow freely. The origins of the internal market programme are based on the Treaty of Rome and the White Paper of 1985. The Single European Act of 1986, which followed and which was ratified by all Member States, defined the internal market as one "without internal frontiers in which the free movements of goods, persons, services and capital is ensured" (1). The 1992 concept in essence means the transformation of the EC from a fragmented to a pan-EC domestic market.

The financial services market is one of the most important individual sectors to face Commission attention in the internal market programme. This is not only because it is large (6% of Community (GDP)(2) but also because it plays a substantial role in the development of other sectors. The integration of the financial sectors of each Community country can build a momentum towards the creation of a Central Eurobank and a Eurocurrency. According to the Commission the logical next step if financial markets are unified is the creation of a Central Eurobank and a Eurocurrency.

The liberalization of capital movements is an indispensable part of financial integration since it is closely linked to the freedom of providing financial services. The elimination of all restrictions on capital flows will allow financial intermediaries the freedom to offer services throughout the EC.

As early as the 1960s the Community adopted legislation (3) requiring Member States to allow free movements of capital for direct investment, personal capital movements and granting and repayments of short and medium credits related to commercial transactions. However, a number of Member States made extensive use of the protective clauses provided for in the Treaty to maintain or reintroduce restrictions on capital movements which were in principle liberalized under Community Law.

A major step toward capital movement liberalisation was taken in 1988 when the Council adopted a Directive (4) requiring the Member States to liberalize capital movements before 1992. Already three countries- Britain, Denmark and West Germany - have no exchange controls. The others apart from Greece, Ireland, Portugal and Spain must comply by July 1990 and these four will themselves have to open up by the end of 1992 unless severe problems arise. Obviously, the EC recognises the difficulties faced by these countries on the process of liberalizing capital movements, due to bop considerations. However, the Commission is hoping that the free flow of capital will be completed by 1992.

The creation of a Common Market in banking is a key element of financial integration. This implies the establishment of a unified market in which banks will have the right to establish their branches and no government regulation should obstruct the neutrality between buying financial services from a domestic bank or buying them domestically from a local branch of a foreign bank.

The Commission's proposal for a Second Banking Coordination Directive, published in February 1988, addressed itself precisely to these issues, with a series of proposals including the concept of a "single banking licence"(5). This would imply that any credit institution authorized in a Member State could establish branches and operate in any other Member State without the need of any other authorization. The proposal embodies a shift in the Commission's policy from imposed harmonization to mutual recognition of national rules and standards. The shift in the Commission's policy would have (if adopted) fundamental and far reaching effects on the Member States' regulatory framework.

Before considering the proposal for the Second Banking Directive in detail it is necessary to outline, in chronological order, other relevant EC legislation which affects the regulation of the Community banking sector.

As early as 1973, the Council adopted a Directive (6) on the abolition of restrictions on the freedom of establishment and the freedom to provide services in respect of self-employed activities of banks and other financial institutions. However, the Directive soon became superfluous because the freedoms it envisaged were sanctioned by the Treaty of Rome itself (thereby having direct effect). Nevertheless the Directive is not totally irrelevant since it contains useful provisions concerning the definition of the words "banks", "banker" and other equivalent terms. This proved to be the starting point on the long road towards an integrated European Market in banking.

However, the abolition of restrictions on the freedom of establishment and on the freedom to provide services is a necessary but not adequate precondition for the establishment of a Common Market. Requirements and regulations which are appropriate to the domestic banks may prove particularly onerous when applied in the same form to a foreign bank.For instance, one of the conditions relating to taking up business is a minimum capital. This would mean that a credit institution wishing to set up in all twelve countries would have to multiply its minimum capital by twelve. This would constitute a clear discrimination to such an institution, compared with another institution wishing to operate only in its country of origin by the creation of twelve branches - ie. with similar territorial expansion. Obviously, the mere fact of treating a banking institution from another Member State in the same way as a domestic institution could not ensure the existence of a Common Market.

This is also true for the requirements relating to the pursuit of business. At the present time a credit institution which is established in several Member States of the Community must comply with the different ratios in force in each Member State with some adverse consequences from the point of view of competitiveness when compared to an institution established in only one country (7). The undertaking of banking business worldwide involves considerable "sunk" costs that are not borne by domestic networks. According to an EC official*, the requirements for the regular returns to banking supervisory authorities vary greatly from one Member State to another. This is very inconvenient for branches operating in other Member States since they have to supply often widely diverging

* (Interview, EC Commission, June 1989)

sets of information to the authorities of home and host countries. Through coordination of national regulations the banks would be able to provide output from a single data base which can be used simultaneously for the regular returns to the various national authorities.

Some progress towards coordination has been made with the First Council Directive (8) of 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions. Indeed, the Directive recognizes that in order to make it easier to take up and pursue the business of credit institutions, it is necessary to eliminate the obstructive differences between the laws of the Member States as regards the rules to which these institutions are subject. However, the Directive lays down a series of principles rather than specific rules. Given the extent of the differences between the national laws, the conditions required for a common market could not be created by means of a single Directive.

The Directive laid down the principle that a credit institution should receive prior authorization before commencing its activities. It also set out some requirements which were made compulsory. These are related to the existence of adequate funds, the submission of a programme of operation and the existence of at least two persons (the so-called "four eyes principle") who effectively direct the business. These requirements are not comprehensive and they are rather vague, while individual Member States may impose additional requirements.

Even more important is the fact that some Member States may continue to apply the criterion of the economic need as a condition for the entry into the Market. If the application for authorization is examined in terms of the economic needs of the market, it means that the responsible supervisory authority may refuse an authorization on the grounds that there are already enough banks to service the area where the new institution wishes to establish itself. The operation of a new institution in this area may create excessive competition undermining the viability of some institutions and the security provided to the depositors.

According to the Directive the criterion of economic need shall be applied only on the basis of general predetermined criteria aimed at promoting: a) security of savings, b) higher productivity in the banking system, c) greater uniformity of competition between the various banking networks and d) a broader range of banking services in relation to population and economic activity. However, the assessment of economic need is largely discretionary. And the Commission considered the elimination of the condition by 1989.

The Directive introduces certain elements of flexibility. One element of flexibility is that prior authorization (which is compulsory for the establishment of any new institution) is not necessary in the host country. Another element of flexibility is that a branch can be established in another Member State in the legal form accepted in the home country.

Obviously, the Directive provides for some harmonization of the national laws relating to the entry and establishment of banking institutions. However, this is not the case with respect to national laws relating to the pursuit of business.

The national supervisory authorities set out specific prudential controls in order to ensure the viability of the individual banks and to protect the interest of the depositors. A harmonization of these controls is the only means by which to open the possibility for a true and proper right of establishment and free provision, of services for banks in all the Member States. The Directive does not really provide for the harmonization of these controls. Instead, it sets out a procedure which would progressively lead to a degree of approximation of these controls.

In these respects the Directive provides that the authorities for the purposes of observation shall establish ratios between the various assets and liabilities of credit institutions with a view to monitoring their solvency and liquidity and the other measures which may serve to ensure that savings are protected. The Advisory Committee (set up by the Directive) has been charged with deciding on the content of the various factors of these ratios. However, the various calculations should be made for observation purposes only and the compulsory ratios in force in the various Member States would not be affected. The Advisory Committee may make suggestions to the Commission with a view to coordinate the prudential ratios applied in the different EC countries.

Other provisions of the Directive deal with cooperation between supervisory authorities. The Directive provides that the competent authorities of the Member States concerned shall collaborate closely in order to supervise the activities of credit institutions operating in several Member States in order to facilitate the supervision of the solvency and liquidity.

The main task of the promotion of close cooperation between national authorities is monitoring the activities of foreign banks in their own territories. The Commission has provided a forum over the years in which supervisors can learn of each others techniques and experience and hear of problems which may be emerging in different national systems which could be of wider concern. The Commission believes that it is particularly valuable in establishing close personal contacts between supervisors in different countries - relationships which in a number of cases facilitate rapid and effective cooperation between the authorities concerned when banks operating within their respective jurisdictions experience problems. National systems have grown up with different traditions: some with detailed statutory arrangements, others with more informal and flexible supervisory frameworks; some have comprehensive examination procedures, others do not. In practice, however, Member States have to learn much from each other and this mutual learning process may well over time produce some convergence between national supervisory systems.

The Directive contains provisions with respect to branches of institutions having their head office in a non-Member State. According to these provisions in no circumstances can an institution from a non-Member State receive more favourable treatment than that accorded to branches of credit institutions having their head office in the Community. Furthermore, the EC may conclude agreements with one or more third countries to apply provisions which, on the basis of the principle of reciprocity, accord to branches of a credit institutions having its head office outside the Community identical treatment through the territory of the Community. These provisions are considered as the first step towards a Common Community policy with respect to the setting up of branches by banks from non-Member States.

Other provisions of the Directive deal with the causes of the withdrawal of an authorization. However, given the importance of these regulations within the national banking laws, these provisions can be considered as almost negligible steps towards harmonization.

The Directive can be considered as the first step forward in the coordination of supervisory regulations which is a necessary precondition for the creation of a Common Market in banking. It provided for coordination with respect to the requirements concerning entry into, and establishment in, the market; it set an institutional cooperation among the national supervisory authorities; and it made a move toward a common policy vis-a-vis third countries.

However, it is fair to say that this first step was rather compromising. Branches of credit institutions originally established in other Member States were still subject to local authorization requirements. The national supervisory authorities were granted significant discretionary powers to apply to the entry and establishment of these branches the administrative provisions and regulatory practices governing the entry and establishment of indigenous banks. Furthermore, the Directive did very little to eliminate the significant disparities between national requirements regulating the establishment of crossborder branches of credit institutions authorized in other Member States. The practical effect of the first Directive was therefore to affirm the right of banks originally established in one Member State to open branches in other Member States but always under the same conditions and controls as those applying to the indigenous banks.

Of significant importance in this respect would be the requirement in the case of a branch, to have "own funds", as if it were a bank incorporated locally. In addition, products which are sold by the branch in the domestic market must comply with the requirements in force in the country where this branch operates.

The realization of a Common Market in banking requires the harmonization of banking laws and regulations. Obviously, this objective cannot be implemented in the short-run. It is a long term goal which has to be achieved by stages. The establishment of the principle of supervision on a consolidated basis is one such stage.

The concept means that the supervisors of the country of origin will monitor banks which have their head office in their territory as well as branch operation in other countries. The principle of consolidated supervision has an important advantage for the supervisors since they would be able to supervise the global operation of the banks. If the powers of the supervisory authorities ended at national frontiers they would be unable to fulfil their control function properly in a world where banking is becoming increasingly international (9). Even more important is the fact that the eventual aim of the adoption of this principle is to provide for overall supervision of a credit institution operating in several Member States by the competent authorities in the Member States where its head office is situated, so that distortion of competition between such credit institutions and the domestic banking institutions of their host countries is avoided.

In this respect, the Council adopted a Directive (10) in 1983 on the supervision of credit institutions on a consolidated basis. The Directive can be considered as the next step forward from the first Coordination Directive. It provides that banking institutions that have a majority holding (more than 50%) in other credit or financial institutions, shall be subject to supervision on the basis of the consolidation of their financial holdings with those of the other credit or financial institutions concerned. Where a credit institution has a participation of 50% or less in another credit or financial institution and a situation of effective control exists, it shall be for the relevant Member States or competent authorities to determine the method of consolidation.

Supervision on a consolidated basis is only required where a credit institution is the head of a group or sub-groups. Furthermore, the Directive left a great deal of discretion to the competent authorities to determine the consolidation techniques. Since the harmonization of these techniques would be very difficult to be achieved the Directive is concerned solely with the establishment of the basic principle of supervision on a consolidated basis. In this respect the Directive requires Member States to eliminate any obstacle to the flow of information across national borders which is necessary for consolidation to be effected.

In itself, this Directive is a relatively simple affair, but it illustrates the increasing willingness of the Community to eliminate the technical and philosophical differences of the Member States and take a specific coordinated action in the financial sphere - an area where only modest common progress has been made.

The First Banking Coordination Directive set minimum requirements for the initial authorization of credit institutions; but there were insufficiently precise and left Member States free to impose stricter provisions if they wished. Barriers to entry and establishment of banking institutions to other EC countries continued to remain substantial.

One of the main reasons for the lack of progress was the feeling that freedom of establishment and freedom to supply services across borders could not safely be granted without first carrying out a thorough harmonization of the laws and regulations governing the provision of the service in question (11). According to an EC official some Member States that were reluctant about operating in an open banking market adopted delaying practices. By 1985 it was time to make a fresh start, and it came from Lord Cockfield, the senior British member of the Commission. Lord Cockfield's White Paper, "Completing the internal market", shifted the emphasis away from thorough harmonization of regulatory systems towards the principle of home country control on the basis of the mutual recognition by EC Member States of each others' systems (12). On the other hand, however, a minimum harmonization is considered necessary to make the principle of mutual harmonization acceptable.

One of the great motivating forces behind the completion of the internal market is the widespread belief that freedom of competition within the EC will benefit both the banking industry and its customers. "The consumer is one area", said the White Paper, "will have access to the full range of banking services available in all Member States" (13). He would be able to choose the best deal to meet his specific needs or requirements. According to the Commission,* liberalization of banking services, as in the case of trade, will increase the welfare of EC citizens.

The Commission believes that liberalization of the banking sector will stimulate competition in that sector and will lead to a better allocation of resources. The resulting rationalizations and increased competitiveness at the EC level would provide EC banking institutions with considerable advantage in exporting their services outside the Community to the rest of the world. The move towards a Common Market in banking services implies

* (Interview, EC Commission, June 1989)

unprecedented opportunities for this sector. No European country on its own will be able to compete in the 1990s and beyond with the giant resources of Japan and the US. If the European organizations take advantage of a single European market of 320 million people, they will be able to compete effectively with their rivals in the non-EC countries. The awareness in the Member States that the European companies would have a unique opportunity to expand and increase their potential strength in what will be the world's largest single market was one of the main driving forces behind the Member States' commitment to create a Common Market in financial services.

The basic issues concerning the EC policy towards the banking sector are contained in the proposal for a Second Council Directive (14) on the coordination of laws, regulations and provision relating to the taking-up and pursuit of the business of credit institutions ("the Second Banking Coordination Directive") submitted by the Commission to the Council in February 1988. According to the Commission* this Directive is to constitute an instrument which is essential for achieving the internal market, a course determined by the Single European Act and set out in timetable form in the Commission's White Paper, from the point of view of both the freedom of establishment and the freedom to provide financial services in the field of

* (Interview, Commission, June 1989)

banking institutions.

The principal aims of the Second Directive are as follows:

1) To remove the barriers to entry and establishment of banking organizations to other EC Member States.
2) To harmonize licencing conditions since the central concept of a Common Market is the principle that a credit institution licensed to pursue banking business in one Member State must be free to engage in the same activity in any other Member State.
3) To promote the cooperation between national supervisory authorities.

Each of these objectives are considered in turn.

A. FREEDOM OF ESTABLISHMENT AND FREEDOM TO PROVIDE SERVICES THROUGHOUT THE EC

The Second Banking Coordination Directive provides that any banking organization established in any Member State of the EC will be allowed to open branches in all the others and its operation will be governed by the supervisory authorities of the country where the head office is situated. This is the adoption of the principle of "home country control".

At present the entry and establishment of foreign banking organizations to national markets are subject to authorization by the host supervisory authorities and this is considered as an important barrier to freedom of establishment in the banking sector. In most Member States, branches of foreign banks are required to have "own funds" or "endowment capital" as if they were new banks incorporated in that country. Obviously, this requirement even if it is appropriate to the local banks may prove particularly onerous when applied in the same form to a foreign bank since the latter should comply with solvency requirements in its home country. And such an uneven impact is considered as a form of discrimination.

In addition, the requirement that the operation of foreign banking institutions in the host country is governed by the regulatory authorities of this country imposes limits on the range of activities the branch could pursue. Today various restrictions exist in different Member States with respect to the type and range of services banks are allowed to offer and this is considered to constitute a serious obstacle on freedom to supply services.

The Second (draft) Banking Coordination Directive is precisely designed to eliminate the above restrictions.

According to the Second Banking Coordination Directive any institution seeking to establish a branch in another Member State will be required to give notification to the competent authority of its home Member State of its intention and also provide it with certain prescribed informations such as a programme of operations setting out inter alia the types of business envisaged and the structural organization of the establishment, the amount of own funds and the solvency ratio of the credit institution and the names of those responsible for controlling the activities of the branch. The above information is necessary for the home supervisory authority to exercise effective control.

Unless the home supervisory authorities doubt the adequacy of the organizational structure of the credit institution taking into account the envisaged operations, they should transmit the notification to the host supervisory authorities. If the home authorities refuse to send the notification to the host authorities they must give reasons for their refusal to the respective institution within three months of receipt of the notification. Any such refusal shall be subject to a right of appeal to the courts. This provision indicates that a refusal should not be discretionary. Once a banking organization proved that it had fulfilled the prescribed conditions the responsible authority had then to send the notification.

When notification is given to the host supervisory authority this cannot refuse permission to establish a branch and the respective institution may commence business upon receipt of the appropriate notice from the competent authority of the host Member State, or upon expiry of the three month notice period, whichever occurs first. Obviously, these provisions eliminate the barriers to freedom of establishment.

As far as the freedom to provide banking services is concerned, the Second Banking Coordination Directive will generally permit any banking organization established in one Member State to offer its services in another Member State. The respective bank need not be established in the host country, nor will it need to modify its banking products to comply with host financial regulations. The services in question must be those included in the relevant list of qualifying bank activities which is annexed to the respective Directive and which includes the following: deposit taking and other forms of borrowing; lending including in particular consumer credit, mortgage lending, factoring and invoice discounting and trade finance (including forfeiting);

financial leasing; money transmission services; credit cards, traveller's cheques and banker's drafts; guarantees and commitments; money market instruments; foreign exchange; financial futures and options; exchange and interest rate instruments; securities; participation in share issues; money broking; portfolio management and advice; safekeeping of securities; credit reference services and safe custody services. This implies that a bank operating in another Member State may not be able to conduct the same range of business as home banks in that country because some activities may be allowed by the host country regulator but not by the home country regulator (15).

However, the respective proposal for Directive recognizing the scope for potential conflict between the different national laws and regulations applies certain restrictions to this wide freedom of the provisions of services. These restrictions may be invoked by the host Member State on grounds of public good. Individual countries will reserve the right to place restrictions on banking organization in order to protect the public good. Since the Directive does not spell out the circumstances in which the public good exception may be invoked, the Court of Justice will have to interpret the respective provision.

The Second Banking Coordination Directive also provides that non-banking institutions that are subsidiaries of banks authorised by a Member State and whose obligations are guaranteed by the parent bank could take advantage of the freedoms provided by the respective Directive if they provide one of the activities included in the respective list. In some countries banking institutions cannot exercise directly certain activities (for example, leasing or factoring) but can only do this through a subsidiary. The provision outlined above is designed to deal with this anomaly.

Broadly speaking, the Directive provides that cross-border branches and services of authorised credit institutions would be supervised by the competent authorities of the home Member State and is designed to eliminate the remaining obstacles to freedom of establishment and to provide services. Any bank will be able to establish and/or provide services in any Member State without the need to obtain local authorization and without having to modify its banking products in order to make them comply with the domestic regulations. This is certainly the case where the services in question are those included in the relevant "qualifying list" and the bank seeking to offer services is authorised to provide them in its home country. The "qualifying list" is very wide and provision is made to update it easily from time to time. Furthermore, as a consequence of the adoption of the principle of "home country control" the local branches of foreign banking organizations may no longer be required to keep minimum "own funds" on their books.

B. THE SINGLE BANKING LICENCE

After considering the freedom of establishment and to provide services, the importance of single authorization by the responsible home supervisory authorities becomes readily apparent. At the core of the Directive is the basic principle which establishes the single banking licence (16). The establishment of a single EC banking licence allows a financial institution licensed in one EC country to operate in all countries of the EC, foregoing the need for 11 additional licenses to be received under 11 additional regulatory schemes (17). The single banking licence will enable the banking organizations to carry out a wide range of banking services provided only that the institution is permitted to offer such services in its home country.

According to an EC official the proposal is based on the "universal banking" model. Indeed, the Commission believes that , once adopted, the Directive will establish the "universal bank" as the standard type of banking institution in Europe and finalise the trend away from the separation of banking business to the creation of one-stop shopping in financial services.

The key feature of the proposed Directive is the concept of the single banking licence. According to an EC official* this concept can be achieved only through the widespread acceptance of the principle of the mutual recognition of the national regulatory standards. One of the major goals of the Second Banking Coordination Directive is therefore to complete the essential harmonization of national supervisory systems and in particular the harmonization of licencing conditions which are necessary to secure the mutual recognition of the supervisory systems, paving the way for the single banking licence recognised throughout the Community.

The respective proposal for Directive introduces the provision that in order for banking institutions to obtain authorization they must as a principle have initial capital of at least 5 million ECUs. This provision is designed to ensure that EC banks that could

* (Interview, EC Commission, June 1989)

undertake cross-border business have sufficient capital.

Furthermore, the controls by the responsible authorities over ownership of a credit institution by the important shareholders is a key element of prudential supervision in banking. In this respect, the Second Banking Coordination Directive provides that the responsible authorities shall not grant authorization permitting the taking up of the business of a banking institution before they have been informed of the identity of the shareholders or members, whether direct or indirect, be they physical or legal persons, holding a qualified participation, and of the amount of such participation. The responsible supervisory authority shall appraise the suitability of the abovementioned shareholders or members.

The respective proposal for Directive also provides for the harmonization of the conditions relating to the operation banking institutions. The own funds of credit institutions must not fall below the initial capital required when they were authorized. In appropriate circumstances, the competent authorities may allow an institution a certain limited period in which to restore its own funds to the agreed period.

The responsible supervisory authorities shall require any physical or legal person, who is considered the direct or indirect acquisition of a qualified participation in a credit institution, to first inform the competent authorities, telling them of the size of the intended participation. The abovementioned persons must similarly inform the competent authorities if they propose to increase their qualified participation such that the credit institution would become a subsidiary.

The authorities shall assess the suitability of the abovementioned persons. They shall require that in cases where these persons exercise their influence in a way which is likely to be to the detriment of the prudent and sound management of the banking activities of the institution, the competent authorities
shall take appropriate measures to bring such situation to an end. Such measures may take the form of sanctions against directors and managers, or suspension of voting rights in respects of the shares held by the shareholders or members in question.

Even more important is the fact that the efficient supervision of credit institutions requires control on equity participation of the respective institutions in non-credit and non-financial enterprises. It is considered that equity participation by a banking institution in a subsidiary may undermine the financial stability of the former if the latter runs into difficulties. This is the so-called contagion risk. Furthermore, equity participation constitute a long-term freezing of the assets of a banking institution something which might affect its ability to fulfil its commitments to the public.

In this respect the Second Banking Coordination Directive sets specific limits as to the amount of participation. A banking institution shall not hold a qualified participation of an amount greater than 10% of its own funds in an undertaking which is neither a credit institutions nor a financial institution. The total amount of specified participation in undertakings other than banking institutions or financial institutions shall not exceed 50% of the own funds of the credit institution. These limits may be exceeded in exceptional circumstances. However, in such cases the responsible authorities shall require the credit institution either to increase the volume of own funds or take other remedial measures.

C COOPERATION BETWEEN THE SUPERVISORY AUTHORITIES OF THE MEMBER STATES

The view is generally held that the establishment and operation of a Common Market in banking require close cooperation between the national supervisory authorities. The First Banking Coordination Directive provided a mechanism for cooperation between the banking supervisory authorities by requiring those authorities to collaborate closely in order to supervise the activities of credit institutions involved in cross-border banking business. The Second Banking Coordination Directive tries to reinforce the cooperation between supervisory authorities by providing clear ground rules which identify the supervisory responsibilities of those authorities.

The respective Directive reaffirms the principle of home country control. A bank authorised in an Member State will no longer be required to seek authorization from the host supervisory authorities. Instead, the latter must allow anyone licenced in another Member State to perform any of a set of designated financial services. The home authorities shall ensure the existence within each institution of sound administrative and accounting procedures and adequate internal control mechanisms. These authorities shall also ensure that such procedures and mechanisms exist in banking institutions concerned in the scope of consolidated supervision.

The reciprocity provisions contained in the Second (draft) Banking Coordination Directive are expected to have important implications for non-EC banking institutions. The present position appears to be that the reciprocity provisions will not be retro-active. Thus all banks incorporated in a Member State by the date of implementation of the Directive should be able to take full advantage of the benefits of a single licence (18). The reciprocity provision applies only to subsidiaries. Branches of foreign banks would not be subject to any additional control but would not be capable of possessing a single licence which will be effective throughout the Community. Non-EC institutions which seek to establish an EC subsidiary or which propose to acquire a "qualified participation" (which effectively means a holding, direct or indirect in an undertaking which represents 10% or more in the capital voting rights or which enables the exercise of a significant influence in an undertaking) in a banking institution after the date on which the respective proposal for Directive comes into force will be subject to authorization by the relevant host supervisory authority. These authorities would be required to notify the Commission.

According to the original proposal the Commission shall within three months of receiving the information examine whether all the EC credit institutions enjoy reciprocal treatment in the non-EC country concerned. If the reciprocity is absent the Commission may suspend the decision of the respective Member State. The reciprocity provision raised substantial criticism from some Member States as being very rigid. In the meantime, the Parliament proposed that the reciprocity provisions should cover branches of non-EC banks as well as subsidiaries.

In April 1989, the Commission produced a revised proposal designed to make the respective provision more flexible and less bureaucratic. According to the revised proposal where EC banks do not enjoy "national treatment" (right comparable to local banks) the EC will take retaliatory measures (19). The Commission does no longer propose that an application should be automatically suspended on a case by case basis. Instead the reciprocity provision is used as a means of safeguarding EC access to third country markets. This will be done in two ways. Firstly, Member States shall inform the Commission whether any credit institutions face difficulties in establishing or undertaking banking activities in any third country. And secondly, the Commission should prepare reports concerning the treatment of EC banks in the non-EC countries. If the banks of a Member State are subject to discriminatory treatment, action may be taken by the Commission. This action may take the form of negotiations with the third country concerned. However, the practicalities of the reciprocity provisions still remain far from clear.

The Commission believes that the Community is one of the most open banking markets in the world and that in a highly financially interdependent world, EC banks should enjoy a national treatment in other world markets. Thus, the Commission not only focuses on the liberalization of financial services within the context of the Internal Market, it also makes a significant attempt to liberalize financial services worldwide as in the case in the negotiations in GATT for trade in services. Obviously, there is a strong link between the creation of a Common Market ln banking and international negotiations for trade in services. A Common Market implies a common policy with respect to the establishment of third country banks. The granting of a single licence which provides the banks with the right to operate freely throughout the EC will possibly have an important effect, not only on the country of the first establishment but also for all the EC countries. In this respect the Second Banking Coordination Directive has adopted the reciprocity provision outlined above to be used as a means of opening up foreign financial markets to EC banks.

The Second Banking Coordination Directive clearly indicates that the EC strategy for the banking sector consists of three fundamental features: the home country control principle, the harmonization of the essential aspects of banking regulation and the mutual recognition of financial standards.

The principle of home country control meaning that all the activities of banking institutions throughout the Community's territory carried out through branching or on a cross-frontier provision of services, in principle, will be supervised mainly by the competent authorities of the Member State head office. The principle of home country control introduces the concept of the single banking licence and associated with it, an agreed list of banking activities.

The licence to operate will be issued by the home country and it will be the home country authorities who are responsible for ensuring that basic prudential standards are maintained. However, at the same time, the host supervisory authorities can enforce its own operating rules. Indeed, while responsibility for the financial soundness of a banking institution, and in particular for its solvency, will rest with the competent authorities of its home Member State, the host country authorities will retain responsibility for the latter relating to liquidity.

Indeed, the Directive provides that host Member

States shall retain primary responsibility for the supervision of the liquidity of credit institutions until further coordination. Liquidity controls are an important instrument of prudential supervision designed to ensure that individual banks are always in a position to fulfil their commitments to the public. The Commission initially believed that coordination would be achieved before the end of 1992 so that responsibility for liquidity supervision could be transferred to the home supervisory authority.

The Directive also provides that supervision of risk exposure should be subject of close cooperation between the competent authorities of the home and host countries. Together with liquidity and capital adequacy, control on risk exposure has traditionally been one of the most important elements of prudential supervision. Risk exposures refer mainly to concentration of credit to any one customer or a group of affiliated customers. Heavy exposures to individual large borrowers involve significant risks to the respective banks. If these borrowers run into financial difficulties the stability of the banks and the protection of the depositors will be undermined.

Controls over exchange risk exposure is another instrument of prudential supervision. Currency or foreign exchange risk relates to the vulnerability of a bank to losses resulting from an imperfect matching of claims and liabilities denominated in foreign currencies in the event of unanticipated changes in exchange rates. According to an EC official*, until further coordination the host country will retain primary responsibility for supervision in the field of risk exposure. The Commission believes that the line between the responsibilities of the home supervisory authorities and those of the host authorities is clearly defined.

The harmonization of the essential aspects of prudential regulations is another key element of the EC strategy towards the banking sector. The harmonization of prudential regulations includes all the aspects regarding the soundness and stability of banking institutions.

Indeed, the role of the EC Commission can be divided into two parts. First is the harmonization of the prudential regulation which ensures the protection of the depositors as well as the stability of the financial system as a whole. The second is to remove the remaining barriers to freedom of establishment in the banking sector and to provide for full freedom of services. And there is a great interconnection between these two tasks. Greater freedom of establishment and to provide services clearly depends on mutual trust between national supervisory authorities that one Member State regulatory regime is broadly equivalent to another.

*(Interview, EC Commission, June 1988)

The mutual recognition of financial standards is one of the fundamental features of the Community's policy in the banking field. Its adoption has shifted the emphasis away from the detailed harmonization of the national regulatory systems which have proven to be impractical in many respects. However, the concept of mutual recognition should not be regarded as the straight opposite of the harmonization procedure (20). The mutual recognition of national regulatory systems can only be justified if the rules and standards of prudential supervision are equivalent. Obviously, equivalent supervisory standards can be achieved only through some harmonization on the Community level.

The Second Banking Coordination Directive constitutes an essential instrument towards removing the barriers to both freedom of establishment and to provide services- ie. achieving a Common Market in the banking field. The approach towards removing these barriers which has been adopted by the Community is to achieve only the essential harmonization necessary and sufficient to secure mutual recognition of authorization and of supervisory systems, thus enabling the principle of home country control and the granting of a single licence recognized throughout the Community.

In this context, the Directive can be implemented only simultaneously with specific Community legislation dealing with the harmonization of national rules and practices referring to the prudent conduct of business. Indeed, as it has been pointed out elsewhere the responsibility for the financial soundness of a credit institution, and in particular for its solvency, will rest with the competent authorities of its home Member State.

The EC strategy designed to integrate the twelve banking sectors by 1992 contains further harmonization measures which are considered below. These measures which will come into force simultaneously (according to the Commission) with the Second Banking Coordination Directive constitute the necessary and essential prerequisites for the unified banking market by 1992.

The proposal for a Directive concerning the own funds represents the first concrete attempt towards harmonization of prudential standards.

The First Banking Coordination Directive contains a definition of own funds. According to an EC official * even if the definition of own funds proved to be sufficient at the initial stage, later it became evident that the definition was inadequate in the light of the

*(Interview, Commission, June 1989)

further moves towards harmonization coupled with the rapid development of the banking industry since 1977.

A precise description, containing all the items that may be considered as the capital of a banking institution is becoming increasingly necessary, especially since the implementation of the Directive on the supervision of credit institutions on a consolidated basis.

Capital adequacy is a cornerstone of banking supervision and a clear definition of own funds is an essential requirement for an effective banking coordination. Community provisions in the area of banking coordination will refer to such definition for a wide range of purposes, and will also improve the comparability between credit institutions which in a common banking market are in direct competition with each other. For competitive reasons the definitions and standards pertaining to their own funds must be equivalent in the Community.

Funds in a credit institution serve a number of purposes. Usually, they finance a credit institution's business, especially when the institution starts its operations. The own funds of a credit institution can serve to absorb losses and therefore to guarantee the stability and the continuity of the respective institution: their role in this respect is essential in maintaining the confidence of depositors. They are also a yardstick reassuring the solvency of the institution and other factors that play a vital role in banking supervision.

Knowledge that adequate capital exists to protect the depositors from losses is reassuring and thus increases the confidence in the bank and the financial system. A bank with a strong capital position will enjoy the confidence of other banks and that is also true for the banking system as a whole. The capital resources of the banks comprising the system must be considered as adequate in order to ensure that depositors continue to remain confident about the stability of the system. The need for a strong capital position does not arise only due to micro-level concern for the interests of individual depositors. There is also a macro-economic dimension which needs to be constantly in the supervisor's view. Banks have a central intermediary role in sustaining economic activity, and the maintenance of a sound banking system is essential for the fruitful development of both the national and international economy.

Own funds therefore occupy a central position in the business of a credit institution; adequate capital is necessary to safeguard not only the solvency of the bank but also its liquidity. Since Member States use a variety of methods to calculate a credit institution's capital resources, the Commission is seeking to move towards establishing a common basis of measurement of own funds. Through the adoption of common criteria, the competent authorities in charge of banking supervision will be placed in the position whereby they can be sure of the basic equivalence of standards of supervision in all Member States. This is very important particularly with a view to completion of the internal market by the end of 1992.

In this context, towards the end of 1986 the Commission proposed a Directive (21) concerning the harmonization of the definition of "own funds" of credit institutions. The main aim of the Commission's efforts is to define the elements of own funds , to apply that definition more uniformly, and to improve the comparability amongst banking institutions competing in the same markets.

However, the Commission believes that the respective proposal for the Directive represents only a preliminary stage in a process to strengthen the capital adequacy of EC credit institutions and to define more strictly the criteria for elements to qualify as own funds.

Certain provisions of the respective proposal for the Directive make a distinction between the "internal" and "external" elements of own funds.

The internal elements can be divided into four sub-groups:

1. Paid-up capital including the benefit of any share premium account but excluding banks' holding of their own shares.
2. Reserves in an legal sense and accumulated retained profits (excluding the amounts allocated to cover general risks)
3. Re-evaluation reserves (formally recognized as part of shareholders funds)
4. Other internal elements.

Internal elements are defined as funds that are at the free disposal of a credit institution in order to cover normal business risks which have not actually been identified; there must be evidence of their existence in the internal accounts of the institution concerned and their amount must be determined by the management of the institution, verified by independent auditors and made known to the competent supervisory authorities.

The second layer of the own funds definition consists of "external elements" which are funds placed at the disposal of a credit institution but not fully owned or controlled by it, or put at the disposal of a credit institution for a limited period only. The external elements can be included in the own funds up to not more than 50% of the total of internal elements. Member States are asked to ensure that credit institutions presently operating above this level will move to this limit in a gradual process.

The respective proposal for a Directive deliberately does not contain an exhaustive list of forms qualifying as "external elements" of own funds and, thus, leaving scope for innovations in this area. However, it provides for certain criteria to be met.

External elements comprise the following:

1. Subordinated liabilities.
2. Capital not paid up in the form of liabilities of members of cooperative credit institutions.
3. Liabilities of members of cooperative credit institutions which are not paid up.
4. Elements other than liabilities of cooperatives but only if they meet certain criteria.

It is considered that the proposal for Directive concerning the harmonization of the definition of own funds of credit institutions is a flexible procedure and provides a maximum of elements and amounts in order to encompass the variety elements comprising own funds presently available in the different Member States, leaving to the discretion of the Member State the possibility to exclude certain elements or to provide lower ceilings for the amounts in question. The proposal gives a neutral enumeration of the components which the Member States may account as own funds.

According to an EC official* appropriate solvency ratios play a central role in the prudential supervision of credit institutions. The Commission believes that ratios which weight assets and off-balance sheet transactions according to the degree of credit risk are particularly useful measures of solvency. It also believes that the development of common standards of capital adequacy in relation to assets and off-balance sheet items at risk is accordingly, one of the essential areas of harmonization necessary for the achievement of mutual recognition and thus completion of the internal market in banking services.

In this context, a proposal for Directive (22) on solvency ratios was submitted in May 1988. It aims to harmonize prudential supervisory rules and to protect

*(Interview, EC Commission, June 1989)

investors. The respective proposal for Directive relates the own funds of a credit institution (the numerator of the ratio) to its total assets and off-balance sheet liabilities, adjusted to reflect degree of risks (the denominator of the ratio). It establishes a uniform method of assessing the ability of banking institutions to meet credit losses arising from the default of their customers.

More particularly, the new proposal for Directive contains common definitions and risk weights for the components of the denominator. It provides that the numerator must be own funds as defined in the own funds proposal and lays down rules for the calculation of the ratio. Besides laying down common definitions and methods of calculation, the proposal provisionally fixes the minimum uniform solvency threshold at 8%. The proposal also specifies the responsibilities of the home supervisory authorities in controlling the ratios and in initiating appropriate action to raise these should the need arise.

The major shortcoming of the proposal for Directive on solvency is that it covers only credit risk, ie. the risk arising in the event of default by counter parties to loan agreements, off-balance sheet engagements etc, without capturing general risks presented by movements in interest rates or foreign exchange rates. However, the Commission is at present working on proposals for the further harmonization of prudential rules relating to these risks and to other forms of market risks.

The Commission believes that this proposal if adopted would achieve a considerable degree of harmonization of prudential standards which are necessary for the internal market. It would also raise supervisory standards in the field of bank's solvency especially in relation to risks arising from off-balance sheet transactions (for instance, guarantees extended by a bank against third parties' obligations) which are an increasingly important banking business.

The Commission made also other important attempts towards harmonization and raising the prudential supervisory standards of the Member States. In 1986 it issued a Recommendation on monitoring and controlling the large exposures of credit institutions. Monitoring and controlling the exposures are an integral part of any supervisory system. Excessive concentration of leading and other exposures on a single customer or a group of connected customers results obviously in a considerable degree of risk concentration undermining the financial stability of the respective banks and the protection of the depositors. According to this Recommendation an exposure of a credit institution is considered to be large exposure when its value has exceeded 15% of own funds. Credit institutions may not incur large exposures which in the aggregate exceed 800% of own funds. Furthermore, credit institutions may not incur an exposure to a Client when its percentage value exceeds 40% of own funds.

Another Recommendation encouraged Member States not yet operating deposit guarantee systems to introduce them by 1990. The introduction of such a system is considered as one of the measures dealing with the management crisis of banking organizations.

Indeed, in December 1985 the Commission adopted a proposal for a Directive (23) on the reorganization and the winding-up of credit which was amended later to include deposit-guarantee schemes. Reorganization measures means measures which are intended to safeguard or restore the financial situation of a banking institution; while "deposit-guarantee schemes" means all provisions designed to guarantee appropriate compensation for depositors or to protect them against any loss.

This proposal for Directive recognizes that consideration should be given to the situation which might arise if a credit institution runs into difficulties, particularly where that institution has branches in other Member States. There is a tendency in the laws and practices in force in the Member States to institute reorganization procedures, aimed at preventing banks from becoming insolvent as soon as financial difficulties become apparent, so as to maintain savers' confidence in the banking system.

However, since it is difficult to harmonize these laws and practices the respective proposal for Directive tries to secure mutual recognition by the Member States of the achievements of each in resolving the financial difficulties of its own banking institutions. It therefore provides that the implementation of reorganization measures in respect of a bank operating in several Member States should be entrusted to the competent authorities of the home country and these authorities must be empowered to enforce their own laws outside their national territory in consultation with the authorities of the other Member States concerned.

The same considerations also apply with respect to winding up. As far as the deposit-guarantee scheme is concerned, the respective proposal provides that these schemes shall cover deposits of foreign branches and shall extend cover to deposits received by branches set up in host countries which have no deposit-guarantee scheme.

The principle of home country control is the central element of the EC policy in the banking field and seems to be the only means of attaining a Common Market particularly within the timescale. Indeed, there are two other alternative approaches to integration in this field: the host country control and the joint control. These two alternatives are considered below.

The principle of host country control implies that branches of foreign banks will be supervised by the host supervisory authorities. This means that the Community should introduce fully harmonised EC-wide regulations to replace the national rules and practices so that to ensure that branches of banks operating in different Member States are subject to equal treatment. However, as it is pointed out elsewhere, the harmonization undertaken by the Commission, until the adoption of the new methods of the Single European Act, judged by the results, have proven to be impractical in many respects.

In fact, it was that experience and the need to complete the Common Market in banking within the timescale that forced the Commission to shift its policy emphasis and adopt as the main tool for integration the home country control. This principle is associated with only a minimum harmonization of prudential regulation necessary to ensure the mutual recognition of financial standards.

Furthermore, there is a justified expectation that the new Community strategy will lead to a major harmonization process at a later stage. Every country in the EC would have to accept other Member State's banking regulations thus exposing local banks to competition with foreign banks which possibly enjoy more liberal rules at home (24). The home country control initially would lead to distortion of competition, putting domestic banks at a disadvantage against foreign competitors which are subject to less stringent controls. As a result, the strictly regulated Member States will be forced to remove the strict regulatory provisions in order not to jeopardise the competitive performance of the indigenous banks. The Commission's efforts in respect of banking have been to identify the areas where it is thought essential that banking law is harmonised, leaving the rest to gradual approximation to achieve common standards (25).

The home country control principle obviously incorporates a mechanism which strongly presses towards harmonization of domestic banking laws and regulations. There is not such a mechanism within the host country control principle. In addition, the host country control principle could be discriminatory against foreign banks. Discrimination can arise due to stringent enforcement of apparently non-discriminatory regulations. And this is clearly demonstrated in the Greek case study. Thus, only by adopting the principle of home country control can a truly common banking market come into existence, which would have the same characteristics as a present-day national market.

Another alternative approach to integration in the banking field would have been joint supervision by both home and host country authorities.

However this form of supervision requires fully and clearly allocated responsibilities between the national authorities. The first major problem then, which arises for the supervisory authorities whose banks are involved in international banking business, is the allocation of supervisory responsibilities. The task of the Commission would have therefore been to address itself to the division of supervisory responsibilities among the national authorities. However, this task would involve lengthy discussions so that they would hopefully lead to a clear understanding between the different authorities parent and host - about the nature of the supervisory responsibilities borne by each in respect of international banking activities undertaken in their territories. Obviously, the clear allocation of responsibilities between parent and host authorities, with both having a duty to ensure that surveillance of banks' foreign establishments was adequate, would involve considerable time delays.

The joint supervision would also require a considerable harmonization effort which as we said above has proven to be impractical in many respects. Indeed, this explains why the EC Commission has shifted its policy emphasis and adopted as its main tool for integration in the financial field the mutual recognition of supervisory standards and the principle of home country control.

It is widely believed that the new Community Strategy and in particular the adoption of the Second Banking Co-ordination Directive will have an important deregulatory impact on the most strict systems. The practical effect of the switch to have home country control will be the gradual deregulation of the banking sector as it would be untenable for the individual Member States to continue to enforce excessively restrictive national regulations against their own banks (26).

The range of activities included in the list is also a subject of concern. Institutions from other Member

States will be allowed to provide the full list of their activities on their host country if they have been authorised in this respect by the home supervisory authorities. On the other hand, the provisions of the proposal for a Second Banking Coordination Directive do not impose upon Member States the obligation to let their domestic banking institutions undertake all these activities. The Member States can therefore continue to impose prudential restrictions on indigenous banks with respect to the scope of banking business. However, this will result in a discriminatory treatment against indigenous banks.

In this respect, the Commission believes that the local banking communities will press the national authorities to adopt a less restrictive stance. It is a justified expectation that the forces of competition will gradually erode the strict prudential controls.

It, therefore, seems that the Commissions programme's overriding emphasis is placed on deregulation. According to the Commission* deregulation has a positive effect on economies: since markets are becoming more efficient, intermediation costs are reduced and the intensification of competition produces a greater range of choice for citizens and businesses and allow them to choose financial products better suited to their requirements

*(Interview, EC Commission, June 1989)

and needs.

In its 1985 White Paper the Commission recognized that the financial services play a central role for the development of the Community's economy. It is considered that the ability of the European manufacturing industry to compete at the international level depends crucially upon cheap financing. The inefficiency of the banking sector imposes an additional cost to the rest of the economy. The EC strategy for the banking field (if implemented) would promote rationalization and have important and far reaching effects on the national economies. But, will that strategy succeed?

BARRIERS TO THE PROCESS OF LIBERALISING BANKING SERVICES IN THE DEVELOPED EC COUNTRIES:

THE U.K. CASE

ESTABLISHMENT, OPERATION AND MARKET ACCESS OF BANKING INSTITUTIONS IN THE UK : CONDITIONS AND CONTROLS IN 1989

1. Regulatory provisions and administrative practices governing the entry and establishment of indigenous banking institutions

According to the Banking Act 1987 credit institutions are defined as institutions that carry on deposit taking business. For the purpose of this Act a business is a deposit taking business if in the course of the business money received by way of deposit is lent to others or any other activity of the business is financed wholly or to any material extent out of the capital of or the interest on money received by way of deposit. The definition of a credit institution is characterized by the idea that the receipt of funds from the public and the granting of credit must be carried out by the same institution.

Any credit institution is required to have an authorization from the Bank of England before gaining access to the U.K. financial market. The minimum statutory criteria which the Bank of England must be satisfied that an institution fulfills before granting it recognition are set out in Schedule 3 of the Banking Act 1987. If following authorization it appears to the Bank of England that any of the criteria applicable to the institution is not being or has not been fulfilled with respect to it, then the Bank of England's powers to revoke the authorization may be exercised. It follows therefore, that the criteria set out in Schedule 3 should be continuously fulfilled by authorized institutions and the Bank of England monitors their fulfillment as part of its regular supervision.

According to this Schedule an institution in order to qualify for authorization should have net assets amounting to not less than £1 million. Net assets are defined as paid up capital and reserves. The above amount of net assets can be varied following a decision of the Treasury after consultation with the Bank of England.

The Schedule provides also broad minimum criteria covering the suitability of management. Everyone actively involved in the management should be a fit and proper person to hold the particular position which he holds, or is to hold. In considering whether a person fulfills this criterion the Bank of England regards a number of general considerations, whilst always taking account of the particular circumstances of the position and of the institution concerned. The Bank of England includes amongst the relevant considerations whether the person concerned has sufficient skills, knowledge, and experience to undertake and fulfil his particular duties and responsibilities. It is also essential that a person actively involved in the management of a bank is of the highest integrity.

Authorization cannot be granted to an institution if the business is directed by a single individual. The Bank of England expects that the individuals concerned would be executive directors or generally persons granted executive powers and responsible immediately to the board. This provision is designed to ensure that at least two minds are applied to the implementation of the policy of the institution. Both persons judgments should be involved in order that major errors resulting in serious difficulties for the institution concerned should be avoided. Both persons must have sufficient authority and responsibility to resist any imprudent and dishonest action taken by the other person.

The Banking Act also requires that an institution conducts, or in the case of an institution which is not yet carrying on a deposit taking business, will conduct its business in a prudent manner. The "prudent manner" criterion is considered essential for granting an authorization. An institution is regarded as conducting its business in a prudent manner if it maintains adequate capital resources, adequate liquidity, adequate accounting and other records of its business and adequate systems of control of its business as a whole. The adequacy of the above elements is judged in relation to the nature and extent of the respective institutions business.

Lastly, the Banking Act 1987 requires that the business of an institution is or, in the case of an institution which is not yet carrying on a deposit taking business, will be carried on with integrity and the professional skills appropriate to the nature and scale of its activities. This criterion goes beyond questions of the suitability of everyone actively involved in the management; it is concerned with the business standards, the status and position of the respective institution in the financial community. In forming its judgment about the above considerations the Bank of England has regard not only to profitable business but also to the existence of management information and control systems designed to monitor and limit the institution's risk exposure. In these respects an institution applying for authorization is required to submit a programme of operations including the types of business envisaged, and the structural organization of the institution. The Bank of England pays particular attention to this programme and it considers it in relation to the quality, experience and skills of the management of the institution concerned.

The Bank of England's experience has been that a newly formed institution which is not directly associated with an established and proven deposit-taking institution can run into early difficulties. These difficulties have usually arisen from lack of relevant expertise and judgment particularly in lending, or from insufficiently tested business strategies. The U.K. supervisory authorities are not easily satisfied that a newly formed institution (which is not directly associated with an established and proven deposit taking institution) will carry on deposit taking business with integrity and professional skill, unless the respective institution has already for some time been carrying on business similar to the planned ones, even if on a lesser scale but financed by bank borrowing or alternative sources other than the receipt of funds from the public.

The U.K. authorities also exert some control on the expansion of branch networks by indigenous institutions. The opening of new domestic branches does not require authorization and is not subject to statutory requirements, but requires notification. The notification requirement does not provide the U.K. supervisory authorities with discretionary powers with regards to branch expansion. However, the Bank of England generally expects the authorized institutions to consult and discuss with the supervisory authorities well in advance any plan for branch expansion. The Bank of England exert control on domestic branching in the context of its overall prudential supervision and considers plans for branch expansion in relation to the financial soundness of the bank.

The analysis of the conditions and controls governing the entry of indigenous banking institutions indicates that the Banking Act provides a statutory framework with respect to granting or refusing an authorization and this framework contains the discretionary powers of the Bank of England. According to the Bank of England* the authorization is not discretionary. The responsible supervisory authority considers whether the prescribed conditions have been fulfilled, in which case the authorization must be issued. However, judgement of fulfillment relies on discretion in absence of quantitative criteria.

The analysis also indicates that the U.K. authorities adopted the provisions of the First Banking Coordination Directive with respect to authorization requirements and set out additional requirements such as the "prudent manner" criterion and the criterion referring to integrity and skill. Furthermore, the entry requirements are perfectly in line with the relevant provisions of the

*(Interview, Bank of England, January 1989)

proposal for the Second Banking Coordination Directive and these provisions could therefore be easily adopted by the U.K. authorities.

2. <u>Regulatory provisions and administrative practices governing the entry and establishment of branches by foreign banking organizations</u>

UK branches of overseas credit institutions are required to have an authorization, if they wish to take deposits in the UK. Deposit-taking authority enabling an overseas institution to operate through a branch in the UK is granted to the respective institution as a whole; and thus a separate deposit-taking authority is not required for each branch office if that institution wishes to operate in the UK with more than one branch. The entry and establishment by foreign banking organisations of branches in the UK is, in principle, subject to the same regulatory and administrative provisions applied to domestic credit institutions.

However, the Banking Act provides that the Bank of England, in assessing applications from institutions whose principal place of business is outside the UK and which have been established or wish to establish branches in the UK, will take into account the supervisory controls imposed by the relevant parent authorities. The Bank of England may regard itself as satisfied that certain of the criteria set out in Schedule 3 are fulfilled if the parent authorities report to the Bank of England that they are satisfied with respect to the management of the respective institution and its overall financial soundness. In these respects the credit institution concerned may be required to supply references from the parent supervisory authorities. The Bank of England expects that any move of the respective institution to establish a branch in the UK has been undertaken with the knowledge of the parent supervisory authorities.

The UK supervisory authorities believe that the primarily responsibility for monitoring the overall financial soundness of the institution concerned rests with the parent authority since the financial soundness of branches is indistinguishable from that of the parent bank as a whole. Accordingly the Bank of England tries to ensure that the financial soundness is adequately monitored by the authorities of the country in which the head office of that institution is based. If these authorities do not impose prudential requirements of equal rigour to those set out in Schedule 3 of the Banking Act with respect to the management and overall financial soundness of the applicant institution, the grant of the authorization would be very difficult to achieve.

UK branches of overseas institutions are not required to have their own endowment capital as is the case in many other countries. The branches of overseas institutions are not considered as separate entities but as integral parts of the international operations of these institutions. However, the Bank of England expects the overseas institutions to maintain an adequate amount of capital resources in relation to their operations worldwide. The UK supervisory authorities may regard the above criterion as fulfilled if it is satisfied as to the supervision exercised by the relevant overseas authorities and these authorities inform the Bank of England that they are satisfied about these aspects of the applicant institution. Indeed, the Bank of England requires from the relevant supervisory authorities an assurance ("letter of comfort") that they supervise the overall activities of the applicant institution. The assurance should confirm that the institution concerned is prudently run and its solvency and liquidity are appropriate having regard to the nature and scale of operations.

In order to qualify for authorization foreign institutions must also satisfy the requirements which the UK authorities impose with regard to competence of management. According to these requirements every director, controller and manager of the overseas branches should be a fit and proper person to hold that position. The Bank of England must also be satisfied that the business will be conducted with prudence and integrity and with appropriate professional skills. In addition the Bank of England expects some of those involved in the management to have appropriate experience, knowledge of the UK financial markets and adequate knowledge of English.

According to an official* of the Bank of England, where the Bank could not be satisfied regarding the adequacy of supervision conducted in the home country, it would be obliged to reach its own judgement on all of the Schedule 3 criteria in order to authorise an applicant from such a jurisdiction. As one might appreciate, it is likely to prove extremely difficult in practice for the Bank of England to satisfy itself directly in this way, bearing in mind that the criteria relate to the foreign institution as a whole not simply to the proposed UK branch. It is the case that a number of applications and proposed applications have not been proceeded with when the Bank of England made it clear that there would be problems in this regard. The UK authorities may prevent the establishment of foreign banking organizations with inadequate supervision by the respective parent

*(Interview, Bank of England, January 1989)

authorities.

The Banking Act sets out specific requirements on the entry and establishment of representative offices of overseas institutions in the UK. According to section 75 an overseas institution may establish a representative office in the UK if it notifies the Bank of England well in advance of its intentions.

In addition to this legal requirement the Bank of England expects to be consulted by overseas institutions in advance of a representative office being set up in the UK and to be assured that this move has been undertaken with the knowledge of the parent supervisory authorities.

There are no restrictions in the Act on the operation of such offices except that they are not authorized to conduct deposit taking business, but the Bank or England expects them to restrict themselves to representative activities in the narrow sense. The offices can represent the interests and promote the banking services of the overseas institutions and report to them on business trends and opportunities, but should not directly engage in deposit-taking, lending or other financial or banking activities.

In these respects the overseas institutions are required to deliver information of documents to the Bank of England in relation to their activities or proposed activities in the UK. The Bank of England seems particularly interested in their backgrounds and intentions.

According to the Bank of England, the controls over the entry of foreign banking organizations to the UK market are governed solely by prudential considerations and the authorization is not discretionary, since authorisation procedures are based on the fulfillment of specific requirements. However, the Bank of England enjoys a considerable degree of administrative discretion in interpreting the above criteria and deciding whether the applicants meet them. The Act itself gives, indeed, very little guidance as to how the authorisation criteria are to be interpreted and applied and, as a Bank of England official* pointed out, the Bank does not hesitate to use its discretion, common sense and experience in judging when the respective institutions are outside the bounds of acceptability. However, the intention of the Bank of England is to remove from entry only those institutions which have a great possibility of failure in order to protect the interests of the depositors. As a result, the controls over entry of foreign branches do not exert an influence on the size and structure of the banking sector, if the Bank of England's judgement is right.

*(Interview, Bank of England, January 1989)

Furthermore, the UK authorities consider branches of foreign banking organizations as a consequence of the operation of these banking organizations worldwide. Obviously, these considerations are in accordance with the principle of "home country control" as it is adopted by the EC strategy designed to integrate the financial markets by the end of 1992. The UK authorities could accept the provisions of the Second (draft) Coordination Directive that refer to the entry and establishment of branches of foreign banking institutions especially since other provisions of the respective Directive ensure the adequate supervision of the entry and establishment of EC banks by the home authorities.

3. Regulatory provisions and administrative practices governing the entry and establishment of majority and minority owned subsidiaries by foreign banking organizations.

Foreign access to the UK banking system through equity participation in indigenous banks is subject to exactly the same restrictions as participation of domestic interests in these banks.

In principle there is no limit to the acquisition by overseas banking organizations of participation in indigenous banks and no local participation is required. As a matter of general policy, however, the Bank of England expects to be consulted in good time before any significant change of ownership and control of a UK bank takes place. Through the requirement of prior notification the Bank of England wishes to discuss with the proposed new management matters relating to the financial soundness of the institution concerned and the management's intention for the future development of business.

Moreover, banking mergers, in common with mergers between other companies, are subject to the provisions of the Fair Trading Act of 1973 according to which when the property of a company which intends to merge is above £5,000,000 the Secretary of State is empowered to submit the case to the Monopolies and Merger Commission, which is competent to decide if the proposed merger may restrain competition in the financial sector or is otherwise against the public interests. The Bank of England always expresses an opinion on the proposed merger. Thus, equity participation of foreign interests in indigenous banks are in the first place regulated in the framework of Anti-trust law aiming of preventing an institution from gaining a dominant position in the financial market.

However, additional restrictions apply with respect to the competence of management. In general terms the UK supervisory authorities try to ensure that the institution under its proposed controller shareholders meets the statutory requirements of authorization as set out in Schedule 3.

It has been the Bank of England's policy to require "letters of comfort" from overseas banking organizations which acquire significant shareholdings in UK banks. The UK supervisory authorities look for "letters of comfort" in respect of: a) wholly-owned subsidiaries, b) majority-owned subsidiaries, c) minority-owned subsidiaries in certain cases.

These letters ensure that the principal owners of a bank recognise its special nature and confirm their acceptance of a responsibility to support it beyond the limited liability attaching to their shareholding should this become necessary. Although the "letters of comfort" are not legally binding, being rather a statement of intent, the fact that it has been given allows the Bank of England to put pressures on the owners and can have an important effect on maintaining market confidence in a bank during periods of uncertainty.

"Letters of comfort" are required in cases where overseas institutions acquire shareholdings of 15% or more in a UK bank. However, a "letter of comfort" may be sought from a shareholder with a holding of as little as 10% if the shareholder concerned has an ability to influence the UK institution. For instance, in the case where a shareholder has an excess voting power in relation to the acquired shares.

In general it can be said that the "letters of comfort" are required for prudential considerations and do not constitute a significant impediment to acquisitions of overseas banking organizations of participation in indigenous banks.

Up to now we have seen that the potential sources of restrictions against the acquisitions by overseas banking organizations of participation in indigenous banks arise from provisions relating mainly to prudential considerations and aim at ensuring that financial institutions are soundly and honestly run and that they are able to meet their commitments at all times. One might argue that in general the UK supervisory authorities have adopted a rather favourable attitude towards equity participation. London is one of the major financial centres due to the willingness of the authorities to see foreign financial companies come to the UK in order to engage in financial activities and in some cases acquire participation in UK financial institutions. Overseas participation in a UK institution may increase the opportunities available to it, just as foreign participation in a manufacturing company may serve to introduce net capital and technology or to open up overseas markets (27).

However, the UK supervisory authorities believe that the openness of the London financial market must not extend to the point that control of the UK financial system passes to overseas interests. It is essential that there should be a strong British presence in the UK banking system which control the supply of credit. On the other hand, it is rather difficult to determine which institutions are vital to national interests . But, these interests, according to the UK authorities*, always require the continuation of a strong British presence on the UK financial sector. The above considerations may lead to restrictions on overseas equity participation in British banks in the future and are inconsistent with the principles of a Common Market. The Commission up to now made significant attempts to eliminate impediments to the establishment of foreign branches but it did not do so with regard to foreign subsidiaries.

However, the adoption of Directives designed to abolish

*(Interview, Bank of England, January 1989)

restrictions with respect to acquisition by foreign banking organizations of participation in indigenous banks should be an indispensable part of any strategy designed to integrate the banking sectors.

4. <u>Regulatory provisions and administrative practices limiting the market access by foreign based banking organizations.</u>

The UK monetary authorities place no limitation on market access by banks operating from outside the country. In the UK there are no restrictions on the holding of deposits by residents at foreign-based banks, and on the borrowing by residents from foreign-based banks since there are no exchange control regulations.

5. <u>Regulatory provisions and administrative practices restricting the domestic operations of established foreign-owned banking organizations.</u>

The UK authorities seem to have adopted a favourable attitude towards the operation of foreign banking organisations. According to some foreign bankers* there are at present no regulatory provisions or administrative

*(Interviews, Hessische Landesbank and Banka Commerciale Italiana, March 1989)

practices concerning the scope of banking business which discriminate against foreign banks. Foreign banking organisations operating in the UK are not subject to any limitations on their business other than those applying to UK banks. Foreign banks have been given the right to participate in trade financing insured by the Export Credit Guarantee Department. They have also been allowed to participate in the government's loan guarantee scheme to provide funds for Britain's smaller businesses.

Furthermore, there are no legal provisions or administrative practices that relate to prudential supervision and which intend to discriminate against foreign owned banks except perhaps the policy of the Bank of England of not providing financial support to foreign institutions operating in the UK when these institutions are in a difficult financial situation. However, the UK supervisory authorities point out that this attitude is consistent with their view that foreign institutions are integral parts of the operations of the parent institutions worldwide and therefore the responsibility for providing financial assistance to them lies outside the scope of the Bank of England. Foreign institutions must first look to their parent institutions in the case of financial difficulties, while the parent institutions look to their own central banks. The Bank of England's attitude towards financial assistance to banks experiencing liquidity and solvency problems is based on the principle of parental responsibility.

The Bank of England recognizes the danger that one institution may find itself subject to supervision from several directions at the same time or escape supervision, and cooperates closely with foreign supervisory authorities and requires from them an assurance that they supervise the whole banking group. To the extent that the Bank of England has ensured that the prudent standards are being met the UK authorities may not impose additional requirements.

The adoption of a non-statutory supervisory system and the consequent lack of transparency with respect to regulation in banking do not give rise to discriminatory treatment against foreign banks. The Bank of England clearly insists that the flexible techniques of prudential supervision are not intended to give any unfair advantage to domestic banks vis-a-vis overseas banks, but they rather aim to take account of the great variety of supervised institutions and the markets they operate in to ensure an effective supervisory system without stifling competition in the banking sector.

Of course, flexibility and informality means that one can never be sure of equal treatment, but must rely on the word of the Bank of England. However, foreign bankers *

* (Interviews, Hessiche, Landesbank and Banka Commercialle Italiana, March 1989)

state that they do not detect any unequal treatment arising from more enforcement of apparently nondiscriminatory regulations. Moreover, they point out that the absence of rigid regulations and the more flexible attitude of the Bank of England, compared with most other central banks means that London offers significant advantages to foreign banks wishing to expand their operations.

On the other hand, however, this flexible supervisory system, moving along non-statutory lines and a case-by-case approach, appears to run foul of the EC passion for transparency. But this lack of transparency does not give rise to potential sources of discriminatory treatment against the operation of foreign banks as the Commission believes.

As a consequence, one may well argue that the UK authorities do not restrict the operation of established foreign-owned banking organisations. The fact that the controls are designed to take into account the obligations of the foreign banks to comply with prudential regulations in the country of origin accords with the principle of home country control and the relevant provisions of the Second (draft) Banking Coordination Directive.

The analysis so far leads us to the conclusion that the

UK authorities have incorporated the provisions of the existing EC Directives which did little more than confirm an existing position. The UK financial market has traditionally been a relatively open and unregulated market. The controls over entry, establishment and operation of indigenous and foreign institutions are motivated solely by prudential considerations. Branches of foreign owned banking organizations are considered as integral parts of these organizations and are primarily the concern of their home supervisory authorities for prudential supervision. This attitude accords to a significant extent with the principle of "home country" control and the relevant provisions of the Second (draft) Coordination Directive. Furthermore, the UK authorities do not restrict the market access by foreign banks not established in the country since they impose no exchange control regulations and therefore already comply with the provisions of the Capital Movements Directive.

The UK banking sector is already relatively open to free competition. However, the question remains; will the UK be able to create with the other Member States a Common Market in banking in the years to come ? The creation of a Common Market in banking requires the elimination of barriers to freedom of banking services which, according to the EC strategy, will take place through the adoption of "home country" control. Greater freedom of banking services clearly depends on mutual trust between governments and regulators that one country regulatory regime is broadly equivalent to another. The mutual recognition of financial standards is one of the fundamental features of the Community's policy in the financial field. However, this can be obtained only through some harmonization to ensure that the rules and standards of supervision of the Member States are equivalent. Whether this harmonization will take place remains to be seen in the next sections.

A COMMON MARKET IN BANKING : COSTS AND BENEFITS FOR THE UK BANKING INDUSTRY AND ECONOMY

The UK banking system consists of the central bank, the Commercial banks, the discount houses, the National Girobank and the National Savings Bank.

The Bank of England , as the nation's central bank, stands at the centre of the British financial system. In common with other central banks it provides the familiar range of services both to the banking system and to the government. It has the authority and responsibility to supervise all the individual banks.

The category of Commercial banks includes: the Clearing banks, the Merchant banks and the overseas banks.

The clearing banks are so called because they have traditionally handled the bulk of the country's cheque and credit clearing (28) There are five London clearing banks operating in England and Wales - Barclays, Lloyds, Midland, National Westminster and its subsidiary Coutts- and three Scottish clearing banks - Bank of Scotland, Clydesdale and Royal Bank of Scotland. In order to highlight the significance of these banks to the British banking system it is essential to say that, according to

Table 1, they represent 52% of the total deposit liabilities in sterling and 8.5% of the other currency deposit liabilities.

Amongst the clearing banks, the London "big four" occupy a special place in the British financial system due to their enormous network of agencies and the very high number of deposits they collect. These banks have developed into universal banks providing a full range of financial services to individuals and companies in both the domestic and international market.

The London clearing banks are rather international financial institutions which provide a wide range of financial services in other countries mainly through the establishment of branches or through the acquisition of participation in existing banks. The international activities of these banks contribute significantly to their profits (29).

TABLE 1

DEPOSITS HELD BY BANKS OPERATING IN THE UK

	In January 1986 in £ million	
	Deposit in sterling	Other currency deposit
Clearing banks	129,276	50,102
Accepting houses	14,268	13,853
Other British banks	36,052	27,938
Overseas banks	68,697	496,181
Total	248,293	588,075

Source : Bank of England Quarterly Bulletin 1987

The importance of merchant banks is rather limited. Whilst trade finance remains the main function of the merchant banks, the traditional demarcations between the activities of merchant banks and clearing banks have progressively been eroded and the former carry out a wide range of financial activities.

As far as foreign banks are concerned we need to say that London's foreign banking Community has continued to expand both in numbers and business volume over the last 10 years. London is the first obvious step abroad for most foreign banks seeking to develop their international presence (30). Altogether, more than 500 foreign banks are represented, through Representative Offices, Branches or Subsidiaries in London and over 60 countries have direct representation through a bank (31). Fewer than ten of the world's one hundred largest banks do not have a London operation: these exceptions are all essentially domestically orientated with a low international profile (32). The foreign banks represent 27.6% of the total deposit liabilities in sterling and 84% of other currency deposit liabilities.

Different groups of foreign banks in London serve particular niches in the international market (33). The US banks - which is the biggest foreign bank group -

have introduced sophisticated marketing techniques in order to serve the multinational corporations in Europe. The European banks see London as a base from which to develop activities on the international markets, ie. to develop their foreign exchange dealings, participate in swaps and bond trading, raise currency deposits and gain access to cheaper sources of finance to support the activities of their customers. The Japanese banks use London principally as a funding centre and offer a full range of international business (34).

Foreign banks are also represented in London through almost 30 consortium banks. These are defined as banks which are owned by other banks but in which no one bank has direct shareholding of more than 50% in which at least one shareholder is an overseas bank (35). These banks are active in loan syndication.

The Discount houses are public limited companies that occupy a special place in the financial intermediation process. They seek out loanable funds mainly from the inter-bank market usually available very short term basis and then use such funds for the purchase of a variety of assets which includes treasury bills, commercial bills and certificates of deposit (36). Their main characteristic lies in the special relationship with the Bank of England. The banks lend to the discount houses on a day-to-day basis with the option to call in the loan at any time. When the banks are short of funds they ask the discount houses to repay the loans. Then the discount houses borrow from or/and sell bills to the Bank of England and use the funds obtained to repay their loans. Through this mechanism the Bank of England is able to supply the banking system with funds during a period of shortage and to withdraw funds from it when there is a surplus. It is through these operations that the Bank of England influences short term money market interest rates. The National Girobank provides a simple money transmission service through the UK postal system and with cash facilities provided through Post Offices, but the growth and size of its activities remain rather limited.

The National Savings Bank is a part of the department of National Savings and provides savings facilities at Post Offices. The funds obtained are passed on to the government directly or indirectly through investments in government securities. The money raised by the National Savings Bank therefore contributes towards financing the government's spending requirements.

The British banking institutions seem to play an important role in the domestic and international economy. Many of them are involved to a considerable extent in branch and subsidiaries operations abroad. They also undertake to a considerable extent cross-border deposit-taking, lending and other banking services. In fact, the UK appears to have a comparative advantage in the provision of banking services.

The UK has for a long time enjoyed a strong position on invisible trade. This dates back to the nineteenth century when the UK was at the head of a large and growing empire with strong maritime links and London had already emerged as an important international financial centre through which substantial capital funds were channelled to developing countries. More recently, despite considerable changes in Britain's role in the world, this strength on invisibles has persisted. The UK has recorded a surplus on invisibles and in many years this has helped to offset a deficit on trade in goods, often pushing the current account into surplus (see Table 2). A regular analysis of trends in invisible transactions in the world is carried out by the UK Committee on Invisible Exports (37) and demonstrates that in the global context the UK retains a strong position on invisibles.

Within the UK's total surplus on invisibles, the services balance acquires a strong position. Within the services balance (see Table 3) the financial and other services balance plays an important role in restoring the whole

TABLE 2

SUMMARY BALANCE OF PAYMENTS

	1981	1982	1983	1984	1985	1986	1987	1988
Current account								
Visible balance	3250	1906	-1509	-5169	-3132	-9364	-10929	-10929
Invisibles								
Service balance	3715	2971	3995	4339	6606	6247	5682	4165
Interest profits and dividends balance	1210	1449	2857	4449	2763	5364	4987	5619
Transfers balance	-1547	-1741	-1585	-1734	-3034	-2181	-3411	-3575
Invisibles balance	3378	2679	5267	7054	6335	9430	7258	6209
Current balance	6628	4587	3758	1885	3202	66	-3671	-14617
Capital transfers	-	-	-	-	-	-	-	-
Transactions in UK assets and liabilities								
UK external assets	-50769	-31407	-30173	-32068	-53279	-92462	-83922	-50073
UK external liabilities	43400	29054	25809	24289	43782	81369	76255	52408
Net transactions	-7370	-2353	-4366	-7780	-9497	-11091	-7667	2334
EEA loss on forward commitments	-	-	-	-	-	-	-	-
Allocation of special drawing rights	158	-	-	-	-	-	-	-
Gold subscription to the IMF	-	-	-	-	-	-	-	-
Balancing item	548	-2234	608	5895	6294	11025	11338	12283

Source : UK Balance of Payments

TABLE 3

SERVICES SUMMARY

	1981	1982	1983	1984	1985	1986	1987	1988
Credits								
General government	410	404	470	474	481	507	517	520
Private sector and public corporations								
Sea transport	3784	3267	3054	3253	3271	3230	3302	3551
Civil aviation	2359	2471	2665	2931	3078	2786	3159	3192
Travel	2970	3188	4003	4614	5442	5553	6260	6085
Financial and other services	7487	8283	9467	10655	12379	13716	14425	14583
Total credits	17001	17613	19659	21927	24651	25792	27663	27931
Debits								
General government	1264	1754	1522	1655	1780	1907	2117	2353
Private sector and public corporations								
Sea transport	3974	3704	3832	3847	3727	3701	3896	4127
Civil aviation	1979	2172	2345	2694	2925	3200	3778	4054
Travel	3272	3640	4090	4663	4871	6083	7280	8127
Financial and other services	2797	3372	3875	4729	4742	4654	4910	5105
Total debits	13286	14642	15664	17588	18045	19545	21981	23766
Balances								
General government	-863	-1350	-1052	-1181	-1299	-1400	-1600	-1833
Private sector and public corporations								
Sea transport	-190	-437	-778	-594	-456	-471	-594	-576
Civil aviation	380	299	320	237	153	-414	-619	-862
Travel	-303	-452	-87	-49	571	-530	-1020	-2042
Financial and other services	4690	4911	5592	5926	7637	9062	9515	9478
Overall balance	3715	2971	3995	4339	6606	6247	5682	4165

Source : U K Balance of Payments

TABLE 4

FINANCIAL AND OTHER SERVICES

	1981	1982	1983	1984	1985	1986	1987	1988
Credits								
UK financial and allied institutions (net credits)								
Insurance underwriters	587	618	743	826	1534	2457	2300	1449
Insurance brokers	314	384	451	535	664	711	717	690
Banks	536	659	726	911	1105	1208	1320	1303
Commodity traders, bullion dealers and export houses	317	367	441	499	511	515	537	555
Baltic Exchange	287	246	246	270	229	221	227	334
Lloyds Register of Shipping	32	37	33	27	25	24	22	18
Other	59	82	95	130	139	178	349	217
Total	2132	2393	2735	3198	4207	5314	5472	4566
UK consultancy firms (net credits)								
Consulting engineers	487	565	561	577	562	508	418	400
Process engineers	296	301	296	319	282	235	248	185
Solicitors and barristers	70	80	95	120	155	190	241	300
Management	41	44	46	48	53	54	60	66
Chartered surveyors	65	73	74	92	99	110	97	100
Other identified	106	104	120	125	112	104	94	134
Total	1065	1167	1192	1281	1263	1201	1158	1185
Telcommunications	285	335	381	594	627	638	678	692
Films and television	124	172	263	291	338	267	341	354
North Sea oil and gas companies	173	210	202	213	205	186	154	180
Land transport - freight	89	95	116	123	129	160	233	264
Advertising	69	55	56	64	77	78	98	128
Royalties from:								
related concerns	238	229	307	380	440	462	654	723
other concerns	338	339	394	406	459	383	443	489
Other services	482	596	835	972	1229	1295	1164	1224
Expenditure in the UK by :								
Overseas students - fees	184	206	210	219	248	275	302	337
Overseas students - other	240	243	258	280	318	361	399	446
US bases and forces	266	296	407	434	498	533	609	508
Commissions on UK imports	245	273	326	380	413	434	486	557
Other services	1118	1223	1338	1389	1477	1675	1771	1925
Statistical adjustment	-	-	-	-	-	-	-	500
Total credits	7487	8283	9467	10655	12379	13716	14425	14583
Total debits	2797	3372	3875	4729	4742	4654	4910	5105
Balance	**4690**	**4911**	**5592**	**5926**	**7637**	**9062**	**9515**	**9478**

Source : UK Balance of Payments

balance to surplus. And the banking institutions seem to be one of the main contributors to the net surplus in the balance of financial and other services, (see Table 4). Obviously, the British banking institutions appear to play an important role in strengthening the UK's balance of payments position. This is a strong indication that the UK might enjoy a comparative advantage in the provision of banking services.

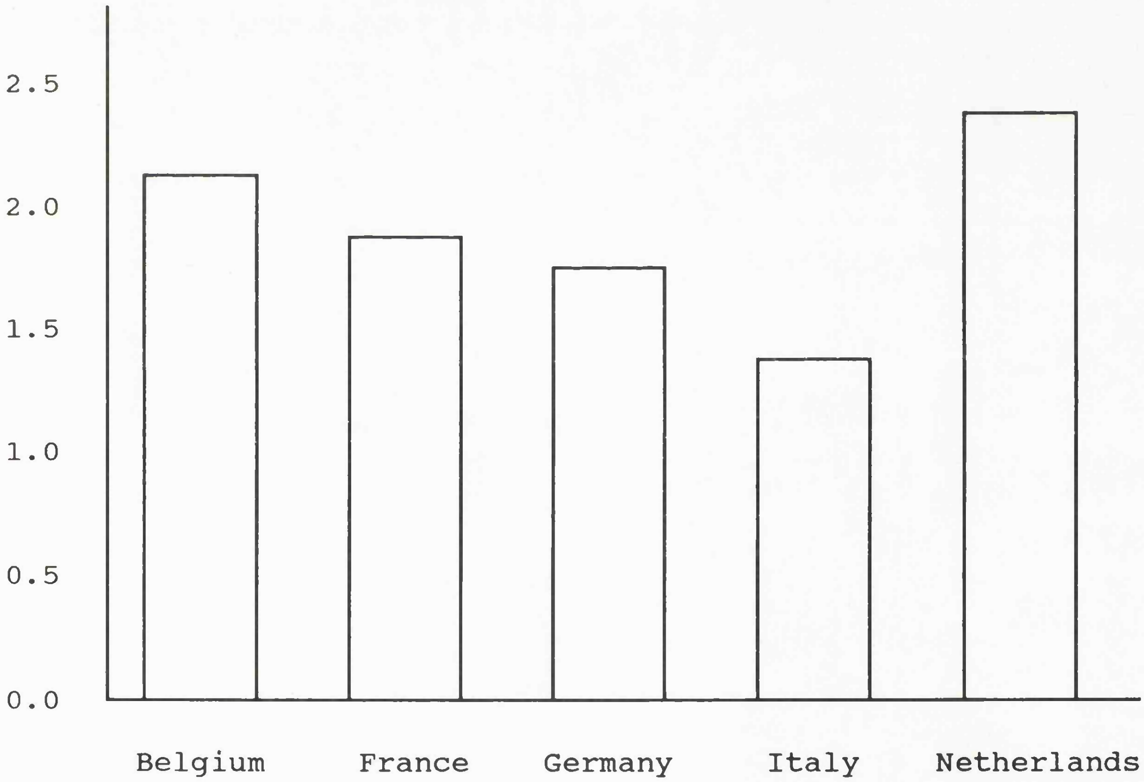
Another confirmation of the UK's comparative advantage in the provision of banking services is provided in Diagram A where the relative value added per employee in banking is presented. This Diagram reveals that the ratio of UK labour productivity to productivity of some European countries such as Belgium, France, Germany, Italy and the Netherlands is well above one. The UK banking industry, therefore, experiences the highest real value added per employee.

Furthermore, a national industry has a comparative advantage in sectors where it is able to produce at a lower relative cost than in other sectors of domestic industry. According to a recent unpublished Lloyds bank study the UK banking sector can produce at a lower relative cost than in other sectors such as airlines, office and data-processing equipments, aerospace, road transportation and telecommunications services and at a higher relative

Diagram A

Real value added per employee in banking

Ratio of UK productivity to : -



Source : National Economic Development Office 1988 cost than in some sectors of electrical engineering, pharmaceuticals, food and drink, medical equipment and insurance. Banking appears to be one of the cheapest and most competitive sectors of the UK industry. There is, therefore, enough evidence of the UK comparative advantage in banking industry.

There are probably several reasons for the UK comparative advantage in banking services. Part of the strength may be due to the high degree of competition in the banking sector. Indeed, the degree of state ownership is very limited while the deregulation and the resulting removal of barriers between different classes of financial services institutions has allowed more room for market forces and has led to increased competition amongst the existing institutions and the emergence of new sources of competition. The high degree of competition promotes innovation, and increase productivity and quality of service.

Other reasons are the abundance of skilled labour and the availability of technological support. Indeed, the production of banking is a labour-intensive activity requiring a well-educated labour force, including a wide range of professional expertise in financial and other technical subjects. However, the UK comparative advantage in the provision of banking services seems to be based, to a considerable extent, on the weak government control and there is enough evidence to justify this argument.

One of the major issues is the capital mass of banking institutions. In contrast to other countries, the UK authorities do not exercise considerable control over inter-bank equity participation neither enforce strict anti-trust laws. Equity participation require only notification to the Bank of England. Mergers between banks, in common with mergers between other companies are subject to the provisions of the Fair Trading Act. For this purpose, a merger is considered as being the acquisition of participation of more than 15% of the share capital of a bank.

According to the provisions of the Fair Trading Act, when the property of a company which intends to merge is above £5,000,000 the Secretary of State for price and consumer protection may submit the case to the Monopolies and Mergers Commission which is competent to decide whether the proposed merger gains a dominant position in the threatening of competition in the banking sector. In this process the Bank of England expresses its advice. However, the UK authorities usually take the view that acquisitions and mergers are part of the competitive process. This view increases the scope of substantial mergers.

This is an important distinction between the UK and other countries and affects the ability of the British companies to operate and compete internationally. To become international a company needs to be of a large size. The internationalization of activities usually involves large firms and considerable financial strength. Larger firms might be able to market their products at lower prices because of lower production or distribution costs since they might be able to exploit increasing returns to scale to a greater degree.

Furthermore, the UK banking institutions are not faced with regulatory provisions and practices affecting the range of services they can offer directly or indirectly ie. through their subsidiaries.

Indeed, there are no regulatory provisions or administrative practices that restrict the ability of the UK banks to engage in any business other than deposit taking. The UK banking institutions are allowed to get involved in real estate investment, insurance business, financial leasing and factoring and securities business. The only limitation arises from the application of particularly heavy weighting in solvency requirements. As a result, the UK institutions are allowed to offer diverse financial services to their customers, to operate in many areas of the market and to gain access to critical facilities or sources of funds.

In contrast to the UK, in other EC countries there are strong regulatory barriers limiting the entry of banking institutions to various sectors of the financial services industry. The limitations in the scope of permissible business activities generally arise in response to prudential considerations (that are discussed elsewhere) and severely restrict the ability of individual banks to diversify the types of activities they may offer to their customers.

Table 5 provides an overview of the portfolio restrictions currently in force in some EC Member States and refers to restrictions applying to business conducted directly by banks. The restrictions on the type of services that can be offered and on the range of activities in which banks can engage directly have considerable effects on the operating behaviour of firms and diminish the potential for profitability. They also limit the level of competition, since they exclude banks from providing services in other sectors, and act as a severe brake on innovation in service development.

TABLE 5

RESTRICTIONS ON ACTIVITIES AND SERVICES IN WHICH BANKS CAN ENGAGE DIRECTLY

	Securities	Real-Estate	Insurance	Leasing
Belgium	P	R	R	P
France	P	R	F	SR
Germany	P	R	F	SR
Italy	R	R	F	SR
Netherlands	P	SR	F	P
UK	P	SR	P	P

P - permitted
F - forbidden
R - restricted
SR - limited by solvency requirements

Source : this table is based mainly on interviews

In addition some countries impose limitations on the extent to which banks can provide certain non-banking services through their affiliates. Only the UK does not apply restrictions on commercial banks' participation in other financial enterprises, though some limitations may arise from comparatively heavy weighting in solvency requirements for specific authorizations to limits on the size of equity participation relative to the capital of the company in which the participation is acquired. In these countries the authorities take the view that the bank entry through affiliates into areas of business carrying risks is incompatible with the principles of sound banking.

Table 6 provides an overview of the restrictions applying to business conducted directly by banks in different Member States. Only in the UK have the authorities adopted, according to a central bank official, a favourable attitude with regard to bank acquisitions in institutions engaged in non-bank business since such operations can contribute to strengthening banks' capacity to withstand growing competition from non-bank and foreign institutions and facilitate innovation. It is generally accepted that the ability of banks to acquire participation in other enterprises increase banking powers and possibly profitability.

TABLE 6

RESTRICTIONS ON BANKS, EQUITY PARTICIPATION

Participations in	insurance companies	other financial institutions	non-financial enterprises
Belgium	F	R	F
France	R	R	R
Germany	P	P	P
Italy	F	R	F
Netherlands	F	R	R
UK	P	P	P

P - permitted
F - forbidden
R - restricted

Source : this table is based mainly on interviews

The form of government regulation can actually affect the operating cost levels of banks. And it is in the system of prudential regulation and supervision that the UK differs most from other countries because there is no specification of strict ratios or norms. Supervision is conducted without any published framework with the Bank of England indicating in general terms the criteria on which it bases its judgments, and it may even specify certain ratios at which it will look. The important point is that it shows no intention of laying down acceptable levels for these ratios since it believes that each individual bank is different and must be treated differently. This is a very flexible system, too flexible and loose for many other countries in Europe and one that appears to give the British banking institutions a considerable competitive advantage.

British banks are allowed to strengthen their capital positions by substantial issues of subordinated loan stock both in sterling and in foreign currency and other funds which are at the disposal of the banking institutions for a limited period only or are not fully owned or controlled by them. These funds are obviously not available to absorb losses in the same way as paid-up capital or reserves. But their inclusion in the capital of the British banks makes them appear better capitalised than in fact they are. According to some bankers for many British banks 50% of their capital base consists of funds which are at the disposal of the institutions for a limited period only or are not fully owned or controlled by them. These funds cannot (or only to a limited extent) be included in the capital base of banks in other European countries.

Furthermore, the adoption of general prudential guidelines along which the individual banks will operate and the nonspecification of strict prudential ratios or norms with respect to liquidity and risk exposure affect positively the operating costs of British banking institutions and the level of their activities. Obviously, the adoption of flexible controls on the size of credit exposure increases the potential expansion of banking business. The flexible application of prudential controls on foreign exchange risk exposure increases banks' ability to participate in international deposit-taking and lending activities and to carry out arbitrage functions in the foreign exchange markets.

One therefore might argue that flexible and loose supervision should be held to a large extent responsible for the relatively low production costs of the British banking industry. The main reason that the British banks are able to compete successfully both in the domestic and foreign markets is not that they are offering a superior product or superior service. They have been able to quote prices which other banks faced with more demanding regulatory regimes, have not been able to meet.

Operating under a favourable regulatory regime the British banks face the attractive prospects of an integrated market having a bigger consumer base than either the US or Japan.

The Second (draft) Coordination Directive aims at giving full effect to the single internal market in the banking sector. The adoption of the home country control principle which implies that a banking institution established in any Member State of the EC will be free to open branches in all the others and its activities throughout the community will be governed by the regulatory authorities of its head office country will remove the economic protection which the national supervisory systems provide and create further opportunities for British banks. The UK banking institutions have for a long time successfully been involved in branch operations abroad.

Furthermore, in an integrated market a bank that sets up branches in other Member States will be able to do the same types of business through those branches that it can carry out in its home country and this provides new opportunities for British banks. In addition to this British banks will be able to undertake cross-border international banking operation on a large scale. Corporate business usually requires close and continued contact between bank and customer. However, the British banks would be able to sell innovative products to other countries directly from their head offices. Some British bankers believe that unit trusts are a prime candidate for vigorous cross-frontier marketing once national restrictions are removed. Mortgage lending, so far one of the most stay-at-home activities could also become a battle ground for cross-frontier competition.

The British banking industry seems to possess the necessary competitiveness to take advantage of the breakdown of barriers to freedom of financial services within the EC. Barriers in banking rank amongst the highest in Europe and are regarded as one of the most important by the UK industry and indeed by the industries of most other countries. Banking still remains more closely supervised than other areas of business activity and governments often use their regulatory powers to restrict foreign institutions looking for a share in the domestic market. The Banca d'Italia, for example, controls the establishment of new offices and has recently stopped issuing licenses (38). And it is in the banking field, where the barriers are relatively high, that the UK may enjoy a comparative advantage. It thus seems that the UK banking industry is most likely to gain from the disappearance of barriers to freedom in banking services.

On the other hand, however, an integrated market in banking does not mean only that a banking organization established in any Member State of the EC will be free to open branches and transact business in all the others, but it also involves a certain degree of harmonization of national supervisory standards. The principle of "home country control" which implies that the banking activities throughout the Community will be governed by the regulatory authorities of the head office country can be accepted through the mutual recognition of financial standards and regulations. However, the concept of mutual recognition can only be justified if the rules, and standards of supervision of the Member States are equivalent. This can be obtained only through the harmonization of the essential elements of prudential regulations of the Member States.

At present, the Member States significantly control the entry, establishment and operation of foreign banking organizations in the domestic market. In the developed countries these controls are mainly imposed in order to safeguard the soundness and stability of banks and therefore to protect domestic consumers rather than to reduce external competition and increase profits for the national industry. Since the controls imposed by the host country are related to prudential considerations they can be eliminated only through harmonization of the essential aspects of banking regulation ensuring that foreign banking organizations are adequately supervised and controlled by the home supervisory authorities.

The harmonization of the essential aspects of banking supervision implies that the British authorities would have to bring their supervisory system closer to those of the other European counties. This is because the UK's system of prudential regulation and supervision differs considerably from those of the other countries since there is no specification of ratios or norms. The Bank of England produces only general guidelines indicating the criteria on which it bases its judgement. This flexible system of supervision appears to be in stark contrast to the supervisory systems of the other European countries based on strict statutory requirements and provisions.

As a result, harmonization for the British industry would mean a considerable strengthening of the supervisory controls which would erode to a significant extent the comparative advantage in the provision of banking services that the UK has been enjoying for so many years with considerable implications for the industry and the UK economy as a whole. The new conditions for operating for British banking would be an additional burden on the functioning of the UK banking organizations and would profoundly affect their ability to compete both in the domestic and foreign markets.

The harmonization of the essential elements of prudential supervision at the EC level means that British banking organizations would face prudential restrictions with respect to the type of services that they offer and on the range of activities in which they can engage. These prudential restrictions would limit their ability to offer diverse financial services to their customers and operate in many areas of the market and therefore diminish the potential for profitability. British banking organizations would also be faced with rigid controls with respect to solvency, liquidity and risks' concentration which would significantly increase their operating costs. British banks might not be amongst the most competitive ones. The British financial products would not necessarily sweep through an integrated financial market, nor would this market offer to the British banking industry a tremendous opportunity for expansion in Europe. The benefits of a common market in financial services for the British banking industry would be less than what many people might have thought. All the above arguments are reflected in the views of many bankers of national and foreign banks who permitted the author to interview them in person.

The conclusion that some people draw is that 1992 will eliminate barriers to freedom of financial services and increase competition between banks throughout the EC. UK banks are presently "ahead of the field" with regard to innovative financial products and therefore should be well suited to gain from the creation of a Common Market in financial services. However, the ability of the British banking industry to produce innovative financial products is to a considerable extent due to the lack of prudential restrictions with respect to financial services and activities that banks can offer and to the relatively high degree of competition that the present supervisory system allows. This ability would significantly be undermined by a strengthening in prudential controls.

Furthermore, the British banking industry is greatly involved in financial operations outside Europe. However, the strengthening of the present flexible supervisory provisions and the consequent erosion of the comparative advantage would significantly damage the UK industry's ability to compete internationally. In an integrated European financial market, British banking organizations might find it increasingly difficult to sustain their non-EC earnings. British banks have substantial economic interests outside Europe and would make considerable losses if any move toward integration in Europe implied additional controls and restrictions on their operations undermining their standing and market share worldwide. Any readier access by the British banking industry to the European financial market may involve also costs for this industry in terms of tighter regulations and a consequent fall in non-EC earnings.

Even if we can identify the sources of costs and benefits for the British banking industry as a result of the integration process it is very difficult to draw conclusions about their extent. Their extent will depend significantly of the philosophy upon which the legislative base of the future Common Market in financial services will be constructed. The stricter the prudential requirements and provisions are the fewer the benefits and the higher the costs for the British banking industry.

Although it can be argued that complete harmonization would ultimately be the only way to achieve a truly open and uniform internal market, any attempt to impose it in one step would be rather difficult. In this context, the Community tries to promote unification by applying the principles of mutual recognition and harmonised minimum prudential standards. One therefore might argue that since the process of integration involves minimum harmonization of prudential regulation the British banking industry will be able to make substantial gains in the Common Market at a low cost.

However, the minimum harmonization of prudential standard will also result in a relaxation of the more restrictive national provisions which presently prevent many banks in other Member States from competing outside their national borders. The strictly regulated Member States would take account of the consequences of the more restrictive national regulations and would not thereby allow foreign banking organizations to operate in their territory under more favourable conditions than its own nationals. Indeed, according to some foreign bankers,* many banking institutions in the other Member States see 1992 as providing them with an opportunity to compete outside their home jurisdictions in a manner which, to date, they

*(Interviews, Hessische Landesbank and Banka Commercialle Italiana, March 1989)

have been unable to do so, due to strict national regulations. British banks would therefore be faced with effective competitors and even in that case their gains would not be as high as some people might have thought.

At present, London is one of the world's most important international banking centres, and more foreign banks are represented here than in any other financial capital. According to a report (39), total bank lending out of London accounts for more than 20% of the market, far higher than any other European financial centre, even if German banks have a larger share of international bank credit than UK owned banks - 8% and 6% respectively at end 1988. According to a foreign banker* daily foreign exchange turnover is estimated to be roughly twice as high in London as in New York or Tokyo, while deposits by nonresidents with banks in the UK accounted for 30% of the total international deposit business of banks.

There are probably several reasons for London's preeminence in financial services. Some of the strength in finance stems from the days when the UK was the major world power and its largest capital exporter; once a financial centre has become established many new entrants to the market will see it as a natural place in which to set up (40). The presence of many financial companies in one centre fosters developments which benefit all of

*(Interview, Banka Commercialle Italiana, March 1989)

them. Foreign banks are also drawn to the City by its dominance in the Euromarket and its pre-eminence in foreign exchange. Other reasons could relate to the availability of technological support and the relative abundance of skilled labour.

However, the main reason often given for London's strength in finance is the low level of regulation in its markets. According to a foreign banker,* underpinning the London's reputation is the unique regulatory skill of the Bank of England. More than any other European country the UK's supervisory system is based on flexibility and dialogue between commercial bankers, their associations and the central bank. Some foreign bankers** have generally praised the flexible way by which the Bank of England ensures the prudent conduct of business without restricting the banks' possibilities of profitability. Foreign banks are keen to exploit this element of flexibility in order to expand their activities carry out financial operations which their home parent may be prevented from undertaking. Furthermore, even the Bank of England (41) points out that flexible regulation is a means to the greater end of continuing to attract international business to London as an open financial centre.

One therefore might argue that the flexible system of

*(Interview : Banka Commercialle Italiana March 1989)

**(Interviews : Banka Commercialle Italiana and Hessische Landesbank March 1989) prudential regulation and supervision is the main reason for London's pre-eminent position in finance. If this is the case, one effect of harmonization of prudential regulation within Europe would be to take this advantage away from London. Indeed, if in an integrated European market the UK authorities bring their supervisory system more into line with the rest of Europe, the Bank of England's sophisticated techniques will become too rigid and London will possibly lose attractiveness as the world's leading financial centre. The possible outcome of the strengthening of the British prudential controls would be to put the London banks on an equal footing with the other European banks and drive business abroad: not only to other European centres but also to other financial centres outside Europe.

Furthermore, the creation of a Common Market in banking does not require only the elimination of the internal barriers, but it also involves the adoption of common external barriers to the entry and establishment of non-EC banking organizations. This means that the UK authorities would also have to bring the strength of their external barriers closer to that of their EC partners. And a strengthening of the external barriers vis-a-vis non-EC banks represents a potential threat to the London market's prominent position in banking. Indeed, Article 7 of the Second (draft) Banking

Coordination Directive suggests that where EC banks are not found to enjoy national treatment in a non-EC country, the Commission may decide that the Member State should suspend new acquisitions by a banking organization originally established in the non-EC country concerned. The Commission's proposal would , by it's centralization, imply a greater bureaucratic burden to the entry and establishment of non-EC banks. The reciprocity provision is considered in the City as a major drawback in maintaining London's comparative advantage as an international financial centre.

However, London as an international banking centre plays an important role to the benefit of the UK economy; and this role is well recognized by the British government. It makes a very substantial positive contribution to the favourable invisible balance and the UK have much to lose if the EC introduces additional controls on the entry and operation of banks that would undermine its prominent position in banking. It is considered as a UK asset whose value should not be eroded by common rules. One therefore might argue that the British would not be prepared to accept tighter regulation in return for the possibility of readier access to the European Market.

The present analysis demonstrates that the Uk authorities have substantial economic interests in opposing any trend toward harmonization of controls at the EC level. This provides a first indication that complete integration in the banking field will be very hard to attain in the foreseeable future. In order to strengthen this argument it is necessary to present the divergence in the supervisory philosophies, interests and practices between the UK and the continental countries.

CONFLICTS IN NATIONAL SUPERVISORY PHILOSOPHIES AND INTERESTS

In most countries financial institutions attract a greater degree of regulation than is normal with the providers of other goods and services. The two main reasons for this are that financial services are much more important than other commodities and, secondly, that financial services are often more difficult than other goods and services to test at the time of purchase, and their benefits may have to be taken largely on trust. The financial market has its own special features to which governments have responded.

The main economic reason for regulatory intervention in the banking field reflects a general concern with the vulnerability of the banking sector and the protection of the depositors. In this respect, the State's role should be a particularly onerous one where the market place does not find satisfactory solutions. However, the extent to which the market place finds satisfactory solutions is a matter of concern and dispute between economists and national regulators. The broad trends in policy thinking and attitudes remain a powerful force in shaping the supervisory approach to banking.

In the system of prudential regulation and supervision the UK seems to differ from the other European countries. The UK philosophy of supervision is explained in a substantial volume of papers and notices issued by the Bank of England. These papers and notices relate to specific areas of prudential supervision such as capital, liquidity and assessment of risks exposure. In this way the Bank of England formulates a general supervisory structure which sets flexible guidelines within which the individual banks should operate. The papers do not impose specific numerical guidelines or prescriptive ratios that all credit institutions would be expected to observe.

The authorities remain firmly opposed to a rigid supervisory framework which would not take account of the differing characteristics of the supervised institutions. Some of them, for instance, will require more capital or/and more liquidity than others reflecting their different kind of business and the experience of their managements. Indeed, the papers are regarded as providing a flexible supervisory framework within which, after bilateral discussion, the Bank of England expects to agree appropriate guidelines with the management of the individual banks in order to ensure that the banks concerned are on a sound footing.

The process of dialogue and cooperation between the supervisors and supervised institutions is a key element in the Bank of England's flexible non-statutory approach to supervision. The Bank of England relies heavily on regular interviews and personal contacts with the management to ensure that the institutions concerned are soundly managed. The general idea behind the Bank of England's personal and informal style of relationship with the management is to make sure that the supervised institutions have the appropriate systems to ensure that their risks and exposures are properly recorded and reported to top management and to the supervisory authority and when the systems are in place they are properly observed (42).

The British supervisory authorities have the responsibility to assess whether the bank's policies with respect to risks and exposures are adequate and to ensure that they are soundly managed. If they conclude that a bank's policies are inadequate they put pressures on the bank concerned to raise the prudential standards to the level appropriate to ensure the sustaining of its prudential soundness. The Bank of England remains firmly convinced that the interests of good bank and of the banking supervisory authorities are one (43): the development of sound banking practices that generate confidence in those who use their services. Moreover, the market imposes a great deal of discipline on its members. Excessive risk taking, for instance, would have detrimental effects on the profits.

On the other hand, however, the market correction of a bank which ignores prudential standards will usually take place with time lags and these in the extreme cases could be against the interests of the depositors. There is, therefore, a need for a system which would permit the supervisor to have face to face contacts with the management, exchanging information and ideas about the prudent conduct of banking business. This system can contribute information which could not emerge from the balance sheets of the supervised banks. The judgement about the quality of management is therefore another key aspect of the Bank of England's approach to supervision. The supervisory authorities' concern has been to keep as a minimum degree of interference as possible in banks, but to retain a personal and informal relationship with the management.

The system provides, therefore, a great deal of flexibility to the supervisors to discuss with the management the prudent running of banks along the general prudential principles set out in the consultative papers being brought out by the Bank of England.

The flexible approach to supervision is justified, according to the Bank of England, first of all by the effectiveness of this approach itself. A statutory supervisory system based on rigid rules and applied uniformly to all the types of institutions on which supervision is exercised irrespective of their size, scope of activity, types of markets in which they operate and the quality of the management, could do damage to the banking system as a whole: too great a degree of uniformity would tend to create a banking community less well able to withstand systematic shocks, just as a genetically homogeneous population can be vulnerable to disease (44). Furthermore, flexibility permits the adaptation of the system to the changing market practices.

A flexible supervisory system is not only effective, but also essential to fair supervision. The adoption of statutory rigid prudential rules that are applied uniformly to the supervised banking organizations with no regard to their considerable degree of diversity entails competitive inequalities. The Bank of England believes that the extent of diversity among banking organizations seems to be substantial. Individual banks tend to give preference to certain types of activities and categories of customers due to their specialization in particular economic areas. Therefore, an effective and fair supervisory system requires a considerable degree of flexibility which enables the authorities to evaluate the extent to which the individual banks managements are in the position to retain control of the various forms of risks' concentration and have at their disposal the appropriate instruments to deal with them.

The issues of prudential supervision are strongly related to considerations of competition in the banking sector and the rules that are essential for the safety of the banking system should not act as a straitjacket on the banks. The operation of the system must, therefore, be carried out with enough flexibility so as not to stifle the benefits in terms of efficiency resulting from a more dynamic and competitive environment. According to the Bank of England, a statutory method of regulation would restrict competition between institutions as to lose their customers the benefits usually associated with it in terms of price innovation and quality and variety of service.

The UK authorities take account on the one hand, of the continuing tension and need to reconcile the objective of achieving a more efficient banking system through competition and, on the other hand, the absolute need to safeguard the financial stability of banks and the public confidence in the system and rely on means of discipline other than strict ratios or norms.

The more frequent disclosure of information about the conditions of banking institutions may reinforce disciplines inherent in the market process. This approach which is described as "freedom with publicity" is designed to ensure that the public has access to adequate information to judge for themselves the credit worthiness of the institutions with which they chose to place their savings. If this is the case banking institutions will be led to prudent policies avoiding risk-taking activities by a market mechanism in which weak banks lose deposits and sound banks gain them. In this respect, the Banking Act contains specific requirements concerning detailed disclosure about the financial conditions and performance of banking institutions.

The impact of the discipline inherent in the market process depends, to a considerable extent, on the perception by the market of the authorities, response to the prospects of failure and liquidation of a bank. In the Banking Act there are extensive provisions relating to sanctions imposed on banks that engage in unsound business practices, while the Bank of England is granted with cease and desist powers against these banks.

Moreover, the existence of a Deposit Insurance System consisting of a Fund and a Board and operating under the Banking Act provides some indications that some banking institutions may be allowed to fail and therefore enforce market discipline standards. In a case of failure of a contributory institution the Board of the System should pay out of the Fund to each depositor an amount equal to three-quarters of his protected deposits. In this way the System provides a safety net for depositors in the case of bank failure which, however is not comprehensive (since it covers only 75% of sterling deposits) giving, therefore, a serious incentive to future depositors to assess the viability of the institutions concerned. The rationale for providing deposit protection goes beyond the investor protection argument in a narrow sense insofar as it can be seen as a key element for safeguarding the stability of the banking system. The System may reduce the incentive for sudden withdrawals of funds from banks perceived to be in difficulty, limit the spread of fear amongst depositors and reduce the risk of development of general banking panics which could undermine the stability in the banking system as a whole.

The task of the Deposit Protection System is supplemented by the intentions and the broad discretionary powers of the Bank of England to intervene in problem cases assisting banks experiencing liquidity and solvency problems. The UK authorities may organize liquidity support for illiquid institutions. This support usually takes the form of loans extended by the Bank of England at a penal interest rate. Liquidity support could also be provided by other large private banks. In the UK banking crisis of 1973-75 the clearing banks participated in liquidity support operations with the instigation of the Bank of England.

In the case of an insolvent institutions the supervisory authorities may consider that the interests of the depositors and the stability of the UK banking system are better protected if they persuade the management of the respective institutions to find another stronger institution with which to merge or by which it may be taken over. The supervisory authorities should use their good skills and expertise to bring such changes of ownership. Salvage of an insolvent institution with the help of other interest banks is the most usual practice. However, the acquisition of an insolvent institution as a subsidiary of Bank of England could be another practice (45) The Johnson Matthey Bank affair is the clearest example.

The Banking Act makes no reference to the Bank of England's discretionary powers to intervene in problem cases assisting banks experiencing liquidity and solvency problems. This is basically due to the fact that an extensive and highly efficient degree of protection over the domestic banking system may lessen the degree of discipline which the market imposes on banks and encourage them to engage in excessive risky activities. The main reason for not stating formal conditions for activating an emergency process is precisely to enforce risk-taking restraints and market discipline standards.

For all these reasons the Bank of England believes that emphasis should be placed on market discipline and a combination of informal powers to intervene in problem cases and deposit insurance eliminates the need for most bank regulation and supervision. However, there are considerable doubts about the extent to which market forces ultimately are capable of imposing an acceptable degree of discipline.

The prime responsibility for regulating banking soundness lies with a bank's own management; and the Bank of England tries to ensure that the bank concerned has at its disposal appropriate systems guaranteeing its financial stability. Indeed, one would normally expect that fraud and other irregularities will be the major cause of bank failures. However, the high degree of competition, that the present British supervisory system allows, may in some cases shift the scope of banking business away from concerns with safety and towards excessive risk taking.

In a highly competitive environment, honest bankers may engage in risky business. In a quest for higher profits or/and market share, they may make subjective judgments about future conditions, they may mismatch the currency denominations of assets and liabilities, extend loans to high risk customers, or hold too few liquid reserves. As a result the activities of fit and proper bankers may involve a considerable degree of risk. The banks' involvement in a wide range of financial services may result in that the senior managements being unaware of the risks involved; while the Bank of England may not be able to find out. The collapse of Johnson Matthey Bankers in 1984 and its rescue by the Bank of England is a clear manifestation of this. Flexible supervision on the day today running of the banks can lead to flabby and complacent control and an unsound base for the system.

The UK authorities in order to maintain a balance between stability and risk-taking try to reinforce the disciplines inherent in the market process through the more frequent disclosure of information about the conditions of banking institutions. But, in practice the concept of "freedom with publicity" does not seem to work properly.

First of all, the availability of better informations is of course to the benefit of the public. However, the disclosure of information provides only limited protection against imprudent business or risks that are not presented in the balance sheets and, indeed, often are exposed after the fact. The effectiveness of the market stabilization effect depends very much on the existence of detailed informations regarding banks situations and prospects, which is not usually the case.

The rationale for bank intermediation lies to a large extent in the existence of imperfect information. Banks. have a special role as "inside lenders" based on specialised information about borrowers, so that it is difficult, if not impossible, for outsiders to assess accurately the riskiness of a bank's portfolio (46). The existence of information asymmetries creates a potential requirement for regulation. Depositors find it extremely difficult to make reliable judgments with respect to the prudent running of business and excessive risk taking by the respective institutions. Inexperienced depositors would understand very little if they looked at the balance sheets of individual banks.

The degree of emphasis that should be place on market discipline as a complement to official prudential supervision of banks should reflect the extent to which market responses to signs of strains developing in an institution can be expected to develop in a way congruent with the overriding public policy objective of preserving the integrity of the financial system. Once it becomes reasonably clear that an institution has difficulties, sudden withdrawals of funds from the institution perceived to be in difficulty will possibly take place undercutting orderly solutions. In addition fears may spread among depositors posing risks to other banks and favouring the development of general banking panics which could undermine the stability of the financial system as a whole.

In other words, reliance on frequent disclosure of information and market discipline as a complement to official prudential supervision of banks may pose risks to the financial system in general as a result of overreaction by the market to actual or perceived changes in a bank situation. The possibility of a generalised financial upheaval triggered by the publicised difficulties of one institution that are transmitted to others via knock-on confidence effects and associated deposit withdrawals creates a major rationale for strong government intervention in the banking sector. The UK secondary banking crisis of 1974/75 is an obvious example of this possibility when a few well-publicised problems in secondary banks led to a wave of deposit withdrawals from secondary banks, eventually threatening the stability of the entire UK banking system.

The UK authorities believe that a combination of the Bank of England's discretionary powers to intervene in problem cases and deposit insurance eliminates the need for most bank regulation and supervision. However, the institutions may, consciously or unconsciously, build into their decision making the view that deposit insurance and the Bank of England's discretionary powers to intervene in problem cases will give added time and leeway to deal with unforeseen problem situations that may arise, thus making institutions less self-reliant and less concerned about risk (47). Furthermore, depositors may anticipate that the government in the last analysis will take actions to protect them against loss and are encouraged to place funds with the institutions paying the highest interest rates, irrespective of whether they are financially weaker than their competitors. As a result, the banks concerned may take excessive risks in order to offset the higher costs of deposits. We may, therefore, end up in a situation where the growth of weak and risky institutions would be subsidised in practice at the expense of sounder banks.

According to the Bank of England, the British supervisory system provides strong incentives to banks to avoid excessive risk taking since it protects the depositors rather than the shareholders against catastrophic loss. However, there seem to be a widespread feeling in the UK that the latter would not be allowed in the case of a major institution. The UK policy seems therefore irrelevant.

The freedom enjoyed by the banks with respect to their permissible activities and their adaptation to the new economic and financial environment have led them to offer a large supply of new financial instruments. Banking groups have developed into financial conglomerates incorporating a wide range of activities. The expansion of business outside the "traditional" banking area and into other types of financial activities (especially securities business) has increased the complexity of business and brought about new elements of risk. Banking has become more complex and more exposed to shifts in market expectations. Confronted with increasing risk and complexity the UK authorities should have taken steps to strengthen their prudential controls on a statutory basis and to reassess the existing balance between market forces and prudential policies.

Peter Cooke, head of banking supervision, has pointed out that in assessing capital adequacy in relation to wide-ranging financial groups supervisors "are to some extent shooting in the dark".* There are, therefore, circumstances in which the restrictive elements in supervision would be generally regarded as essential. The UK authorities should therefore put an effective ceiling on the maximum capacity for overall expansion of a bank for a given amount of capital resources with a view of sustaining the soundness of individual banks and that of the system as a whole.

Furthermore, the supervisory umbrella should be extended towards a more comprehensive coverage of banking business in order to avoid gaps and inadequacies in the supervisory process. The basic approach to the consolidated supervision of UK institutions is described in a notice (48) issued by the Bank of England in May 1985. According to this notice the Bank of England seeks to examine the capital adequacy and risk concentration of banks on a consolidated basis, while the foreign exchange risk exposure on a consolidated basis is not contemplated. The extension of the principle of consolidation to cover foreign exchange exposure will provide the UK authorities with the possibility of monitoring the capital strength of a banking institution taking into account the totality of its business in order to evaluate adequately the respective bank's total

* (Interview, Bank of England, January 1989)

foreign exchange exposure and to ensure its viability. The extension of supervisory coverage through consolidation procedures to include foreign exchange exposure contributes to the competitive equality (one of the main principles of the UK supervisory system) and minimizes any potential for circumventing the prudential controls.

The above considerations are also shared to a greater or lesser extent by the majority of the continental European countries which believe that the costs of regulation in terms of competition, prices, innovation and variety of services are outweighed by its benefits ie. the protection against the risk that some sizeable parts of the banking system as a whole may collapse. The conflict between stability and competition in the financial system is one of the unresolved problems of economic policy; and the continental European countries - in stark contrast to the UK - seem to place more emphasis on the former rather than on the latter.

It is perfectly apparent that the differences in the supervisory philosophies are substantial. Furthermore, it is often said that differences in philosophies usually reflect divergent interests and this also holds in the case of European banking. It seems that the UK authorities place a great deal of emphasis on the interests of the bankers rather than on those of the public; and there are some indications which can justify this argument.

The first indication comes from the nature of the British regulatory regime. The UK banking institutions operating in an environment free of legal requirements are more likely to undertake relatively risky policies while they attract depositors by paying slightly higher interest rates than would possibly have been the case in a strict regulatory system. If the risky policies succeed the bankers are those who reap most of the benefits. If the risky policies fail the losses fall mainly on the authorities, and the public. Since shareholders are confident that banks will not be allowed to collapse they will be those who would gain the greater and lose the less. The rules of the game as they are formulated by the present regulatory regime benefits the bankers at the expense of the public.

The Bank of England has long been accustomed to consult with the banking community over its methods of operation. It has longstanding relations with the British Banker's Association, which represents the point of view of the whole banking community and other bodies such as the Committee of London Clearing Banks, the Accepting Houses Committee and the London Discount Association. The Bank of England has also close relations with foreign banks' groups such as the Foreign Banks Association the American Bank Association and the representative office of the Bank of Japan. Through these association the Bank of England tries to seek opinions on its own actions derived from the practical experience of the banking community. On the other hand, through these associations, private bankers have been able to act together to influence the supervisory policy in order to promote their interests. Consultation, and the search for consensus, become the outstanding characteristics of the Bank of England/associations relations.

As a result of this consultative process significant changes have been taking place in the proposals originally put forward by the Bank of England. The liquidity and foreign currency exposure papers are a manifestation of this. The Bank of England tried to move towards extending and formalising the supervision of the British banking system. The original papers, however, attracted considerable criticism from the banking community as being too tight, therefore posing a potential threat to the banks' freedom of operation. This argument was sufficient to convince the Bank of England and the conditions in the final versions of the papers were changed to allow more flexibility. The bankers were able to persuade the UK authorities that their proposals should be adopted.

Recently the Bank of England considered additional liquidity requirements for banks to hold a stock of high quality liquid assets against a percentage of their short term liabilities. These requirements (if adopted they would reverse the trend towards informality and flexibility) were considered necessary since the current system had proved to be unsatisfactory and ineffective especially in abnormal circumstances. Many institution had experienced short term problems with their normal sources of liquidity due to the unexpected interruption in forecast cash flows. The additional requirement was therefore designed to ensure that banks had adequate levels of liquidity to cope with sudden and unexpected liquidity pressures. However, its proposal brought a strong reaction from the bankers who claimed that the requirement concerned will impose an unreasonable cost on their operations. Even though the Bank of England was firm in its belief that a framework for monitoring the availability of high quality liquid assets is particularly important when an institution experiences an unexpected interruption in forecast cash flows, it finally withdrew its proposal.* The interests of sound banking were superseded by the interests of the bankers.

* (Interview, Bank of England, January 1989)

The Bank of England usually publishes its ideas and allows plenty of time for the bankers to respond and comment before finalizing its rules. It seldom acts without receiving clear signals from the bankers that they too support the proposed changes in policy. The extensive process of consultation and dialogue between the Bank of England and the banking community and the ability of the latter to influence and manipulate public policy in its favour demonstrates that the UK authorities attach a particular priority to the interests of the bankers.

In stark contrast to the UK, the authorities of the continental European countries attach priority to the interests of the depositors and of the public in general rather than those of the bankers. In particularly, Germany represents the opposite extreme. The German authorities have a strong attitude to favour the interests of the depositors in order to protect them from potential losses. The consequences of the lack of "consumer protection" policy were revealed after the Second World War, when depositors lost more of their savings. Banking institutions used the deposits to finance the War expenses and thus lost a substantial proportion of funds.

One therefore might argue that the authorities of the

Member States attached different priorities to the interests of different political groups and this would restrain considerably the common grounds for harmonization of the banking regulation. It is considered that this would constitute the most serious impediment to the establishment of a Common Market in banking in the foreseeable future.

This elimination of the barriers to freedom of banking services is closely linked with the establishment of a harmonised supervisory regime in Europe. On the one hand, there are understandable concerns for greater intensity and coverage in regulation in Europe and the British are "the odd man out" among the European supervisors. On the other hand, the British have consistently pressed towards more competition within Europe. However, the connection between liberalization and regulations appears to be very strong.

Against this background, the EC Commission proposed a Directive designed to bring about home country control before the end of 1992. However, the future is not free from areas of potential controversy between the UK and the continental European countries. In the next section some of the directions in which one can see the debate going over the adoption of this Directive are reviewed.

IMPEDIMENTS TO THE ADOPTION OF THE HOME COUNTRY CONTROL PRINCIPLE

In the UK the Banking Act does not lay down any formal restrictions on the type of business which an authorised institution may undertake. Only the Bank of England needs to ensure that the respective institution has adequate financial resources for the scale and nature of its intended business. The UK institutions are allowed to get involved directly in the provision of certain "non-banking" financial products such as financial leasing, real estate investment, insurance business and securities business. However, some limitations to the above kind of business may arise from capital adequacy requirements.

British banks have been allowed to penetrate the markets traditionally reserved for the investment banks and other financial institutions such as insurance companies. Furthermore, the UK authorities do not impose any regulatory or administrative constraint on banks' equity participation. Only the Bank of England wishes to be notified in advance about any acquisition.

In contrast to the UK, in the continental countries, the authorities impose certain prudential limitations on the scope of permissible business activities which banks may undertake directly or indirectly (through their affiliates).

In Germany, even if the system is basically of the universal type and with a very broad definition of banking activities there are certain limits on a banks' permissible activities. Universal banks are not allowed to engage in certain types of business which are reserved by special acts for specialised banks or other financial institutions. The issue of mortgage bonds is reserved for the mortgage banks. The operation of investment trusts is reserved for specialised banks issuing investment certificates. Banks are also prohibited from engaging directly in commerce, industry and insurance business. On the other hand, however, there are no limits to the extent to which banks may acquire participation in other financial or non-financial enterprises. The German banks hold substantial shares in non-financial enterprises.

In France, banks are prohibited from engaging in the insurance business and severely restricted from investing in real estate. Banks may not invest more than 20% of their own funds in shares of any one enterprise without authorization by the central bank.

In Italy, banks are allowed to conduct directly only banking business. Banks are not permitted to undertake insurance business and to invest in real estate, except for their own operating needs. Securities business of commercial banks requires prior authorization by the central banks which is generally not granted. Participation in non-banking institutions are not permitted, with the notable exception of investment in companies performing activities complementary to banking business such as finance companies and data-processing business.

The limitations on the range of business into which banks may get involved arise in response to three broad categories of concern: conflict of interests, safety and soundness, and concentration of power. The prohibition on the banks' ability to engage directly in the provision of certain non-banking products such as insurance services is felt necessary since certain high risk activities should be kept separate from normal banking business. Restrictions on security underwriting arise from the consideration that banks' involvement in underwriting as well as lending business may give rise to serious conflicts of interests: the wish to preserve customer relationships might induce banks to overlend to underwriting customers, impairing the safety of the respective banks. Limitations on investment in real estate are imposed due to the illiquid nature of that form of activity.

Finally, the constraints on banks' equity participation may arise from several reasons. The illiquid nature of equity participation leads to the risk that liquidation of such investment can take place only at a high cost. Substantial equity involvement also undermines the respective bank's financial stability if the affiliate runs into difficulties. Banks, involvement through subsidiaries into types of activities carrying risks is considered incompatible with the principle of safe and sound banking. Controls on banks' equity participation may also be used as a means of preserving concentration of power and to limit the possibility that lender-customer relations may be influenced by ownership considerations.

For all these reasons, in stark contrast to the UK, the continental countries restrict the scope of banking activities. The significant differences in the limits of banks' permissible activity between the UK and the continental countries would constitute a significant impediment to the adoption of the principle of home country control in the foreseeable future. The continental countries would not allow British institutions to carry out activities which their own institutions are restricted from undertaking since this is considered necessary to ensure sound banking. On the other hand, the British authorities would not adopt similar prudential restriction on the scope of banking business since such restrictions limit the level of competition in the financial services industry, act as a severe brake on innovation and affect the quality and variety of services. This means that different products would be marketed within national borders; a situation which clearly conflicts with the principles of a Common Market.

The range of services that can be offered through branches by one state to the others are relevant to inter-state competition, and this is an aspect in which harmonization has not been attempted. Instead, the Second (draft) Banking Coordination Directive includes a list of services which any state can provide in any other state unless the host state objects on the grounds that it is against the "public good". Indeed, according to this proposal it will not be necessary for the banks to modify their products in order to make them conform with the requirements of the host country. The only exceptions which apply to this wide freedom is that the services in question must be those included in the relevant list of qualifying bank activities and the "public good" exception.

The relevant list does not include certain types of financial activities - such as insurance business - which are permitted to be offered by banks only in the UK. The continental countries would, therefore, continue to restrict British banks to offer these types of activities even after the adoption of the respective proposal for a Directive. As far as the services that are included in the list are concerned, the adoption of the Directive may produce a situation in which a host state does not allow its own institutions to offer certain financial services. If that fact persuades it to modify its own permitted activities, the single market is carried a little further without harmonization.

Indeed, one might argue that this can happen. In France, for instance, the segmentation between deposit business and securities business has, recently, been eroded. Thus, in Italy, the banks might be allowed to enter into the securities business in the future. However, the rules concerning the range of services that can be offered by banks may not change so easily. Apart from prudential considerations, it would be necessary to give some time to the institutions to adjust to the new situation. Some countries would not, therefore, be able to meet the deadline of 1992 and continue to impose restrictions on the institutions freedom to provide services.

These restrictions may be invoked by the host Member State on grounds of public good. The respective proposal for a Directive does not spell out the circumstances in which the public good exception may be invoked. However, it is clear that the exception is the subject matter of Community Law and therefore it will be the Court of Justice, and not the authorities of the individual Member States, which will interpret its scope and application. The Court of Justice will possibly have many differences to resolve and its decision may make a contribution to the detailed shape of the Community's financial services.

The respective proposal for Directive makes no reference to banks' equity participation in other financial institutions. It is therefore assumed that the restrictions that exist at present in some Member States should be eliminated. However, here again, national rules and regulations may not change so easily. As far as the banks' right to own shares in non-financial companies is concerned, the proposal stipulates that each holding may not exceed 10% of the banks's capital and that the total of the holdings may not be more than 50%

of capital. Opposition is expected to this, particularly from Germany where banks have very large industrial holdings. The process of financial integration is unlikely to progress smoothly given the difficulties of harmonizing highly differentiated banking systems. With the exception of the UK where deregulation of market structures has reached an advanced stage, the European countries have adopted a gradualist approach. The pace of deregulation has been faster in some countries than in others.

Broadly speaking, the differences in the range of activities in which banks are permitted to engage are substantial since in some countries the concern over issues of stability and depositor protection is stronger than in others. The adoption of the Second (draft) Banking Coordination Directive would imply that foreign banking organizations may have wider or narrower fields of activity than domestic institutions. Member States are likely to find this arrangement difficult to swallow particularly when regulations differ widely. Opposition to certain areas of the respective (draft) Directive seems inevitable.

The Bank of England assesses banks, solvency on a case-by-case basis without setting any specific minimum solvency limit that the institutions should observe.

For the purpose of monitoring banking solvency the capital base is defined to include: share capital, minority interests in subsidiaries that are consolidated for supervisory purposes, general reserves (balance on profits and loss accounts, including hidden reserves) and provisions (general bad debt provisions, less any associated deferred tax asset). Preferred shares and subordinated debt are also included in the capital base subject to a limit of 50% of the unlimited elements after the deduction of intangible assets (see Appendix 1).

The criterion which determines the status of capital base in the UK is in accordance with the criterion set out in the Commission's proposal for a Directive on the own funds of credit institutions. However, the Bank of England recognizes that there are a number of elements (such as subordinated debt with a fixed maturity and the excess of market value over book value of some bank assets, notably bank premises and long term investments) that strengthen the balance sheets of banks but do not satisfy the above criterion. These items are also taken into account to some extent but only after the calculation of the risk asset ratio.

However, the identification of the constituents of capital is only the first step in the process of assessing an institution's solvency. The capital base is adjusted by deducting all intangible assets, investments in unconsolidated subsidiaries and associated companies including, but not limited to, unconsolidated joint ventures; and bank holdings of capital instruments of other banking organizations. (See Appendix 1)

The gearing ratio is expressed as the ratio of the adjusted capital base to total liabilities other than capital liabilities. However, this capital adequacy test is not considered as important since it does not take into account the different nature and degree of risk attached to any particular transaction. In this respect a form of risk asset ratio is considered as a more useful and effective test of solvency. Under this approach each broad category of assets and off-balance sheet obligations are given a weighting to reflect the different degree of riskiness inherent in each according to the nature of the obligation. The total of weighted risk assets is then measured in relation to the adjusted capital base to derive a ratio : the risk asset ratio.

The calculation of risk asset ratio represents only one element in the assessment of an institution's solvency. Indeed, the authorities take into account of the risk asset ratio as well as other qualitative factors, in their overall prudential assessment. They also consider the type of security held against advantages, the profitability, the managerial skills and the sources of additional capital.

This line of thought led the UK authorities to set a minimum confidential risk asset ratio for each individual institution to reflect considerations which cannot be incorporated within the simple structure of risk weightings applied to assets. The minimum ratio is reviewed in the regular prudential discussions of the Bank of England with the management of the supervised institutions and is subject to periodical adjustment in the light of the continuing supervisory process. The policy of the Bank of England is to establish bounds within which the risk asset ratios of institutions which undertake similar types of business can move according to skills and experience of managements. Thus, the UK authorities assess the solvency of each supervised institution according to the particular circumstances of the institution concerned.

By contrast, other European countries have banking laws that always specify solvency ratios.

In Germany, the banking Law establishes specific definition of capital and statutory provisions on capital adequacy. Broadly speaking, capital includes paid-up share capital, plus reserves to the extent that they are shown in the balance sheet, and net profits allocated to the capital. Banks may also include participation certificates in their liable capital up to an amount equivalent to 25% of the capital, reserves and allocated net profits component of liable capital. The loans and participation of banks should not exceed 18 times its liable capital.

In France, for supervisory purposes, capital is defined to include share capital, reserves and retained earnings, general provisions and subordinated debt, provided that the characteristics of such debt are close to that of equity capital. The value of capital for supervisory purposes is determined after deduction of certain elements, eg. the unpaid portion of share capital, losses, goodwill and start-up expenditures. Banking institutions are required to observe a minimum ratio of 5% between net own funds and the risks arising from their business.

In Italy capital is defined as paid-up share capital plus reserves. Banks are required to maintain a minimum capital ratio (8%) between their capital base and risks. The Banking Law also specifies the different weights attached to various categories of risks.

The controls over solvency is one of the major differences between the UK's and continental countries, supervisory systems.

As with many items of the balance sheet, the definition for solvency purposes of a bank's capital varies significantly across Member States. This state of affairs largely reflect differences in philosophical and practical (mainly accounting) considerations and up to now a consensus has not emerged within the supervisory community as to the conditions of eligibility for inclusion in the capital base of a number of potential components of capital. In a number of continental European countries there is a strong belief about the conditions for considering potential constituents of capital as elements of the capital base: they must be permanently available to absorb losses. By contrast, UK supervisors treat in practice other elements as components of capital for supervisory purposes even if they do not possess the characteristics described above.

Indeed, where country practices and philosophies differ considerably is with regard to the treatment of subordinated debt. British banks are allowed to strengthen their capital base by substantial issues of subordinated loan stock both in sterling and in foreign currency. The UK authorities take the view that such debt may provide support to the bank funding and protection to depositors in the event of liquidation. On the other hand, the German authorities argue that subordinated loanstock does not necessarily have any of the essential attributes of capital : it is not permanently available to meet current losses of an on-going concern and it usually carries contractual servicing obligations. The effective amount of capital which is used for solvency calculations should not be affected by the addition of low quality items vis-a-vis the primarily constituents of capital.

The definition of capital for supervisory purposes could possibly be a major issue which the UK authorities will find themselves debating with their Community partners in the context of the Second (draft) Coordination Directive. A major effort is underway at the European level, to improve comparability of countries' definition while at the same time preserving a needed degree of flexibility in the allocation of the various component of capital, in the light of a proposal for a Council Directive on the harmonization of the concept of own funds. However, the fact that this move has remained since 1985 only a proposal highlights the difficulties to promote convergence of philosophies and practices in this particular area.

As regards the measurements of capital international comparisons are conditioned not only by the diversity of approaches and coverage of risks across countries but also by the application of different weights attached to similar categories of risks. In this area, too, it would be unrealistic to expect a rapid convergence of legal requirements and supervisory practices.

However, where the UK practice and philosophy differ most with those of the other European countries are with regard to non-statutory supervision. The Bank of England holds the view that the prudential control on solvency should be as flexible as to take account of the particular character of each institution. No single solvency measure can incorporate the whole range of considerations which affect a bank's capital adequacy so that it can ensure that the capital position of the institution concern is regarded as acceptable by its depositors. Any action aimed at strengthening capital adequacy requirements in the UK would be constrained by considerations relating to banks' competitiveness and their capacity to adjust to changes in market structures.

Furthermore, time is needed to enable banks to undertake the necessary structural adjustments and considerable attention should be paid to the existing constraints on banks' ability to raise new capital funds.

On the other hand, the principle that great emphasis should be placed on capital adequacy as a means for strengthening supervisory safeguards receives strong support from the authorities of the continental Member States. The need to adopt explicit measures of capital adequacy with a view of sustaining the soundness of individual banks and the system as a whole has become a major consideration. The continental countries apply sound capital ratios as a practical means for strengthening prudential safeguards, while the British practice borders on the reckless. There should, therefore, be no illusion that significant advances towards harmonization of capital adequacy could be achieved in the foreseeable future.

However, harmonization of capital adequacy requirements is a necessary prerequisite for the adoption of the home country control principle : a principle upon which the EC strategy designed to integrate the national financial markets is based. In the absence of harmonization the German authorities, for instance, might argue that there is not in the UK an equivalent safeguard in respect of solvency control and the German depositor would be exposed to significantly greater risks in the absence of supervision by the German authorities. Without some harmonization of solvency requirements it is very difficult to allow the activities of foreign banking organizations to be governed by the regulatory authorities of the head office country, since most of the continental countries would consider that the degree of protection provided to their residents is inadequate and unacceptable.

Furthermore, the issue of capital adequacy for supervisory purposes cannot be disassociated from considerations relating to the competitive positions of banks. A bank subject to lower capital standards not only enjoys a higher leverage potential but also has a pricing advantage over its competitors. Capital divergences give rise to "unfair advantages" for banks with lower capital base. In highly competitive markets, such as the future European market, harmonization of solvency requirements is necessary to eliminate the imbalance in competitive conditions.

Freedom of banking services demands, therefore, a certain degree of harmonization over solvency controls. Precisely because freedom of services requires this degree of harmonization it is difficult to be achieved. In the UK there is a considerable opposition to any additional control. In the continental countries there is a great fear of the UK as competitors and a genuine belief that strict statutory supervision is the only effective method of depositor protection. It is difficult to see where there is room for compromise particularly within the timescale.

In the UK the Banking Law does not incorporate any statutory control on risks' concentration. The policy of the Bank of England towards large credit exposures is determined on a case-by-case basis and takes into account the particular characteristics of individual banks including the nature of their business and experience of their management. The level of exposure in relation to capital base which may be considered prudent for one bank may not be for another.

The Bank of England expects each bank to set out its policies on large exposure including exposure to individual customers, banks, countries and economic sectors in a policy statement. These policies should be formally adopted by the bank's board of directors and be reviewed during the discussions with the Bank of England. Through these discussions appropriate levels of credit exposure would be agreed on a case-by-case basis. The banks may not implement significant changes in their policies without prior notification to, and discussion with, the Bank of England. Each bank should also satisfy the authorities that it has at its disposal the necessary control systems to give effect to a bank's policy on large exposures.

The Bank of England also requires specific justification to the individual exposures exceeding 10% of a bank's capital base. Indeed, the Bank of England requires reports on all exposures above 10% of the capital base in order to ensure that such large exposures are given proper consideration.

Exposures that exceed 25% of a bank's capital base are required to be notified to the Bank of England before the respective bank becomes committed to the counterparty. Exposures above 25% of the capital base are not normally regarded as prudent. However, the Bank of England recognizes that there may be particular circumstances which justify the exposures above that level. Where a bank, for instance, is acting as a manager for an issue, its total exposure to the issuing company may need to rise above 25% of the banks capital base. A bank may be prudently exposed to a particular sector even if the level of its exposure exceeds 25% of its capital base because the respective bank specialises in certain types of lending.

The Bank of England also monitors the exposure of individual institutions to movements in exchange rates flexibility taking into account the particular character of each institution. The prime responsibility for controlling the exposures arising from foreign currency operations lies with a bank's own management. The Bank of England tries to be informed about the extent of each bank's exposure and the bank management techniques to control such exposures during the regular process of supervision. As a general rule the net open dealing position in any one currency may not exceed 10% of the adjusted capital base and the net short open dealing position of all currencies taken together should not exceed 25% of the adjusted capital base.

In stark contrast to the UK, the continental countries impose strict statutory controls on banks' risk exposure.

In Germany, banks must report to the Bundesbank "large loans" extended to a single borrower. "Large loans" are defined as the sum of claims on a single customer which exceed 15% of the banks' capital. No single "large loan" may exceed 50% of the bank's capital while the total amount of a bank's large loans should not exceed eight times its capital. Furthermore, banks' net open foreign exchange positions at the close of each business day must not exceed 30% of their capital.

In France, risk exposure to an individual customer, or to different customers having interests in common, may not exceed 5% of a bank's capital, while the aggregate of all individual risk exposures exceeding 25% of the bank's capital should not amount to more than eight times the bank's capital. Banks are not permitted to take open foreign exchange positions up to 40% of their capital.

In Italy, banks are subject to lending limits designed to avoid excessive risk concentration. The limit up to which banks can grant loans of more than one fifth of their own funds without authorization is 40% of their customer deposits. Furthermore, additional portfolio restraints are applied with respect to foreign exchange risk exposure. Banks are required to balance daily their foreign exchange positions vis-a-vis residents and non-residents. Positions in US dollar, EEC currencies and other currencies have to balanced separately. Open positions to some other currencies are subject to specific ceilings.

Diversification of risk exposure has traditionally been one of the most important elements of on-going prudential supervision. And the differences in the rules relating to the concentration of risks could possibly be another issue which the UK authorities will find themselves debating with their Community partners in the context of the Second (draft) Banking Coordination Directive.

Many continental countries take the view that excessive concentration of exposure is the primary factor behind financial difficulties encountered by banks facing changing economic conditions. The emergence of severe disequilibria in a wide range of industrial sectors and the much greater volatility of exchange rates that has been experienced for more than a decade are factors contributing to a sharp deterioration in portfolio quality and to a generalised rise in risk and problem loans. As a result, statutory limitations on the size of exposure arising from claims on individual or associated customers and open foreign exchange positions is a matter of great concern for continental supervisors, especially in the light of structural changes in economic and financial environment taken place in the recent years and the consequent rise of the potential forms of risk.

The UK authorities, on the other hand, hold the view that a certain degree of concentration is unavoidable and necessary in practice since individual banks tend to specialise in specific market segments or economic sectors. A certain degree of specialization may be a considerable asset for an individual bank which possesses the necessary expertise and knowledge of the functioning of certain markets. Indeed the diversification into areas with which the respective bank is not familiar could be a factor that involves risks. It is therefore unrealistic to believe that an acceptable degree of convergence of approaches in the field would be reached in the not too distant future.

The lack of harmonization with respect to controls on risk concentration would constitute a formidable impediment on the way of granting parental supervision on foreign banking organizations. Without some harmonization the adoption of home country control principle would lead to significant competitive imbalances while some continental countries could consider that the degree of protection provided to their residents is inadequate and unacceptable. It is, therefore, perfectly apparent that a Common Market in banking in its most liberal sense will be very difficult to come about.

Common Market is usually held to mean a Community wide market having the characteristics of a national market. The existing markets differ significantly in the nature and amount of regulation. The problem which the Commissions confronts is how to reconcile the objective of dismantling the barriers to freedom of banking services with that of satisfying the authorities in all the Member States that there is adequate protection for the depositors. The reconciliation of this objective can take place only through the mutual recognition of regulatory standards. However, the need for "prudence" constantly propounded in the case of banking undermines the principle of mutual recognition upon which the success of '92 depends.

In the view of the wide divergence of national rules and practices with respect to diversification of risk exposure the Commission recognizes the fact that it would be very difficult to produce a measure which would bring about home-country control at a stroke and in the Second (draft) Banking Coordination Directive proposes that until further coordination host Member States should control risks arising out of open positions. However, host country control on risk exposure will possibly be unworkable if at the same time solvency control rests with the authorities of the head office country. Controls over concentration of risks are expressed in terms of a relationship between the size of exposure and the bank's capital, because it is ultimately from this source that any loss arising from the exposure has to be made good. The line between home and host responsibility is not clearly defined.

In the UK the monitoring of banking liquidity takes place flexibly and in the context of regular discussion with the management. The prime responsibility for regulating banking liquidity lies with a bank's own management. The

Bank of England does not impose any liquidity ratio which the individual banks should observe. It rather tries to ensure that the supervised institutions have prudent policies with respect to liquidity and adequate internal control systems. The authorities consider that adequate liquidity is based upon three elements: an institution's expected cash flow, its capacity to borrow in the market and its stock of readily available high liquid assets. The main supervisory objective is to ensure that banks management policies pay considerable attention to these three elements. These elements may vary between banks according to the type of their business and the individual institutions are generally expected to maintain a prudent mix of different sources of liquidity appropriate to particular circumstances.

The measure of liquidity is based on a cash-flow approach according to which liabilities and assets are inserted in a "maturity ladder" with the net positions in each time period being accumulated. This measure by comparing sight and near sight liabilities with cash and assets capable of generating cash immediately in the first maturity bands on the ladder is similar to a simple liquid asset ratio. However, this measure takes also into account of the development of liability or asset management techniques for controlling liquidity through cash-flows. It also takes into account of assets which are capable of generating cash in particular circumstances.

By contrast other European countries set specific liquidity requirements.

In Germany, the authorities apply two liquidity ratios for prudential purposes. The long term liquidity ratio ("Principle II") implies that the sum of certain long term assets (fixed assets, unlisted securities, participation, balances and loans with agreed maturities or periods of notice of four years and over) should not exceed longer term resources as defined in the principle (they include varying proportions of longer term liabilities). The ratio must be met at all times and is calculated on a monthly basis. According to Principle III, the total of prescribed shorter-term assets should not exceed the total of shorter-term resources as defined in the Principle (they include varying proportions of deposits and interbank balances).

In France, the Committee on Bank Regulation imposes two ratios to ensure adequate liquidity. On the basis of the long-term ratio the total loans must not in principle exceed three times the total of own resources plus certain long-term liabilities. If the ratio is exceeded, the bank has to satisfy an alternative requirement whereby own resources and medium and long-term liabilities plus interbank borrowing with a maturity of more than two years account for at least 80% of lending with a maturity of over two years. The ratio is calculated on a quarterly basis. The short-term liquidity ratio which applies on a daily basis, relates prescribed liquid assets to short term liabilities and should not fall below 30%.

In Italy the Banks are not subject to any formal liquidity requirement for prudential purposes and the observation of balance-sheet relations is used as an indicator in the assessment of individual banks liquidity. These controls are similar to the UK ones. However, the liquidity position of Italian banks is also affected by the cash reserve ratio against deposits set for monetary policy purposes.

The controls over liquidity is one of the most important differences between the UK's and continental countries' supervisory systems. Liquidity ratios setting statutory proportions between certain liquid assets and prescribed liabilities are applied in a large number of continental European countries in stark contrast to the British system where no formal liquidity requirements or statutory ratios exist. It is therefore evident that to allow the highest level of freedom and give all banking institutions the right to operate throughout the Community subject to supervisory regulations of their head office country is very difficult. The wide divergence of practices in the field of liquidity control would be deemed to constitute unfair competition and some continental European countries could consider that the degree of protection provided to their residents is inadequate and unacceptable.

Furthermore, harmonization of the liquidity controls appears to be difficult particularly within the timescale. Most of the continental European countries, which believe that statutory liquidity requirements are important as tools for prudential supervision, would argue that the observation of balance-sheet relations as an indicator in the assessment of individual banks' liquidity is irrelevant and ineffective. On the other hand, the UK would argue that strict statutory requirements compel banks to retain more liquidity than necessary, (the freezing of an excessive volume of assets for liquidity purposes may impose an unreasonable cost on banks' operations restricting their profitability) and may bear more heavily on some institutions than others as a result of institutional and structural differences amongst banks. It will, therefore, be very difficult to achieve equivalent standards of liquidity supervision. As a result, the principle of home country control would clash with the wish of some governments to ensure that they are in a position to protect their consumers and the rival principle of host country control would have a strong following.

In some countries - such as Italy and Belgium - monetary controls are perceived as having important prudential connotations, since they have an impact on a bank's asset structure, and are used as a substitute to liquidity controls. As a result, the adoption of the principle of home country control in the banking field would require the harmonization of the national monetary policies- i.e. a Monetary Union.

The Commission believes that the unification of the economic and monetary policies will be the next step after the integration of European financial services. The integration of the financial sectors of each Community country would advance the Commission's agenda for the monetary integration in Europe. However, the present analysis leads to the conclusion that monetary unification is a prerequisite for the integration of financial services. Monetary unification should, therefore, go hand in hand with the integration of the financial sectors.

BARRIERS TO THE PROCESS OF LIBERALISING BANKING SERVICES IN THE DEVELOPING EC COUNTRIES : THE CASE OF GREECE

ESTABLISHMENT, OPERATION AND MARKET ACCESS OF BANKING INSTITUTIONS IN GREECE : CONDITIONS AND CONTROLS IN 1989

1 Regulatory provisions and administrative practices governing the entry and establishment of indigenous banking institutions

According to the Greek Banking Law (5076/1931) banks are defined as those enterprises whose customary business, irrespective of any other business conducted by them, is to receive deposits from the public and to extend loans for their own account. They must be set up under the legal form of limited companies. Firms carrying out banking business and operating under any other legal form are not permitted to use the word "bank".

The day-to-day supervision of the banking system is entrusted to the Bank of Greece which is the nation's central bank. This supervision is carried out in accordance with the provisions of Law 1665/1951 relating to the operation and control of banks. Generally speaking the Bank of Greece is responsible for supervising compliance with banking laws and monitoring banks' financial conditions. However, the operations of the Bank of Greece are carried out on behalf of the government and under the directives issued by the Ministry of National Economy.

Indeed, the ultimate responsibility for bank supervision and for the proper functioning of the credit system rests on the Ministry of National Economy. This Ministry is responsible for maintaining public confidence in the operation and stability of the credit system. The Bank of Greece is, therefore, a dependent public institution subject to instructions from the Ministry of National Economy; it does not enjoy much freedom of action; and it is the Ministry of National Economy which has the last word concerning the Bank's responsibility.

The undertaking of banking business requires authorization. The authorization is granted by the Bank of Greece according to the provisions of the basic banking laws 5076/1931 and 1665/1951. The criteria for authorization are related to minimum capital and management qualification requirements.

Indeed, any banking institution seeking an authorization is required to have a sufficient level of share capital in order to safeguard the interests of its depositors. The minimum level of share capital required for the establishment of a new bank is fixed at the discretion of the Bank of Greece and currently has been set at the amount of 2 billion drachmas (49). While existing licence holders which do not meet the requirement are allowed a period of time to comply. The share capital must be deposited with the Bank of Greece and the receipt of the deposit is attached to the application (for the establishment of the new bank) submitted to the authorities. The capital deposited with the Bank of Greece can be withdrawn only after the establishment of the new bank.

In the two basic banking Laws there are no explicit requirements as regards the professional qualifications, trustworthiness or nationality of the management of an applicant bank. Only the Decision 1360/5 of March 3rd 1965 of the currency committee contains the requirement that the majority of the board of directors of a Greek bank have to be Greek nationals residing permanently in Greece and that they should participate in the share capital (and therefore on the voting power) of the bank by at least 60%. Two exceptions of this rule have been granted to the Arab Hellenic bank and the International Hellenic Bank. In these two cases 40% of the share capital is covered by Greek nationals while the remaining 60% is covered by foreign nationals (but of Greek origin in the case of International Hellenic Bank).

Even though there are no specific regulations or administrative provisions which set specific minimum standards as regards the technical competence and the trustworthiness of the persons who determine the policy of a credit institution, when an application for authorization is examined by the authorities their reputation is considered and possibly affects the granting of the authorization. An authorization may be refused on the grounds of lack of reputable management. The authorities also try to assess the professional qualifications of the proposed managers, their working experience in banking, industry or commerce and their adequate knowledge of the Greek laws and regulations with regard to banking. An authorization may be refused on the grounds that the management is not sufficiently qualified to run its business properly and able to benefit the economy. However, in practice this has never been used as a reason for refusing an authorization.

In general it can be said that any banking institution seeking an authorisation has to prove that its management is reputable and capable of running its affairs smoothly. The above requirements apply equally to foreign nationals and to controlling personnel of branches of foreign banks. On the other hand, the Bank of Greece enjoys full discretionary powers in taking a decision to accept or refuse applications and in interpreting the authorization criteria (because they are not laid down specifically) and deciding whether the applicant meets them. Furthermore, the Greek authorities have not adopted the principle that a bank must be effectively managed by at least two persons (this is the so-called "four eyes" principle) as a requirement for authorization; and two years ago the Bank of Greece permitted the entry of a new banking institution in the form of sole proprietorship (Bank of Crete).

The Greek authorities before granting any authorization also take into consideration the general or local "economic need" for a new bank, but this concept is discussed elsewhere.

The Greek authorities also exert considerable control on domestic branching by already authorised credit institutions. A licence from the Bank of Greece is required for the opening of any new branch of existing banks operating within the country; and the Bank of Greece enjoys substantial discretionary powers in taking a decision to grant or refuse the licence after taking into particular account the local or regional economic needs of the proposed branch. The Bank of Greece could also use its discretionary powers to exert prudential control - for instance in some cases the authorization of new branches has been granted upon condition that the banks concerned would increase their share capital up to a specified level.

The analysis of the authorization requirements with respect to entry of indigenous banks indicates that the national authorities enjoy significant discretionary powers to interpret and apply the provisions of the banking laws. However, the controls over entry are motivated solely by prudential considerations. They are not applied with the intention of prohibiting entry of those institutions which would succeed; they are rather designed to cut out only those institutions which would have failed. As a result, the control over entry of indigenous banks do not have a bearing on the size and structure of the Greek banking industry, if the authorities judgement is right.

2 Regulatory provisions and administrative practices governing the entry and establishment of branches by foreign banking organisations

The entry and establishment by foreign banking organizations of branches in Greece is, in principle, subject to the same regulatory provisions applied to domestic credit institutions. The granting of authorization to foreign-owned establishments is subject (as in the case of domestic banks) to specific requirements concerning the legal form of the institution, minimum capitalization, nationality and competence of the management and the general or local economic needs. Reciprocity tests are not applied when considering foreign banks application for entry.

Foreign banks are required, for the establishment of their first branch in Greece, to import, in foreign exchange, the equivalent of 2 billion drachmas. This amount should be converted into drachmas and be used as the branch's capital as long as it remains in operation. If the branch's capital is reduced, because of operational losses, below this level the shortages have to be covered through the imports of foreign exchange which will again be converted into drachmas (50).

The foreign banks' branches are subject to the same management requirements as domestic banks. The Bank of Greece would need to be satisfied that the management is well experienced, trustworthy and properly qualified. The managers should also be resident in Greece. Even if there are no separate provisions in the Greek banking law concerning the nationality of those responsible for the management, the Bank of Greece would like to see some Greek national involved in the management for their knowledge of domestic laws, regulations, market practices and implicit conventions regarding "the rules of the game". On the other hand, a quota system applies for each bank on the work permit which should be obtained by foreign nationals (other than EEC) before taking up a position.

The Greek supervisory authorities , before granting an authorisation, need also to be satisfied that the de-novo entry and establishment of a banking institution is justified by the general and local economic needs. This requirement, relatively subjective in nature, gives the authorities a considerable degree of discretionary powers in deciding whether to grant or refuse an authorisation. They can refuse authorisation even if all the conditions we have prescribed before are fulfilled.

Where a market is fragmented and characterised by numerous institutions competing for a limited amount of business, the resulting competitiveness may be destructive. Governments might seek to remedy this problem by prohibiting new entrants. Restrictions on a new banking facility upon evaluation of the "economic need" may be erected when the degree of competition in the domestic (or local) market is considered the appropriate one in terms of the banking system's ability to perform its intermediary function and to provide an adequate range of services (51). In this case, the establishment of new banks is considered dangerous since it could create conditions of excessive competition (ie overbanking) and therefore enhance the risk of banking failures.

However, Greece is considered by some bankers* as underbanked. According to them the demand for banking services in Greece (estimated on the basis of income per capita) is well above supply of these services and a significant amount of resources are not attracted by the banking system. Furthermore, a relatively large "black market" in banking services operates in a well organised manner and the limited amount of the official supply of banking services is considered the main cause of its existence (52). Indeed, the evidence of this black market is used to highlight the poor quality and quantity of services offered by the official banking sector. The same bankers estimate that another 300 new branches are necessary in order to bring supply into line with demand. The concept of "economic need" is therefore used for other reasons than to avoid "overbanking" situations.

In the case of indigenous banks setting up operations for the first time in Greece, or for expansion of these operations, authorisation is granted relatively easily. However, in the case of foreign banks the Greek

* (Interviews : National Bank of Greece and Commercial Bank of Greece July 1988)

authorities, before granting an authorisation, take into consideration the possible adverse developments on the indigenous institutions of the future activities of foreign banks. Despite the considerable efforts made in the past few years the Greek institutions are still uncompetitive and technically less developed in relation to better equipped organised and experienced foreign banks. If these institutions were subject to rigourous competition their prospects for growth, or, in many cases, even survival would be dim.

The above considerations in favour of restrictions on foreign banks penetration into the domestic market are similar to the familiar infant industry argument. Furthermore, protective measures designed to diminish the competitive advantages enjoyed by more developed banking organisations are justified for other reasons. The banking industry seems to play an important role in the development of other sectors of economic activity and the government has endorsed the concept that "the strengthening of the domestic banking organisations is an essential characteristic of economic growth". A strong national banking industry is therefore deemed desirable for many reasons.

The Greek authorities* point out that in the last few years the Commercial banks (and especially the two

*(Interview, Bank of Greece, June 1988)

largest ones) made considerable progress towards reorganization. The Commercial banks completed various construction works at a large number of branches to ensure operational improvements and expanded their national and international network with the establishment of new branches.

Furthermore, the recognition that the Commercial banks will be called upon to operate within a highly competitive market which is developing freely and rapidly in the context of the European Communities forced them to step up their efforts towards reorganization. The reorganization programmes include a wide range of changes covering basic aspects of planning and programming, modernization of transactions, introduction of new types of operations and adoption of new systems concerning internal audit and security of transactions (53). The authorities believe that these programmes when completed will give them the ability to compete successfully with the foreign banks.

However, at present, as we have seen above, some form of protection is considered necessary in order to protect the development of indigenous credit institutions. In these respects the foreign banks wishing to set up operations for the first time in Greece are asked to specify in detail the type of foreign banking business, the programme of operation and the number of branches they are planning to open in Greece. The authorities seek to ensure that the activities of foreign banks will not compete directly with those of the indigenous banks. Furthermore, the state-owned Commercial banks are asked unofficially to comment on whether they believe that the respective foreign banks will attract a significant proportion of business away from them and restrain their activities.

Limitations on new entry may also be felt necessary not only for avoiding direct competition between foreign and indigenous institutions and therefore keeping the latter in a position to provide competitive services to their customers, but also for financial protection. Indeed, the Greek authorities* also express concern that the foreign banks by virtue of their operations could circumvent relatively easily the Greek exchange controls which are necessary for the implementation of domestic monetary policy. The foreign banks have close links with foreign enterprises (operating within the country) which are their main customers. These foreign enterprises concentrate mainly in export activities and therefore can escape domestic exchange controls through an appropriate management of export earnings. The Greek authorities therefore fear that the foreign banks may use

* (Interview, Bank of Greece, June 1988)

domestic savings to participate in speculative activities of foreign enterprises against the drachma. They seek therefore to ensure that the above prescribed activities will not be carried out by the foreign bank wishing to operate within the country,

The objective of restrictive policies is both to protect domestic savings being used for speculative purposes and to promote indigenous institutions and not to avoid "overbanking" situations. The concept of "economic need" is used as support for protectionism of the domestic banking system and financial protectionism. Such protectionism takes usually the form of restrictions on the number of branches the foreign banks are allowed to operate within the country.

In fact, there are no distinctions in the Greek Law between indigenous and foreign banks with respect to the expansion of branch networks. The Greek banking Law establishes a policy of national treatment and the foreign banks have to meet the usual requirements of authorization for the establishment of any new branch. However, the national authorities, through the application of "economic need" criterion, place limits on the expansion of foreign branch networks restricting foreign banks, ability to compete directly with indigenous institutions.

According to the First Banking Coordination Directive the "economic need" criterion will be legal until 15 December 1989 as a condition for the entry into the market and whenever applied in Member States should aim at promoting security of savings, higher productivity in the banking system, greater uniformity of competition between the various banking networks and a broader range of banking services in relation to population and economic activity. Obviously, according to this Directive the "economic need" criterion should be used for prudential considerations. One, therefore, might argue that the authorities' objectives of using the economic need criterion violates certain provisions of the First Banking Coordination Directive.

An authorization is also necessary for the entry and establishment of representative offices by foreign banking organizations in Greece. Requests by foreign banks to establish representative offices are liberally treated provided that the representative offices do not directly engage in banking business and are not serving as intermediaries between credit institutions and local customers. The representative offices should operate only as economic observers and their role is limited to collecting and issuing information. In these respects the Bank of Greece if it is deemed necessary, may require that the parent bank submit reports or material concerning the activities to be conducted by the representative office.

The above analysis leads to a number of conclusions. The Greek banking Law establishes a policy of national treatment with respect to foreign bank entry in the Greek banking system. In Greece the first branch of a foreign bank is considered as a new entity and not as an extension of banking business. So, a minimum capital is required for the establishment of the first foreign branch and its level is equal to the minimum capital for any new domestic bank. The requirements regarding the qualification and competence of the management and the application of the "economic need" criterion are also the same, in principle, as those imposed on the establishment of any new domestic banks.

However, the application of national treatment constitutes an important obstacle to foreign bank entry. Especially, the set of minimum standards for branches' capital is a significant impediment to the potential expansion of banking business in Greece from a foreign banking concern. The size of initial capital requirements deters, according to some foreign bankers, foreign-owned institutions from establishing local organizations since the expected volume of business does not seem to justify such a capital outlay. The Bank of Greece also applies specific requirements on the nationality of part of the management. Even if these requirements are applied in order to ensure that some directors have adequate knowledge about domestic laws and banking regulations, their existence could be another potential restriction against foreign bank entry.

As it has been pointed out elsewhere there are a number of instances where the impact of uniform requirements is uneven. It is, therefore, quite evident that only by adopting the principle of "home country control" - can a truly common banking market come into existence. And indeed, this is the EC policy designed to integrate the twelve national markets by 1992.

Even more important is the fact that the Greek authorities enjoy considerable discretionary powers to limit foreign bank entry through more stringent enforcement of apparently non-discriminatory regulations. The economic need criterion applies, in principle, equally to both domestic and foreign banks. In practice, however, discriminatory treatment against foreign banks arises in the actual application of this requirement since there is considerable lack of transparency in respect of the criteria used for assessing the general or local economic needs for a new bank.

3 Regulatory provisions and administrative practices governing the entry and establishment of majority and minority owned subsidiaries by foreign banking organisations

The Greek authorities also limit foreign banks' access to the domestic market through the acquisition of participations in the indigenous banks. Indeed, foreign access to the domestic banking system through equity participations in indigenous banks is subject to specific restrictions as to the maximum degree of foreign ownership allowed by the decision 1360/65 of March 3, 1965 of the Currency Committee. According to this decision nonresident participation is not allowed to exceed 40% of the capital stock of a bank established in Greece. However, exceptions to this practice were authorized by the Greek authorities in two cases so far : to the Arab Hellenic bank and to International Hellenic Bank both only 40% owned by Greek interests.

In principle the banks with foreign interests are subject to the same requirements as domestic banks with regards to nationality and competence of management. The majority of the members of the board of directors should be of Greek nationality, permanently resident in Greece (with the exception of the Arab Hellenic bank and the International Hellenic bank) while the competence of personnel in control is assessed in the same way as for Greek credit institutions.

As in the case of de-novo entry and establishment of foreign banking organization, no requirements are laid down with regard to guarantees or "letters" of comfort from parent institutions, but the Bank of Greece in examining applications may stipulate specific requirements. When a foreign bank applies for permission to own less than 40% of the total share of capital it might be necessary to provide evidence that it intends to promote the activities and the competitive position of the subsidiary through the application of modern banking techniques. Guarantees with regard to the foreign investment were required only in the two cases where the foreign institutions acquired controlling interest.

Recently, the Greek authorities have started encouraging the acquisition by foreign banking organization of minority interest (less than 40%) in indigenous banks. This significant shift in attitude reflects the authorities views that some foreign participations would facilitate the introduction of new services, techniques, instruments and management strategies which will foster the efficiency of domestic banks and enable them to compete successfully with their foreign counterparts in the single financial market of 1992. In particular, some degree of foreign ownership is seen as a means of introducing innovations such as the use of cheques, and business consultancy; and stimulate the growth of banking related specialised services such as leasing factoring and consumer finance. In the above activities the foreign banking organizations hold a strong comparative advantage in terms of know-how and experience.

On the other hand, the establishment of subsidiaries through the acquisition of majority interests by non-residents banks is prohibited as a general rule. The reasons for forbidding non-resident acquisitions of majority holdings in indigenous banks are broadly the same as for limiting de-novo entry. The authorities' objective of placing such a strict rule (decision 1350/65) was to protect the domestic banking system from foreign competition and to avoid foreign majority participation in a sector which is regarded of vital importance for the general attainment of economic policy goals. The regulation which set a ceiling on the maximum level of participation is the most serious obstacle since it limits directly the scope for foreign access to the Greek banking sector. Other impediments such as regulations with respect to nationality and competence of management are considered of relatively minor importance.

Broadly speaking, restrictions on the entry and establishment of foreign subsidiaries are substantial. Foreign banking organizations are faced with the position of introducing new services, techniques, instruments and management strategies with little control and with most of the profits going to local interests. It seems that the countries which restrict the establishment of foreign branches, are those where establishment of foreign subsidiaries is also difficult. Countries applying a strict policy with respect to de-novo entry cannot offer foreign banks a viable alternative to establishment in the domestic market via the acquisition of indigenous banks.

It is rather surprising that while the Commission made significant attempts to eliminate impediments to the establishment of foreign branches, it did not do so with regard to foreign subsidiaries. Indeed, some banking organizations (especially the German ones) are specialized in the entry into foreign markets through subsidiaries so that they obtain a given portfolio and then they try to expand it. The adoption of Directives designed to abolish restrictions with respect to acquisition by foreign banking organizations of participations in indigenous banks is, therefore, essential for the creation of a Common market in banking.

Even if the difficulties facing the Commission in its task are recognised, it is considered that its strategy does not appear to be a comprehensive attempt to integrate the twelve national markets in one unit. Despite the intention of the Directives government action will be able to inhibit entry even after their implementation.

4 Regulatory provisions and administrative practices limiting the market access by foreign based banking organisations

The Greek exchange control regulations substantially preclude external banks from conducting banking business in the country with Greek residents or companies.

Under these regulations the outward transfer of capital originating from lending abroad through the acquisition of financial assets including bank deposits by bank and nonbank residents requires authorization by the Bank of Greece. Non-bank residents are not generally permitted to open deposit accounts with external banks. The opening of such accounts might be authorised only on an exceptional basis in the case of state-owned companies or some other enterprises when justified by their external operations. Authorizations are not normally granted to resident banks for capital outflows in order to create balances with foreign banking institutions for reasons of domestic monetary policy.

The borrowing by banks and non-banks residents from foreign-based banks is also subject to exchange control regulations. Greek residents are normally prohibited from borrowing from external banks unless an authorization is granted by the Bank of Greece. The authorization is granted only if the loan is raised with a view to financing export credits, raw materials and mechanical equipment and to paying royalties on imported know-how. The Bank of Greece recently permitted borrowing from foreign based banks by manufacturing, mining and hotel firms without prior approval but on specific terms regarding the period of the loans and the interest rates.

The Greek residents banks are subject to exchange control regulations insofar as operations on their own account are concerned. Commercial banks may accept deposits in convertible drachmas or foreign currencies from non-resident banks on terms established by the Bank of Greece. The terms usually refer to the period and to the interest rate paid on the loans. Moreover, Commercial banks and investment banks may borrow convertible currencies abroad, provided that they extend medium-term and long-term loans of equal amounts in foreign currency (or drachma loans with a foreign exchange clause) to productive enterprises established in Greece. As a general rule, foreign investments in Greece by non-residents banks are liberalised and may be subject to preferential treatment if aimed at the promotion of national production or otherwise contribute to the economic advancement of Greece. However, other banking services are not allowed freely.

As a general rule, Greek residents are not permitted to enter into arrangements with foreign based banks for services provided abroad on the basis that the underlying transactions clash with the exchange control requirements. Indeed, the limitations on market access by banks operating from outside the country are not primarily motivated by the intention to discriminate against the activities of these banks. They have been basically introduced because of the desire to minimize capital outflows. This provides a clear indication of the strong links between the controls on capital flows and the barriers to trade in banking services. Indeed, the discrimination against banking organizations on the grounds of the fact that they are established in a Member

State other than that in which the services are to be provided constitutes a serious barrier to trade in banking services.

One of the main objectives in the imposition of foreign exchange controls on capital flows is the enhancement of the domestic capital market. The enhancement of the domestic capital supply is of enormous importance to the country as a means of supporting domestic economic development. The funds channelled into the domestic capital market can be used for investment in government securities and for financing industrial projects in the private sector of the economy. The foreign exchange control regulations have been introduced and maintained for various reasons, to safeguard the effectiveness of the domestic monetary policy and to achieve certain macroeconomic policy goals. However, even if the exchange control regulations belong to the domain of domestic monetary policy, the importance of such obstacles to international banking activity is evident.

5 Regulatory provisions and administrative practices restricting the domestic operations of established foreign-owned banking organisations

The extent to which foreign banking institutions authorized to operate in the national market can compete on an equal footing with indigenous banks depends in the first instance on the non-discriminatory character of the regulatory provisions concerning the scope of banking business. And in Greece there are only a few regulatory provisions which relate to the scope of banking business and distinguish between indigenous and foreign owned banks.

Foreign banks established in Greece are not subject to the requirement to devote 15% of their total deposits for long term loans to finance productive investments. In this respect the foreign banks are subject to a preferential treatment. Instead, their operations are subject to the requirement that their loans for working capital cannot exceed four times their endowment funds- ie. the sum of their foreign currency deposits with the Bank of Greece and the total of their long term foreign currency financing of the Greek State, public corporations and investment banks. Obviously, this requirement restrains intentionally the foreign banks' lending activities and (according to some foreign bankers) outweighs the preferential treatment outlined above.

With the notable exception of these two regulations, foreign banking organizations established in Greece have, in principle, to meet the same requirements as indigenous ones. Indeed, the regulatory provisions applied to banks make little distinction between banks of different nationalities. However, a form of discriminatory treatment against foreign banks arises from the lack of transparency in the exercise of discretionary powers by the responsible supervisory authorities.

With respect to prudential supervision there are no legal provisions that in any way distinguish between indigenous and foreign banks. The Greek authorities point out that they have adopted the principle of national treatment with respect to prudential controls. However, some foreign bankers* believe that in practice discriminatory treatment against foreign banks arises in the actual application of such controls.

The prudential supervision in banking is exercised on a non-statutory basis and the Bank of Greece is empowered with considerable discretionary powers to impose compulsory increase in the capital of banks within specified periods in relation to the risks assumed by the banks concerned. However, this is an area where the foreign bankers detect unequal treatment due to more stringent or more restrictive enforcement of apparently non-discriminatory regulations. In Greece there are no specific solvency ratios and the Bank of Greece

* (Interviews NatWest Bank, Barklays Bank, American Express Bank, July 1988)

imposes higher solvency requirements on foreign banks especially when they try to attract business away from the indigenous ones. The lack of transparency with respect to prudential supervision and the considerable discretionary powers enjoyed by the Greek supervisory authorities may therefore hinder foreign banking institutions and limit their capacity to compete on equal terms with the indigenous banks.

Thus, the EEC Commission's call for transparency with respect to prudential supervision in banking is relevant in the case of Greece. Furthermore, it is fairly evident that the principle of host country control could be discriminatory against foreign banking institutions. This is one of the main reasons behind the Commissions' decision to promote integration in the financial markets by transferring the responsibility for supervision of the respective institutions to the competent authorities of the country where the head office has been established.

Of much greater concern are a number of rules and requirements which, while applying uniformly to both indigenous and foreign banks, fall with particular severity on the latter.

Many foreign bank managers* have complained that the Greek

* Interviews: (Nat West Bank, Barclays Bank, American Express, Credit Commercial de France, July 1988)

banking system is over-regulated by a plethora of legal and administrative practices. Indeed, in Greece, as it is pointed out elsewhere, the Monetary authorities are intended mainly to control commercial bank behaviour, through a wide range of rules and regulations. The regulatory structure consisting of a combination of direct restrictions on the portfolio policies of Commercial banks, interest rate ceilings on deposits and loans and ceilings on the supply of certain types of credit, reflect the authorities' objectives to influence the composition of real expenditure and real resource allocation rather than market preferences.

The administrative determination of interest rates and the control of the banking financial operations do not permit the banks - both indigenous and foreign - to pursue an independent and autonomous policy. However, even if the existing regulatory framework does not intentionally discriminate against foreign-owned banks, it limits their competitive opportunities. The foreign banks established in Greece would be able to perform better than their rivals among the big state-owned banks in the case of the free market in which the price mechanism governs the use of real resources and profit motives dictate the allocation of investments and lendings. Foreign banks are relatively better equipped, organized and more experienced to operate under the conditions of the free market.

Moreover, the direct controls of the banking financial operation, even if they apply equally to both domestic and foreign banks, may give rise to discriminatory treatment against foreign banks due to the different kind of activities they carry out. More specifically, the foreign banks mainly try to meet the financial needs of large multinational enterprises established in Greece and would not get involved in the financing of the small scale manufacturing in the case of absence of direct controls of the banking financial operations. In contrast, the indigenous banks would extend loans to the small scale manufacturing and to productive industrial investments, even in the case of absence of direct controls of the banking financial operations.

Some foreign bankers* believe that the compulsory reserve requirements of 10% on bank deposits for credit to small-scale, industry are excessive for foreign banks. This argument is based on the view that foreign banks are not familiar with domestic market practices and thus the keen competition with indigenous banks to make use of funds earmarked for loans to small scale industry-owning to the harsh penalty represented by the very low interest rate on unused balances with the Bank of Greece - takes place on unequal terms at the expense of foreign banks. As a

*(Interviews, Barclays Bank, Nat West Bank, American Express Bank July 1988)

result the foreign banks' unused balances of funds compulsorily deposited with the Bank of Greece for financing small-scale manufacturing are relatively high in relation to those of the indigenous banks. This entails a substantial cost on the foreign banks since the yield of funds remaining unused at the central bank is about 8 percentage points lower than the average cost of accumulating deposits. And the loss incurred by the foreign banks due to unused balances of funds earmarked for the financing of small-scale manufacturing and productive industrial investment, is relatively higher than those incurred by the indigenous banks for the same reasons.

The regulatory provision regarding the compulsory use of certain percentages of private deposits to finance small-scale manufacturing must be seen as a particular disadvantage against foreign banks and prevents them from making intensive efforts to accumulate private deposits. An increase in their private deposits would increase their unused balances of funds compulsorily deposited with the Bank of Greece resulting in a substantial loss. As a consequence the foreign banks already established in Greece do not make substantial efforts to expand their borrowing activities. The administrative interventions to absorb resources for the purpose of financing certain sectors of economic activity restrain the borrowing activities of foreign banks in Greece.

Lastly, foreign bankers* believe that the application of exchange control regulations even if they do not constitute an exception to national treatment and apply, in principle, equally to both indigenous and foreign banks, bear more heavily on foreign banking organizations.

The foreign exchange control regulations restrict the private investors ability to transfer funds abroad and to use the services of the international money markets. The foreign banks would be able to provide an excellent link with the international money markets through their international networks. The existence of exchange control regulations restricts also the foreign banks ability to transfer funds abroad and to use them for more profitable investments. In general it can be said that the exchange controls restrains the introduction of more services in connection with capital market, money market and foreign exchange market operations. The existing worldwide networks of foreign banking organizations provides an excellent basis to expand this range of activities. The discriminatory effects of the applications of the exchange control regulations on foreign banks are also illustrated by the fact that while

* (Interviews, American Express, Barclays Bank, Nat West Bank, July 1988)

the indigenous banks have proportionally more clients the foreign banks tend to go for wealthy individuals who express a relatively high demand for international money.

Furthermore, the exchange control regulations apply to the repatriation of profits and contribute to the overall expenses of the foreign banking organizations.

The repatriation of the after-tax profits requires authorization by the Bank of Greece. Foreign banks are granted the authorization to repatriate after-tax profits up to the amount of foreign exchange imported from their offshore operations. The Bank of Greece may also approve repatriation of larger amounts if the respective foreign banks show substantial economic benefits to Greece from their operations. Some foreign bankers * stated that it has proven difficult for foreign banks to demonstrate such substantial net economic benefits.

The existence of regulatory and administrative practices, which even if they do not constitute an exception to national treatment, may influence the competitive balance as between foreign and indigenous banks indicates that the mere fact of treating banking institutions from other member States in the same way as indigenous banks could not ensure fair conditions for competition and the

* (Interviews, Barclays Bank, Nat West Bank, American Express, July 1988)

existence of a common market. This highlights the need for harmonisation with the EEC.

The analysis so far leads to the conclusion that the Greek banking market is almost isolated from abroad since freedom of international banking operations is severely restricted due to application of foreign exchange control regulations. Within this isolated market the national authorities limit the entry and establishment of branches and subsidiaries of foreign banking organizations as support for protectionism of the domestic banking system and financial protectionism. Furthermore, the authorities also restrict the operation of established foreign-owned banking organizations for the same purpose.

Any classification of identified obstacles by order of importance is a difficult and subjective exercise. It would, nevertheless, appear from the analysis of obstacles that the most serious category of impediments relate to limitations to the granting of right of establishment to foreign-owned banks. The existing regulatory provisions and administrative practices provide scope for some foreign banking presence but the right of establishment is severely limited. The restrictions on the operation of established foreignowned banks are considered as the second serious category of obstacles. The fact that the foreign banks, despite the small number of their branches, account for almost 15% of the overall banking activity in Greece, may provide an indication of the degree of severity of the different kinds of obstacles thus justifying the above presented order of importance.

In the field of international banking transactions the impediments that exist are not intended to discriminate against foreign based banking institutions and result from measures the authorities have taken in pursuit of other policy objectives. It is difficult to form an opinion of the extent to which the restrictions on the market access by non-resident banks effectively limit the scope of international trade in banking. One might argue that the pursuit of proper banking business requires a physical, operative presence and only through establishment can a foreign banking organization compete effectively with indigenous banks. As a result, the impediments on the market access by foreign based banks are not considered as important as the other two categories of obstacles.

The analysis of the impediments on trade in banking services reveals that the Greek authorities ignore certain provisions of First Banking Coordination Directive (since national economic interests are involved) and impose numerous restrictions on the foreign banking organizations. The question is whether this picture will be reversed in the years to come. Will Greece implement the provisions of the First Banking Coordination Directive? And even more important, will it operate in a unified European market based on the Commission's strategy which means that almost all the controls (except those associated with the establishment of foreign majority owned subsidiaries) would be eliminated? These questions are answered in the next two sections.

AN INTEGRATED BANKING MARKET : PROBLEMS FOR THE GREEK BANKING INDUSTRY AND ECONOMY

At the centre of the Greek financial system is the Bank of Greece, the country's central bank. Around it there is a thin complex of governmental and private financial institutions which include commercial banks investment banks and government-owned specialized credit institutions. There are, however, no building societies, hire purchase and finance houses nor any other kind of organization (apart from insurance companies) which could be characterized as a financial intermediary. Non-banking institutions do not play an important role in financing investment mainly due to the underdeveloped nature of the capital market. The banking system is the most important institutionalized means of mobilizing and allocating private and financial resources. In order to highlight the development and the operation of the Greek banking industry within an integrated banking market, it is necessary that the structure of the Greek credit system first be discussed.

The Commercial banks constitute the main part of the Greek banking system and play an important role in the accumulation and allocation of savings. Through their operation absorb the largest part of deposits in drachma and foreign exchange (around 70% according to Table 7) and finance almost all sectors of the economy with the notable exception of agriculture.

The National Bank of Greece holds a predominant position in the whole banking system. It accounts for more than 50% of commercial bank deposits and 40% of all deposits and provides more than 45% of all commercial bank loans and advances. It also controls a number of other banks such as the National Investment Bank for Industrial Development, the National Housing Bank, the Trader Credit Bank and the Arab Hellenic Bank (54). It also owns or has interests in a wide range of other sectors of the Greek economic activity such as finance, manufacturing, insurance and tourism.

The Commercial Bank of Greece is the second largest bank in Greece. It accounts for almost 16% of commercial bank deposits and more than 10% of all deposits and covers almost 8% of total credit supply, (see Table 7). It also controls a number of other banks such as the Ionian and Popular Bank, and Bank of Piraeus, the Bank of Attica and the Investment Bank (55). Similarly with the National Bank of Greece, the Commercial Bank of Greece has interests in a number of important sectors of economic activity such as insurance, manufacturing and tourism. These two banks have a small number of branches abroad to serve the Greek community established there.

The National Bank of Greece and the Commercial Bank of Greece are under public ownership and for this reason all other banks and subsidiaries controlled by them are state-owned. There is also a small number of smaller domestic banks which are under private ownership. Moreover, at present, 20 foreign banks operate in Greece with total deposits of around 15% of overall commercial banking activity. Their main customers are a small number of foreign enterprises operating within the country (56). The operation of foreign banks is, therefore defensive in nature and derivative of the operation of foreign enterprises.

TABLE 7

DEPOSITS HELD AND LOANS AND ADVANCES MADE BY GREEK AND FOREIGN CREDIT INSTITUTIONS IN 1987 (DRS MILLIONS)

Commercial banks	Deposit	Loans/advances
National Bank of Greece	1,366,523	679,821
Commercial Bank of Greece	362,715	182,875
Ionian Popular Bank of Greece	191,532	99,421
Credit Bank	101,780	51,192
Other Domestic Banks	207,920	103,975
Citibank	75,523	92,759
Bank of America	67,136	44,972
Continental Bank	52,398	38,791
Other Foreign Banks	123,456	121,207
Total	2,548,989	1,408,013
Special credit institutions	561,127	765,283
Investment banks	125,172	152,588
Total	3,235,288	2,325,884

Source : EPILOGHI, September 1988

The Investment Banks are state-owned financial institutions specialised in investment financing and their principal task is to boost the country's economic development. Their main operation consists of selecting and financing the investment programmes of manufacturing and other firms such as mining, tourism and shipping (57). These banks participate in the equity capital of these enterprises and provide technical assistance to them. The operation of these banks take place in accordance with the government's industrial policy. In recent years, for instance, the Investment Banks have stepped up their efforts to support viable firms with temporary financial problems (the so-called "problem companies") on the basis of a plan set out by the government. This provides a further evidence of the strong state involvement in the banking sector. The state intervention is further enhanced through the operation of Specialized Credit Institutions.

Specialized Credit Institutions are State-owned institutions which extend credit to specific sectors of economic activity whose attractiveness to banks is limited due to comparatively low return offered and the rigidities they impose on bank managements. The most important of them are the Agricultural Bank of Greece and the National Mortgage Bank which extend loans to farmers and to low income groups for house construction respectively; on terms determined by the government on the basis of its agricultural and social policy (58). The government determines directly the operation of these institutions.

The structural information concerning the functions of the Greek banking system that are provided above lead us to the conclusion that the Greek authorities are advocates of strong state ownership in the banking system. The major principle of the strong public ownership in the banking system is to affect the allocative efficiency of the market. The national authorities believe that there are considerable divergences between private and social costs and benefits. It is considered that private lenders operating commercially look only at the returns to themselves in considering an application for a loan whereas the investment financed by the loan might bring benefit not only to the borrower but also to the whole economy in terms of higher GDP or to employees in the form of higher wages and greater employment opportunities.

Public control through public ownership is essential to ensure that the necessary volume of external finance is available to finance a sustained increase in specific industrial investment. The availability of external finance is considered by the authorities as a constraint on investment of small and medium size firms and risky projects necessary for the national economic development. Public ownership is therefore essential to arrange the allocation of funds according to social priorities rather than criteria of short term private profits.

The above considerations, however, are incompatible with the principle of an integrated financial market. In an integrated financial market interest rate parity would emerge as borrowers in high rate markets turned into savers in low rate markets to reduce their cost of capital. As a result, capital would flow to areas where the returns are the highest. Obviously, in principle, the philosophy of control over the Greek banking system conflicts with the philosophy of a Common Market in financial services.

In an integrated European financial market the allocation of funds would be arranged according to criteria of short-term private profits and this may have detrimental effects for the domestic industry. In an integrated financial market the ability of a government to guide a flow of savings into preferred channels of investment is significantly reduced. This conflict between financial integration and independence in controlling the allocation of credit is magnified because the structural goals that are the object of allocational credit policy differ from country to country. In short, a high degree of financial market integration inevitably reduces the efficiency of a credit policy designed to produce a desired allocation of real resources. The Greek government (with the other Member States governments) was assigned the task of creating a Common Market in financial services by 1992, but it seems that it did not realize the implications of this.

Another feature of the Greek banking industry is its highly oligopolistic structure. As we have seen the greater part of banking activity is accommodated by the two commercial banks, namely, the National Bank of Greece and the Commercial bank of Greece. They both cover around 60% of commercial banking activity and along with their subsidiaries it is estimated that they hold over 75% of the Greek banking market. The marked concentration in the Greek banking market may be described as a high degree of oligopoly at the producers level.

However, the implementation of the First Banking Coordination Directive would significantly undermine the state-owned banking organizations oligopoly position.

The First Banking Coordination Directive (if incorporated into the Greek banking Law) would abolish the economic need criterion as an entry requirement and significantly diminish the discretionary powers enjoyed by the national supervisory authorities to prevent the establishment by foreign banking organizations of branches in the domestic market. The elimination of the economic need criterion which is the most important impediment to establishment and at present operates almost as an absolute entry barrier ruling out new entry whatsoever, would substantially change the balance as between foreign and indigenous banking institutions in favour of the former. A great deal of "new entry" would take place in the market putting an end to the monopoly position enjoyed by the big state-owned banking organizations. Over time the number of foreign banks established in the country would substantially increase since the supply of banking services falls short of the needs of the domestic economy and there are still considerable resources remaining untapped by the banking system.

The elimination of the economic need criterion as an entry requirement would change the market share picture between foreign and indigenous banks, presented in Table 7. Foreign banks can develop more efficient marketing and production systems and therefore are relatively quick in exploiting opportunities and able to perform better than their slower-moving big state-owned banking organizations. The former would therefore attract a significant amount of business away from the latter.

Of course, the elimination of the economic need criterion does not imply that the national supervisory authorities would lose their ability to restrict the entry and especially the operation of foreign banks already established in the country. The authorities will still be able to impose relative entry barriers which place a potential new entrant at a disadvantage but not an insurmountable one. These barriers concern authorization and other operational terms on which the authorization is granted such as licensing procedures, requirements for minimum earmarked capital, restrictions on who can own a bank and regulatory and administrative provisions on nationality, language requirements and competence of personnel and management. The above impediments effectively limit the scope for international trade in banking.

Even more important is the fact that the Greek authorities would still be able to apply impediments on the operations of established foreign-owned banking organisations. These impediments concern restrictions on the type of services that can be offered and on the range of activities in which foreign banks can engage and restriction with respect to administrative prudential controls that are applied in a discriminatory manner against foreign-owned banks.

Even if the Greek authorities could always invent and rely on new ways of restricting the operation of foreign owned banking organizations (especially through more stringent enforcement of apparently non-discriminatory regulations), the elimination of the economic need criterion as an entry requirement would significantly increase the market share of foreign banks at the expense of the indigenous banking institutions. This criterion is currently used as a powerful instrument of protectionism of the domestic banking system so as to prevent direct competition between foreign and indigenous institutions keeping the latter in a position to provide competitive services to their customers.

Such protectionism usually takes the form of restrictions on the number of branches the foreign banks are allowed to operate within the country; its elimination would provide foreign banks with an opportunity to expand through the establishment of a greater number of branches. Up to now foreign banks have not ventured beyond Athens, Thessaloniki and Piraeus. There are, therefore, strong reasons to believe that certain main provincial centres like Patra, Heraklion, Volos etc., could be the new target for foreign banking expansion in Greece.

The analysis so far leads us to the conclusion that the implementation of the First Banking Coordination Directive would imply a substantial reduction in the market share of the state-owned banking organizations and an absolute reduction in their business. The former effect is considered to be stronger than the latter due to the underbanking aspect - ie. the supply of banking services falls short of the needs of the economy.

Next to this problem there would also be another one: the opening up of Europe's financial service markets to ensure that the best available operator within the Community is providing given services in any location. This means that no government regulations should obstruct the neutrality between buying financial services from a domestic bank, buying them domestically from a domestically established bank, or importing them from abroad. As a result, the state-owned banking organizations would have to cope with severe competition within their national boundaries from giant multinational banking institutions enjoying benefits of scale from their extensive global operations, having relatively easy access to international capital markets (and therefore acquiring factor inputs, such as capital, at a lower cost than the state-owned banking organizations) and operating (as it is pointed out elsewhere) under a favourable supervisory system. The state-owned banking organizations would, therefore, be squeezed by freedom of competition.

Indeed, the analysis of the structure of the Greek banking system leads us to some conclusions about the possible implications of the Second (draft) Banking Coordination Directive and the consequent unification of the European banking markets. The traditional structure of the large state-owned companies which have never faced effective competition and with an extensive home base and a small number of establishments abroad would undergo drastic changes within an integrated European banking market.

The change which in theory would merge the twelve independent markets into one market is the proposal that once a banking organization has been sanctioned to establish and operate somewhere in the Community, it would have the right to establish and operate anywhere in the Community according to the rules of the country where the head office is established. Even if the Second (draft) Banking Coordination Directive does not bring about absolute home country control its adoption would eliminate potential sources of discriminatory treatment against the establishment of foreign banking organizations that arise from provisions as regards the fixing of minimum standards for branches' capital and the nationality and competence of personnel.

The Greek authorities would not also be able to impose any restriction on the type of services that can be offered and on the range of activities in which foreign banks can engage and at present constitute important obstacles to the potential expansion of business. Furthermore, the prudential supervision with respect to solvency would no longer be applied in a differential manner to foreign-owned banks. The use also of the concept of the capital of the bank as a whole, rather than the branch capital, for supervisory purposes would eliminate an important hindrance to the potential expansion of the foreign branch business.

Obviously, the integration of European financial markets would substantially increase the opportunities for the establishment of EC banks in Greece. Given the freedom of establishment that will prevail and the equal terms of competition that will exist with regard to these institutions the Greek banking industry will have to cope with severe competition. However, this industry is uncompetitive and relatively underdeveloped.

In order to demonstrate the relatively low level of development of the domestic industry is essential to state that the Greek banks undertake only a limited number of banking services from those included in the relevant list of qualifying bank activities which is annexed to the Second (draft) Coordination Directive. More specifically, Greek banks are not involved in money market instruments, participation of share issues and the provision of services related to such issues, credit reference services and safe custody services, while factoring and leasing is undertaken only to a very limited extent. The Greek banking industry would therefore be squeezed after the elimination of barriers to freedom of banking services.

The compression of the state-owned banking industry would also have significant repercussions for the rest of the national economy. Indeed, as it is pointed out elsewhere, the state-owned banking sector plays an important role for the development of the Greek economy. This explains the fact that the Greek government considers it necessary to have a specific policy with regard to the size and structure of the state-owned banking industry. Its compression would jeopardize the development of important sectors of the economy and particularly the medium and small scale industry. The Greek authorities are advocates of a strong public ownership in the financial sector and would not remain indifferent to the developments at the European level.

The Greek government have perfectly legitimate fears about the effects of the freedom of banking services on the domestic banking sector. This sector could be overwhelmed by complete freedom of competition. Of course, one might argue that all these are the implications of the creation of a real Common Market and that if Greece is entitled to export light industrial goods then it is only right that other countries should be able in return to provide in Greece banking services. However, Greece is able to experience a relatively good export performance in light industrial goods due to a strong domestic banking sector. Indeed, the domestic banking sector is very important for the development of other sectors of the economy. This is the main reason behind the fact that freedom of trade in services lags so far behind freedom of trade in goods and will possibly continue to lag behind in the future.

The Greek banking organizations may be able to cope to some extent with the severe competition that the integration of financial markets implies if they accelerate their modernization efforts in order to strengthen their international competitiveness. Indeed, recently the Greek banks started undertaking a significant modernization effort and they are in the process of introducing new operating methods, expanding their communication systems and undertaking personnel programmes. Many bankers believe that the political will is there to continue modernizing the Greek banking system. However, there is a number of difficulties on the way of modernising the banking system.

The modernization programme does not have a set timetable since the pace of the modernization depends on the state of the economy in general. The exogenous limitations on the modernization effort are related to strict government regulations which restrain competition in the financial market and has given the Greek banking industry very little incentive to innovate. Indeed, as it is pointed out elsewhere, all interest rates are determined by the authorities in a governmental process of controlling money flows while the public sector deficit is financed through compulsory reserve requirements on the banks. As a result the size of bank profits are, in effect, dictated by the government. The modernization effort cannot be successful if it is not accompanied by a gradual change of the current highly regulated environment. The gradual full deregulation of interest rates and freedom for the allocation of funds are necessary with a view to ensuring efficient operation of the market mechanism and releasing the forces of competition. However, as it is demonstrated elsewhere, it would be very difficult to abolish all government regulations in the not too distant future.

Next in line is the union. The bank employees' union, Otoe, strongly opposes any move towards modernization, since in many cases this involves great staff reductions. This union is strong and militant. On a number of occasions it has virtually brought the country to a stop by striking and it is capable of bringing considerable pressure on the government. Recently, it took a rather extremely critical view against the integration of European financial services pointing out that the Second Banking Coordination Directive if adopted would lead to the "destruction" of the domestic banking system.

The view is generally held that a strong foreign presence through acquisitions of participations in indigenous banks would give a boost to Greece's modernization progress. Indeed, it seems almost certain that foreigners would move in, even in that way, since Greece has a lot to offer to foreigners. Despite a significant increase in deposits there are still considerable resources remaining untapped by the banking system. The dynamic shipping and tourist industries promise a substantial expansion of banking business. However, the Greek authorities are generally reluctant to see the control of the domestic financial system moving into foreign hands. For some Central Bank's officials liberalization of foreign participations in indigenous banks could mean colonisation for the majority of Greek banking institutions.

The elimination of restrictions on market access by foreign banking organizations not established in the country will have considerable repercussions for the Greek economy.

The adoption of capital movements Directive of 1988 will put an end to the fairly restrictive Greek exchange controls on movements of capital. There is considerable risk that capital will flow outside the country not only because of relatively low interest rates but also because of lack of confidence in the home currency, since its bop suffers from chronic deficit. On the other hand, an increase in direct investment in Greece is probable because foreign investors will not be subject to restrictive rules with respect to re-exportation of capital and repatriation of profits. However, one would normally expect the long term inflows to rise less steeply than the short term outflows. A deterioration of the capital account due to short term capital flows would not be offset by increased long term capital inflows.

The abandonment of foreign exchange controls would tend to shift investors towards assets with higher expected returns. As a result, the country's macroeconomic performance would be severely affected by a prolonged outflow of domestic capital. Capital flight is a perverse exportation of domestic savings and foreign exchange that (given the insufficiency of both) would severely hinder the potential for growth. The first consequence would be the intensification of the shortage of foreign exchange and to finance investment. This will restrict the growth potential of GNP and employment. It will also create an inflationary bias if the country fails to scale back its investment efforts accordingly.

The extent of capital outflows (and therefore the severity of the consequences on the national welfare) will depend considerably on how much confidence the Greek economy will inspire and in particular on the developments of the bop. In the recent years the country has experienced a considerable improvement in its bop position (59). Thus, one might argue that the problem that liberalization of capital movements would widen the scope for capital flights prompted by lack of confidence in drachma would become manageable as Greece establishes a stronger bop position.

However, there are considerable difficulties on the way of putting the Greek bop on a sound footing. The completion of the internal market for industrial goods by the end of 1992 implies an elimination of tariffs and other barriers to trade and a significant deterioration in the current account of the bop. Trade liberalization would lead to significant changes in the levels of exports and imports, but the volume of imports would expand quite rapidly in relation to the volume of exports. This will lead to a steep increase in the current account deficit.

This deficit can be restored by the appropriate adjustment in the exchange rates. Indeed, the exchange rate can be used as an instrument of protection replacing the use of the barrier to trade. However, the exchange rate realignments and the expectations associated with them would motivate considerable capital outflows under a free capital movements regime. Given the climate of general uncertainty within which these developments take place it is inevitable that the short term capital market would take on a speculative character. And we will possibly witness massive capital flights out of Greece.

The above analysis leads us to the conclusion that the

Greek authorities would not be able to accept the disadvantages that arise from the need to implement the EC regulations especially with respect to capital movements. Furthermore, it appears that the completion of the EC internal market for industrial goods would constitute an important obstacle towards capital movements liberalization. The present level of confidence in the drachma cannot be maintained with an increasing current account deficit. The deterioration in the current account would lead to severe capital outflows in the absence of foreign exchange controls. One might argue that the main factor which would contribute to the restoration of overall confidence in the home currency is the successful implementation by the national authorities of the monetary and fiscal measures which should be taken in order to combat inflationary pressures.

Indeed, the pursuit of policies of monetary discipline is the basic factor creating confidence and preventing speculation and capital flights. However, the adoption of strict monetary and fiscal policies designed to curve out the speculative motives does not appear acceptable. Fiscal and monetary restraint could cope with speculative pressures against the drachma but would result in a cutback in domestic output and investment. Internal financial programs will make the achievement of full employment problematical and would halt the development process at the time that the authorities try to achieve faster growth rates in order to match the levels of economic development of other European countries.

The Greek government would therefore be unwilling to take the necessary steps to adapt its domestic monetary and fiscal policies to accommodate a free capital movements position, because the country may expose itself to a reduction in economic welfare. Alternatively, the goals of full employment and a satisfactory growth rate could be achieved in free capital movements position through a realignment of the exchange rate. In theory, a flexible exchange rate regime can accommodate capital flows without preventing the pursuit of full employment and economic expansion. However, exchange rate depreciation requires a decline in real wages which involves high political cost.

Furthermore, the national authorities believe that the current account difficulties originate from the supply side and in non-price factors for which price adjustment is not appropriate. Indeed, Greece concentrates on the production of commodities of inferior design and style to those of other countries and it tends to export relatively low valued products and to import relatively high valued products due to the stage of development of the domestic industry. They therefore express doubts about the extent to which the long-run bop could be improved by continual exchange rate depreciation. The apparent inability and failure of currency depreciation to reconcile the conflict between full employment and bop equilibrium would lead to the call for foreign exchange controls.

The standard economic theory reveals that free trade (or more trade) is preferable to autarchy (or less trade). However, this theory is based on some important assumptions that do not hold in practice. The respective theory assumes that unemployment and bop problems do not exist. However, in real life unemployment and bop problems do exist and by reducing imports the tariff barriers stimulate employment directly and improves the bop. Of course, one might argue that unemployment and bop problems can be solved in a flexible exchange rates regime. However, the effectiveness of such a regime requires a flexible real wage which is not often the case. Furthermore, a defence for a policy of limiting trade can be mounted by the desire to protect certain industries which are vital to national economic development and/or to encourage "infant" industries to develop.

Another possibility could be that the government may finance the capital flights by borrowing abroad. However, the budget would have to adapt to the requirements of servicing the external debt. The cost of the external debt would open a wide fiscal gap that the government would find it very difficult to close since it is hard to raise taxes and/or to cut in public investment and social spending. The remaining route would inevitably be money creation to finance the budget deficit. However, this would lead to even higher capital flows due to the expansion of money supply.

On the other hand, the EC budget could play an important role as cushioning the impact of external pressures on the domestic economy. It could be an important supplier of resources in support of the bop adjustment process and strengthen the confidence in the domestic currency. The EC budget could therefore provide a double easing of the foreign exchange constraint. It could put the Greek bop on a sound footing and combat speculation against the drachma.

Indeed, the Member States have recently decided to increase to a considerable extent the EC resources for redistributive purposes. However, the doubling of these resources over the course of four years are not adequate to alleviate the new process of integration. The size of the resources available for redistributive purposes might be an important determinant of the level of integration that can be achieved. Since the supply of resources for redistributive purposes are insufficient to accommodate the demand for foreign exchange a case would be made for selective measures for controlling capital movements. According to capital movements Directive, Greece (and the other developing countries) should eliminate the exchange controls by the end of 1992 unless severe problems arise. The Commission recognizes the Greek bop problems but is hoping that the free flow of capital will be completed by 1992. However, changes will not be as great as the Commission hopes. Greece would not be able to open up its capital market in the near future. Complete freedom of capital movement does not therefore appear achievable.

IMPEDIMENTS TO THE ADOPTION OF THE HOME COUNTRY CONTROL PRINCIPLE

In this chapter we discuss other motives that have a major influence in determining whether Greece is prepared to operate in a unified banking market based on the principle of home country control in the not too distant future. These motives are mainly related to regulatory provisions and administrative practices that are imposed, at present, on banking organisations established in Greece for economic considerations. These regulatory provisions and administrative practices impose a heavy burden on the functioning of indigenous banking institutions and substantially affect their ability to compete on an equal footing with foreign-owned banking organizations operating abroad or in Greece under the principle of home country control.

The study also provides some indications about the extent to which these regulatory provisions and administrative practices can be harmonized with those in the other Member States. The analysis leads to the conclusion that the national authorities would be reluctant to remove the economic protection that the national system provides and adopt the principle of home country control.
In implementing the monetary and credit policy (as they

are formed by the government) the Bank of Greece controls directly the interest rates. Ceilings on rates paid to depositors and charged to borrowers are set in an attempt to influence the demand for various types of deposits and loans. The structure of deposit and loan rates reflects the authorities objectives and are subject to periodical review. The present rates are presented in Table 8. The structure of the interest rates bank borrowing and lending is in accordance with the importance the monetary authorities attach to each type of activity and can hardly be justified on the grounds of banking criteria.

The interest rate on savings deposit with the Agricultural Bank and the Postal Savings Bank are a bit higher than the rate on savings deposit with commercial banks. This reflects the authorities objective to make these specialised credit institutions able to attract private deposits and reduce their dependence on Central Bank's funds. Commenting on this difference an official of the National Bank of Greece* pointed out that the Commercial Banks can offer rates on savings deposits at least 2 percentage points higher than these which can be offered by the Specialized Credit Institutions because the former are better organized, they have lower operational cost and their lending rates are higher. However, the authorities would like to see the Bank of Greece treating these institutions in virtually the same

* (Interview, National Bank of Greece, July 1988)

way as Commercial Banks; a development which would enhance the effectiveness of monetary policy since these institutions are usually financed by monetary expansion.

TABLE 8

INTEREST RATES ON BANK DEPOSITS

Types of Deposit	
Savings:	
With commercial banks	15
With the Agricultural Bank	15.25
With the Postal Savings Bank	15.5
On three months notice	15.5
Time:	
3 to 6 months	15.5
6 months to 1 year	16
1 year and over	17-19
Up to 1mil Dr	17
1,000,001 Dr - 5mil Dr	18
5,000,001 Dr and over	19

Bank Lending Rates (maximum rates)

Type of credit	
Working capital:	
General rate	20.5
Small scale industry from special funds	17
Long term loans:	
General rate	18
Small scale industry from special funds	15
Agriculture:	
Short term loans	16-18
Long term loans	15
Housing loans	21.5

Source: Monthly Statistical bulletin (Bank of Greece)

Similarly, the differences in lending rates cannot be justified on the basis of banking criteria. The policy of interest rate differentiation is according to the contribution of the various types of loans to the country's economic development.

Long-term loan rates are 2 to 2.5 percentage points lower than working capital rates, conforming with the authorities' efforts to encourage formation of fixed capital and to discourage the financing of speculative, non productive activities. The lending rates to small scale industry are 3 to 3.5 percentage points lower reflecting the authorities view that this sector is of a high priority. Most of the Greek industrial firms have adopted inefficient methods of operations and therefore suffer from high production costs while their export potential is relatively insignificant. The authorities (especially the Ministry of National Economy) believe that the small scale industry if it grows will offer new competitive products in the international market carrying out the adequate adjustment of domestic production to changes in economic conditions and solving the persistent bop problem.

If the banks had selected their loans according to the contribution of these loans to their own profits and not to the country's economic development the lending rates would have been quite different. The long term lending rates should have been higher (around 2 to 3 percent according to some bankers) since long term lending means higher credit risks to be assumed by the banks. Long term lending also affects negatively the liquidity position of the banks. Furthermore, the lending rates to small scale industry should also have been higher on the grounds of security and cost criteria. As one might have expected the small firms suffer from high economic instability.

According to a KEPE study (60) closing down rate of the small firms is relatively very high and can reach the 17 percent per annum. Another 30 per cent change management and possibly operation in the market. As a result the reliability of the small firms is put to a question. Relatively higher credit risks have therefore to be assumed by the banks when they lend to small scale industry. The lending to small scale industry also imposes higher administrative cost to banks due to the small size of every loan and to their large number.

From the above analysis it is fair to say that the authorities use an interest rate policy as a means of influencing bank lending favouring certain sectors which are considered to be of high priority irrespective of the profit considerations of banks. It is worthwhile mentioning that the administrative determination of interest rates concerns only their highest rate (ceiling). However, since there is excess demand for credit from all the sectors of the economy the highest rate is also the lowest.

Since the banks can select their loans not according to the contribution of these loans to the country's economic development but on the basis of the contribution to their own profits and (since there is excess demand for credit) finance only the sectors whose lending interest rate has been at a relatively high level. The authorities tried to influence directly the amount of credit extending by the Commercial Banks to these activities (61).

The authorities require the Commercial banks to devote 10% of their private deposits for loans to small scale industry and another 15% for long term loans to finance productive investment. The part of the funds in question that the Commercial banks are unable to invest according to the above requirements must be deposited to the Bank of Greece. The interest rate applicable to a part of unused funds deposited with the Bank of Greece is 8% per annum. Since the interest rates paid by the Bank of Greece on the unused funds deposits are rather low and since the State gives its guarantee for a considerable portion of credit to small-scale industry and of long term productive investment financing, the Commercial banks have a strong interest to invest the total amount of the funds in question as required by the national authorities.

The administrative regulations to absorb resources for the purpose of financing certain sectors (small-scale industry, productive investment) gives rise to divergences in comparison with market requirements and led to considerable difficulties regarding the Commercial banks' credit operations and profitability. In the Report of the Governor of the National Bank of Greece for the year of 1987 (the largest Commercial bank) it is stated that there are clear signs that the compulsory requirements for credit to small-scale industry (10% of bank deposits) are exceedingly high in comparison with the reasonable needs they are intended to meet. This view is based mainly on the diminishing number of applications for new loans submitted each year to the National Bank of Greece for approval, less 5% of which was rejected. The loss incurred by the National Bank of Greece owing to unused balances of funds earmarked for the financing of small scale industry was over 4 billion drachmas. Note that the net profits of the bank for the same period was of the same amount.

Even if the authorities are in the process of withdrawing the requirement providing that the banks should devote 15% of their deposits for long term loans to finance productive investment the view is generally held that the authorities use a wide range of regulations to give financial support to economic sectors or activities that are considered by them as productive. The Greek authorities strongly believe that the credit policy is a powerful weapon which would promote domestic economic development and solve the Bop problem.

Indeed, the Greek economy suffers from a strong bop problem. It is worthwhile mentioning that this problem forced the government to adopt in 1985 a severe stabilization plan (62), which involved a reduction in real wages and high political cost to the government. Even if the bop recorded a significant improvement it did not cease to constrain the conduct of economic policy and the country's economic development. The authorities believe that the bop problem is rather structural and reflects the adjustment of domestic production to changes in economic conditions (63). This adjustment can take place mainly through the growth of small-scale industry and therefore the authorities encourage the channelling of funds to these activities.

The authorities also restrict the expansion of bank credit to the construction industry and trade for bop considerations. Loans to housing are usually granted by the specialized credit institutions for social reasons and are subject to severe restrictions : they are granted only in the case of the first house and a ceiling exists of up to 4 million drachmas. Loans to trade are permitted only in the case of exports.

According to a report (64) of the Ministry of National Economy the level of private investment in buildings is very high in comparison with the level of investment in the manufacturing sector (see Table 9). The investors preferred to invest more in buildings than in industry and if we compare the marginal and average capital stock/cash flow in the industrial sector and building (Table 10), that preference seems out of line with usual investment decisions based on profitability. The main reason for this is the lower risk which has to be taken investing in buildings. The high demand for real estate leads to a price increase in this sector. This results in an increase in nominal wages in every sector of the domestic economy including the manufacturing sector since the prices of real estate influence the estimation of real income because of the economic and social importance of the real estate. Of course, the preference for real estate did not stop because of the speculation that its rate of appreciation would exceed inflation. The vicious circle of inflation and investment in real estate has been a constant factor. Furthermore, also according to that report, the excess demand for this non-tradeable sector absorbed resources for the tradeable (industrial) sector with significant repercussions for the bop. The above considerations explains the authorities reluctance to permit banks to expand credit to the construction industry.

TABLE 9

INVESTMENT DISTRIBUTION

	1978	1981	1984
Agriculture	9.1	5.9	8.5
Mining and quarrying	1.9	6.8	3.9
Manufacturing	15.0	14.5	13.9
Energy	7.1	5.6	10.2
Transport	19.9	20.1	18.6
Real estate	30.6	24.2	19.7
Public activities	0.7	1.6	1.1
Other	15.7	21.3	24.1
Total	100.0	100.0	100.0

Source: Ministry of National Economy 1987

TABLE 10

AVERAGE RATIO CAPITAL STOCK/CASH FLOW

	in the whole economy	industrial sector
1977-79	3.91	2.38
1980-82	4.07	2.52
1983-85	4.22	2.67

MARGINAL RATIO CAPITAL STOCK/CASH FLOW

	industrial sector	buildings
1977-79	1.82	15.57
1980-82	-0.18	7.40
1983-85	-0.21	2.20

Source: Ministry of National Economy 1987

The 1992 concept in essence means the transformation of the EC from a fragmented to a pan-EC domestic market. This transformation will be based on the principle of home country control. However, there are strong reasons to believe that this transformation will be very hard to attain in the next few years. The analysis so far leads to the conclusion that, in Greece, strong restrictions are imposed on portfolio policies of the Commercial banks and the latter can do very little to influence the selection of their lending. The existing regulatory regime acts as a straitjacket on the banking organizations in the pursuit of profits and growth and substantially restrict their ability to compete internationally. If foreign banking organizations were free to operate in Greece without complying with the above-mentioned regulatory regime this would result in unfair competition and eventually undermines the effectiveness of the monetary and credit policy. The adoption of the Second (draft) Banking Coordination Directive is, therefore, considered highly unlikely.

The effects of substituting the methods of mutual recognition for that of prior harmonization are rather unclear. This method obviously results in minimum harmonization and therefore brings into competition not only financial undertakings but also national regulatory regimes. The Commission believes that the strictly regulated States would reduce their regulatory constraints as their own domestic operators would be severely handicapped in the face of more flexible competitors. However, the strictly regulated Member States may well retain their controls (especially if, as in the case of Greece, there are important economic interests behind them) and resist the principle of home country control. This principle clashes with the wish of the Greek government to protect its own domestic operators and to provide financial support for certain economic sectors or activities. The relatively low level of development of the domestic industry and the poor performance of the Bop (especially the current account) seem to constitute important obstacles to freedom of banking services in the case of Greece.

In order to ascertain the exact degree to which the authorities put pressure on commercial banks to give priority to their lending to certain sectors or activities and therefore affect their profitability, it is necessary to examine the extent to which banks may own shares in industrial and commercial enterprises.

According to Article 16 (3) of Law 5076/1931 banks are forbidden to own shares in any one company which exceeds 20% of their banks' capital and for larger participation the authorization of the Ministry of Commerce is necessary. There is no limit to banks holding shares in companies in respect to the total of all participations in relation to the capital of the bank. Furthermore, Article 16(5) of the same law states that the limitation does not apply to participations in companies established abroad or have as their main objective the promotion of their bank activities.

However, this law is very old, in some parts rather unclear and has, to a large extent, lost its value. Central bank's officials* pointed out that banks' equity participations in any one company requires case-by-case authorization by the Ministry of Commerce. Before granting the authorization the Ministry tries to ensure through a "gentlemen's agreement" with the respective bank that the latter will use sound banking criteria in supplying credit to the company in which it is asking to participate. The aim of the Ministry in pursuing this policy is to protect both the interests of the banks and the companies against excessive resource to bank borrowing since this could have a severe negative impact on future capital structure and its growth prospects. Furthermore, the Ministry of Commerce tries to ensure that the respective banks will continue to supply credit in other companies that may compete with those in which the banks are asking to participate. The

* (Interviews, Bank of Greece, June 1988)

main objective is obviously to ensure fair competition.

However, even more important is the fact that the Ministry of Commerce tries to ensure that the banks' investment in companies will not undermine the government's credit policy. Indeed, as some bankers commented, the Ministry shows an unwillingness to grant authorization to investment in commercial enterprises while such authorisations have been granted relatively easily in cases of industrial enterprises. These controls substantially restrict the ability of banking institutions to pursue an independent and profitable investment policy with respect to acquisitions in other enterprises.

The state-owned banking institutions enjoy less freedom as to their equity participation investments since the authorities impose special requirements on them. These are perhaps most obvious in the area of what are known as the "problem companies" - ie. large enterprises suffering from long-term structural losses. Totalling more than 30, these have been nationalised while the state-owned banks were forced to participate in these over-indebted enterprises through converting their debt into equity. New management has been put in, but the view is generally held that it will be very difficult to restore the respective companies to health.

The issue of the problem companies rebounds on the strength of the state-owned banks since the debts involved gradually have to be written off. Moreover, the state-owned banks are required to support the respective enterprises by financing (at a relatively low interest rate) their new investment and commercial activities and by helping them to change their administrative structure to organize their cash management and to produce more satisfactory results in order to turn the companies round. The burden for resolving the problem companies issue falls on the two major banking groups and in particular the National Bank of Greece.

Obviously, the authorities impose special requirements on the state-owned banking organizations with regard to their investments. These special requirements have significant repercussions for their profitability and severely affect their ability to compete with foreign-owned banking organizations operating even under the principle of host country control. As a result, the national authorities have adopted regulatory provisions and administrative practices designed to influence the competitive balance as between state-owned and foreign banking institutions in favour of the former. As long as they continue to impose special requirements on the state-owned banking institutions, they would also continue to put restrictions on foreign banks entry and operation.

The Greek banking system has various peculiarities in its structure which are directly related to the stage of development of the Greek economy. The inadequate development of the Greek capital market implies that a substantial proportion of private savings that would otherwise have been invested in securities go instead either into real estate or into bank deposits. This has encouraged the country's large firms to develop strong ties of interdependence with the commercial banks. The relatively limited self-financing of business firms, combined with their high working capital requirements, increases the dependence of borrowed funds that can be supplied only by the banking system. This kind of dependence is usually transformed to equity participations by banking institutions in the respective enterprises.

As a result of the government policy and the inadequate development of Greece's capital market the Commercial banks have accumulated substantial business interests in a large number of industrial enterprises. Indeed, the Greek Commercial banks participate in the share capital and management of more than 200 industrial enterprises. The National Bank of Greece owns about 90 industrial firms. These shares value about 33 million drachmas; ie. they correspond approximately to the 80% of the bank's capital which accounts for 41.9 billion drachmas (65). The Commercial Bank of Greece owns shares in about 30 industrial enterprises. These shares value about 12.5 billion drachmas - ie. they correspond to more than 50% of the bank's capital which accounts for 22.3 billion drachmas (66). The larger part of these shares concern the acquisition of the Commercial bank in "Nafpigia Elefsinos" which is a problem firm. The shares in this firm value 8 billion drachmas (almost 45% of the bank's capital).

However, the above situation contradicts certain provisions of the proposals for the Second Banking Coordination Directive. According to these provisions (which rather adopt the model of the British banking system) the credit institutions shall not own shares in any one non-credit company which exceeds 10% of their own funds. Furthermore, the total value of the shares acquired by a credit institution shall not exceed 50% of the respective institution's own funds. If the total value of the shares acquired by a credit institution exceeds the above percentage a corresponding increase in the institution's own funds shall take place.

As one might have expected, the above provisions will have significant repercussions for the Greek banking system which has adopted the model of the German banking system, having considerable business interests in industrial enterprises. The Greek Commercial banks should increase significantly their own capital in order to comply with the respective provisions. Considerable opposition to these provisions of the Second (draft) Banking Coordination Directive are therefore expected from the Greek authorities.

The Greek authorities also force the Commercial banks to give priority in the lending facilities to the public sector. Indeed, the Commercial banks are required to invest a certain percentage of their funds from private deposits in three month interest bearing treasury bills issued by the government and they are not allowed to sell them or to discount them at the Bank of Greece. The compulsory investment in treasury bills represents a considerable amount of the private deposits (at the time of writing 38%). The interest rates paid on the investment of these assets are normally well below the average of bank lending rates, currently 16%. Furthermore, Commercial banks are permitted to invest, in interest-bearing treasury bills, part of the unused balance of funds earmarked for long term financing of productive investment (up to 4% of total deposits with the banks); and they are allowed to invest, in three-month interest-bearing treasury bills, part of their compulsory reserves with the Bank of Greece (2.5% of the banks, total deposits). These regulations were designed to provide an incentive to Commercial banks to invest in treasury bills issued by the State.

The raising of funds through the purchase of treasury bills by banks is usually a major source of financing the public sector borrowing requirements (Table 11). The purchases of treasury bills by Commercial banks are compulsory or under the incentives presented above. The Commercial banks consider that the optional purchases of treasury bills are not profitable.

TABLE 11
SOURCES OF FINANCING THE PUBLIC SECTOR BORROWING REQUIREMENTS

	1985 amount	%	1986 amount	%
Domestic borrowing	539,578	66.6	541,313	71.1
Treasury bills purchased by banks	336,086	41.5	215,573	28.3
Treasury bills and bonds purchased by private savers and enterprises	8,852	1.1	16,131	2.1
Loans and advances from specialized credit institutions and commercial banks	119,646	14.8	238,458	31.3
Bank of Greece	74,994	9.2	71,151	9.4
Foreign borrowing	270,330	33.4	220,217	28.0
Total	809,908	100.0	761,530	100.0

Source: Bank of Greece (1987)

Obviously, the restrictions imposed on banks to give priority in the lending facilities to the public sector further limit their profitable investment operations and their ability to compete internationally. As a result, the Greek authorities would find it very difficult to allow the highest level of freedom and give foreign banking organizations the right to establish, operate and/or market their products in Greece subject to the supervisory regulations of the country in which the head office is situated. Without coordination of the rules applied to banks the indigenous banking institutions would suffer a severe disadvantage and would be unable to compete on equal terms with the foreign ones which are subject to more liberal rules.
In Greece there will possibly be considerable opposition to any move towards the adoption of the home country control principle, that is that a banking institution need concern itself only with the rules of the country where he is originally established.

The budget deficit is a major problem. Faced with a need to improve living standards Greece has undertaken ambitious programmes to accelerate the rate of economic growth to provide more government services. These programmes involved not only the expansion of public investment in transportation, power and sanitation, but also higher government expenditures on education, public welfare and other services to meet the rising expectation of population. At the same time that expenditures were rapidly increasing, the revenue system was not structurally capable of supplying a rapid increase in financial resources. The resulting budget deficits were covered by government borrowing from the domestic banking system. Even if at present there is an explicit desire to cut in the size of public spending and to increase revenue, this is not considered as feasible as a consequence of political factors. The budget deficit seems to constitute a serious obstacle to trade in banking services.

The analysis so far leads to the conclusion that strong restrictions are imposed on portfolio policies of the Commercial banks and the latter can do very little to influence the selection of their lending. Indeed, more than 60% of the bank deposit should be used compulsory to finance certain economic sector while the allocation of the rest is influenced mainly by the authorities' policy. Without eliminating these restrictions the freedom to allow foreign banking organizations to establish and operate domestically subject to the supervisory regulations of the country in which the head office is situated could undoubtedly be deemed to constitute unfair competition against the indigenous banks. It is therefore perfectly apparent that within the timescale the Greek authorities cannot possibly accept a measure which would bring about "home country" control at a stroke.

The Commission believes that the regulatory provisions would be eliminated by the Greek State itself. By substituting the methods of mutual recognition for that of prior harmonization it reflects the question of regulatory distortion of competition to the Member States. In order not to penalise their own operators the most strictly regulated States will have to undertake a "narrowing revision" of their national provisions.
As a result, harmonization of government regulation will take place at a later stage. Obviously, the Commission considers that the government involvement within the financial markets are solely motivated by prudential considerations.

However, a rationale for government involvement within a financial market can be based not only on the stability of the financial system but also on the need to attain particular macroeconomic and social objectives. This is particularly true in the case of a developing country such as Greece. The goals of full employment and long term economic growth could be achieved through many forms, but in the case of Greece the financial assistance of particular sectors of the economy through manipulation of the domestic financial market is considered as the most effective one.

The Commission does not take into account that in the developing countries government regulation can be used to influence investment behaviour and promote macroeconomic stability. The harmonization of this kind of regulation will be very difficult to be attained particularly within the timescale since it reflects vital economic interests. In the case of Greece, integration in the banking field would require the reconsideration of the whole spectrum of state regulation, with a view to ensuring efficient operation of the market mechanism and realising the forces of competition. However, this requires a substantial reduction in the current account and budget deficits. Any move towards this direction is considered as highly unlikely to take place in the near future. As a consequence, the "home country" control would clash with the wish of the Greek government to ensure that it is in a position to protect its own operators. The rival principle of "host country" control would, therefore, have a strong following.

Another difficulty in the way of integrating the Greek banking sector could relate to prudential considerations.

The Bank of Greece retains full responsibility for prudential oversight of banks and is empowered to issue any regulation with the view of promoting the conditions for safe and sound banking and maintaining public confidence in the stability of the overall financial system. Prudential supervision in banking is administered informally along non-statutory lines based on close cooperation with the banks concerned. This kind of supervision, according to some central bank officials, enables the supervisory authority to adjust their requirements to specific circumstances such as the type of business carried out by the respective banking institutions and the inherent risks.

Even more important is the fact that the extensive use of direct controls has rendered the use of prudential controls unnecessary. In a country where the banks are subject to a wide range of compulsory investment requirements, there is really very little need for controlling the levels of credit exposure and setting solvency ratios. If ratios between liquid assets and deposits are set by the authorities for monetary purposes the control of banking liquidity for prudential considerations become unnecessary. Furthermore, the application of foreign exchange controls restricts considerably banks' foreign exchange transactions and have indirect, though important, supervisory implications on foreign exchange risk exposure. The introduction of direct controls apart from achieving the government's macro-economic targets can also sustain to some extent the soundness of individual banks.

The important supervisory implications of direct controls, the limitations in the scope of permissible banking activities and the little importance of private banking (since the state-owned banks hold a predominant position in the whole banking system) made the issue of prudential supervision of very little importance. The Greek authorities took these factors for granted and neglected to formulate an effective and general structure of prudential supervision. This explains the absence of statutory prescriptions and rules for the prudential behaviour of banks in the Greek Banking Law. This is particularly true with respect to prudential control on solvency.

The banking law does not set any statutory provision in relation to capital adequacy and no specific solvency ratios are imposed. Instead, the central bank's supervision of capital adequacy is administered rather flexibly on a case-by-case basis. The Bank of Greece is empowered to lay down solvency regulations which stipulate banks to maintain a specific level of capital in relation to their deposits or to increase their capital base. Before issuing these regulation the Bank of Greece takes into consideration various factors such as the banks' business volumes, the type of banks' business and the inherent risks.

However, the solvency controls are rather imprecise, difficult to be applied by an unexperienced staff and therefore could lead to a flabby and complacent supervision. The power of the Bank of Greece to impose compulsory increases in the capital of the banks were rather rarely used in the case of Greek banks and the latter are characterised by a relatively low capital base. Undercapitalization is a major problem for the Greek banks.

Banking supervisors usually recognise that the establishment of appropriate solvency ratios play a central role in the prudential supervision of banking institutions. Furthermore, the development of common standards of capital adequacy in relation to assets is one of the essential areas of harmonization necessary for the achievement of mutual recognition and the completion of the internal market in banking. In this respect a ratio of capital to assets of 8% is expressed as a common minimum standard which European banks will be expected to observe by the end of 1992.

This will have critical effects on the Greek banks. At best, they will have to double their capital and to restrict the expansion of their balance sheets over the next few years, putting them at a competitive disadvantage. The Greek banks are expected to suffer considerably from the imposition of the capital ratio. On the other hand, the national authorities might strengthen their prudential controls in order to maintain sound banking practices especially in those areas where greater freedom of action will be conferred to banks. As it is pointed out out elsewhere the authorities are in the process of loosing the exchange controls and to withdraw the requirement providing that the banks should devote 15% of their deposits for long term loans to finance productive investment. These developments will broaden the range of business and result in new and additional elements of risk. Even if, however, the authorities reassess their supervisory framework and adopt stricter solvency requirements in the next few years in order to face these new developments, the higher demand for capital due to the imposition of the EC standard capital ratio is expected to face considerable opposition from Greece.

PART 2 : INSURANCE

UNIFYING THE EUROPEAN INSURANCE SECTORS :

EC PROPOSALS FOR DISMANTLING BARRIERS TO THE LIBERALISATION OF INSURANCE SERVICES

The insurance industry is vast and immensely important in terms of the services it provides, the funds it makes available for investment, the people it employs and the general impact it has on Members economies. It is one of the largest industries in the world.

The operation of the insurance industry involves the large scale channelling and accumulation of funds. Indeed, the development of the insurance industry means that it cannot be seen only in terms of its "insurance" function since firms in insurance operate in the market for savings, primarily from individuals or through group pension schemes, in the market for supply of funds for investment in both the public and private sectors and in the market for management of funds on behalf of other institutions (pension funds, unit trusts, investment trusts). It is no longer appropriate especially in the case of the life assurance business, to regard insurance as the "object" of the business and investment as a side result. The insurance industry has become a major part of the capital market transforming individual savings into interest bearing capital.

The Rome Treaty provides that restriction on the right of establishment and on freedom to provide services within the Community shall be progressively abolished, even if other provisions recognize that the liberalization of banking and insurance services connected with the movement of capital shall be effected in step with the progressive liberalization of movements of capital. Turning to the legislation of the six original Member States it is fair to say that insurance had become an increasingly regulated activity with the result that neither freedom of establishment nor freedom of services was the general rule in Europe before the Treaty began to take effect.

Indeed, the insurance industry operates in a series of markets which are of crucial importance for the functioning of the whole economy. Insurance has intense social importance, requiring a sense of security and stability. Market failures have severe economic, social and political consequences to which governments are naturally very sensitive. The protection of the users of such services is an important issue for governments which control this industry for prudential considerations - ie. to ensure that insurance undertakings remain solvent and always able to meet their financial commitment.

The importance of insurance companies as channels for savings and investment, the way in which these savings are used, where the investment takes place and in what areas, become important for economic growth and the control of the insurance sector for economic considerations is an issue of high importance for almost every government. There is also a bop aspect especially since these services play an important role in international trade. Government controls over entry, establishment and market access of foreign insurance concerns could be justified on grounds of bop.

Moreover, the degree of concentration in insurance is likely to be higher than in other branches of the economy. Insurance companies usually socialise their risks and the industry itself is therefore characterised by extensive coinsurance, reinsurance and a variety forms of reciprocity and interdependence which might lead to fairly high levels of concentration and to anticompetetive behaviour. Indeed, the existence of a group of dominant companies with the power to dictate terms to the rest of the industry and to the customers restrains the benefits of free competition, such as better and more efficiently produced products with lower premiums than would otherwise be charged. On the other hand, contracts in most kinds of insurance (especially life insurance) are usually long term, a substantial part of the market is consequently tied up for long periods and the benefits cannot be specified in advance in real terms and comparisons between policies cannot be easily made. By their nature insurance products are more difficult than other goods and services to test at the time of purchase. Government controls on the insurance industry therefore take place because competition presents some specific features and problems.

It is generally agreed that for economic social and political reasons regulation of insurance is important to ensure solvency and misappropriation of funds and to contribute to an orderly and disciplined market and to national economic growth. However, the extent and the way in which the insurance is regulated differed from one Member State to another, the right of establishment is severely restrained, while many restrictions or even prohibitions are applied on the right of a customer in one Member State to deal, with an undertaking in another Member State.

The main objective of the Rome Treaty is the achievement of a common market. In order to apply this principle to the insurance sector, in 1961, the Council adopted an ambitious programme (67) for the abolition of restrictions on freedom of establishment and freedom to provide services. The programme was designed to move progressively towards the dismantling of barriers to insurance transactions by removing the economic protection which the national supervisory system provides and to bring about the harmonization and coordination of laws and practices which would facilitate freedom of establishment and services, through the realization of successive rapid stages.

In accordance with the general programme for the abolition of restrictions on freedom of establishment and freedom to provide services, a Directive (68) was adopted on 25 February 1964 requiring the abolition of restrictions to establishment and provision of services in the field of reinsurance and retrocession (re-reinsurance).

A number of reasons explain the early adoption of a Directive in this field. Reinsurance is an arrangement between insurers to insure the risks they have entered into in their direct insurance business (69). It is a type of risk spreading which has become increasingly important as the increasing size of risks and technological developments have caused insurers to run to reinsurance as additional protection. It is also a way of sharing business rather than risks and there has been a tendency for insurance companies to expand internationally by way of reinsurance rather than by direct operations which involve the establishment of expensive offices and in many cases are restricted. Moreover, captive insurance companies (which have been formed mainly by multinational non-insurance companies to handle their insurance business in full or part) have come to rely on reinsurance protection for their very large risks and exposures. The growth in captives has in turn helped to expand the size of the reinsurance market. There was, therefore, a considerable growth in the importance of reinsurance.

Even more important was the fact that reinsurance is international in character (because the ability to meet large scale risks may demand resources greater than are available from one country) and was subject to little control in the original six Member States. The first stage of the programme could, therefore, be easily achieved. Indeed, this Directive, as in the case of the early Directives with respect to capital movements liberalization and Banking, achieved little more than the confirmation of an existing position.

This was the only measure adopted within the traditional period originally envisaged by the Treaty. That period expired in 1970, by which date both freedom of establishment and freedom of services should have been accomplished. In fact, it was not until 1973 that effective measures were agreed in respect of freedom of establishment and provision of services. Obviously, the ambitious programme proved to be unsuccessful.

Two Directives were adopted by the Council on 24 July

1973. One Directive (70) abolishing restrictions on freedom of establishment in the business of non-life insurance which even if it eliminated some particular discriminatory treatment of the nationals of the other Member States, it is considered of minor importance. On the other hand, some progress has been made, especially in freedom of establishment and national regulatory systems have been to some extent brought into conformity with the First Council Directive (71) on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of business of direct insurance other than life assurance.

Indeed, the Directive recognizes that in order to facilitate the pursuit of the business of insurance with the EEC it is essential to eliminate certain divergences which exist between national supervisory legislation , because continuance of this divergence after the abolition of restrictions on the right of establishment would mean that obstacles to establishment would continue to exist; while in order to achieve this objective and at the same time ensure adequate protection for insured and third parties in all the Member States it is desirable to coordinate the provisions relating to the financial guarantees required of insurance undertakings.

The Directive provides that each Member State shall make the taking up of the business of direct insurance subject to an official authorization and that any undertaking for which an authorization is sought should : 1) adopt a certain legal form, 2) limit its business activities to the business of insurance and operations arising therefrom to the exclusion of all other commercial business, 3) submit a scheme of operations which shall concern mainly the nature of the risks which the undertaking proposes to cover, the tariffs which it is proposed to apply for each category of business, the guiding principles as to reinsurance, the items constituting the minimum guarantee fund and estimates relating to the expenses of installing the administrative services and the organization for securing business; and in addition, for the first three financial years: estimates relating to expenses of management other than costs of installation, and in particular current general expenses and commissions, estimates relating to premiums or contributions and to claims, a forecast balance sheet, estimates relating to the financial resources intended to cover underwriting liabilities and the solvency margin, and 4) possess a minimum guarantee fund.

The authorization should be given for a particular class of insurance and an undertaking seeking an authorization to extend its business to other classes should submit a scheme of operations as regards such other classes and is required to show proof that it possesses the solvency margins with regard to such other classes.

However, these coordinating measures do not prevent Member States from maintaining or introducing laws, regulations or administrative practices requiring directors and managers to have technical qualifications or requiring articles of association, general and special policy conditions, tariffs and any other documents necessary for the normal exercise of supervision to be approved; but these provisions shall not require that any application for an authorisation shall be dealt with in the light of the economic requirements of the market.

Any undertaking having its head office in a territory of a Member State and seeking an authorization to open an agency or branch in another Member State should submit its statutes and a list of its directors and managers, produce a certificate issued by the competent authorities of the head office country, attesting the classes of insurance which the undertaking is entitled to carry on and that it possesses the minimum guarantee fund or, the minimum solvency margin and stating the risks which it actually covers and the financial resources. It should also submit a scheme of operations and designate an authorized agent having his permanent residence in the host country, and possessing sufficient powers to bind the undertaking in relation to third parties. However, the Member States may apply additional measures if these are considered necessary to achieve an effective level of protection and if these measures are not applied in the light of the economic requirements of the market.

There also are provisions referring to the conditions for exercise of business. Indeed, the Directive provides that the home supervisory authorities should verify the state of solvency of the undertaking with respect to its entire business. Each Member State should require an undertaking to establish sufficient technical reserves. The amount of such reserves shall be determined according to the rules fixed by the State where business is carried on.

Furthermore, the home supervisory authorities should require the establishment of adequate solvency margins in respect to the entire business. The solvency margins correspond to the assets free of all obligations (liabilities and intangible items) and enable the undertaking concerned to meet unforseen needs.

The supervisory authorities, on the other hand, should have considerable powers to intervene if the solvency margins fail to reach the prescribed level. In this case the home authorities should require a plan for the restoration of a sound financial position. If the solvency margin falls below the guarantee fund the supervisory authorities shall require the undertaking concerned to submit a short-term finance scheme for its approval. It may also restrict or prohibit the free disposal of the assets of the undertaking.

The Directive contains even stricter sanctions. It sets the conditions which lead to the withdrawal of authorisation. The competent authorities may withdraw the authorisation if the undertaking: 1) no longer fulfills the conditions of admission, 2) has been unable, within the time allowed, to take the measures contained in the restoration plan or finance scheme and 3) fails seriously in its obligations under the national regulations.

In the event of the withdrawal of the authorisation the home authority should notify such withdrawal to the supervisory authorities of other Member States which have issued an authorisation to the undertaking; they shall thereupon withdraw their authorisation. The home authorities, in conjunction with other authorities, should take all the adequate measures to safeguard the interests of the insured and in particular shall restrict the free disposal of the assets of the undertaking if such restriction has not already been imposed.

An authorisation granted to an agency or branch of an undertaking whose head office is situated in another Member State may be withdrawn if the agency or branch: 1) no longer fulfills the conditions for admission, and 2) fails seriously in its obligations under the regulations of the country where business is carried on, with respect in particular to the establishment of technical reserves. The host authorities should consult the home supervisory authorities before withdrawing the authorisation.

The Directive also contains rules applicable to agencies or branches established with the EEC and belonging to undertakings whose head offices are outside the Community.

According to these rules the access to the business by any undertaking whose head office is outside the Community should be subject to an authorization. The authorization shall be granted by a Member State if the undertaking : 1) is entitled to undertake insurance business under its national law, 2) establishes an agency or branch in the territory of such Member State, 3) undertakes to establish account specific to the business which it undertakes, 4) designates an authorized agent to be approved by the competent authorities , 5) possesses, in the country where it carries on its business, assets of an adequate amount, 6) keeps a margin of solvency, and 7) submits a scheme of operations similar to that we described above. Furthermore, the Directive provides that the law of the Member States shall be applicable to the calculation of technical reserves the determination of categories of investments, and the valuation of assets. It is quite obvious that the Directive considers the agencies and branches established with the EEC and belonging to undertakings whose head offices are outside the Community as new entities rather than as the consequence of the operations of the respective undertakings worldwide.

The Community may by means of agreements concluded with one or more third countries, agree to the application of provisions different to those for the purpose of ensuring under conditions of reciprocity adequate protection for insured persons in the Member States. Here it is essential to add that Switzerland had expressed an interest in concluding such an agreement with the Community. The Commission negotiated a text with the authorities of that country and proposed a Directive (72) on the implementation of the agreement. According to this proposal the insurance undertakings of the Member States would be able to operate in Switzerland under the same rights as in the Community while Swiss insurance undertakings will enjoy similar rights. This proposal has not been adopted yet.

The Directive contains a model set of state control laws for implementation by the Member States. It has influenced legislation and regulation in the Member States especially with regard to freedom of establishment and it had considerable effects on improving intra-EEC penetration of insurance services. The Directive has made the granting of an authorization generally not discretionary. The responsible authorities should consider whether the prescribed conditions have been fulfilled, in which case the authorization must be granted. The Directive does not prevent Member States from applying additional provisions, but these provisions shall be designed to safeguard the interests of the insured persons and may not require that any application for an authorization shall be dealt with in the light of the economic requirements of the market. The scope of supervision should, therefore, be purely prudential.

Far from setting up a common procedure for the granting of authorization, the Directive provides a firm basis for coordination between the Member States as regards the conditions for exercise of business and especially the maintenance of financial security by prescribing common standards for calculating the minimum solvency margins. The Directive does not attempt to create a central controlling authority responsible for insurance supervision. Powers and responsibilities are not transferred to the Community bodies but to the home supervisory authorities. The coordinating model adopted by the Directive leads to the reallocation of responsibility with regard to insurance supervision among the Member States and in favour of those where the head office is situated - ie. the Member States whose insurance industry is relatively strong and competitive. However, the adopted supervisory system does not rely on complete decentralised control - ie. making each individual Member State responsible for ensuring these rules. Instead, the system of control is based upon cooperation and consultation among the responsible authorities in the Member States because control is to be exercised partly through the home authorities and partly through the host authorities.

Further consideration of the Directive leads to the conclusion that the it suffers from some major shortcomings. Even if it provides a great deal of coordination as regards the nature of insurance undertakings and their satisfactory running, especially concerning the maintenance of their financial security so as to prevent unfair competition; some of its provisions are very general and especially those which refer to technical reserves. The level of adequate technical reserves is left to be determined by the different national supervisory authorities and this contributes to the problem of an insurer operating internationally due to the obligation to comply with different requirements. This was mainly due to the fact that the Member States were unable to agree on a precise form for the Directive.

The original Member States were not exporters of insurance services and they have no significant share in the world insurance market. The Six had strict control operations in their territories. However, the case for the UK was exactly the opposite. The regulatory regime on insurance companies was liberal. The interested parties in the UK felt that if Britain joined the EEC and a Directive providing for strict control laws was adopted, the insurance earning would seriously be restrained. The UK pressed therefore for the adoption of a more liberal form of control. The Directive being, therefore, a compromise could not contain a precise coordinating model.

The Directive also provides that Germany may maintain the provisions prohibiting the simultaneous undertaking in its territory of health insurance, credit and suretyship insurance or insurance in respect of resource against third parties and legal defence either with one another or with third classes. The above provision seems to create distortions since German companies undertaking insurance business in these classes can establish themselves in the other Member States while companies undertaking combined insurance business in these classes in other Member States and wish to carry on their full range of business in Germany they are put to the trouble and expenses of creating separate subsidiary companies to engage in these classes which are subject to specialisation requirements (73).

The Directive also does not bring any harmonization of "material control" (policy conditions, premium rates, wording forms etc) (74); while it allows Member States to apply any rules as to the choice of the assets in excess of those representing the technical reserves.

In the course of the attainment a Common Market in insurance services, the Council after the Commission's proposal introduced in 1979, adopted the First Council

Directive (75) on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life insurance. The Directive was necessary to eliminate the divergences which existed between national control laws and intended to abolish restrictions on the freedom of establishment in the business of direct life insurance.

The significant time lag between the adoption of the coordination Directive in the field of non-life insurance and the life coordination Directive was necessary to solve the problems connected with life assurance than those of other types of insurance. The life insurance industry is dependent on the savings of the general public, manages funds on behalf of the insured persons over a long period and, therefore, is subject to strict control in the various Member States. The diversity and inequality of the strict national control regulations made the task of coordination even more difficult.

Even more important was the dispute over composites. Member States have different regulations and practices as to the simultaneous carrying on of life assurance and non-life insurance. Some Member States (such as France, Germany and Italy) have adopted the so called "principle of specialization " by setting rules which provide that the same undertaking could not carry on both types of insurance because of prudential considerations. There are fears that the life insurance funds might be used to support the risk of insurance operations other than life insurance. On the other hand, in the UK, Belgium and Luxembourg companies could carry both types of business.

In dealing with this problem the Directive provides that newly formed companies should no longer be authorized to carry on these two activities simultaneously and should be specialised in one type of business or the other. On the other hand, pre-existing companies which transact both life and non-life business may continue to do so, provided that they observe strict rules on separate management in order that the respective interests of life policyholders and non-life policyholders are safeguarded and the minimum financial obligations in respect of the one of the activities are not borne by the other activity. An undertaking could set up a new branch or agency in another Member State only for its non-life business; for the conduct of life insurance it would need to create a separate subsidiary company. Moreover, Member States are given the option of requiring those existing undertakings established in their territory which carry on life insurance and non-life insurance simultaneously to put an end to this practice.

Generally speaking, the Directive moves along the same lines as the first non-life coordination Directive, and its main provisions cover.

- the legal form of insurance undertakings
- the restriction of their activities to insurance and operations directly arising therefrom
- coordinating authorization procedures making it easier for an insurance company in any Member State to set up a branch or agency in another Member State
- the requirement that all classes of insurance must be subject to state supervision
- the issues leading to the withdrawal of an authorization
- close cooperation among national supervisory authorities
- the attribution to the home supervisory authorities the sole responsibility that the undertaking concerned maintain the adequate solvency margin and guarantee fund
- the attribution to the host supervisory authorities the responsibility for supervision of technical reserves

The branch or agency will be subject to local laws of the host country. The local laws may cover requirements on the premium rates and policy conditions which may be in force in the host country. In addition it may be subject to restrictions on its investment policy and have to maintain its assets in the form prescribed in the host country. Although the Directive recognizes that these various subjects should be coordinated, it provides that this is not essential at the present stage. The principles governing the solvency margin are the same as in the first non-life coordination Directive. Moreover, the levels of the minimum solvency margin are determined according to the classes of insurance underwritten.

However, even before the adoption of the life coordination Directive further developments had taken place.

According to the Treaty of Rome, all discriminatory treatment based on nationality with regard to establishment and to the provision of services is prohibited from the end of the transitional period. The principle of such national treatment applies in particular to the right to join professional organizations where the professional activities of the person concerned necessarily involve the exercise of this right. In view of these considerations the Council after Commission's proposal introduced in 1976, a Directive (76) on measures to facilitate the effective exercise of freedom of establishment and freedom to provide services in respect of insurance agents and brokers and, in particular, transitional measures.

The Member States used to impose different provisions for the taking up and pursuit of activities of insurance agent and broker. In some cases there was freedom to take up and pursue such activities but in other cases there were strict conditions making access to the profession conditional upon possession of formal evidence of qualifications. The main scope of the Directive was the adoption of measures in order to avoid undue constraint on the national of Member States in which the taking up of such services is not subject to any conditions.

Article 57 of the Rome Treaty provides that in order to make it easier for persons to take up and pursue activities as self-employed persons, Directives are to be issued for the mutual recognition of diplomas, certificates and other evidence of formal qualifications and for the coordination of the provisions laid down by law, regulation or administrative action in Member States. The Directive is therefore transitional in character and it is necessary in the absence of mutual recognition of diplomas or of immediate coordination. Its purpose will disappear if ever the coordination of conditions for the taking up and pursuit of the activities in question and the mutual recognition of diplomas, certificates and other formal qualifications is achieved.

The Directive adopts procedures necessary to ensure due recognition in one Member State of a broker or agent from another Member State. In doing so it sets standards of experience, based essentially on time spent in the profession, although recognition and weight are given to the possession of professional qualifications.

The Directive lays down the procedures and the documentation to be produced when a national of one Member State wishes to work in another Member State either by establishment or by offering services. The effect in practice is that, an intermediary wishing to work in another Member State whose national intermediaries are required to register, must register likewise. To do so he must obtain the documentation described in the Directive and go through the procedures there outlined. Thus, brokers operating in Europe on a services basis in insurance or reinsurance, life or non-life, should, as of now, take care to ensure that they and their staff as individuals are duly registered in those countries requiring registration of their own national brokers. However, all these bureaucratic procedures could be considered as an important barrier to the establishment or freedom to provide services with respect to intermediaries.

Some progress towards the achievement of a common market in insurance was made in 1978 through the adoption of a Council Directive (77) on the coordination of laws, regulations and administrative provisions relating to Community co-insurance. Co-insurance means the insuring by two or more insurance undertakings one of which is the leading insurer acting without joint and several liability of a single risk under a single contract at a single premium and for a single period. The lead insurer will commonly take a larger proportion of the risk than any of the others; but not necessarily so, because he may occupy the leading position due to his recognized skill or due to a longstanding business relationship with the policyholder.

The Directive recognises that the effective pursuit of Community coinsurance business should be facilitated by a minimum of coordination in order to prevent distortion of competition and inequality of treatment. It constitutes a first step towards the coordination of all operations which may be carried out by virtue of the freedom to provide services, since insurance companies from Member States would then for the first time be able to write coinsurance across all EEC boundaries for certain kinds of non-life risks. It applies to certain kinds of risks situated with the Community covered by a single contract at an overall premium for the same period by two or more insurance undertakings, of which at least two are established within the Community (78).

The Directive also applies to risks which by reason of their nature or size call for the participation of several insurers for their coverage. For the purpose of covering the risk, the leading insurer is authorized in accordance with the conditions laid down in the first non-life coordination Directive, ie. he is treated as if he were the insurer covering the whole risk. However, this is interpreted by the majority of Member States as meaning that the leading insurer must be established in the State where the risk is situated but by the Commission as meaning that the leading insurer may be anywhere in the Community provided that he is authorised in some Member States, in accordance with the provisions of the first non-life coordination Directive (79).

Many Member States introduced legislation which prevented risks or policyholders from being covered by insurers not established in their own territory. They therefore insisted that the lead insurer should be established in the State where the risk was situated, while the other coinsurers could be established in any other State. In this case the home State would be able to apply its own national regulatory system on the coinsurance contract and to ensure that the insurance product is similar to the one which would have been available if only insurers established in their own territory had taken part. From the customer's point of view the participation of foreign based insurers would have absolutely no effect.

This attitude of the majority of the Member States which introduced legislation in order to require the lead insurer to be established within the jurisdiction of the State where the risk or the policyholder is situated as a necessary condition to transact coinsurance business, substantially limits the effectiveness of the Directive. However, it was thought that this radical divergence of views between the majority of the Member States and the Commission would be removed through the speedy implementation of the second non-life Coordination Directive whose proposal had already been submitted to the Council. The second non-life coordination Directive was intended to eliminate through coordinating measures all the barriers on the effective exercise of freedom of services without calling into question the interpretation of the Coinsurance Directive or even that of the Rome Treaty.

The Coinsurance Directive provides for some coordination with respect to technical reserves and the assets representing them. The amount of the technical reserves shall be determined by the different coinsurers according to the rules of customary practice in the Member State where they are established. The Directive also calls for close cooperation between the competent authorities for an effective supervision of the coinsurance activities. However, the Directive fails to settle any questions or give its guidance with respect to the choice of the law to be applied to the contract.

The Directives we have seen so far (and especially the two Coordination Directives) succeeded in implementing a considerable degree of harmonization. They set up a uniform supervisory system throughout the EC. They harmonised the requirements to be met with respect to granting of an authorisation with respect to guarantees and in particular to the most important financial requirements imposed on insurers, namely the solvency margin and guarantee fund. As a result, insurers within the EC have to fulfil broadly similar financial requirements in respect of their worldwide activities. The Directives also lay down the respective responsibilities of each national authority (since they consider branches and agencies as the consequence of the international operations of the respective insurance undertakings) so as the host authorities to recognise authorisation granted and supervisory measures undertaken by the home authorities, avoiding any overlapping. They provide for an international system of supervision based on the close collaboration between the Member States and their respective supervisory authorities.

However, despite the degree of harmonisation achieved by the Directives, considerable obstacles remained with regard to freedom of establishment and to provision of services. The host supervisory authorities may apply additional requirements to the granting of an authorisation in order to ensure that a foreign insurer is subject to comparable supervisory control with that of a national insurer. The host supervisory authorities may also impose their own rules on the technical reserves, on the matching and localisation of the assets representing them and on investments.

In contrast with the field of financial safeguards, there has been no Community harmonisation of insurance contract conditions although some attempts made by the Commission proposing for a Directive (80) on the coordination of laws, regulations and administrative provisions relating to insurance contracts. The proposal does not try to harmonise all the aspects of insurance contracts law but only some basic features. Especially the duties of the proposer with regard to the declaration of the risk and the consequences of an incorrect declaration which may lead to considerable differences in the amount paid by the insurer in the event of a claim. The proposal also tries to harmonise the measures to be taken by the policyholder in circumstances giving rise to a claim. However, this proposal has never been adopted.

In the absence of Community harmonisation of insurance contracts the Member States exercise varying degrees of control over insurance contract conditions. The arguments that justify supervision over insurance contracts are basically consumer protection - ie. to protect policyholders from bad bargains. In doing so some Member States impose considerable restrictions on the terms and conditions of the policies while others rely more on self regulation rather than statutory control. The degree of freedom enjoyed by insurers to determine the terms and conditions of their policies is very important since it reflects the degree of competition in the insurance market.

On the other hand, the proposal for a second non-life Coordination Directive (81) proposed by the Commission as early as in 1975 was calling for complete free choice of the law applicable to the contracts. The Commission's view was that any insurer should be able to provide contracts to which his own national law would apply within the concept of freedom of services. However, some Member States expressed concern about the substantial differences between national laws which affected the rights of policyholders, the level of premiums and the amounts received by the policyholders in the case of a claim. There were fears that policyholders may enter into contracts with low premiums but subject to a law with which they were unfamiliar and found themselves covered less well than they had expected. Thus, the regulatory regime which denied freedom of choice of the law applicable to the contracts remained.

Even more important was the fact that Member States subjected cross-frontier insurers to the requirement of prior establishment and authorisation. Foreign insurers intending to transact direct insurance business in some Member States should establish a branch office or agency within their jurisdiction and to obtain an authorisation. The requirement of establishment and authorisation discriminate against a foreign insurer since he has to pay the costs of setting and running his branch office, of obtaining his authorisation and of complying with the national laws and administrative practices in the host

State. The discrimination against insurance concerns on the grounds of the fact that they are established in a Member State other than in which the services are to be provided is incompatible with the principle of a common market. There can be a common market in insurance only when every insurance concern in the Community is genuinely able to provide services freely in Member States in which it is not established.

During the last years considerable efforts were undertaken towards a common market in insurance services and there are a number of reasons for this.

First of all, the increasing growth of service industries and the rapid technological changes led to the internationalisation of the industry. Services are no longer an afterthought in international discussions but instead the increasing focus of attention. The increased realisation that insurance is a major component of services as a whole and its importance is likely to increase in the future is an important factor.

Even more important is the deadline of 1992. Indeed, the Single European Act laid down a timetable for the completion of the internal market. The Single European Act reiterated the essential aim of the Treaty of Rome to organise the free movements of persons, services and capital. It was designed to speed up adoption of Directives by doing away with the time delays associated with unanimity voting. In some areas such as insurance and banking, Directives now have to be adopted by qualified majority voting accelerating the process of integration in these fields.

The Commission's White Paper clearly indicates that mutual recognition of norms and standards should be applied to financial products. The Single European Act substituted the principle of mutual recognition of national standards and regulations for that of prior harmonisation. Faced with the difficulties encountered in arriving at full harmonisation, it is based on the principle of minimum harmonisation of legislation and reciprocal recognition of supervision as a corollory, on the application of a single control at head office level. The European Financial Area is going to be set through the acceptance of comparability of supervisory controls and without prior harmonisation.

It is quite obvious that the difficult task of creating a genuinely common market in financial products is left to an intergovernmental model of integration. The Community does not try to create a supranational control on insurance, since no expansion of the role of the Community's bodies takes place. Instead, the process of integration is based on the reciprocal recognition of supervision. The responsibility is attributed to the national authorities of the States where the head offices of the undertakings are situated. The power is reallocated among national authorities while the community authorities are excluded from any involvement.

The Single European Act offers, therefore, an alternative model to economic integration based essentially on an intergovermental structure. It is a model much more flexible and it is based on pragmatism. Recognising the traditional differences in the level of supervision and consumer protection, it provides for suitable means for organising a genuinely free market: the mutual recognition of national standards and regulations and for minimum harmonisation.

This process of integration is not new. It is the process which the Member States used to achieve political cooperation during the 1970s. And this process is now used for economic issues.

In this framework the Council adopted in 1988 the Second Directive (82) on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 73/239/EEC.

The object of the Directive is to supplement the first non-life Coordination Directive and to lay down special provisions relating to freedom to provide services for the undertaking and in respect of the classes of insurance covered by that first Directive. It therefore recognizes that in order to develop the internal market, it is desirable to make it easier for insurance undertakings having their head office in the Community to provide services in the Member States, thus making it possible for policyholders to have recourse not only to insurers established in their own country, but also to insurers which have their head office in the Community and are established in other Member States. It also recognizes that policyholders who, by virtue of their status, their size or nature of the risk to be insured, do not require special protection in the State in which the risk is situated should be granted complete freedom to avail themselves of the widest possible insurance market; while it is desirable to guarantee other policyholders adequate protection.

The Directive sets out specific provisions with regard to law applicable to contracts of insurance covering risks situated within the Member States. According to these provisions, where a policyholder has his residence or central administration within the territory of the Member State in which the risk is situated, the law applicable to the insurance contract shall be the law of that Member State. However, where the law of that Member State so allows , the parties may choose the law of another country. When the risk is situated in another Member State, the parties to the contract of insurance may choose to apply either the law of the State where the risk is situated or the law of the State where the policyholder is situated. If the Member States grant greater freedom of choice of the law, the parties concerned may take advantage of this freedom. Only in the case of special classes of large risks (such as aircraft, railway rolling stock, ships, goods in transit and aircraft liability), the parties of the contract may choose any law. These provisions clearly mean that the Member States can maintain restrictions not only for "mass risks" (ie. personal lines) but also for "large risks" (except in special classes). The Directive did not bring about a truly European solution: Free choice of EC laws.

The scope of the Directive includes compulsory insurance, but requires the contract covering such insurance to be in conformity with the specific provisions relating to such insurance, as provided by the Member State imposing the insurance obligation.

With regard to freedom to provide services the Directive is based on the distinction between "large risks" and "mass risks". For the former, the policyholder needs no special protection and insurance contracts taken out are therefore governed by the principle of home country control. For "mass risks" - essentially the risks of individuals- maintaining the regulations and controls of the service country is fully justified. Therefore, these risks remain under host country control and cannot as yet be written on a service basis - ie. by means of transfrontier transaction concluded on the basis of the regulations and under the control of the insurer's country. The scope of effective freedom of services is relatively limited.

Other provisions of the Directive state that the Member States legislation shall provide that the undertakings which have a branch or agency in the country of the risk cannot insure the risk through services. This is the so-called "Cumul" rule. According to the Directive "Cumul" between establishments (agency or branch) and free services is possible for large risks and for mass risks for which the establishment in the Member States concerned has no authorization. The "Cumul" rule penalizes the large insurers with branch/agency networks throughout the Community; it interferes with free competition because it places domestic insurers in an advantageous position. The whole concept of limiting the simultaneous pursuit of activity by way of freedom to provide services and activity by way of establishment is, commercially, discriminatory and unjust.

The Directive provides that the taking-up and pursuit of freedom to provide services should be subject to procedures guaranteeing the insurance undertakings' compliance with the provisions regarding both financial guarantees and conditions of insurance; while these procedures may be relaxed in cases where the activity by way of provisions of services covers policyholders who by virtue of their status, their size or the nature of the risk to be insured, do not require special protection in the State in which the risk is situated.

In these respects, each Member State within the territory of which an undertaking intends to provide services may make access to such activity subject to administrative authorization. The authorization should be granted if the undertaking: 1) produces a certificate issued by the home authorities attesting that it possesses for its activities as a whole the minimum solvency margin calculated according to the provisions of the first Directive; 2) produce a certificate issued by the authorities indicating the classes which the undertaking has been authorized to practice and attesting that those authorities do not object to the undertaking providing services; 3) submit a scheme of operations containing: (a) the nature of the risks which it proposes to cover, (b) the general and special conditions of the insurance policies which it proposes to use, (c) the premium rates which applying for each class of business, (d) the forms and other printed documents which it intends to use in its dealings with policyholders, in so far as these are also required of established undertakings.

Any decision to refuse authorization must be accompanied by the precise grounds and communicated to the undertaking in question. Moreover, each Member State shall institute the right to take legal action in the courts against a refusal of authorization. These provisions clearly indicate that the authorization is not discretionary. However, if the undertaking proposes to cover "large risks" it is not necessary to submit a scheme of operations, but only to state the nature of risks which it proposes to cover.

With respect to "mass risks", these coordination measures does not prevent the Member States from maintaining or introducing laws, regulations or administrative provisions concerning, in particular, approval of general and special policy conditions, of forms and other printed documents for use in dealing with policyholders, of scales of premiums and of any other document necessary for the normal exercise of supervision provided that the rules of the Member State of establishment are not sufficient to achieve the necessary level of protection and the requirements of the Member State of provision of services do not go beyond what is necessary in that respect.

However, with respect to "large risks" the Member States shall not lay down provisions requiring approval or systematic notification of the above conditions. They may require only non-systematic notification of these conditions.

The Directive also provides that technical reserves should be subject to the rules and supervision of the Member States receiving services where the provision of services involves risks in respect of which the States receiving the service wish to provide special protection for policyholders. If, however, such concern to protect the policyholders is unjustified, the technical reserves continue to be subject to the rules and supervision of the Member State in which the insurer is established. For large risks, the non-localisation rule applies, which means freedom from rules in force in the country of the risk as regards the representation of assets and evaluation of reserves. For the "mass risks" compliance with the national law of the Member State of provision of services is required, blocking freedom of services for all practical purposes. Here again the Community missed a good chance to bring about a truly European solution: the application of non-localization rule for all classes of insurance.

The Directive also provides for special cooperation with regard to freedom to provide services between the competent supervisory authorities and contain provisions for a system of penalties to apply where the undertaking providing the services fails to comply with the provisions of the Member State of provision of service.

According to these provisions, if the host supervisory authority ascertains that an undertaking does not comply with the legal rules in force, they may request the undertaking concerned to put an end to the irregular situation. If the undertaking fails to comply with the request the host authorities may inform the home authorities so that the latter can take all the appropriate measures to ensure that the undertaking concerned puts an end to the irregular situation. These provisions do not affect the right of Member States to punish irregularities committed within their territory.

The Directive also recognizes that the provisions in force in the Member States regarding the forms of indirect taxation differ widely. The divergence in the structure and rate of these taxes and contributions lead to disturbances of competition in insurance services between

Member States.

Here it is essential to give some brief indications about certain specific aspects of the taxation treatment of insurance business. Some countries do not subject insurance transactions to any form of indirect taxation; others allow the policyholder to deduct from his taxable income all or part of the premiums paid for insurance of certain classes, especially life assurance; while others impose a tax on insurance premiums at a rate varying according to the class of insurance or/and a tax on receipts for payment of benefit or indemnity or of loans on policies. These taxes are levied directly on the policyholder and form part of the cost of insurance. In the absence of harmonization of taxes, the costs borne by the policyholders vary - everything else being equal- creating a degree of distortion of competition.

Lastly, the Directive allows for relatively long transitional periods in the cases of Greece, Ireland, Spain and Portugal. Until 31 December 1992, they may treat "large risks" as "mass risks". From 1 January 1993 to 31 December 1994, the regime for "large risks" shall apply to risks where the policyholder is engaged professionally in an industrial or commercial activity or in one of the liberal professions, and the risks relate to such activity, and risks relating to some classes of insurance (such as railway rolling stock, aircraft, ships, goods in transit, aircraft liability, and liability for ships). For the risks relating to other classes even longer transitional periods apply exceeding well the deadline of 1992.

The Directive is considered as an important milestone on the road to the completion of the single European market, even if many of its provisions restrict significantly the effective exercise of freedom of services.

BARRIERS TO THE PROCESS OF LIBERALISING INSURANCE SERVICES IN THE DEVELOPED EC COUNTRIES : THE UK CASE

ESTABLISHMENT, OPERATION AND MARKET ACCESS OF INSURANCE CONCERNS IN THE UK : CONDITIONS AND CONTROLS IN 1989.

1. Regulatory provisions and administrative practices governing the entry and establishment of indigenous insurance concerns

The Insurance Companies Act 1982, which is the main UK insurance law makes a fairly detailed classification of insurance business providing at the same time a clear definition of the term "insurance business". The terms "long term business" and "general business" correspond respectively to the terms "life" and "non-life" insurance business as they are used in the Community Directives.

Domestic insurance concerns must be constituted in the form of incorporated companies limited by shares or by guarantee or unlimited. Obviously, we refer to insurance companies as opposed to friendly societies, trade union or employer's associations and Lloyd's which was exempted from certain provisions of the Act. The regulation of the insurance industry in the UK is the responsibility of the Department of Trade and Industry (DTI).

Insurance concerns may not simultaneously carry on long term business and general business. Authorization for new composite companies (which transact both long term business and general insurance business) is not possible.

Insurance concerns should have fully paid up share capital. The share capital is not required to be any specific amount but the DTI will need to be satisfied that adequate financial resources will be available to support the business. It is generally believed that insurance companies should possess a higher initial share capital than ordinary companies since they must remain solvent and always be able to meet their financial commitments. The amount of the minimum share capital required varies according to the class of insurance business to be transacted. Presently, a share capital of £5m upwards (or £10m upwards if substantial amounts of marine, aviation and transport business are to be transacted) could be considered a reasonable minimum.

A key requirement of authorization is that directors, controllers and managers of all applicants together with their agents are fit and proper persons. This involves an extensive investigation into financial and moral integrity of the applicant and its management. In particular the DTI considers any information covering qualifications, experience, court convictions and public criticism. It also examines whether the persons concerned have been declared bankrupt or failed to discharge debts, or found guilty of fraud or misconduct, or been a director or controller of a company that has been wound up or ceased trading.

The DTI have to be satisfied that, if a class of business requires reinsurance, the reinsurance arrangements will be adequate and suitable. It does not normally allow more than 20 per cent of the insurance company's liabilities to be reinsured with one company. The DTI considers the suitability of the reinsurance arrangements relating to the worldwide activities of the applicant.

The entry requirements include the submission of a properly organized Business Plan required by the DTI as part of the process of applying for authorization. The Business Plan should contain:

1) A brief summary of the object of the company and a statement showing the amount by which assets are expected to exceed liabilities at the date of authorization.

2) Details of any association between the directors, controllers and anyone acting as an insurance broker or agent.

3) Details of the classes of business for which the company is already authorized in the UK and which it wishes to be included in the new authorization.

4) Details of the source of business and the approximate

percentage expected from each source.

5) The nature of the commitments the company plans to take on and general and special policy conditions it plans to use.

6) Guiding principles on reinsurance.

7) The assets which will represent the Minimum Guarantee Fund and whether they are admissable under the value in line with the Assets Valuation Regulations.

8) Estimated costs of installing administrative services and sales organizations and the financial resources planned to cover these.

9) Financial projections for each of the three financial years covering:

a. a forecast balance sheet (on both optimistic and pessimistic assumptions)

b. a plan (on the same bases) setting out detailed estimates of income and spending on direct business and reinsurance business, and

c. estimates of the financial resources intended to cover underwriting liabilities and the solvency margins.

10) A statement showing the type of investments expected to comprise the insurance funds and the estimated proportion represented by each type of investment.

For life companies the Business Plan has also to include:

1) A statement for each of the first three years following authorization for each type of contract, on both optimistic and pessimistic assumptions and broken down between the UK, other EC states and elsewhere, covering:

a. the number of contracts or treaties expected to be issued,

b. total premium income, and

c. total sums assured or amounts of annuity per annum.

2) A certificate by the actuary that he considers the premium rates suitable, the finances sufficient to cover both the technical reserves and the required margins of solvency for three years.

The Business Plan forms the "nub" of a firm's application and is used by the DTI to examine in particular the financial projections and the margin of solvency during the period covered by the projections. The initial free assets are expected to be sufficient to cover the required solvency position at the end of the three years covered by the projection. The DTI usually gives advice before a formal application is filed on the amount of financial resources required.

Assuming the application is successful, the applicant will be authorized to carry on insurance business in the classes for which the application was made. If the concern seeks to carry on insurance business in other classes another application should be made.

The entry requirements as presented above indicate that the UK authorities not only adopted the provisions of the EC Directives but also set additional requirements so as to ensure adequate protection for potential policyholders. Ranking these requirements in order of importance is a difficult and subjective exercise. But it seems that those referring to the management of the companies are the most important. The second most serious type of requirements concerns the solvency and reinsurance requirements.

The conditions governing the entry of firms to the insurance market, as set out in the Insurance Companies Act and as applied by the DTI, involve solely prudential considerations. In principle, the authorization is not discretionary. The responsible authority considers whether the prescribed conditions have been fulfilled, in which case the authorization must be issued. However, assessment of whether the criteria are met is subjective. This means that authorisation is discretionary in practice.

The authorization requirements are not applied with the intention of prohibiting entry of those concerns which would succeed; rather they are designed to cut out only those firms which would probably have failed. As a consequence, if the DTI's judgement is right, the authorization requirements neither limit entry nor reduce the number of firms in the industry.

2 Regulatory provisions and administrative practices governing the entry and establishment of brances by foreign insurance concerns

Even if foreign insurance concerns are granted complete freedom to supply directly insurance services to the UK market, many of them prefer to establish themselves within the country. Only through establishment can a foreign insurer compete effectively with indigenous companies since individuals are reluctant to enter into a contract with an insurer which lacks a domestic establishment to offer the kind of services they require. Moreover, contracts affected abroad fall outside the favourable tax treatment and the protection of the domestic law (basically the Policyholders Protection Act 1977). Even more important is the fact that London plays a dominant role in international insurance. London is an unregulated market in which foreign insurers can enjoy a share even on risks for which their parent may be prevented from writing.

Foreign companies are required to obtain an authorization from the DTI in order to operate certain classes of insurance according to the standards set out in the Insurance Companies Act 1982. The authorisation is not discretionary. The responsible authority considers whether the prescribed conditions have been fulfilled in which case the authorization must be granted. Furthermore, the UK authorities have adopted the provisions of the EC establishment Directives with respect to management and solvency requirements. These Directives have done very little more than confirm an existing situation since the UK was always an open market.

As far as the reinsurance arrangements are concerned (which according to the provisions of the EC Directives are left to the discretion of every Member State) the DTI does not normally allow more than 25 per cent of the insurance companies' liabilities to be reinsured with its parent or more than 20 per cent with any other company, neither does it allow for more than 25 per cent of the liabilities to be reinsured in any one country, other than the country in which the applicant has its head office. These requirements are set out in order to avoid risk concentration and are considered to be of foremost importance, even if they are circumvented by the foreign companies which place their reinsurance business with their subsidiaries (which use different names).

The above analysis indicates that the controls over the entry of foreign insurance organizations to the UK market are rather weak and are governed by prudential considerations. The controls over entry are motivated by the desire to remove from entry firms which have a great possibility of failure in an industry which at the time of sale provides only a promise of future performance.

Furthermore, the UK authorities consider branches and agencies of foreign concerns as a consequence of the operation of these concerns worldwide. Obviously, these considerations do not differ very much from the principle of "home country control". The controls over entry and establishment of branches and agencies of foreign banks into the UK market are motivated solely by prudential considerations and they could easily be abolished if the EC moves towards a Common Market in financial services.

3 Regulatory provisions and administrative practices governing the entry and establishment of minority and majority owned subsidiaries by foreign insurance concerns

The insurance law provides for equal treatment for all UK concerns, whether foreign or domestically owned. The supervisory authorities treat foreign subsidiaries in the same manner as domestic concerns.

Acquisitions by foreign insurance organisations of interests in indigenous concerns, like any other acquisition, are subject to the provisions of the Fair Trading legislation which is designed to prevent any single company acquiring a dominant position in the market. There are not statutory limits on the acquisition of participations in other companies.

Moreover, as a matter of general policy the DTI would expect to be given prior notification of any intended acquisition in an authorised insurance company. The DTI generally wishes to be satisfied that the parent company has adequate capital and managerial resources to support such operations and may require to be furnished with specific information.

Foreign subsidiaries are considered in law domestic corporations. Their establishment is therefore subject to the same requirements as the establishment of indigenous insurance concerns. Especially the DTI should be satisfied about the financial and moral integrity of the new management. However, the above requirements are motivated (as in the case of establishment of foreign agencies and branches) by prudential considerations. One, therefore, might argue that the UK authorities do not restrict the entry and establishment of foreign owned subsidiaries.

4 Regulatory provisions and administrative practices limiting the market access by foreign based insurance organisations

Generally speaking the UK authorities do not impose any provision which prevents or hinders foreign based insurance companies from supplying insurance, reinsurance or co-insurance in the domestic market. An insurance company may export insurance services in the UK in the sense that it underwrites, at its head office in another country the insurance of risks that may be incurred in the UK.

Foreign insurers who are neither established nor authorised in the UK are allowed to write insurance business without incurring the costs of establishment or of obtaining authorisation, except in the case of compulsory insurance. Companies wishing to provide a range of insurance services in the compulsory classes should establish themselves in the national market and comply with reasonable supervisory standards. However this exception is not important because the compulsory classes are very few (motor third party liability and nuclear liability insurance).

The UK is one of the few countries which allows a considerable degree of freedom of international insurance transactions. In other EC countries legislation prohibiting insuring abroad extends beyond compulsory insurance, sometimes covering all classes of insurance. Furthermore, the UK residents may enter into insurance contracts with an insurer abroad even when this insurer is also established and authorised in the UK for the same classes of insurance. The UK authorities do not apply the so-called "cumul" rule. In addition, the national monetary authorities do not impose any exchange control regulation or practice which prohibits or restricts the residents' ability to obtain the necessary foreign exchange to use for the transfer of premiums or for insurance taken out abroad. The insurance contracts written in the UK can also be expressed in foreign currency.

The UK supervisory authorities not only impose no restrictions concerning the placing of contracts but also allow complete freedom with respect to conditions applying to transactions. However, the fiscal policy has a distorting effect on insurance services business and inhibit the freedom of insurance transactions even if that freedom basically exists. The tax relief for life assurance is granted only when a contract is effected with an insurer established and authorised in the UK. This discriminatory tax treatment clearly discourages the supply of foreign insurance and raises the problem of tax harmonization with respect to insurance in the EC.

as far as reinsurance is concerned, insurance companies established in the UK are allowed to place their reinsurances abroad. However, they are subject to some controls of prudential nature as it has been pointed out. Co-insurance is permitted on an international basis. Foreign insurance companies are generally allowed (except for the compulsory classes) to participate in co-insurance operations covering risks located in the UK without the need of authorisation.

Furthermore, the UK authorities do not impose any restriction on the entry of the intermediaries to the market. The Insurance Brokers Registration Act of 1977 incorporated the provision of the EC Intermediaries Directive providing for the effective exercise of freedom to provide services.

5 Regulatory provisions and administrative practices restricting the domestic operations of established foreign-owned insurance companies

The UK market is largely unregulated and the UK authorities do not impose any regulatory provision or administrative practice which relates to the scope of insurance business and distinguish between indigenous and foreign insurance concerns. Companies are free to determine their premium levels and contract wording and have a free hand when formulating their investment policy. The rules on the admissibility of certain types of assets and restrictions on the extent to which individual holdings of assets may be taken into account affect, (as it has been pointed out elsewhere) only to a small extent their investment policy and profitability.* Furthermore, branches of foreign companies are allowed to calculate their solvency margins in respect of the whole of their business and to establish both their solvency margins and guarantee funds at their head offices. They can therefore rely upon the financial guarantees existing at the head office.

As a consequence, branches and agencies of foreign concerns established in the UK are legally integral parts of the entities to which they belong and are thus regarded by the UK supervisory authorities as being primarily the concern of their home supervisory authorities for prudential supervision. The principle of home country control almost applies with respect to the operation of foreign insurance concerns.

The analysis so far leads us to the conclusion that the UK authorities have incorporated the provisions of the EC Directives which did little more than confirm an existing position. The UK insurance market has always been a relatively open and unregulated market. As far as entry, establishment and operation of indigenous and foreign

* (Interviews: Aegon Insurance, March 88)

institutions are concerned the controls are rather weak and motivated solely by prudential considerations. Branches and agencies of foreign companies are considered as integral parts of the entities to which they belong and are primarily the concern of their home supervisory authorities for prudential supervision. This approach accords to a large extent with the principle of "home country control" which is an indispensable part of the 1992 Community's strategy for the financial sector. Furthermore, the UK authorities do not restrict the acquisition by foreign institutions of participations in indigenous ones or the international insurance transactions. The UK insurance market is already open to free competition and no government regulation obstructs the neutrality between buying insurance services from indigenous institutions, buying them domestically from foreign institutions established in the UK, or importing them from abroad.

However, the question remains; will the UK be able to create with the other Member States a Common Market in insurance in the not too distant future ? In order to create one market it is necessary to have "freedom of establishment" and "freedom of services". These freedoms are already granted in the UK but they are restricted in the continental European countries. These restrictions are said to be necessary to protect policyholders from purchasing policies providing inadequate cover from foreign insurers. Indeed, as it has been pointed out elsewhere, the harmonization of the essential aspects of prudential supervision is an indispensable part of a Common Market. Will that harmonization take place ?

An attempt at answering these questions will be made in the following sections.

A COMMON MARKET IN INSURANCE : COSTS AND BENEFITS FOR THE UK INSURANCE INDUSTRY AND ECONOMY

There are at present (as Table 12 reveals) more than 800 individual companies to write insurance business in the UK (although this figure includes some with principal business abroad). Their size varies substantially. The largest ten companies in the life market accounted (as Table 13 indicates) for some 45.6% of the whole premium income. While for the non-life market the respective figure is 56%. These figures reveal that the insurance industry is highly concentrated within the UK and that the distribution of firms size is highly skewed.

TABLE 12

INSURANCE MARKET IN 1986

Type of companies	Life	Non-life	Composite	Total	Market share %
Domestic	192	431	60	683	95
Foreign	20	122	9	151	5
Total	212	553	69	834	100

Source : ABI UK market statistics

TABLE 13

TOP TEN INSURANCE COMPANIES IN THE UK IN 1986

Life

Rank	Company	Premium (£ million)	Market Share %
1	Prudential	2,352	10.8
2	Norwich Union	1,340	6.2
3	Standard Life	1,306	6.0
4	Legal & General	948	4.4
5	Commercial Union	723	3.3
6	Sun Alliance	705	3.3
7	Royal Insurance	692	3.2
8	Eagle Star	634	2.9
9	Guardian Royal Exchange	627	2.9
10	Allied Dunbar	569	2.6
Top ten total		9,896	45.6
Industry total		21,692	100

Non-life

Rank	Company	Premium (£ million)	Market Share %
1	Sun Alliance	1,063	9.4
2	Royal	848	7.7
3	General Accident	786	7.1
4	Commercial Union	749	6.8
5	Eagle Star	656	6.0
6	Guardian Royal Exchange	592	5.4
7	Norwich Union	501	4.6
8	Prudential	355	3.2
9	Co-operative	307	2.8
10	Cornhill	303	2.8
Top ten total		6,160	56.0
Industry total		11,000	100.0

Notes: 1. These figures show UK premiums only. Worldwide premiums of these 10 companies is nearly £14billion.

Source : ABI UK market statistics

The British insurance companies play an important role in the domestic and international economy. In 1986, the 5 largest UK insurance companies were numbered amongst the world's top 15, and 10 amongst the top 50. Many British insurance companies are involved to a large extent in branch and subsidiaries operation abroad. They also export to a significant degree insurance services in the sense that they underwrite, at their head office, the insurance of risks that may be incurred abroad. These companies, since they are especially active in foreign operations, derive a considerable proportion of their business and profits from overseas.

The measure of the significance of the overseas activity of the British insurance industry in terms of earnings is illustrated in Table 14 which presents the overseas earnings of the various groups of financial institutions. The insurance sector (including Lloyds) is the largest foreign earner among the financial institutions with earnings in 1988 of £4834 million. Some £1417 million of this was underwriting income earned on overseas business written in the UK by Lloyds underwriters.

The overseas earnings of the insurance sector are not only larger that those in any other financial sector, but they also are higher than the foreign earnings from North Sea oil - which accounted for about £4200 million. This provides some indications of the importance of the industry to the national economy and demonstrates the fact that the industry is internationally orientated. The insurance overseas earnings make a very important contribution to the UK's bop position and in particular the UK appears to have a competitive advantage in the provision of insurance services.

TABLE 14

OVERSEAS EARNINGS OF UK FINANCIAL INSTITUTIONS

in £ millions

Insurance:	underwriting	1082
	profits from overseas subsidiaries	663
	property income	24
	portfolio investment income	693
Lloyds:	underwriting (overseas business written in the UK)	1417
	portfolio investment income	258
Brokers	brokers	717
Total		4854
Debits:	direct investment income due to overseas affiliates	20
Net earnings by UK insurance institutions		4839
Banking:		1399
Leasing		40
Investment trusts		171
Unit trusts		218
Pension funds		732
Securities dealers		554
Commodity traders and export houses		573
Brokerage		858
Total earnings of above institutions		9374

Source: The UK Bop Yearbook 1988

A further measure of the comparative performance of an industry internationally could be the relative structure of prices within the industry. And Table 15 presents percentage differences in price by territory compared with the average of the four lowest prices. This comparison of the pricing structures of the insurance industries indicates that the UK experiences the lowest price level. It is therefore quite obvious that the UK possesses a competitive advantage in the provision of insurance services.

However, this competitive advantage seems to be based on the weak government control of the British insurance sector and there is enough evidence to justify this argument.

TABLE 15

PERCENTAGE DIFFERENCES IN PRICE BY TERRITORY COMPARED WITH THE AVERAGE FOR THE FOUR LOWEST PRICES IN 1987

	Life assurance	Large risks
Belgium	+ 58	+ 11
France	+ 33	+ 12
Italy	+ 83	+ 9
Luxembourg	+ 66	+ 17
Netherlands	- 9	- 1
Spain	+ 57	+ 25
UK	- 30	- 5
West Germany	+ 15	- 1

Source : Prudential Bache Capital Funding

One of the key issues is the capital mass of companies. In other words, to become international, a company might need to already hold a good share of its home market. The internationalisation of activities involves large firms and considerable financial strength. Larger firms may compete more effectively internationally since they can market their products at lower prices because of lower production or distribution costs. This could arise because the larger insurer: 1) is able to acquire factor inputs - risk capital and reinsurance - at a lower cost than smaller insurers, 2) can develop a more efficient production and marketing system, and 3) is able to exploit increasing returns to scale to a greater degree.

In contrast to other countries, the UK authorities do not enforce strict anti-trust laws, something which increases the scope for substantial mergers. The main Anti-Trust Law in the UK is the Fair Trading Act 1973 and it is designed to prevent single undertakings and groups from acquiring an unduly dominant position in the market. However, the Office of Fair Trading, which is responsible for the implementation of the Act, usually takes the view that acquisitions and mergers are part of the competitive process even if it recognises that they result in a reduction in the number of competitive firms and therefore reduce competition in the market. The UK authorities do not place any restriction on the size of the companies while composite companies are still allowed to operate and are those which dominate the market. This is an important distinction between the UK and other counties and affects considerably the ability of the British companies to compete internationally.

Furthermore, the UK companies are not faced with legislation which affects the way they produce their products.

Unlike the practices in other countries insurance companies in the UK do not have to apply for approval for premium rates neither to comply with rules with respect to the bases or assumptions to be used in the calculation of the premiums. Companies are free to set the prices of their policies at competitive levels according to the exact characteristic of the policies. They are able to lower specific premiums due to the finer distinguishing of risks and target a particular group or groups of policyholders to whom they will offer special insurance rates and consequently gain a competitive edge over other companies. The regulation has considerable effects on the operating behaviour of firms and on the premiums level.

UK companies do not have to seek approval for each new policy from the supervisory authorities. As a result, market participations can adjust flexibly to changes in the markets and the range of policies which have emerged has been wide. Fierce competition encourages companies to experiment and many innovations have flourished. A measure of the relative performance of an insurance industry is the degree of product variety; and the variety of insurance products on offer in an unregulated environment is relatively wide. A recent study (83) presenting details of the different types of insurance policies that are available in different countries concludes that in the UK there is one of the most extensive product varieties in the world due to the absence of regulatory restrictions.

The form of government regulation can actually affect the operating cost levels of companies. The UK regulatory environment gives companies virtual freedom to invest their funds so as to achieve the highest rate of return. This contrasts noticeably with their competitors who face regulatory requirements that limit the freedom of the companies'investment policies. Free regulation should be held responsible for the relatively low level of British premiums. And low premiums have a direct impact on market share.

The regulatory provisions relating to technical reserves are also relatively loose in the UK. While the other countries require their companies to hold adequate equalisation reserves so that they would be in a position to absorb losses which can be anticipated to arise in the long term; such reserves are not considered necessary in the UK. This difference in the regulatory regimes implies a relatively low cost on the operation of British companies.

It is therefore fairly evident that the British industry's indisputable ability to compete internationally is a clear consequence of the UK authorities' gentlemanly approach to control of the insurance sector. Operating under a favourable regulatory regime, UK insurers face the attractive prospects of a market of 320 million people.

Many people believe that UK insurers will be among the major beneficiaries if plans go ahead to integrate the European Insurance Markets. British insurers have had for over 100 years a significant involvement in most national and international direct insurance markets. They have the tradition of a supervisory atmosphere which encourages innovation and responsiveness to customers' needs and promises significantly increased earnings. This is a tradition not enjoyed by the majority of European insurers. Response to the proposal for a future integrated market in the UK has been favourable. The Association of British Insurers and Lloyds saw it as a major boost. Lloyds currently derives less than 10% of its business from the EC which it regards as an enormous untapped market. The UK service industry is strong, self-confident and prepared to take advantage of the new opportunities in Europe. With the London market in a leadership role will find new opportunities to insure the activities of people and governments.

The EC is a source of flows of Directives to which the UK insurers turn their attention. The services Directive with respect to large risks will allow the British insurers to take large industrial and commercial risks in other Member States. The adoption of services Directive with respect to mass risks (which is necessary if freedom of services is to be implemented) will remove the economic protection which the national supervisory systems provide and create further opportunities for British insurers. At the first sight the direct market prospects seem to be favourable.

On the other hand, however, an integrated financial market does not mean only that companies are able to transact business anywhere in Europe on the terms approved in their home territory and policyholders are able to buy where they wanted, but it also involves a certain degree of harmonization of national supervisory standards. The principle of "home country control" (upon which the EC strategy is based) means that the insurer need concern himself only with the rules of the country where he is established. Where policyholder protection is a particular need there may have to be a significant harmonization of national supervisory systems before "home country control" could be achieved. Since the need for "prudence" is constantly pressed in the case of insurance the principle of mutual recognition of regulatory standards can be accepted by some Member States only through harmonization.

The EC Council has reached agreement on a services Directive with respect to large risks without any prior harmonization of the supervisory standards. However, as it has been pointed out elsewhere the need for "prudence" is rather weak in the case of large risks. Mass risks are at the moment limited by the regulations existing in the continental European countries. This protectionism is said to be necessary to protect policyholders from purchasing policies providing inadequate cover from foreign insurers (84).

One would normally expect industrialised countries to be characterised by "open markets" while protective barriers are a distinctive feature of developing countries. However, protectionist measures adopted in many European countries are not aimed at reducing external competition and increasing profits for the internal market. The objective is rather to protect domestic policyholders from the insolvency of foreign insurance companies or their failure to provide an acceptable standard of service.

A Common Market, where companies would be able to transact business anywhere in Europe on the terms approved by the home supervisory authority may come about only if the supervisory control exercised in the home country is comparable to that in the host country. The comparability of supervisory controls can be achieved only through harmonization. This means that the British would have to bring their supervisory system closer to those of the other European countries. A strengthening of the supervisory control would erode to a significant extent the competitive advantage in the provision of financial services that the UK has been enjoying for so many years with significant implications for the industry and the UK economy as a whole.

The new conditions for operating for British insurance would be an additional burden on the functioning of companies and jeopardise their external development. The additional controls would profoundly affect the efficiency and profitability of the British insurance concerns. British insurance companies would lose the clear cut price advantage (which is now credited to them), since many instances higher prices on the continent are due to factors (ranging from premiums and policy controls to taxation and investment constraints) which would affect British insurers operating within an integrated insurance market. British companies would not be the cheapest. One therefore may not accept that British insurance products will necessarily sweep throughout an integrated insurance market, neither that the UK industry would take significant advantage of the new opportunities in Europe.

At the same time the strictly regulated States would reduce their regulatory constraints because their own domestic operators would be severely handicapped in the face of more flexible competitors. Such a tendency will possibly lead insurance undertakings conscious to new state of affairs to review their structure, increase productivity and creativity and compete effectively with the British rivals.

It is widely believed that the freedom of services will firstly benefit the so-called "liberal" markets which have the least restrictive regulations of which the classic example is the British market. However, freedom of insurance transactions is closely associated with harmonization of insurance regulation. The existing markets differ significantly in the nature and amount of regulation and they also differ in the nature and variety of products that can be offered. A Common Market (which is usually held to mean a Community wide market having the characteristics of a national market) will therefore profoundly change the regulatory framework of insurance undertakings operating in the different markets. The liberal markets will experience a reinforcement of controls while at the same time the more strictly controlled markets will develop in a more liberal way. And after this process the British insurance companies would be able to make only limited gains from the Community's wide market. The EC would not provide British isurers with a unique possibility for expansion.

Furthermore, the UK insurance industry which is the most international in the world, places its main emphasis for external expansion on North America, and the former Dominion status territories. Indeed, Table 16, presenting evidence of the premium income of UK insurers in overseas territories in 1986, reveals that the premium income earned by UK insurers in USA, Canada and Australia is much higher than that earned in the European countries. The fact that earnings from the USA accounts for about two-thirds of the total UK overseas earnings gives a clear indication of the concentration of the UK insurance overseas business.

Obviously this picture will be reversed within an integrated financial market. UK insurers would see their non-EC earnings falling, while their EC earnings will present a small improvement as trade and integration occurs. The UK would become much less dependent on USA earnings and take a little advantage of the European market. The extent of this trend will depend on the philosophy upon which the legislative base of the European market will be constructed, since this philosophy will determine the degree of regulatory process of the UK market. However, it is considered that any strengthening in the controls would significantly damage the UK industry's ability to compete internationally.

One therefore might argue that the British would not be prepared to accept tighter regulation in return for the possibility of readier access to the European Market. For the UK authorities the EC is not the centre of the Universe and the British industry has substantial economic interests in other overseas territories. UK insurers have much to lose if EC tendencies to introduce additional controls on their operations undermine their standing and market share worldwide.

TABLE 16

PREMIUM INCOME OF UK INSURERS IN OVERSEAS TERRITORIES
(1986) (£ million)

	General	Long term
Belgium	164	13
Denmark	77	52
France	144	102
Germany	280	145
Ireland	184	312
Netherlands	400	297
Australia	452	377
Canada	895	576
New Zealand	60	45
South Africa	143	99
USA	3234	442
other	606	161

Source : ABI

Furthermore, the London market will have to remain relatively unregulated in order to retain its privileged position in the international insurance forum.

London's dominance as an insurance/reinsurance centre undoubtedly originates from its 19th Century beginnings when the UK was at the head of a large and growing empire and London had already emerged as an important international financial centre. Despite considerable changes in Britain's role in the world, London retained its pre-eminent position due to relative freedom from legislative restrictions enjoyed by those engaged in business. The legislative freedom of the British insurance market is a major factor underlying the dominance of London as a world centre. Foreign insurers have generally praised the highly unregulated environment which does not restrict their profitability. The question is whether London will retain its pre-eminent position within an integrated financial market.

Priorities necessary to stay at the top take the form of three elements: competitiveness, cost effectiveness and convenience. However, the factors contributing to the attainment of these elements depend very much on the autonomy which underwriters in London enjoy. However, this autonomy could be lost within an integrated financial market, since the UK authorities would have to bring their supervisory system closer to that of their EC partners. And a strengthening of the government regulation represents a potential threat to the London market's prominent position in insurance. London would lose its attractiveness and a significant amount of business would be transferred to other financial centres. Can the UK government ever accept that ?

The role that London as an international insurance market plays to the benefit of the UK economy is well recognised. In view of the growing UK deficit in manufacturing trade and the instability in the exchange parity of the pound, London's insurance-related contribution to the country's bop has grown immensely in its economic significance. The government seems to be committed to London's future as a worldwide insurance centre. London, in its capacity as international insurance centre , may find itself dealing with non-EC policyholders under more liberal conditions than some member countries might at present visualise for EC insurers. Whatever happens in the rest of the EC, the UK would not impose additional controls. London would continue to be a free, open market in which foreign insurers can enjoy a share, even on risks for which their home parent may be prevented from writing. It is considered as a UK asset whose value should not be eroded by common rules. The UK authorities will not possibly accept a strengthening of the prudential controls that would diminish London's status as an international financial centre.

In this section it has been pointed out that there is a close association between the removal of barriers to insurance transactions and the harmonization of the regulatory structures and the UK authorities have substantial interests in rejecting any trend towards harmonization. This provides a first indication that a freedom of services will be very hard to attain in the years to come. This argument is further strengthened in the next sections by demonstrating the conflicts in the supervisory philosophies, interests and practices between the UK and the continental countries.

CONFLICTS IN NATIONAL SUPERVISORY PHILOSOPHIES AND INTERESTS

In most countries insurance companies are subject to more stringent control than is normal with the suppliers of other goods and services. There are two main reasons for this. The first is the obvious importance of the services they provide to their customers. The second is that by their nature insurance services are more difficult than other goods and services to test at the time of sale. Indeed, at the time of sale insurance provides only a promise of future performance, that is, the insurer undertakes, if a claim is made to have sufficient funds to settle it in full. This is most obviously true in the case of life assurance where the intervening period could be more than twenty years. If an insurer for any reason defaults, the financial consequences for the policyholders would be very serious.

The basic object of government supervision of insurance companies is the protection of policyholders from the consequences of insolvencies. In this respect, the government intervention in insurance conditions should focus only on the points where the market place does not find satisfactory solutions. However, the supervisory authorities in different States have different views about the extent to which the market place finds satisfactory solutions. The political and economic philosophy of the party forming the government may significantly affect the extent of intervention applied to the financial services sector.

In the UK the supervisory authorities adopted a flexible form of state intervention in order to protect the public without stifling competition between the financial institutions as to lose their customers the advantages usually associated with it in terms of price innovation and quality and variety of service. Thus, the effort is wholly devoted to overseeing the fitness and properness of controllers, directors and managers and the solvency of insurance companies.

The issue of the fitness and properness of those involved in the management of an insurance concern is a key element of the UK supervisory process. The supervisory authorities' concern has been to keep to a minimum degree of interference as possible with the market forces but to ensure the competence and quality of the management. According to the UK authorities the rules of the game in the financial markets need to be formulated by those who play it and this has traditionally been the way it has been done. Some of these rules, especially those referring to solvency, need enforcement by statute but the rest should be self-imposed. The case against strict regulation is that it may limit competition and discourage the successful operation of the market forces.

Indeed, the UK authorities take the view as a government committed to the market economy that their role is to get the economy operating as efficiently and as fairly as possible. Most of the regulatory side can be done on a self-regulatory basis by the industries themselves. The regulatory role of the government would be very limited. In general great emphasis is placed on competition to promote both allocative and productive efficiency in the market and on self-regulation to protect the consumers against the potential consequences of market failure.

Self-regulation is considered as preferable to government regulation and is accordingly promoted whenever it is regarded as appropriate. Thus, when the UK authorities felt the need to control the amount of the commission to be paid in order to achieve competitive equality the government left to the relevant parties concerned to negotiate the agreement under the supervision of Life Offices' Association (LOA). The policy conditions and the premium rates (ie. the price and quality of financial products) while attract strict control in most countries, in the UK are self-regulated.

Another way of preserving both competition and stability in the financial system could involve reinforcing by other means disciplines inherent in the market process. Ideas along this line run from the fact that more frequent disclosure of information about the condition of insurance institutions reduce their probability of failure.

In fact, a central element of insurance supervision is "freedom with publicity". While there is an absence of regulatory constraints in such areas as policy terms and premium rates and insurance companies are, to a large extent, allowed to conduct their business as they think best, the regulations contain certain requirements concerning detailed disclosure about the financial condition and performance of companies. The Insurance Companies Act gave to the DTI considerable discretionary powers "to produce such books or papers as may be so specified...at any time, if they think there is good reason to do so". This information is designed to ensure that the responsible supervisory authority or indeed anyone interested in doing so, can make a independent assessment of the strength of a company. The concept is that if the public has access to adequate information about the soundness of the institutions it will place its savings only in the sound ones. As a result, the responsible management will be more sensitive to risk, promoting safer and sounder practices. In other words, the availability of adequate information develops a market mechanism in which sound institutions attract business away from weak ones promoting the stability of the whole financial system.

The UK authorities place a great deal of emphasis on market discipline as a complement to official prudential supervision. They believe that the market place by determining the successes and failures of the institutions imposes a great deal of discipline on its members.

However, the impact of market discipline depends, to a large extent, on the perception by the market of the authorities' response to the prospect of failure of an institution. The Insurance Companies Act contains a considerable number of provisions dealing with the sanctions imposed on insurance concerns and grants the responsible supervisory authorities cease and desist powers against concerns engaging in unsound business practices. It also established procedures for dealing with failing companies. The authorities can also intervene in problem cases in order to limit the scope for counterproductive reactions by the market. Indeed, in a crisis situation the DTI uses its powers to persuade strong insurance concerns to take over the companies perceived to be in financial difficulty or provides emergency support facilities in cases where insolvency is threatened. These practices have been extensively used in 1974: a year when several companies suffered severe financial difficulties (85). However, the Act does not include any provision of policies relating to public intervention in crisis situations. And the main reason for the non-existence of policy statements and formal conditions for activating an emergency process is to enforce market discipline standards.

Furthermore, the existence of a Guarantee Scheme operating under the Policyholders Protection Act provides further indications that some companies may be allowed to fail and enforce risk-taking restraints and market discipline standards. The Act provides that policyholders of offices which have gone into liquidation or which are in financial difficulties may be compensated by up to 70% of any liability of the company to the policyholder. The Act does not provide for 100% compensations in order to give an incentive to policyholders to place their savings with sound institutions so as the market mechanism can operate effectively.

However, there are doubts about the extent to which market forces ultimately are capable of imposing an acceptable degree of discipline.

First of all, competition may shift the focus of policies away from concerns with safety and towards greater risk taking in a quest for larger profits. Competition may well turn out to be excessive undermining company solvency and thus the security provided for policyholders. Insurers when fixing premiums may make subjective judgments regarding future conditions and companies wishing to expand or sustain their market share could take an over-optimistic view of trends in claims and investment yields. The activities of fit and proper operators may, therefore, involve a degree of risk and create a probability that insolvency may arise. The competition in the financial services sector should therefore be controlled.

As far as self-regulation is concerned, it is fair to say that self-regulatory bodies are rather impotent with regard to the regulation since they are voluntary associations and do not possess any powers with which to discipline their Members. Indeed, the experiences of self-regulation are not encouraging. The LOA reached an agreement with its members concerning the payment of commission which was designed to prevent its influencing the selling of life products. However, some companies went in for aggressive marketing and did not join the association. Instead, they offered better commission rates, something which led other members of the LOA to resign in order to compete with them on equal terms and as a result the agreement collapsed. From a liberal perspective the concept of government regulation by means of "freedom with publicity" could be considered as effective. Consumers would be able to possess adequate information about the activities of the insurance companies and judge for themselves the soundness of the institutions and as a result, companies would be led to prudent policies.

However, in practice, the principle of "freedom with publicity" is no more than a formal procedure. Experience suggests strongly that consumers find it difficult or impossible in practice to make reliable incremental appraisals of the degree to which institutions are taking excessive risks before the time the consequences of such activities become readily apparent (86). Indeed, inexperienced consumers would understand very little if they look at the balance sheets of the individual companies.

Even more important is the fact that the "freedom with publicity" disappears if there is something adverse (interesting) to be published. Indeed, the evidence suggests that the authorities encourage firms (the Vehicle and General Insurance Company for instance) at a weak financial position not to publish balance sheets or other accounts because they recognise the strong possibility that such publicity would be highly damaging to the firms concerned. Obviously, "freedom with publicity" is an illusory form of regulation which does not work in practice.

Confidence is one of the most important elements in the functioning of the financial markets. The process by which financial institutions become insolvent is usually very inefficient. If there is the least doubt about the solvency of an institution this would go bust due to the reaction of the public. Furthermore, confidence is a public good. A lack of confidence in any institution may spread to the whole financial system since the people do not usually distinguish between different institutions. This would undermine the stability of sound institutions and therefore that of the financial system as a whole. Indeed, this is the main reason that the DTI stated that the principle of "freedom with publicity" should be substituted with the principle of "freedom with responsibility". According to this principle companies would still have freedom to set premiums and set policy conditions and they are also free to make mistakes about trends in claims, administrative expenses and investment yields. But the DTI must look for a high degree of responsibility from insurance companies so that mistakes are kept to a minimum.

The analysis so far leads us to the conclusion that the effectiveness of the market stabilisation effect depends very much on the existence of detailed information regarding companies' situations and prospects which usually is not the case. On the other hand, the market may overreact to the existence of such information while the public confidence in some institutions would be undermined. Furthermore, the market response to signs of strains developing in one institution usually spreads to the whole financial system and this does not correspond with the public policy objective of sustaining the integrity of the financial system. Indeed, free markets are not efficient by definition. They are efficient only under certain conditions which are not fulfilled in the case of financial markets. The market failures that exist in the particular area lead to a strong argument for state intervention.

There are also other reasons for state intervention in insurance. This is related to the term of implicit contracts. One of the main characteristics of the insurance industry is that people sign what are really remarkably vague contracts (87). With profits contracts are very good examples of this case. The state intervention is therefore necessary in order to close the gap between entitlements and expectations. Indeed, the making of regulations to govern insurance contracts especially in the field of private person's insurance is a form of consumer protection commonly adopted in the regulation of insurance. These regulations forbid or prescribe certain contract terms in order to eliminate the possibility that people's expectations turn out to diverge from prospective settlements. The intervention for the definition of the contract is therefore necessary and desirable.

It is generally accepted that insurance cover is a complex "product" to buy. The terms of the policy represent its quality. The fewer conditions, warranties and exclusions in the policy, then naturally the wider the cover and the better the product. There should therefore be some form of statutory control in order to prevent insurers incorporating in their policies as many exclusion clauses, conditions and warranties as they consider necessary and to ensure fair insurance contract terms and better products for the public. Supervision of policy wordings is necessary to protect members of the public from being mislead into buying unsuitable insurance policies from incompetent, or even dishonest, insurers and to tilt the balance of the "deal" more in the policyholders favour. This balance basically benefits the insurers.

The above considerations are also shared by most of the continental European countries which believe that the possibility of a disaster - namely an insurance company becoming insolvent - outweighs any benefit associated with competition in terms of price, innovation, quality and variety of service. Indeed, the UK's philosophy and practice of insurance supervision is very different from those of most of its European partners.

In all countries the underlying principle is that the consumer must be protected and that the policyholder should be safeguarded from the risk of losing his investment, maintaining at the same time confidence in the financial system as a whole. However, the way and (even more important) the extent to which these are done differ from country to country. The UK supervisory system is concerned with fitness and solvency. The main aim is to ensure that those who carry on insurance business appear to be fit and proper persons while the results of the companies are monitored to ensure that they set up adequate reserves against the liabilities they have taken on and that in addition they retain their required margin of solvency.

The returns submitted to the responsible supervisory authority are made public so that the financial operations are open to scrutiny, not just by the supervisory authority, but also by the public. But, the main feature of the UK system is that management of insurance concerns is given almost complete liberty of action. They can frame their own policy conditions and premium rates and the authorities leave the maximum scope for competition. Any tension between these two aims is resolved by having as a back stop the Policyholders Protection Act. The policyholders have usually higher returns on their money and a wide choice of products but the system does not guarantee survival to a company, neither are the policyholders protected completely from loss. The UK authorities take the view that the protection of the company from failure and the policyholder from loss can occur only at a very high price in terms of reducing the scope for competition. The UK system is based on protective regulation.

In other countries consumer protection takes a different form. Germany represents the opposite extreme. Since it is between the UK and Germany that the most obvious potential for trade and integration exists, it is useful to examine briefly its supervisory system. The security of the consumer is maintained by strict supervision. Policy wording and premium rates are closely monitored by the authorities. Solvency rules require insurance companies to hold substantial levels of assets and reserves to ensure that in any case that the firms will be able to pay claims. Insurance regulation requires investments to fulfil the condition of maximum security. Competition is restricted in order to limit risks incurred by the institutions. The system offers a very high degree of security to the company, and a high degree of security for the policyholder but at the cost of an indifferent result on their investment coupled with a restriction on the choice of policy. The German authorities consider that this cost is significantly outweighed by the benefits associated with the high degree of security provided to policyholders.

The UK and Germany represent the extreme positions and the other countries fall in between the two with most of them being closer to the German position. Ireland is very close to the UK position and Holland not far away. The analysis so far leads us to conclude that the UK's supervisory philosophy conflicts with that of the continental countries. Indeed, the major European states seem to believe that the UK market is relatively unregulated and that the UK system is weak.

In France, an authorisation is required for large risks to be taken out abroad. This authorisation may be granted if these risks are insured with continental insurance companies but not with British companies. Even if this restriction will be abolished in 1990 due to the implementation of the non-life services Directive, it is a clear indication that the French authorities believe that the UK market is unregulated. Germany allows insurance taken out abroad but forbids intermediaries to place business across frontiers. This restriction applies particularly in the case of business placed with British insurers where the authorities react immediately to any unlawful actions. However, in the other cases the authorities remain relatively passive.

Even more important is the fact that (according to an EC official)* in the EC Council the British delegation found itself on the defensive during the negotiations for the adoption of the non-life services Directive. The other delegations, particularly the French and the German, argued that the UK has traditionally been devising methods of regulation which operate along less formalised lines with more emphasis placed on self-regulation and therefore the authorities assumed a passive role. However, self-regulation should not be accepted as a means of preventing an undesirable situation developing and that the DTI's gentlemanly approach to control of the insurance system is dangerously inadequate. The authorities should therefore consider it necessary to regulate by legislation and to move to a more active role in seeking to foresee and forestall eventual insolvency.

Indeed, the delegations of the continental countries argued strongly that there is a case for a redistribution of responsibilities between government regulation and self-regulation. The unfortunate events of the early 70s have been mentioned as a proof that the policyholder is inadequately protected. The UK's present effort on regulation is rather weak and only 60 people in the Insurance Division of the DTI are employed on regulation. On the other hand, the scale of the supervisory effort in most Common Market countries is markedly greater. West

*(Interview, Commission EC, June 1988)

Germany employs 350, France 200 and Italy 170.

The British delegation counter-argued that comparisons between countries' supervisory effort can be easily over-simplified.* The UK supervisory effort for example would need to be greater if it were not for the appointed actuary system under the Insurance Companies Act, and the strength of the actuarial profession in the UK. Major reliance is also placed on external auditing. However, even if this is the case it is not enough to cover the difference in the degrees of supervisory efforts.

On the other hand, the British believe that the continental market is over-regulated. A recent unpublished study undertaken by the ABI comparing and analysing the effects of the differences in the regulatory regimes on the cost and price levels and the range of products, points out the continental regulation on insurance companies stiffens market competition causing a serious loss of efficiency without improving the position of insurance consumers. The authorities should learn the lesson of the continental experience accepting tighter regulation. Even if this study does not consider the differences in product quality in terms of insolvencies and consumers complaints over claims handling, it is believed that the study will seriously be taken into account by the UK authorities.

*(Interview EC Officials, Commission, June 1989)

It is perfectly apparent that the differences in the supervisory philosophies are substantial. On the other hand, it has been said that differences in philosophies often reflect divergent interests and this also holds in the case of European insurance. It seems that the UK authorities attach a particular priority to the interests of the insurers rather than those of the policyholder and to the public in general.

The DTI has close and longstanding relations with the insurance associations which represent the various sectors of the industry. The associations appear to play an important role in the supervisory process since the practice of the Insurance Division of the DTI is to consult widely with these bodies over its methods of operation; particularly before submitting any proposal for legislation to the Parliament. The main bodies consulted are: the ABI, the LOA, the Linked Life Assurance Group, the Institute of London Underwriters, the Reinsurance Offices Association and the British Insurance Broker's Association. The discussions between the DTI and the industry associations are of great importance to the latter parties since the legislation becomes more flexible after the negotiations and does not hinder the liberty of action of the management of the insurance concerns.

As a result of this consultative process significant changes have taken place in the proposals originally put forward by the DTI. The adoption of the Insurance Companies Regulations 1981 is a clear manifestation of this. The adoption of the final paper was the result of many years of extensive discussions where the interest of the consumers were not represented. The Insurance Companies Regulations govern how particular types of assets should be valued and impose limitations on the extent to which the value of certain assets may be taken into account when determining the solvency of an insurance company. The original paper attracted considerable criticism from the insurance community as being too tight and therefore posing a potential threat to the companies' freedom of operations. The limitations imposed were considered particularly restrictive. The DTI finally stepped back and changed the conditions in the last version of the paper allowing much more flexibility.

As a matter of usual practice the DTI publishes its ideas and allows plenty of time for the interest groups of the insurance community to respond and comment before finalising its rules so that these do not limit the discretion allowed to insurance companies. The extensive process of consultation between the DTI and the insurance community demonstrates that the insurers' interests are considerably taken into account by the national authorities.

As it has been pointed out elsewhere, insurance cover is a complex product to buy and as a result most of the countries have adopted some form of statutory control over what might be considered unfair insurance contract terms. However, in the UK, insurance contracts were exempted from the provisions of the Unfair Contract Terms Act of 1977 in order not to limit the ability of the insurance companies to produce innovative products. Yet, discussions during 1984 with all interested parties on the Law Commission's Report on Insurance Law, confirmed the wide divergence of opinions between consumers interests who wanted legislative reform (because the existing system allows too much discretion and that consumers must be safeguarded against fraudulent claims) and insurers who considered statutory action as greatly reducing the effectiveness of the industry. The authorities finally turned the balance of the dispute in the insurers' favour and did not adopt any form of statutory control. The political pressure to keep the industry unregulated outweighed the consumer pressure for a measure of statutory protection.

In contrast to the UK, the German authorities attach priority to the interests of the policyholders rather than those of the insurers. The German insurance market disposes an insurance association called the Gesamtverband ber Deutschen Versicherungswirtschaft and a number of committees which deal with various lines of business.

However, these groups are not powerful enough to have significant influence on the legislative process. The geographical spread of insurance centres in Germany with over a thousand kilometers between the north and the south is a disadvantage and very often tends to become a problem for the work of these associations (88).

Furthermore, the insurance buyers also belong to organisations such as the Deutsher Versicherungs-Schutzverband. These are very influential groups; they are in favour of standard policies and of a high degree of market regulation to ensure fairness in the conduct of financial transaction. The Federation of the German Industry is one of these groups and has an important say in every negotiation. In Germany the balance of power appears to be in favour of the consumer.

Even more important is the fact that the German authorities have a strong attitude to the interests of the consumer in order to protect him from potential loss. This type of "consumer protection" attitude was adopted after the Second World War when policyholders lost almost all their insurance savings. The insurers used these savings to finance the War and thus lost a substantial proportion of funds.

It is therefore fairly evident that the authorities of the

Member States attached different priorities to the interests of the different political groups and this constitutes the most serious impediment to the creation of a Common Insurance Market in the years to come. Against this background, the EC Council has reached an agreement on a non-life insurance services Directive which has not imposed any additional controls on the UK industry and has moved the rest of Europe closer to the UK philosophy by allowing companies established in one country to market their products for large risks across international borders.

In the EC it has been the custom hitherto to produce a non-life insurance Directive, and then to produce a life one incorporating the same provisions of the text of the one affecting non-life insurance. Since the non-life services Directive has been adopted one might argue that a life services Directive will be adopted according to the shape of the non-life one. However, the future is not free from areas of potential controversy between the UK and its EC partners. These areas would constitute serious barriers to freedom of insurance services with respect to mass risks. The aim of the next section is to identify and evaluate the barriers to freedom of services which arise from the present situation in order to indicate that complete freedom of services for mass risks will be very hard to attain in the next few years.

IMPEDIMENTS TO THE ADOPTION OF THE HOME COUNTRY CONTROL PRINCIPLE

In the UK the authorities do not impose any direct control on the determination of premium levels. The financial system in the UK is essentially a market system within which insurance companies compete one with another for providing services in terms of prices (the returns they offer and the premiums they charge). The responsible supervisory authority tries to ensure through financial statements that premiums calculation must reflect all costs such that the long term viability of the firms is guaranteed. The DTI has considerable discretionary powers to intervene if it considers that the premium levels are not the appropriate ones. However this was never the case.

Indeed, in the UK, self-regulation is regarded as preferable to government regulation. The LOA sets out acceptable codes of conduct in respect of premium rates. However, since the LAO is a voluntary association, it is unable to force regulatory policies and since membership does not offer any benefits there are no sanctions against those who do not comply with the codes. There are therefore no controls over premium rates in the UK. The authorities believe that controls over premium rates reduce profitability and efficiency without commensurate benefits for the consumer.

In contrast to the UK, in the continental countries the authorities regulate the premium rates in order to prevent excessive competition in the market which would undermine the financial stability of the companies and the interests of the policyholders. Firms must calculate their premiums in accordance with strict regulatory guidelines. Otherwise approval cannot be obtained from the responsible supervisory authorities. The normal method of control adopted is for the supervisory authority to lay down the bases or assumptions to be used in the calculation of the premium including both interest and mortality rates and this forces the companies to have virtually identical premium rates throughout the range.

In Germany there is almost no competition in the pricing of life products. The authorities argue that competition would lead to insolvency so premiums are kept at artificially high levels. The reason given for the high level of premiums is that they must be fixed for the whole duration of the contract. The authorities therefore like a large safety margin. Competition between life products is not related to price but to the amount paid back to the insured in the form of dividends.

In France and Italy life assurance premium rates have to receive prior approval by the responsible supervisory authorities for the same considerations. The authorities also fix the maximum and the minimum levels of the life premium rates.

The controls over premium rates is one of the most important differences between the UK's and continental countries' supervisory systems. In the UK there are no such restrictions and companies can sell policies at whatever rate they like allowing very much more competition in the UK market at a price basis. It is therefore evident that to allow the highest level of freedom and give all companies the right to market their policies in other countries subject to supervisory regulations of the country in which the head office is situated is very difficult. Without some harmonization of the supervisory control of premium rates this could undoubtedly be deemed to constitute unfair competition and some countries could consider that the degree of protection provided to their residents is inadequate and unacceptable.

It is therefore considered that there is very little room for a compromise particularly within the timescale. In the continental countries there is a strong consideration that strict supervision is the only effective method of consumer protection while in the UK there is a considerable opposition to any additional control.

The UK authorities do not control the policy conditions and companies are allowed to issue any policy they like. The general policy conditions are part of the insurance concern's business plan. Before he can obtain an authorisation the insurer must submit to the insurance supervisory authority the policy conditions. The DTI also needs to be notified about any alteration in them. However, these requirements are not significant since the authorities try to be informed about the variety of contracts available in the market. There is no government control over insurance contracts. In the UK self-regulation seems to perform some of the functions of administrative control. The LOA sets out accepted codes of conduct in respect to policy conditions; but it is unable to force regulatory policies.

In most continental countries, on the other hand, the supervisory authorities control the policy conditions and companies are not allowed to issue policies until they have agreed the contracts with the authorities. A comparative analysis of the insurance contract supervision of the Member States is beyond the scope of the study; but it is necessary to give a few examples.

In Germany contract regulation is considered as an instrument of prudential control. Contracts of both life and non-life insurance should be submitted to the responsible supervisory authorities for prior approval. The authorities try to make contract conditions as uniform as possible throughout the industry. This policy is considered necessary for curbing non-price competition and as a means of reducing the complexity of consumers' purchase decisions.

In France, the system of control in insurance contracts is less tight. Policy wordings are submitted to the supervisory authorities for prior approval. The authorities do not try to impose standardised policy conditions, but rather to exclude unfair contract provisions such as hiding certain "surprising" exceptions from liability in the fine print.

Italy also controls policy wordings tightly in order to avoid excessive competition between insurers primarily with the objective of protecting policyholders' interests. Excessive competition may undermine company solvency and thus the security provided for policyholders. The control of insurance contracts are tighter on life products in order to protect individuals from the consequences of bad bargains. Due to these considerations the responsible supervisory authority may refuse approval of the submitted contracts or require drafting amendments on the ground that it considers them in the interests of the policyholders.

In contrast to the UK, in most continental countries the supervisory authorities control the policy conditions. The result of this different regime has been that the range of policies has been much wider in the UK market. Unit linked policies are not allowed in most of the European countries due to prudential considerations (there is no guarantee on the eventual value of the underlying assets). Will British insurance companies (who operate under UK rules) be allowed to offer unit linked policies in the rest of Europe ? We rather doubt it.

Harmonization of the insurance contracts conditions is a necessary prerequisite for the creation of a European Market in insurance. In the absence of harmonization the German authorities, for instance, might argue that there is not in the UK an equivalent of safeguards in respect of the control of policies and the German policyholder would be exposed to significantly greater risks in the absence of supervision by the German supervisory authorities. Without some harmonization of the insurance contracts conditions it is very difficult to allow full freedom of insurance transactions (ie. to give all companies the right to market their policies in other countries subject to the supervisory regulations of the country in which the head office is situated) since most of the continental countries would consider that the degree of protection provided to their residents is inadequate and unacceptable.

Furthermore, the different regimes with respect to controls over insurance contracts has led to a greater variety of contracts available on the UK market. Indeed the range of policies observed is everywhere narrower than in the UK. Harmonization is therefore necessary if the UK is not considered by the continental countries to have an unfair competitive position.

Freedom of insurance transactions demands therefore harmonization over insurance contract conditions. If an insurer is free to cover risks in another Member State without complying with legislation as regards policy conditions, this may result in unfair competition and inadequate protection for policyholders. There must therefore be some harmonization of this aspect. Precisely because freedom of services requires this degree of harmonization it is difficult to achieve. In the UK, on the one hand, there is considerable opposition to any illiberal restrictions. In the continental countries, on the other hand, there would be a great fear of the UK as competitors and a genuine belief that tight supervision is the only effective method of consumer protection. The Member States will find it very difficult to reach a compromise in the near future.

The Council of Ministers has reached agreement on a non-life insurance services Directive which moves most of the continental countries closer to the UK philosophy of supervision, by lifting controls over premium rates and policy conditions for large commercial and industrial risks. Can the same step be taken with respect to "mass risks" ?

The controls over premium rates and policy conditions for large risks are very weak even in the continental countries. The principle object of such controls is consumer protection. The arguments that justify supervision to protect policyholders from "bad buy" would be difficult to apply to justify control of insurance policies and premium rates relating to large commercial and industrial risks. Large buyers of insurance have sufficient bargaining power to negotiate fair conditions and are able to obtain sufficient information about the solvency and reputation of any insurance company whether domestic or foreign. On the other hand, the case of protecting policyholders from the consequences of bad bargains is much more persuasive in relation to individuals and small traders who do not possess the necessary information. Furthermore, the case of protecting policyholders from the consequences of insolvency is more persuasive in relation to life assurance (rather than to non-life insurance) because the settlement of the claim is taking place in the very long run.

The Member States have reached agreement in the Council with respect to large risks. However, for major commercial and industrial risks, the way was open for cross-border insurance of these risks and the respective Directive did little more than confirm an existing position. The Member States would find it very difficult to reach a similar agreement with respect to mass risks due to the substantial implications of such an agreement.

Insurance contracts have to be written in conformity with the legal contracts of the country where they will be enforced. For cross-state business this gives and immediate choice that the policy can either be written in conformity with the position in the company's country or in the policyholder's country. The UK authorities believe that it is the consumer interest which should be paramount whenever a policy is actively marketed and that as a result policies should be allowed to be written in line with the policyholder's law and subject to his courts but that when the policyholder takes the initiative the position is different.

The second non-life coordination Directive provides that with respect to "large risks" the law applicable to the insurance contracts (with a few exceptions) shall be the law of the Member State where the policyholder is situated. The Directive did not bring about a free choice of laws for large risks even if the mutual recognition of supervisory controls is a main principle of the EC strategy designed to integrate the financial market by 1992. The continental Member States prefer to retain a regime which denies freedom of choice for their insureds even if the UK authorities believe that it is the consumer's right to select freely the law of his choice. Given the fact that the harmonisation of legal contracts of the different EC Member States is difficult, the continental Member States will continue to maintain restrictions with respect to the law applicable to the insurance contracts.

Governments, of course, have a responsibility to ensure that individual policyholders are protected against insolvencies especially with regard to long-term (life) insurance. In the continental European countries restrictions on foreign suppliers of insurance are often imposed because the national supervisory authorities cannot easily check their solvency. An agreement at the European level should, therefore, be reached on solvency standards and checks, so that the supervisory authority in the importing country could rely on its counterpart in the exporting country, if this constraint on free trade had to be removed.

The two establishment Directives set general rules with respect to solvency margins. In calculating the available margin of solvency the assets have to be valued in accordance with the rules of the home Member State. Indeed, each Member State has discretion as to the rules on valuation of assets and liabilities for establishments within its jurisdiction. These rules are very weak in all countries with respect to non-life insurance. However prudential considerations are very strong with respect to life assurance. Here again the UK authorities' philosophy and practice are different from those of most of the other European countries.

In the UK the assets have to be valued in accordance with the DTI basis. There are rules on the admissibility of certain types of assets and restrictions on the extent to which individual holdings of assets may be taken into account for solvency margin purposes. The DTI have to be satisfied that a conservative approach is adopted with respect to investment. However, the view is generally held that the above regulations do not affect the investment policy of firms. The specified percentages, to which certain categories of assets may be taken into account in calculating the value of assets of a company, are considered by some experts* as quite big. Companies would follow to a large extent the same investment policy even in the absence of these regulations. This argument is

*(Interviews: Chartered Insurance Institute and ABI, March 1988)

strengthened by the fact that the DTI returns in 1987 of five of the largest companies reveals that the assets which have not been included in the admissable assets due to the admissibility limits represents no more than 0.4% of the gross total of admissible assets. Indeed, the insurance companies in the UK have considerable freedom over their investment policy. There are no direct constraints on investment policy and investment decisions are basically influenced by profitability expectations.

In contrast to the UK, in most other countries the rules on the valuation of assets significantly limit the freedom of the companies investment policy. These rules are designed to prevent them from undertaking risk taking activities and to protect domestic policyholders from the insolvency of insurance companies.

In Germany the valuation rules guide insurance companies to invest in government bonds and other titles issued by the State since these investments are considered as fulfilling the condition of maximum security. Obviously, these regulations affect to a considerable extent the investment returns. In France there are also strict rules prescribing the proportion of assets which have to be invested in certain securities and property. The rules on the prohibition or concentrating investment in one debtor are particularly restrictive.

The rules relating to the valuation of assets could possibly be another issue which the UK authorities will find themselves debating with their Community partners in the context of a life freedom of services Directive. It is normal in the UK for the supervisory authorities to give companies virtual freedom to invest the money in the form which is most advantageous to the insurers so as to give them high investment returns. On the other hand, in the continental countries there is a genuine belief that the restrictive element in supervision with respect to investment is essential to protect policyholders from the insolvency of insurance companies. Without some harmonisation of the rules on the valuation of assets, the granting to all companies the right to market their policies in other countries subject to the supervisory regulations of the country in which the head office is situated would undoubtedly be deemed to constitute unfair competition against the companies of the continental countries. Furthermore, these countries would consider that the degree of protection provided to their residents is inadequate and unacceptable.

Another area of potential controversy would possibly relate to equalisation reserves. Almost all the continental countries believe that equalisation reserves (which accumulates from the excess of premiums over claims and expenses in years when the loss ratio is better than average) should be compulsory in life assurance; so that the companies should be in a position to absorb losses which can be anticipated to arise over the long run. The equalisation reserves is another instrument of control to prevent solvency in the continental European countries.

On the other hand, the UK authorities argue that an equalisation reserve is not necessary because a prudent management should, through reinsurance, always be in a position to absorb worse than average loss experience. They also believe that it is wrong in principle to require a company to set up reserves in respect of potential losses on business which has not been written. Furthermore, if the loss occurs in the first year of a company being authorised to write a particular line of business there will be no equalisation reserve available to meet losses in excess of the average.

The present position is that each Member State has discretion as to whether equalisation reserves should be compulsory or not. However, the question over equalisation reserves will arise in the context of freedom of services for life assurance. In the absence of Community harmonisation over equalisation reserves, the French authorities, for instance, may argue that there are not in the UK equivalent safeguards in respect of the equalisation of reserves. On the other hand, in the UK, there is considerable opposition to the imposition of any additional control. Here again it is difficult to see where there is room for compromise.

The issue of fiscal harmonisation is also important. Freedom of insurance transactions and lack of harmonisation with respect to taxation would create a degree of distortion of competition and lead to a de-nationalisation of insurance and savings. Of course national authorities would not remain indifferent to this. There are three levels of taxation that should be considered. Taxation on premiums, taxation on benefits and taxation on the insurance companies.

Tax harmonisation is rather difficult since there are considerable divergences among the Member States. In the UK the authorities believe that there should be a low burden of taxation on business in order to encourage competitiveness and expansion of business. Relatively high levels of taxation constitute a fiscal distortion and are an anomaly which discriminates against life assurance as opposed to the other forms of savings. Indeed, the insurance business in the UK is subject to one of the most favourable tax regimes in Europe. (89). Taxation on premiums and on insurance companies are relatively low while receipts for payments of benefits in may cases is tax free.

On the other extreme is France whose authorities see the insurance industry as a major provider of tax revenue and the tax rates are the highest in Europe. The UK and France represent the extreme positions and the other countries fall in between the two with Germany being closer to the UK position and Italy closer to the French one. Unequal tax regimes can give rise to a high degree of unequal competition and therefore harmonisation of tax regulations is a necessary prerequisite to freedom of services in life insurance. However, an acceptable degree of tax harmonisation is rather difficult to achieve due to large differences in the interests of the Member States. The tax authorities view the problem as one element in their total taxation policy and changes are unlikely to be made.

A services Directive has been adopted with respect to large risks without the necessary harmonisation of taxation. Cannot that happen with respect to mass risks as well ? Large risk insurance competes only with captives or self-insurance. It is therefore possible (leaving on the one side the tax considerations which may point towards imposing high taxes on captives rather than on the traditional insurance market) to liberalise large risk insurance in isolation. It is also possible to liberalise large risk insurance without considering too much free capital movements across Member States and the harmonisation of taxes. But in the case of life insurance the opposite is the case. Life insurance (with its important savings element) is in direct competition with the other forms of investment and savings. The effects of the distortion of competition are much more important in life assurance. And the authorities of the Member States of high tax regimes would be reluctant to liberalise trade in life assurance. Unequal tax regimes would constitute a serious obstacle to trade in life assurance services in the years to come.

Lastly will be the dispute over composites. This dispute was behind the fact that six years elapsed between the adoption of the non-life establishment Directive and that of the life establishment Directive. As it has been pointed out elsewhere most of the Member States have adopted the so called "principle of specialisation" by setting rules which provide that the same undertaking could not carry on both types of insurance because of prudential considerations. Life insurance funds might be used to support the risk of insurance operations other than life assurance. On the other hand, in the UK, insurance companies could carry both types of business. Most of the Member States were not only unwilling to allow British composites to become established for both classes in other countries but considered it undesirable that composite should continue to exist at all.

The eventual compromise was that pre-existing companies which transact both life and non-life business continue to do so, provided that they observe strict rules on separate management and financial obligations. On the other hand, newly formed companies should no longer be authorised to carry on these two activities simultaneously and should be specialised in one type of business or the other. This solution was not costly for the British insurance companies since it did not affect the scope of their business.

Indeed, the British Insurance Law does not contain any restriction in relation to the services provided by insurance concerns affiliates. Insurance companies are relatively free to acquire participations in other companies and financial institutions. There are no limits to the acquisition of participations; only the DTI needs to be notified in advance and satisfied that an authorised insurance company has adequate capital and managerial resources to support any acquisition. As a result, non-life insurance companies can enter the field of life business through acquisitions.

The question over composites will possibly be reviewed (according to an official of the EC Commission*) in 1990, so that it will inevitably arise again in the context of

*(Interview : EC Commission, June 1989)

freedom of services for life assurance. Most of the continental countries (in particular France and Germany) will be unwilling to allow British composites to offer services in both classes in their countries while their indigenous companies could not. On the other hand, in the UK many of the leading companies are composites engaged in both classes of business. And the UK authorities will be reluctant to restrict the scope of business of the leading insurance companies. If six years elapsed between the two establishment Directives to reach a compromise which was not costly for the British companies; how many years would be necessary to solve once and for all the dispute over composites ?

The number of the identified barriers to freedom of insurance services which arise from the present position is really great. Evaluating these barriers is a subjective, difficult and complex undertaking due in part to the fact that the subjects analysed differ widely. Nevertheless, it is believed that the issues of premium rates, policy wordings and the valuation of assets are of foremost importance since controls over these matters are considered by the continental countries as important instruments of solvency regulation. On the other hand, however, an excessive regard for solvency and consumer protection should not be allowed to override the issue of fiscal harmonisation.

The above analysis leads us to conclude that a complete and total freedom of insurance transactions will be very hard to attain in the next few years. It is perfectly apparent that within the timescale the EC Commission will find it impossible to produce a measure which would bring about home-country control at a stroke. It would also be difficult to reach a level of freedom similar to that of large risks.

For mass risks there would seem to be another level at which a solution could be found. The question of liberalisation of life insurance services could be linked with freedom of capital movements. If an investor can open up a bank account in any Member State and invest in any form of security, why should he not equally be free to address himself - at his own risk - to an insurance company in any other Member State to buy life insurance, which after all is merely often another form of investment. Insurance companies, however, would still be prevented from actively seeking such business and advertising their products to the potential purchasers. At this level a future Directive for mass risks would do little more than confirm and recognise an existing situation. A small amount of business is already written in this way and with the freedom of capital movements (built in the Capital Movements Directive) a future Directive for mass risks may have some impact.

On the other hand, however, some Member States may resist even that level of freedom since personal policyholders may face currency risks in cross border placing of insurance. Indeed, currency risks would constitute another barrier to freedom of insurance risks transactions with respect to mass risk. And this barrier could be eliminated only through Monetary Union. Indeed, Monetary Union is required if personal policyholders are not to face currency risks in cross border placing of insurance. However, it is considered that the excessive regard for "prudence" would override this major consideration.

The principle of home country control, which is obviously the preferable solution for an insurer who wants to do international business, clashes with the wish of governments to ensure that they are in a position to protect their consumers. The rival principle of host country control would, therefore, have a strong following. In other words, any early expansion of international trade in insurance services for mass risks would take place through the Establishment Directives mechanisms. But this means that different products at different prices would be marketed within national borders; a situation which clearly conflicts with the principles of a Common Market.

Some UK insurers* believe that even if the extent of the progress appear to be rather limited, this is not the end of the matter. They recognise the fact that the harmonisation of the technical rules necessary for solvency and consumer protection, are a necessary prerequisite to freedom of services for life insurance, and that an acceptable degree of harmonisation is not achievable within a few years. But they also believe that other forces are at work and continental insurers are already very aware of the danger of losing business to other competing industries such as banks. The Second Banking Directive opens up the possibility of the provision of competing financial services on an international basis which will make it difficult for life companies to maintain their position at an international level if they continue to be restricted in their home markets. This will obviously bring pressure on the continental countries for greater liberalisation by the supervisory authorities to prevent severe reduction of the life industry as substitute savings services take over. However, it is believed that such hopes or expectations seem to be totally out of proportion with reality. The fragmentation of the markets for all the savings services would be significant.

Up to now we have analysed some future areas of potential controversy between the UK and its partners over the freedom of life insurance services. But it is also

*(Interviews : Eagle Star , Commercial Union Assurance March 1988)

important to discuss, within the general Community framework, the extent to which the community markets would open to full competition without prior harmonisation. Indeed, this is the case that the UK authorities try to promote. The experience suggests that progress in the Common Market is a question of bargaining. But the UK authorities have nothing to bargain with since they already operate an open market. The only things they have are the EC Treaty and the Commission's White Paper of January 1985.

The Treaty lays down a right to freedom of trade in services. Indeed, freedom to provide services is one of the most important objectives of the EC Treaty. The right to provide services ranks equal with the free movement of persons and capital and only to the free movement of goods is a greater priority attached. However, this right is not unqualified. Specific requirements imposed on a cross frontier supplier of services compatible with the Treaty where they have as their purpose the application of rules regulating certain types of activity provided that certain conditions are fulfilled (90). In the case of insurance have been justified (by the judgments of the relevant courts) to place restrictions on freedom of trade in insurance. Obviously, the UK authorities cannot put the less liberal states on the defensive.

The Commission's White Paper of January 1985 on the completion of the internal market and the Committment of all Member States to the achievement of this objective by the end of 1992 built up momentum to abolish internal barriers. The Member States recognised that completion of the internal market in the long run will be to the benefit of all and not least in strengthening the Community's industries ability to compete with those from third countries. The parallel with the elimination of tariff barriers in the early days of the Community is exact. There is also a recognition that there must be a readiness to compromise. However, the need for "prudence" constantly pressed in the case of financial services would undermine the principle of mutual recognition of regulatory standards upon which the success of '92 heavily depends.

The implementation of the Single European Act changed the basic rules. The Act designed to speed up adoption of Directives through qualified majority voting (and avoid time delays associated with unanimity). However, given the nature of the supervisory regimes in Europe it is considered that the British would find themselves in the minority. Our analysis leads us to the conclusion that a single market for insurance in its most liberal sense is unlikely to come about.

BARRIERS TO THE PROCESS OF LIBERALIZING INSURANCE SERVICES IN THE DEVELOPING EC COUNTRIES: THE CASE OF GREECE

ESTABLISHMENT OPERATION AND MARKET ACCESS OF
INSURANCE COMPANIES IN GREECE:
CONDITIONS AND CONTROLS IN 1989

1. Regulatory provisions and administrative practices governing the entry and establishment of indigenous insurance companies

The Greek Insurance Law provides that insurance concerns are firms that carry on insurance business. Insurance concerns should be constituted in the form of limited companies and should concentrate only in the conduct of insurance business.

In Greece, insurance concerns may simultaneously carry on life assurance and general business with no restriction on the number of classes except that requirements as to share capital and guarantees must be calculated accordingly. In Greece there is an exception to the "principle of specialization". The EC Commission has recently advised the Ministry of Trade to adopt the provisions of the EC Directive requiring the adoption of the "principle of specialization" requiring separation of funds and management of the composite companies. The justification for such separation is that it prevents cross-subsidisation. However, given the fact that in Greece some lines in general business have produced substantial losses, due to result of premium rate control, cross-subsidisation is considered necessary. As a result, the EC Commission advises have been ignored by the government.

The undertaking of insurance business requires authorization. The authorization is granted by the Ministry of Trade according to the provisions of the Law Decree 400/1970. The authorization may be granted for all classes or for certain specified classes. The insurance concerns can only undertake the classes for which the authorization is granted. If the concern wishes to carry on business in other classes another authorization is necessary.

In order to obtain an authorization, insurance concerns should have a share capital equal to the aggregate of the respective amounts prescribed for the individual classes to be undertaken. The amount of share capital required is greater than that prescribed by the general law for commercial and other undertakings of identical legal form. The authorities recognize the specific nature of insurance and the detrimental effects that an insolvency may have on the policyholders.

The minimum share capital must be fully paid up and, at present, its amounts are as follow: a) for life assurance

Dr 150m, b) for credit insurance Dr 135 m, c) for insurance in respect of aircraft and ships Dr 140m, d) for any other class Dr 120m. The amount of the share capital varies according to the class of insurance undertaken, the highest amounts being required in life assurance. One forth of the share capital should be applied to a security reserve whose withdrawal could only take place after the authorization of the Ministry of National Economy. In contrast to an ordinary company, the share capital of the insurance company does not serve solely to provide the means required for the operation of the entity. It mainly serves as a guarantee for the insured. However, this control conflicts with Article 5 of Directive 73/239/EC which prohibits the blocking in any way of the fixed or movable assets of the insurance companies.

The provisions of the Law Decree 400/1970 which is the main Insurance Law in Greece does not contain any specific provision in respect to the professional qualifications and trustworthiness of the management of an insurance concern. However, the Ministry of Trade usually examines the reputation of the respective management and its professional qualifications. An authorization may be refused on the grounds of lack of reputable or qualified management. However, this has never happened.

The Ministry of Trade needs to be satisfied about the reinsurance arrangements of the insurance concerns. Insurers operating within the country are required to make adequate reinsurance arrangements. Part of this requirement is that a share of reinsurance business should be placed with the state-owned insurance corporations. There is no such provision within the Greek Insurance Law; but, as a normal practice the Ministry of Trade requires insurance companies, to place part of their reinsurances with the big state-owned insurance concerns. This requirement limits considerably the freedom of the insurance companies to formulate their own reinsurance policies and to place their reinsurances with those institutions that the insurers find the most economical and efficient.

An insurance concern seeking a licence authorization should produce a business plan. This plan must specify the object and organization of the concern, the articles of association, the documents on which contracts are to be based, the premium rates, the technical bases and the reinsurance arrangements. In particular the business plan must demonstrate that the respective concern will always be able to fulfil its commitments.

The approval of insurance products are of a great importance in granting an authorization. The documents on which contracts are to be based, the premium rates and the technical bases have to be submitted to the supervisory authorities for explicit approval. These have to comply with particular requirements set by the authorities. Controls over insurance contracts and premium rates are, in principle, imposed by prudential considerations but, in practice, (as it is pointed out elsewhere) they are used as a means of defending fairly effectively the large market share of the state owned insurance corporations.

The national supervisory authorities enjoy significant discretionary powers. They do not only interpret and apply the provisions of the Law Decree but they are also set additional requirements whose fulfilment is a key of obtaining an authorization. The reinsurance arrangements are the most serious obstacles to entry and establishment of indigenous concerns. Since they are motivated by economic considerations (and not by prudential ones) they may discourage or even prohibit entry into the market of some concerns which would succeed. The second most important obstacle concerns the tight controls over premium rates and policy wording since they are imposed by economic considerations.

The analysis of the authorization requirements with respect to entry of indigenous concerns indicates that the authorities limit entry and reduce the number of firms in the market in order to defend effectively the market share of the big state-owned insurance corporations. Furthermore, the authorities seem to ignore the provisions of the EC Directives and the Commission calls to implement them if national economic interests are involved.

2. Regulatory provisions and administrative practices governing the entry and establishment of branches by foreign insurance organisations

The entry and establishment of foreign insurance concerns in Greece is, in principle, subject to the same regulatory provisions applied to domestic insurance companies. The entry and establishment requires an authorization which is granted by order of the responsible authority. The authorization is not general but it always given in respect of specified classes. Foreign concerns are required to be constituted in the legal form identical with that approved for domestic concerns and not in a form recognised in the country in which the head offices of the respective concerns are situated. They are also subject to the same solvency and management requirements as indigenous concerns. The Greek Insurance Law makes no stipulation about the nationality of those responsible for the management of a foreign concern. However the Ministry would like to see some Greeks getting actively involved in the management since they may have adequate knowledge of domestic laws, regulations and market practices.

Any foreign insurance concern seeking to carry on insurance business in Greece should produce proof that it is authorized to undertake in its country of origin insurance business of the classes which it proposes to undertake in Greece. This proof usually takes the form of an authorized declaration of the concern. The Ministry of Trade reserves the right to make the granting of an authorization conditional upon reciprocal treatment in the foreign concern's own country. However this cannot be considered as an obstacle to the entry of an EC insurance company. The entry and establishment of foreign insurance concerns is subject in principle to national treatment. However, this treatment is discriminatory against foreign concerns.

Insurance concerns have to split up into virtually separate units in order to operate in different countries since they must comply with the different regulations in force in these countries. The national authorities consider the branches of foreign concerns as new entities rather than as a consequence of the operation of these concerns worldwide; and this constitutes an important obstacle to the entry of foreign concerns into the Greek market. The initial share capital required, for instance, is considered by some foreign insurers as exceptionally large relative to the amount of business which foreign concerns undertake in Greece.

Even more important is the fact that in practice the national authorities use their discretionary powers to impose more stringent controls on the entry of foreign concerns. All the insurance companies seeking an authorization must submit to the supervisory authorities all the proposed reinsurance arrangements including the maximum figure which they propose to bear without reinsurance. However, the requirements concerning the reinsurance arrangements are more stringent in the case of foreign insurance concerns.

Foreign and indigenous insurance concerns are required to place part of their reinsurance business with the state-owned insurance corporations. Furthermore, the Greek authorities believe that the branches or agencies of foreign concerns try to establish close links with their head offices. These links can be used by the foreign concerns established within the country as a means of a) transferring, through reinsurance, business outside the country, b) participating in speculative activities against the drachma and c) investing abroad the savings accumulated in the form of insurance funds and denying the domestic capital market of funds making more difficult the industry to raise adequate funds for investment.

As a consequence the Ministry of Trade does not normally allow more than 10% of the insurance companies' liabilities to be reinsured with their parent companies abroad. The Greek authorities also try to persuade the foreign concerns to direct reinsurance business to the domestic market by increasing the proportion of business they carry on without reinsurance and by placing a large proportion of reinsurance to the state-controlled insurance concerns. If they do not do so the national authorities may require modifications on the business plan (especially the provisions referring to the classes of business the respective concerns propose to undertake), delay the granting of the authorizations and restrict the number of branches the respective concerns are allowed to operate within the country.

The above requirements are not included in the Greek Insurance Law, but they are imposed by the Greek authorities in order to protect the development of the domestic insurance industry, to avoid unnecessary loss of foreign exchange and to ensure that funds accumulated by insurance operations are channelled into the local capital market. Through these requirements the authorities believe that they cut the links between the foreign insurance concerns established within the country and foreign based insurance companies. Even if foreign concerns circumvent part of these controls by placing part of their reinsurance business with their subsidiaries (which use different names) abroad, the net effect might be an extra financing cost imposed on foreign concerns and/or further restrictions on the size of their business.*

The analysis of the controls on entry and establishment of foreign concerns indicates that the national authorities enjoy considerable discretionary powers to restrict foreign concerns through more stringent enforcement of apparently nondiscriminatory regulations. Indeed, the principle of host country control could be discriminatory against foreign institutions. Despite the intention of the already existing Directives there are a plethora of other ways in which authorities action can inhibit entry. Eagle Star did not find it easy to break into the Greek market: although the National Insurance Law incorporates a rather weak requirement (which does not conflict with the provision of the EC Directives) that a Greek actuary should sign the application, it was a requirement that emerged strongly on the realization that there were only ten registered actuaries in the country; they viewed the signing of these

*(Interviews, Alico and Cigna, July 1988)

application as a significant source of income and they closely cooperated with the Ministry of Trade. These considerations were behind the Commissions decision to promote integration in the financial markets through the principle of home country control.

3. <u>Regulatory provisions and administrative practices governing the entry and establishment of minority and majority owned subsidiaries by foreign insurance organisations</u>

Foreign access to the domestic market through equity participation in indigenous insurance concerns is subject to certain restrictions imposed by the national authorities. Foreign and national equity participation in indigenous institutions are subject to authorizations by the Ministry of Trade. Thus, both participations are, in principle, subject to equal treatment. However, the national authorities do not treat foreign acquisitions in the same manner as domestic acquisitions.

The Ministry of Trade does not authorize the acquisition by foreign insurance organization of majority interest in indigenous insurance concerns. The Greek Insurance Law does not include any provision as to the maximum degree of non-resident participation in the capital stock of a Greek insurance concern allowed. However, the Ministry of Trade, as a common practice, does not issue authorizations for the acquisition of majority interests by foreign insurance organisations in indigenous concerns. Furthermore, as in the case of establishment of foreign branches and agencies, reciprocity provisions apply against foreign states.

With respect to the requirements concerning the management qualifications insurance companies with foreign interests are treated in the same manner as domestic concerns. The national authorities need to be satisfied about the reputation and the professional qualifications of the management. Moreover, the majority of the board of Directors should be Greek nationals residing permanently in Greece. This constitutes an important practical obstacle against the establishment of foreign subsidiaries. Usually the authorities require the voting powers of the Greek directors to be higher than the Greek participation in the capital stock of foreign subsidiaries.

The Greek authorities usually encourages foreign insurance companies to acquire minority participation in indigenous institutions. Foreign Minority participation in indigenous institutions is seen as a means of acquiring the sophisticated managerial capacity, expertise and technology which major multinational groups possess. The acquisition of these elements may foster the efficiency of the domestic concerns and enable them to produce new services and increase their capacity to handle larger risks and provide better reinsurance cover. Some degree of foreign ownership is seen as a means of introducing innovations in the structure of the domestic industry and enabling it to face successfully the attractive prospects of the common market of the 1992.

On the other hand, the establishment of majority owned subsidiaries by foreign insurance organizations is not permitted. The reasons for forbidding non-resident acquisitions of majority holdings in indigenous insurance concerns are broadly the same as limiting foreign entry through branches. The authorities intention is to protect the domestic insurance sector from foreign competition and to avoid foreign control over an industry whose importance to the whole economy is vital. Broadly speaking, restrictions on the entry and establishment of foreign subsidiaries are substantial. Foreign insurers are faced with the position of having to supply capital, sophisticated managerial capacity, expertise and technology with little control and with most of the profits going to local interests.

It is rather surprising that while the Commission made significant attempts to eliminate obstacles to establishment of foreign branches, it did not do so for foreign subsidiaries. Indeed, some insurance companies (especially the German ones) are specialized in the entry into foreign markets through subsidiaries so that they obtain a given portfolio and then they try to expand it. The adoption of Directives designed to abolish restrictions on the entry and establishment of foreign subsidiaries is essential for the creation of a common financial market.

4. Regulatory provisions and administrative practices limiting the market access by foreign based insurance organisations

The Greek authorities forbid any insurance (with a few exceptions) to be taken out abroad by, or, in behalf of any person domiciled in Greece with any concern neither established not authorized to undertake insurance in Greece. Insurance may only be taken out with a Greek concern or with a foreign concern specially authorized to write in Greece the classes of insurance specified in its authorization. Insuring abroad is generally forbidden except in those cases when the risk insured is situated out of the country (i.e. international transport, aviation and marine hull).

It is not possible for a Greek policyholder to insure with a foreign based insurance company even when the Greek authorities are convinced that there is no sufficient capacity within the domestic insurance market to provide the cover required. Furthermore, Greece imposes strict foreign exchange controls regulating the outflow of capital which would restrict the payments of premiums abroad.

Reinsurance transactions between insurance companies represent a major source of insurance trade. Insurance concerns established in Greece are generally allowed more freedom to place reinsurance business abroad, but even in this case severe restrictions apply. Insurers operating within the country are usually required to reinsure part of their portfolio with the state-owned insurance corporations. There are therefore considerable limits on the insurance companies to formulate their own reinsurance policies. The share of the reinsurance business which is required to be placed with the state-owned insurance corporations varies according to the size and type of reinsurance business.

The foreign reinsurance operations are further restricted by other administrative practices. Foreign based reinsurers are required to open "non residents" accounts (with the Greek authorized banks) which are subject to special rules. The convertibility and the disposition of these funds are severely restricted. Funds deposited in the "non-residents" accounts are considered blocked and can only be used after specific permission of the Bank of Greece. The above requirements restricts severely the freedom of international reinsurance transactions which is the most international of all insurance activities. This provides a clear indication that the entry and access by foreign insurance companies into the domestic market is considerably limited. Moreover, it is obvious that Greek authorities have not yet adopted the provisions of the EC Reinsurance Directive.

The requirements that a portion of risks should be reinsured with state-owned insurance corporations interferes with the free placement of reinsurance with those institutions that the insurers find the most economical and efficient. The requirements concerning the opening of "non-residents" accounts and the placing of deposits with the direct insurers act as an impediment to supply of reinsurance into the domestic market. These requirements impose additional capital costs and currency risks to foreign based reinsurers and are harmful to insurers as well. The expenses incurred by these requirements have to be financed by higher reinsurance premiums. The authorities do not only directly prohibit, to some extent, free international reinsurance transactions but also set requirements which have the same effects of an outright restriction. These controls contradict with the provisions of the EC reinsurance Directive which requires free international reinsurance transactions.

As far as co-insurance is concerned although it is a common practice on a national level is not permitted on an international basis. Foreign insurance concerns cannot participate in co-insurance arrangements unless they are established and authorized in Greece. No risk expected to occur in Greece can insured by foreign based insurance organizations. This situation contradicts with the provisions of the EC Co-insurance Directive.

Prohibitions and restrictions on transactions arising from the provisions of insurance services on a trade basis are imposed (according to an analyst of the Ministry of Trade) in order to protect domestic policyholders from the insolvency of insurance companies. It is generally believed that insurance organizations wishing to provide insurance services in the domestic market should establish themselves in Greece, obtain an authorization and comply with prudent supervisory standards. However, it seems that prudential considerations cannot justify alone the prohibition of international insurance transactions. The main objective is rather to avoid the loss of foreign exchange which would occur through the purchase of insurance and reinsurance from abroad. The importation of insurance from abroad would lead to a long term outflow of premium payments only partly offset by the benefit received having adverse development on the bop, a constraint to the country's economic development.

Since insurance is a financial service the placing of insurance abroad is like any other portfolio investment. In a weak currency country the freedom of international insurance transactions would significantly deteriorate the capital account of the bop and might exert further downward pressures on the exchange rate of a weak currency. Domestic savings, through remittances of premiums abroad, would be used in speculative activities against the drachma. Thus, prohibitions and restrictions on freedom of insurance transactions take the form of foreign exchange controls.

The imports of insurance services through underwriting the insurance of risks (that are expected to be incurred in Greece) abroad may have adverse developments on the operation of indigenous insurance concerns. The kind of product the foreign based insurance companies offer does provide greater potential consumer satisfaction than most that are available nationally. This is because that the indigenous institutions are still uncompetitive and less developed in relation to giant insurers enjoying benefits of scale from their extensive operation. The need of protection of the former against the latter is based on the "infant industry" argument.

Outflow of funds for insurance and reinsurance has been clearly identified as an area where apparent savings can be made by imposing restrictions on placing of insurance abroad. The nature of insurance (and especially that of life assurance) means that a substantial amount of funds is accumulated within the insurance companies. Substantial delays occur between the payments of premiums and the settlement of claims. If insurances are placed with foreign based insurers the accumulating funds are lost to the domestic capital market. However, these funds are considered of a great importance to the country's economic development.

The Greek authorities believe that the scarcity of funds hinders the economic development. The prohibitions of the imports of foreign insurance services is seen as a mean of ensuring that funds generated by insurance operations are channelled into the domestic capital market. These funds can be invested in government securities or be used to finance industrial projects essential to the country's economic development.

Furthermore, the Greek authorities significantly restrict the entry of foreign intermediaries to the market. Foreign intermediaries wishing to carry on business in Greece should obtain an authorization from the Ministry of Trade. However, the educational and professional qualifications acquired outside Greece should firstly be recognized in the country. Furthermore, intermediaries from other countries may exercise the profession in Greece but they should only be persons of Greek birth from those other countries. This is a clear discrimination on the grounds of nationality and thus a breach of the Article 7 of the Treaty of Rome. These restrictions further isolate the domestic market from imports of insurance services from abroad.

5. Regulatory provisions and administrative practices restricting the domestic operations of established foreign-owned insurance organisations

The extent to which foreign insurance organizations authorized to operate in the national market can compete on an equal footing with domestic insurance concerns is an indispensable part of the study. And the Greek authorities significantly influence the terms under which foreign concerns operate; some of the conditions imposed directly affect their ability to compete on equal terms with indigenous institutions and in particular with the big state-owned insurance corporations. The most important of them concern the scope of insurance business; i.e. restrictions on the type of services that can be offered and on the range of activities in which foreign concerns can engage.

The Law Decree 1256/1982 requires the state owned banks to recommend in writing to their clients that they place their insurance with the insurance concerns controlled by the State. Upon conclusion of the insurance contract through the agency of state-owned bank, the public sector insurance company is required to deposit the commission for the service rendered in a special account opened by the bank for the benefit of its employees' insurance fund. This constitutes a further incentive to the staff of banks to ensure that the obligation to recommend a public sector insurance company is fulfilled. This regulation contradicts fair trade practices and restricts competition in the market. The state owned banks acquire a dominant position not only in the financial sector but also in the whole economy. They have a great number of customers while many private companies depend on their patronage. Consequently, through this provision the authorities channel a large proportion of business to the state controlled concerns while private concerns (domestic and foreign) lose this amount of business.

Another provision of the Law Decree 1256/1982 requiring all public property, including the assets of Greek public undertakings, to be insured exclusively with public sector insurance companies. Indeed in Greece the State is its own insurer, while private insurance concerns are prevented from writing insurance business of public institutions. This regulatory provision discriminates severely against the private non-life insurance concerns since the Greek public property insurance markets accounts for approximately 25% of annual premium income in Greece.

Generally speaking the regulatory provisions of the Law Decree 1256/1982 by prohibiting placement of insurance contracts of the public property with private insurance concerns and by providing that the state owned banks should encourage their customers to place their insurance business with the bank-controlled insurance concerns restricts the freedom of insurance transactions within the domestic market. This freedom is the main element of the functioning of a competitive insurance market.

Some foreign insurance concerns established in Greece drew attention to the distortions of competition resulting from the adoption of the Law Decree 1256/82 and expressed their views to the EC Commission. The Commission asked the Greek Government in 1982 to bring the offending situation to an end. However, the actions taken by the Greek authorities introduced only minor modifications to the respective Law Decree. As a result in 1985 the Commission has adopted a decision (91) stating that the Law Decree is incompatible with Article 90 (1) of the EC Treaty requiring the Member States neither to enact nor to maintain in force any measure contrary to the rules contained in the Treaty, in particular those rules providing for in Article 7 and Article 85 to 94. However, the respective Law Decree is still in force. One therefore might argue that if the Commission's regulations conflict with national interests, they might be ignored in subsequent behaviour by member governments.

The existence of bank controlled insurance companies has been a source of complaint by private insurers* who felt that the bank controlled companies deprived them of many sources of income and their operation to a large extent

* (Interviews: Nationale Netherlande, Deutch Victoria July 1988)

have detrimental effects on the principles of competition. The authorities do not only use the provisions of Law Decree 1256/82 to move business away from private insurance concerns (domestic and foreign) and in favour of state-owned insurance companies, but also bring pressures on private enterprises which depend on government patronage to deal with the state-owned insurance companies.* Indeed, the private enterprises which enjoy any of a wide variety of concessions (such as tax incentives) are strongly advised to insure their interests with state owned insurance concerns. The insurance arrangements of these enterprises are often important elements in the negotiations with the Greek authorities. These practices interfere with the free placement of insurance with those institutions which the insured find the most economical and efficient. Another issue of great importance is the administrative determination of premium rates and, therefore, the non-existence of competition in the pricing of insurance products. The administrative price structures are mainly based on the average production costs of the state-owned insurance companies and the ability of foreign insurers to offer lower prices is significantly diminished.

Competition between insurers could be related to the amount paid back to the insured, if policies were offered on a "with-profits" basis. However, this is not usually the case

* (Interviews; Ioniki, Etniki, Nationale Netherlande July 1988)

in Greece since policy wording is closely monitored by the authorities. Insurance contracts need to be authorized by the Ministry of Trade. And, even if this requirement applies in principle, equally to both indigenous and foreign insurance concerns, it falls with particular severity on the latter. Indeed, the Ministry of Trade has close and longstanding relations with the state-owned insurance concerns; and the Ministry authorizes new insurance contracts only if these contracts can be issued by the state-owned insurance concerns. In 1987 Nationale Netherlande was refused authorization of an innovative product on the grounds that this produce might undermine the company solvency.* However, this product is offered since 1983 by the company and its subsidiaries in other European countries, even if some of these countries supervise insurance contracts tightly. In Greece, the controls over premium rates and insurance contracts are motivated, in principle, by prudential considerations, but in practice, restrict significantly the ability of foreign concerns to compete effectively with the big state-owned insurance companies.

Solvency requirements place also foreign concerns at a competitive disadvantage compared with the indigenous companies. In principle, the rules concerning solvency supervision are identical for domestic and foreign

*(Interview : Ministry of Trade, Nationale Netherlande July 1988)

concerns. Foreign insurance concerns should adapt themselves to the rules applying to indigenous insurance concerns.* This is contrary to the spirit of the provisions to the EC Directives which consider foreign companies coming from other EC countries as consequences of the worldwide operation of these companies and not as new entities. The national authorities seem to ignore the strong financial ties that foreign establishments have with their parent organizations abroad and the strong capital base of these organizations as potential cover for Greek policyholders when assessing foreign companies' solvency status. Obviously, in this case the granting of national treatment is discriminatory against foreign companies.

Even more important is the fact that the lack of transparency with respect to solvency supervision gives rise to sources of discriminatory treatment against the operation of foreign insurance concerns. In Greece solvency supervision is exercised on a non-statutory basis and the insurance supervisory authority has considerable discretionary powers to impose certain requirements with respect to the adjustment of share capital. These requirements apply in a discriminatory way against foreign insurance concerns since they are subject to more stringent solvency criteria in relation to indigenous companies.** In the case of foreign concerns a growing volume of business

* (Interviews: Alico, Sigma, March 1988)

** (Interviews : Nationale Netherlande, Deutche Victoria March 1988) needs a higher capital cost.

The system of exchange control regulations is also discriminatory against foreign insurance companies. The exchange control regulations apply to profit remittances. The repatriation of profits requires authorization by the Bank of Greece. The authorization is generally granted for the repatriation of after-tax profits up to the amount of foreign exchange imported from their offshore operations. The foreign companies may be granted permission to repatriate larger amounts if they produce evidence that their operations benefit the domestic economy. Significant in this context are also the bureaucratic procedures which lead to lengthy and irregular delays in obtaining permission from the national authorities for profit remittances. The net effect of such restrictions is a considerable extra financing cost imposed on the foreign companies.

The above analysis lead to the conclusion that the national authorities severely restricts the operation of foreign concerns. In reviewing the range of restrictions described, the most serious impediments, in terms of degree of severity are those applied on the range of activities in which foreign concerns can engage. In particular, the Law Decree 1256/1982 which involve a preference that insurance contracts be placed with state-owned insurance concerns is considered to be of foremost importance. The amount of business that foreign (and private insurers) lose as a result of this regulation is enormous. The second most serious category of obstacles concerns restrictions on the type of services that can be offered by foreign concerns. The tight controls on rates and policy wordings are considered as important restrictions on the expansion of foreign insurance business. Discriminatory solvency requirements also can have a significant impact on a foreign insurer's ability to compete. The exchange control regulations on profit remittances are not considered to be of great importance since they do not affect directly foreign concerns' ability to compete.

Impediments on the operations of foreign concerns are even more serious than those on their entry, in terms of both numbers of restrictions and degree of severity. Almost half of the insurance companies in Greece are foreign, but their market share is very limited (only 18%), even if they possess sophisticated managerial capacity, expertise and technology and are able to develop more efficient production and marketing systems in relation to indigenous concerns.

The analysis so far leads to the conclusion that the Greek insurance market is almost isolated from abroad since freedom of insurance transactions is prohibited. Within this isolated market the authorities limit entry and reduce the number of firms (especially of the foreign ones) in order to defend effectively the market share of the big state owned insurance corporations. Even more serious are the obstacles on the operation of the already established firms which are imposed for the same purpose. The authorities seem to ignore the provisions of the existing EC Directives and the Commission calls to implement them since national economic interests are involved. Furthermore, they enjoy considerable discretionary powers and exploit the lack of transparency with respect to prudential supervision in order to restrict foreign concerns through more stringent or more restrictive enforcement of apparently nondiscriminatory regulations.

The question is whether this picture will be reversed in the years to come. Will Greece implement the provisions of the existing EC Directives? And even more important, will it operate in an integrated financial market based on the principle of the home country control, which means that almost all the controls (except those associated with the establishment of foreign majority owned subsidiaries) would be eliminated? These questions are answered in the next two sections.

AN INTEGRATED INSURANCE MARKET: PROBLEMS FOR THE GREEK ECONOMY

The key feature of the Greek insurance industry is the domination of the state controlled companies that in 1986 held almost half of the total (life and non-life) business. In the Greek insurance sector there is a distinction between insurance companies in which the share capital is controlled by at least one state-owned commercial bank and other companies the share capital of which is controlled by persons or companies other than banks.

Indeed, the large commercial banks have a share in the equity of insurance companies with prominent position in the domestic insurance market. The National Bank of Greece controls seven insurance companies amongst whose are Ethniki and Astir; the Commercial Bank of Greece controls two insurance companies the Ionian and Phoenix; and the Agricultural Bank of Greece controls the Agrotiki Insurance (92). The Links between the insurance companies and the banks are not merely in the form of equity control, but also in the form of financial and commercial transactions of every day nature.

In order to understand these links it is essential to refer to the provisions of the Law Decree 1256/1982 which requires the state owned banks to recommend in written to their clients that they place their insurance business with the insurance concerns controlled by the State; and that all public property, including the assets of Greek public undertakings, to be insured exclusively with public sector insurance companies. The authorities also use administrative practices (which have already been discussed) to channel business to big state owned insurance corporations.

Another feature of the Greek insurance industry is its highly oligopolistic structure. Table 17 shows the largest ten insurance companies in terms of their premium income, in 1986, in the life and non-life market. The top ten companies in the life accounted for 94% of the whole premium income. In the non-life market the top ten companies accounted for 77.3% of the whole premium income. These figures reveal an extremely high degree of market concentration. The marked concentration in the Greek market is described as a high degree of oligopoly at the producers level.

The bank controlled insurance companies hold a substantial market share. On aggregate they accounted for more than 40% of the whole premium income in the life market; while in the non-life market the respective figure is 50%. However, the view is generally held that they are not as efficient as they should be in order to justify their dominant position in the market. Instead, they use regulatory provisions and administrative practices to attract business away from private insurance concerns and to attain (or sustain) a large market share. A clear case of inefficient oligopoly is present.

TABLE 17

TOP TEN INSURANCE COMPANIES IN 1986

Life

Rank	Company	Premium (Drs)	Market Share %
1	Interamerican	4,796	41.4
2	Ethiki*	2,613	22.5
3	Agrotiki*	1,019	8.8
4	Astit*	660	5.7
5	Aspis-Pronoia	564	4.9
6	Phoenix*	500	4.3
7	Ellinobretaniki	326	2.8
8	Europaiki Pistis	187	1.6
9	Laiki	140	1.2
10	Ionian*	97	0.8
Top ten Total		10,902	94.0
Industry Total		11,596	100

Non-life

Rank	Company	Premium (Drs)	Market Share %
1	Ethniki*	8,143	27.7
2	Agrotiki*	3,619	12.3
3	Astir*	3,336	11.4
4	Phoenix*	3,068	10.5
5	Pomellinios	982	3.4
6	Intertrust	863	2.9
7	Magdeburger	749	2.5
8	Ionian*	728	2.5
9	Kosmos	704	2.4
10	Emporiki	501	1.7
Top ten Total		22,693	77.3
Industry Total		29,261	100

* Bank controlled insurance companies

Source: L'Argus 1987

TABLE 18

INSURANCE MARKET IN 1986

Type of Companies	Number	Market Share
Domestic	71	82%
Foreign	72	18%
Total	143	100%

Source: Greek Institute of Insurance Studies (EIAS)

The Greek insurance sector is a highly oligopolistic one with a small number of state controlled insurance companies dominating the market. The degree of competition is therefore very limited. Competition is more apparent between the oligopolists rather than between the oligopolist group and the rest of the market. The Law Decree 1256/1982 and some administrative practices makes the state owned insurance companies to compete each other in attracting insurance business from the banks clients and from the State.

The state owned insurance companies with a large, for Greek standards, size control to a large extent the market conditions under which the private insurance companies operate. These conditions (such as prices and contracts) are directly controlled by the Ministry of Trade, but the administrative price structures and the type of products are mainly based on average production costs of the state-owned insurance companies and the type of contracts they usually offer respectively.

As far as the private sector is concerned, there are at present about 140 private individual companies authorized to write insurance business in Greece. But, the entry into the market is restricted. Half of the companies are foreign (see Table 18). However, their market share is very limited (only 18%). Some of them definitely exhibit high performance, but even so, they cannot challenge the big state owned insurance corporations because of the restrictions on their operations.

The Greek authorities are advocates of strong public ownership in the financial sector. Strong public sector is essential to ensure that the necessary volume of external finance is available to finance a sustained increase in certain type of industrial investment and to arrange the allocation of funds according to the social priorities rather than criteria of short-term private profits. Private institutions operating commercially in considering their investment policies look only at the returns to themselves. However, the loans bring also benefits to the borrowers. The allocation of funds according to the government priorities (i.e. to finance the huge budget deficit and some industrial investment with cheap funds), rather than according to benefits of the lenders establish an important economic case for strong public ownership in the financial sector.

Indeed, as it is pointed out elsewhere the authorities impose special requirements on the state-owned insurance concerns with regard to their investments. These special requirements have significant repercussions on their profitability and severely affect their ability to compete on an equal footing with private insurance institutions. As a result the national authorities have adopted regulatory provisions and administrative practices (which are presented in the various parts of the study) designed to influence the competitive balance as between state-owned and private insurance concerns in favour of the former. Furthermore, these regulatory provisions and administrative practices are also applied in order to strengthen the financial position of the state-owned insurance concerns so that they would be able to support the government policy. It seems, therefore, that the Greek government considers it necessary to have a specific policy with regard to the structure of the domestic financial sector.

However, these considerations are incompatible with the principle of an integrated financial market. In an integrated financial market interest rate parity is emerged and borrowers in high rate markets turn to savers in low rate markets to reduce their cost of capital. As a result capital is flown to areas where the returns are the highest. Furthermore, if an integrated market in financial services is to work, it will do so through an impetus of competition in the most regulated and oligopolistic dominated sectors, and through the provisions of services by the best operators in markets that are currently protected. The Greek government (with the other Member States governments) was assigned the task of creating a Common Market in financial services by 1992 but it seems that it does not realize the implications of an integrated market in financial services.

The various peculiarities of the operation of the Greek financial system are mainly due to country's economic problems. These are a huge government budget deficit and a bop deficit. The two attendant problems are, therefore, the financing of government expenditure and the financing of imports. The efficient utilization of scarce resources within the economy is the major reason behind the controls imposed on financial institutions. However, these controls are against the principles of integration which should lead to the promotion of greater competition through the liberalization of ossified national regulatory structures. The liberalization of the Greek financial sector is considered as not feasible in the not too distant future. Any move towards effective liberalisation of the financial system to permit greater competition and remove the constraints on the institutions would have to be done in fairly gentle stages, to give time for the institutions to prepare for a new environment.

Furthermore, the liberalization of state controls would lead to an increase in the cost of money and to the lack of adequate capital which would be used to finance the public sector deficit requirements and certain sectors of economic activity. On the other hand, any attempt to reduce budget and bop deficits through public sector austerity takes time and (even more important) faces considerable political costs. In addition, the government will face increasingly the need for an allocational credit policy in view of the completion of the EC internal market for industrial goods since some sectors will face still competition from abroad.

Indeed, the integration of financial markets involves a loss of independence in two basic areas; a loss which some of the EC Member States will be reluctant to sustain. Firstly, the degree to which a Member State may influence its own monetary aggregates even under a flexible exchange rate is greatly reduced. Secondly, the ability to guide a flow of savings into preferred channels of investment is also significantly reduced. However, some Member States- especially the ones which are at the lowest level of development- rely heavily on the control of the allocation of credit to influence the structure of investment spending. This conflict between financial integration and independence in controlling the allocation of credit is magnified because the structural goals that are the object of allocational credit policy differ from country to country. In short, a high degree of financial market integration inevitably reduces the efficacy of a credit policy designed to produce a desired allocation of real resources; this is something that some Member States will not be able to accept.

The analysis of the structure of the Greek insurance industry leads us to some conclusions about the possible implication of the EC Directives and the consequent opening up of Europe's financial service markets. The traditional structure of the large state-owned companies which have never faced effective competition even in the domestic market and with an extensive home base and a small number of establishments abroad would undergo drastic changes. These companies would lose a substantial amount of business due to implementation of the EC Directives with respect to coinsurance and reinsurance. They would also face stiff competition from foreign and domestic insurance concerns operating domestically.

The Greek authorities could always invent ways of restricting the entry and operation of foreign concerns, but the implementation of the EC Directives will provide a more favourable environment for the operation of foreign concerns. Foreign concerns are relatively quick in exploiting opportunities, can develop more efficient marketing and production systems and are able to perform better that their slower-moving big state-owned insurance corporations. The amount of business that the state-owned insurance companies would lose from the abolition of Law Decree 1256/1982 would be substantial. The private concerns (domestic and foreign) operating nationally would significantly undermine the state owned insurance concerns' oligopoly position.

Next to this internal problem there would also be an external one: the opening up of Europe's financial services market to ensure that the best available operators within the Community is providing given services at any location. The state-owned insurance concerns would face competition in the domestic market from giant multinational insurers enjoying benefits of scale from their extensive global operations, possess larger capital, write a geographically widespread business, have easy access to international reinsurance and capital markets (and therefore are able to acquire factor inputs, such as risks capital and reinsurance, at a lower cost than the state-owned companies) and operate (as it is pointed out elsewhere) under a favourable supervisory system. Given these advantages the foreign based institutions would be able to provide better services and at lower prices than their rivals among the state owned insurance concerns. As a result, the state owned insurance industry would be squeezed by freedom of competition. The question is whether the national authorities will remain indifferent to these developments.

One might argue that all these are the implications of the creation of a real Common Market. The economic rational for liberalization derives from the theory of the comparative advantage. This theory predicts significant efficiency gains flowing to the world economy and to each country from a more efficient use of resources. The removal of barriers would give rise to a reallocation of resources. Resources would be transferred from activities in which the country does not possess a comparative advantage (such as insurance services) towards those activities in which its comparative advantage enables it to be internationally competitive (such as light industrial goods). As a result domestically owned resources, freed by the existence of a foreign supply of insurance, may result in a greater value of output elsewhere in the economy.

The comparative advantage concept predicts that the whole trading community benefits from free trade and every country is at least as well off with trade as with no trade. However, this concept does not mean that losses can be avoided from resulting structural changes. The extent of these losses depends very much on where the freed domestic resources would most likely to be deployed, and how quickly they could be so deployed. Furthermore, the applicability of the comparative advantage concept to insurance is still unresolved. There is nothing to guarantee that capital and labour released by the existence of a foreign supply of insurance will be used in the production of goods in which the country may have a greater comparative advantage.

Even more important is the fact that the national authorities seem to have a specific policy with respect to the structure of the domestic insurance sector. State-owned insurance concerns should acquire a dominant position within the national insurance sector in order to be able to support the state policy. The authorities have adopted regulatory provisions and administrative practices designed to influence the competitive balance as between state-owned and private insurance concerns in order to enable the former to attain (or sustain) a larger market share without being as efficient as they should be in order to justify their dominant size. The state-owned insurance concerns are very important in achieving some of the government's policy goals. The financial services sector is very important for the development of other sectors of the economy. This is the main reason behind the fact that freedom of trade in services lags so far behind freedom of trade in goods. And it will possibly continue to lag behind in the future.

On the other hand, progress in the EC is to a large extent a question of bargaining. However, the EC Commission has virtually nothing to bargain with, and persuade the Greek government to remove the economic protection which the national supervisory system provides. The policy for the completion of the internal market is not accompanied by a substantial increase in compensatory payments and sources of financing which would become available to some countries (especially those which are at the process of development) to alleviate the new process of integration.

Of course, the Member States have recently decided to increase the EC resources for redistributive purposes. However, it is considered that the doubling of these resources over the course of four years are not adequate to enable the less advanced economies to meet the consequences of the completion of the internal market. The size of the resources available for redistributive purposes might be an important determinant of the level of integration than can be achieved. And it seems that the Community is not prepared to move beyond negative integration which may be necessary for the completion of the internal market.

The EC Commission believes that the multilateral removal of barriers within the EC would bring about a more intensive flow of reciprocal trade in insurance services. However, the present study indicates that such an action would likely bring rather dubious results. Greece (and other countries which are still in the process of development) is traditionally importer of insurance services and therefore is expected to expand these imports to a substantial extent after the dismantelling of the protective barriers to trade in international insurance services. On the other hand, a multilateral elimination of the protectionist measures against the provision of international insurance services would not bring about an expansion of Greek export activities since the Greek services production is not yet in a position to export and any external restriction or barrier have almost nothing to stop. Free trade seems to be only admissible in relations between countries that are structurally similar and not between developed and developing countries. For Greece, (and other developing countries) integration may only mean a uni-directional flow in services with no compensation.

In any discussion concerning the possible implications of the implementations of the EC Directives a great deal of emphasis should be placed on bop considerations since countries formulate their general commercial policies according to their international competitiveness.

The Greek insurance industry is rather uncompetitive. The bop is accounted with a deficit of the insurance sector as we can see from Table 19 which represents the importance of the insurance sector to the invisible balance and its payments and receipts. The insurance invisible payments represent 0.0078% of the total invisible payments, while the insurance invisible receipts represent only 0.0016% of the total invisible receipts. As a result, the insurance balance is in deficit of 9,317 million dollars while total balance of invisible experiences a substantial surplus. The deficit in the insurance accounts has been paid considerable attention by the national authorities (93) and this deficit is generated by reinsurance business. The development of the Greek reinsurance market lacks behind from the development of the insurance market. Unlike other countries there are no specialized reinsurance companies in Greece.

The one and only specialized reinsurance company is the Hellenic Reinsurance Corporation which has been jointly established by the National Bank of Greece and the Commercial Bank of Greece; and its size relatively to the rest of the industry is limited. The large bank controlled insurance concerns play an important role in providing reinsurance coverage with the encouragement of the authorities, but they are relatively uncompetitive. The private sector insurance companies are not in a position to offer adequate reinsurance coverage to other Greek companies mainly due to their size and the amount of their share capital. Thus, the prospects of creating a competitive reinsurance market are rather limited; and as a consequence the Greek authorities will possibly continue to apply restrictions on reinsurance which is the most international of all insurance activities. In other words, the adoption of the EC reinsurance Directive would significantly deteriorate the insurance balance; something which the authorities could not accept.

TABLE 19

INVISIBLE RECEIPTS AND PAYMENTS AND INSURANCE

RECEIPTS AND PAYMENTS IN 1986

	Thousand $
Total invisible receipts	6,511,660
Insurance invisible receipts	10,999
%	0.0016
Total invisible payments	2,597,980
Insurance invisible payments	20,316
%	0.0078
Total balance of invisibles	3,913,680
Insurance balance	- 9,317

Source: Bank of Greece, Monthly Statistical Bulletin, November 1987, and calculations by the author

Indeed, effects on bop position is a main motive that has a major influence in determining whether a country is prepared to operate an open market in insurance services. Greece (and some other Member States which are at a relatively low level of development) imposes severe restrictions on the international insurance transactions for bop considerations. The Greek bop suffers from deficits and the country was given a long traditional periods to adopt the Freedom of services Directive with respect to large commercial risks. Recently the Commission has considered proposals for Freedom of Services Directive for mass risks (a term to cover small commercial risks personal insurance and life assurance). The question is whether freedom of services with respect to mass risks will be able to be implemented. This question is answered by assessing the possible adverse effects of such a move on the bop in quantitative terms.

Insurance imports in the beginning result in an outflow of premium followed in time lag by a countervailing inflow of claims payments. The effects on the bop depends on the time lag. The longer the time lag the longer will be the effects on the bop since the smaller will be the reduction in the bop costs provided by the inflow of claims payments. Given the fact that life insurance has longer lag than non-life insurance the Member States which face bop problems will possibly find it very difficult to cope with a Freedom of Services Directive with respect to mass risks. Insurance transactions in mass risks would be limited by the regulations existing in countries facing bop problems.

The implementation of the EC Directives with respect to entry and operation of foreign insurance concerns may result in a lower direct bop cost than the supply of insurance on a services basis. One might argue, that as far as foreign concern established domestically are well managed develop efficient production and marketing systems and have easy access to international reinsurance and capital markets may be able to compete effectively with foreign based insurance concerns and reduce the bop costs accruing from the supply of insurance on a services basis. In this respect, the so-called "cumul" rule (which provides that the undertaking which have a branch or agency in the country of the risk cannot insure the risk though services) adopted by the Freedom of Services Directive could have important positive effects on the bop. It is, however, because foreign concerns would rely on international reinsurance and capital markets that the bop effects would be negative. Furthermore, the remittances to the parent organizations would increase substantially due to elimination of foreign exchange controls. To the extent that indigenous insurance concerns lose market share, this will tend to increase bop costs.

Generally speaking, bop considerations have always been a major factor leading to the erections of barriers to entry and establishment of foreign concerns and especially to international insurance transactions. Since Greece is not generally expected to put its bop in a sound footing these considerations would continue to exist even after 1992.

The degree of competitiveness of an industry depends very much on its stage of development.

The Greek insurance industry is relatively underdeveloped.

It operates in a very small domestic market which in terms of premium income is the eleventh in the EC (see Table 20), however, the level of insurance per capita is a more proper indicator of a market's development since it takes into account population differences. Table 21 presenting details of per capita expenditure in each EC country reveals that the level of insurance per capita in Greece is the lowest in the EC.

The low level of insurance per capita can be explained by various factors. Insurance operation provides that the insurer undertakes to settle a claim if and when a claim is made. In the case of life assurance that promise may not need to be fulfilled for twenty or more years ahead. In a highly inflationary country the financial consequences may be serious for the policyholders, especially if the contracts are offered on a non-profit basis. Only 10% of the population is covered by life assurance, which is encouraged by only a small tax relief. Persons resident in Greece do not enter into long term contracts to acquire additional capital on retirements. In most of the European countries more than half of the assurance companies' activities concern pension insurance while in Greece this type of insurance is undertaken of only to a limited extent (94).

TABLE 20

PREMIUM INCOME IN EACH EEC MEMBER STATE
($ MILLIONS)

Country	Total Premium	% EEC	Life Premium	% EEC	Non Life Premium	% EEC
WG	59,685	32.15	25,304	31.56	34,381	32.59
U.K.	45,804	24.67	27,201	33.93	18,603	17.64
F	36,440	19.63	14,108	17.69	22,260	21.20
I	14,452	7.78	2,641	3.29	11,811	11.20
NL	11,474	6.18	5,234	6.53	6,240	5.92
ES	5,319	2.87	1,088	1.36	4,231	4.01
B	5,057	2.72	1,400	1.75	3,657	3.47
D	3,806	2.05	1,579	1.97	2,227	2.11
Ir	2,180	1.17	1,283	1.60	897	0.85
P	783	0.42	76	0.09	707	0.67
G	461	0.25	14	0.18	320	0.30
L	192	0.10	46	0.06	146	0.14
Total EEC	185,653	100%	80,173	100.00	105,480	100.00

Source: Sigma

TABLE 21

PER CAPITA EXPENDITURE ON INSURANCE ($) EEC RANKING

Country	Total	Life	Non-life	Total	Life	Non-life
WG	978	415	563	1	2	1
U.K.	807	479	328	2	1	7
NL	788	359	429	3	4	3
D	743	308	435	4	5	2
F	658	256	402	5	6	5
Ir	616	362	253	6	3	8
L	533	128	406	7	8	4
B	510	141	369	8	7	6
I	253	46	205	9	9	9
ES	183	28	109	10	10	10
P	76	7	69	11	12	11
G	46	14	32	12	11	12
EEC Average	576	248	327			
US Average	1,536	621	915			

Source: Sigma

Furthermore, one might argue that insurance as a tertiary industry, it needs to be based on highly advanced economies and, on such, might not be deemed an appropriate activity for developing economies where a wide range of secondary industry has not yet been established. The current highly regulated environment is also another factor which lead to a low per capita demand for insurance in Greece. Policy wording and rates are closely monitored by the authorities and as a result over the last few years there has been very little product innovation.

The high level of inflation, the relatively low level of development of the secondary industry and the state policy lead to a low per capita demand for insurance in Greece. This low demand inhibits the development of the Greek insurance industry and this industry does not seem to be prepared to operate in an open market. On the other hand, however, the low level of insurance per capita makes the prospects encouraging. The expansion of demand for insurance may be sufficient in the future to lift the Greek insurance industry from its underdevelopment status.

However this can occur only in the very long run and until then the authorities will have considerable interests in delaying the implementation of the EC Directives and restricting the openness of the Greek market to foreign competition.

Recently the Greek insurance companies started carrying on a significant modernization effort. They are in the process of introducing new operating methods, expanding their communication systems and undertaking personnel training programmes. These initiatives form part of a policy designed to cope with the competitive environment that is emerging with the gradual unification of the European insurance market. However, the production of insurance is a labour-intensive activity, requiring a well-educated labour force, including a wide range of professional expertise in financial and other technical subjects. This kind of labour force seems to be lacking in Greece and this situation can not be changed in the next few years. There will be, therefore, good reasons for providing some kind of protection to the domestic financial system.

Furthermore, it is considered that the modernization effort cannot be successful if it is not accompanied by a gradual change of the current highly regulated environment to allow the Greek insurance industry to be more innovative and creative. However, the controls over policy wording and premium rates are seen by the national authorities as powerful protectionistic instruments capable of defending effectively the state-owned insurance concerns against competition within the isolated Greek insurance market and, therefore, are very difficult to be loosen.

IMPEDIMENTS TO THE ADOPTION OF THE HOME COUNTRY CONTROL PRINCIPLE

In this section the study presents other motives that have a major influence in determining whether Greece is prepared to operate in an open market in the not too distant future. These motives are related to regulatory provisions and administrative practices that are imposed on insurance firms (domestic and foreign) established in Greece for economic or prudential considerations or both. If these regulatory provisions and administrative practices are applied for economic considerations they will impose a heavy burden on the functioning of insurance concerns and restrict their ability to compete internationally. If they are applied for prudential considerations they are not only significantly affect the ability of established insurance concerns to compete on an equal footing with foreign based insurance companies; but they also give some indications of the authorities reluctance to permit imports of insurance services from foreign insurers that do not comply with these regulations with a view to protect policyholders from incompetent and unscrupulous foreign insurers.

The study also provides some indications about the extent to which these regulatory provisions and administrative practices can be harmonized with those in the other Member States. The analysis leads to the conclusion that the national authorities would be reluctant to remove the economic protection and allow foreign based insurance concerns to supply services to the Greek market.

As a common practice the Greek authorities tightly control premium levels and insurance contracts. In the case of life assurance the premium levels should be approved by the Ministry of Trade before the respective companies obtain authorizations. Any change in the premium levels requires also the approval of the respective authority. The Ministry sets the bases and the assumptions which are used in the calculation of premiums. It also sets indicative rates which are almost compulsory since they should be taken considerably into account by the respective companies if they wish to obtain approval. As a result, the life assurance companies have almost equal premium levels.

In the case of general insurance the premiums are determined by the national authorities. The premium rates in the fire, motor and almost all the lines of accident insurance are fixed by the Ministry and are not allowed to fluctuate. Only in the cases of large fire risks, some lines of accident and theft insurance the companies can negotiate the rates with the interested parties but under the rule that the Ministry will be informed about the rates charged and intervene in the cases when the level of rates is not the appropriate one.

The administrative determination of premium levels prohibits price competition within the Greek insurance system. In fact, this is the intention of the national authorities. Intensive competition on the price level may undermine company solvency and thus the security provided for policyholders. If the insurance companies can set premiums freely and are eager to expand their market share they may take an over-optimistic view about future conditions and set the premiums too low with serious financial consequences for the companies themselves and their policyholders. The Greek authorities control closely the premium rates in order to avoid destructive competition between insurers with the objective of protecting policyholders' interest.

The national authorities also impose tight controls on insurance contracts. Contracts of insurance are governed not only by the rules of the general law of contract, but also by special provisions which are imperative in character in the sense that they admit of no exception or variation, not even by agreement between the parties to the contract.

The general policy conditions are part of the insurance concerns' business plan and should be submitted to the Ministry before the respective companies obtain authorizations. The companies should also submit to the Ministry any alternation in them for explicit approval. The function of the supervisory authority is to ascertain that the contract conditions contain nothing contrary to the laws about contracts or the proper insurance practice.

Furthermore, the Ministry may require modifications on the contract conditions on the grounds that they are necessary to protect policyholders interests. The Ministry attempts to make contracts conditions as uniform as possible throughout the market in order to eliminate intensive competition between insurers since this competition undermines company solvency and the security provided for policyholders. The insurance supervisory authority considers that standardised policy conditions are necessary to avoid destructive competition between insurers with the objective of protecting policyholders interests.

The tight controls over policy wordings and rates are also used as a means of influencing the competitive balance as between state-owned and private insurance concerns in favour of the former. The administrative price structures are mainly based on average production costs of the state-owned companies. And the authorization for new contracts is granted only if these contracts can be issued by the state-owned companies.

The rigid system of controls on contracts and rates severely restricts the freedom of private insurers to determine the terms and conditions of their policies. It reduces the ability of the industry to adapt to the changing market practices or to consumers demand and to extend the range of products available or to modernize their presentation for the benefit of the consumer.

On the other hand, in other European countries the system of controls are more flexible. Policy conditions are submitted so the supervisory authorities for approval, but the authorities do not attempt to impose standardised policy conditions and the rates suggested by the authorities are merely indicative and not compulsory. The tight controls over policy wordings and rates have direct repercussions on private insurance concerns and affect considerably their ability to compete internationally.

Complete freedom of services means that companies being able to transact business anywhere in Europe in terms approved in their home territory and policyholders being able to buy where they wanted. The above considerations lead us to conclude that total freedom of services will be very hard to attain in the next few years.

As it has been pointed out prohibition and restrictions on insurance transaction are imposed in order to protect domestic policyholders from the insolvency of insurance companies. If an insurer is free to cover risks in another Member State without complying with legislation as regards rates and conditions, this may result in unfair competition and inadequate protection for policyholders. There should, therefore, be some harmonization of these aspects or an obligation to comply with the legislation of the country where the risk is situated.

Precisely because freedom of services requires this degree of harmonization it is difficult to be achieved. Consensus over large risk has been reached with respect to freedom of insurance transactions and a Directive has been adopted. However, the case for protecting policyholders from the consequences of buying insurance products of dubious quality is more persuasive in relation to individuals and small traders than for large companies since the latter are able to obtain sufficient information about the quality of the products and the solvency and reputation of any insurance company. There are, therefore, significant barriers in the process of adopting a freedom of services Directive with respect to mass risks.

It is considered that the effects of substituting the methods of mutual recognition for that of prior harmonization are rather unclear. This method obviously result to a minimum harmonization and therefore brings into competition not only financial undertakings but also national regulatory regimes. Through this method the Commission believes that Member States with strict regulatory regimes would deregulate their markets in order not to penalize the indigenous undertakings. However, the strictly regulated Member States may well retain their controls (especially if, as in the case of Greece, there are economic interests behind them) and resist competition and freedom of international financial transactions.

The Greek authorities control also the investment activities of insurance concerns. The controls over investments are imposed in principle by prudential considerations, -i.e. to prevent insurance concerns to undertake risky activities and therefore to protect the interests of the policyholders. In practice, however, they are used for economic considerations and basically with a view to finance part of the substantial government demand for capital.

The Law Decree 400/1970 clearly defines the various options and types of investment allowed to the insurance companies. Broadly speaking the insurance companies operating in Greece may invest in deposits in Greek and foreign banks established in Greece, in immovable property and in government bonds. The Law Decree recognizes that the funds invested by the insurance companies are funds belonging to the insured and therefore the investments are required to fulfil the conditions of maximum security. The concern for the pursue of a prudent investment policy and the protection of the policyholders is obvious in the regulatory framework.

In addition to the regulations which clearly defines the various types of investment the Law Decree sets requirements concerning the maximum proportion of funds that should be concentrated in some types of investment. However, this latter requirement is not observed by the companies. The private insurance concerns invest the largest part of their funds to government bonds and other assets issued by the State. The rate of return in this type of investment is directly negotiated by the respective companies and is the highest that can be achieved, especially after the imposition of a tax on immovable property. The private insurance industry is encouraged to invest almost exclusively in government bonds and thus to finance part of the substantial government demand for capital.

Private insurers may also invest a considerable amount of their funds to the domestic capital market. However, Greece does not possess the sophisticated capital market insurance companies require. The domestic market offers very limited opportunities. On the other hand, foreign exchange control regulations prohibits insurance concerns operating in Greece to transfer funds abroad, to invest them in the international financial markets which offer higher expected yields. Obviously, these controls substantially restricts the ability of financial institutions to pursue an independent and profitable investment policy and to compete on an equal footing against foreign based institutions at the international level. Foreign based institutions invest in the international financial markets and achieve higher returns; and this may be reflected in lower premium rates.

As it has been pointed out elsewhere insurance concerns do not merely provide insurance services but they are also involved in the mobilization and allocation of capital funds. This role is very important to the national economic interests. Any action taken by the authorities to protect the economy from an outflow of capital and to channel the capital to certain types of investment is understandable, especially in a developing country suffering by a scarcity of funds. What is not understandable is how this situation will change after 1992.

The state-owned insurance concerns enjoy less freedom as to their choice of investment. The national authorities require them to support certain shares in the stock exchange. More than 30% of their investment consist of share of problem firms and other large overindebted enterprises. The state-owned insurance are required to support the state-owned banks in their efforts to restore the problem firms and other large overindebted enterprises to health.

Obviously the authorities impose special requirements on the state-owned insurance concerns with regard to their investments. These special requirements have significant repercussions on their profitability and severely affect their ability to compete not only internationally, but also with private institutions established domestically. As a result, the national authorities have adopted regulatory provisions and administrative practices (which are presented in the various parts of the study) designed to influence the competitive balance as between state-owned and private insurance concerns in favour of the former.

The insurance companies in Greece enjoy only very limited freedom over their investment policy. Profitable investment operations have proved difficult to achieved because of the constrains imposed by national authorities. The EC Insurance Coordination Directives provide that the Member States may impose their rules with respect to investment. Indeed, it is very difficult to harmonize their investment rules of the Member States due to different economic interests involved.

The EC strategy designed to integrate the financial markets by substituting the principle of mutual recognition for that of prior harmonization tries to force the strictly regulated states to reduce their regulatory constraints on the insurance concerns in order not to jeopardise their external development.

As a result, harmonization of government regulation will take place at a later stage. Obviously, the Commission considers that the government involvement within the financial markets are solely motivated by prudential considerations.

However, motives in control of financial markets arise not only from the need to protect the stability of the financial system, but also from the desire to attain particular macroeconomic and social objectives. This is particularly true in the case of a developing country such as Greece. The financial system is a very important channel for the exercising of government economic policy and thus a great deal of government regulation of insurance is directed towards this aim. This regulation imposes cost on these institutions in terms of profitability and considerably affect their ability to compete at the international level, but it is imposed with much wider goals in mind mainly full employment and long term economic growth. These goals could be achieved through many forms, but in the case of Greece the direct manipulation of the domestic financial market is considered as the most effective and politically acceptable one.

The Greek authorities have assumed a very active role in regulating investment policies and therefore have vital economic interests in resisting competition. The insurance companies are a major pillar for the whole economy providing cheap finance for the budget deficit and for an important part of the Greek industry.

The need for instituting protectionist measures against the unrestricted provision of international insurance services may not only relate to consumer protection or economic considerations. The State in erecting barriers may have other motives in perspective political and financial. Indeed, the taxation system has a major influence in determining whether a country is prepared to break down barriers in international transactions in insurance services and operate in an open market. Although an extensive report of the taxation treatment with respect to insurance is outside the scope of this study it is necessary to give some indications about certain aspects of the taxation treatment in order to present a more comprehensive view of the conditions under which insurance companies operate in Greece.

According to some insurers* the Greek tax insurance rates rank among the highest in Europe. As far as products taxation is concerned, premiums are subject to high rate specific taxes which differ according to the line of business and the nature of insured risks: car 4%, fire 30%, life 9.5%. In Germany the respective figures are 5%, 5%, 0% and in Netherlands 4%, 12%, 0%. Payment of premiums for life insurance give rise to a tax credit for the insured party equal to 15% of the part of the premium, limited to Dr 100,000, while the corresponding figure for Germany is 25%. In Greece the life assurance policies enjoy a relatively (with most of the other European countries) small tax relief while taxes are also imposed on receipts

* (Interviews: Agrotiki, Ioniki, Ethniki, Alico March 1988)

for payments of benefits whose average rate is around 7%. Furthermore, premiums for accident, health and life insurances do not give rise to a tax allowance of the insured person something which is an established practice in most European countries.

As far as insurance companies taxation is concerned, in Greece the companies are taxed at a rate of 58% on retained earnings and 40% on distributed profits. These rates are considered to be among the highest in Europe. Life insurance companies are not subject to any beneficial treatment while in many European countries these companies are allowed to deduct from their taxable income the part of their financial income attributable to policyholders. The taxation regime impacts on the premium rates or bonuses payable on the policies. In Greece taxes are fairly high since the insurance industry is seen as a major provider of tax revenue. The tax treatment imposes a heavy burden on the functioning of insurance companies established in Greece and restrict their ability to compete with foreign based insurers which enjoy favourable tax treatments.

Financial and political motives in retaining barriers in international transactions in insurance services may arise from the strong desire to raise revenue for the State. In Greece direct taxation is very small and any increase in the level of direct taxation involves high political cost. Moreover, once imposed it is difficult to administer and subject to evasion. The people feel little responsibility for financing government and the attitude of escaping as much tax as possible is widespread. Usually greater scope for income tax evasion exists for the self-employed rather than for the employees whose income tax is deducted at source by their employers. The opportunities for tax evasion are great in Greece since it is estimated that about one-fourth of the Greek workforce are self-employed. Furthermore, the issue of tax evasion arises most obviously in the context of the black economy which in a developing country such as Greece appears to be relativley large.

For all these reasons the Greek authorities look out for obvious signs of property-owning or wealth that by their visibility can be more easily taxed. This is the main motivation behind the high tax insurance rates in Greece. Taxation makes insurance companies tax-collecting agents that mobilize the adequate resources required by the government to finance its activities.

The issue of tax treatment is important, in non-life and even more so in life, where it is far more complex not just as regards taxation of premiums, but also with respect to deductibility and taxation of benefits. With the present tax treatment, freedom of international transactions in insurance services for Greece means de-nationalization of insurance and savings. The national authorities would obviously not remain indifferent to this. The taxation treatment would be a serious obstacle to the liberalisation of international insurance transactions in the case of Greece.

As far as the tax climate is concerned, it is rather evident than an important element of the main political parties in the Greek parliament is that a reduction in the budget deficit should be pursued as one of the major aims in the coming years. There are already concrete plans for future tax increases prepared by the Ministry of Finance. Even if, for the time being, it can not be anticipated when and to what extent those plans will be enacted, it is fair to say that a tax reduction is considered as highly unlikely due to large Public Sector Borrowing Requirements.

The analysis leads to the conclusion that the national authorities would be reluctant to eliminate the barriers to freedom of financial services and adopt the principle of home country control. Some people in Greece believe that by the end of 1992 the country will open up its financial market to the rest of the EC and a Common Market in financial services will be created. Such hopes and expectations, however, seem to be totally out of line with reality. The fragmentation of the markets would remain significant.

SUMMARY AND CONCLUSIONS

The Commission's White Paper published in 1985 commits the EC to realizing by the end of 1992 a Common Market not only for goods but also for services including financial services. To achieve this purpose the Commission has shifted the emphasis away from systematic harmonization of national supervisory systems and in favour of the home country control principle based on the mutual recognition by EC Member States of each others' systems. This policy implies a sufficient minimum harmonization in order to make the concept of mutual recognition acceptable. However, the analysis leads to the conclusion that a Common Market in financial services in its most liberal sense will be very difficult to establish in the foreseeable future.

First of all, whatever the Commission might say, its policy does not seem to limit the powers of the domestic authorities to place and retain barriers to trade in financial services. Despite the intentions of the Directives, government action can inhibit entry and establishment of foreign financial organizations through restrictions on foreign equity participations in indigenous institutions. The Commission has up to now made significant attempts to eliminate impediments to the establishment of foreign branches but it did not do so with respect to foreign subsidiaries. The adoption of Directives designed to abolish restrictions and coordinate the regulatory provisions with respect to acquisition by foreign financial organizations of participation in indigenous institutions should be an indispensable part of any strategy designed to integrate the financial sectors. Even if the difficulties facing the Commission in its task are recognized, it appears that its strategy does not promise a comprehensive approach to integrating the European financial markets into one unit.

Furthermore, the analysis suggests that the fragmentation of the European capital markets would persist due to vast divergence in practical and philosophical approaches to prudential supervision and national economic and political interests involved among the developed EC countries. It is in the system of prudential regulation and supervision that the U.K. differs most from the other European countries because there is no specification of strict rules. Supervision is conducted without any published framework with the authorities indicating in general terms the criteria on which they base their judgements. This is a very flexible system, too flexible and loose for many other countries in Europe.

In the U.K. supervisory system special emphasis is placed on the suitability and competence of those actively involved in the management of a financial institution since the prime responsibility for relating its soundness lies with its own management. A fundamental issue in this regard is the perception that the interests of good managements and of the supervisory authorities are one: the development of sound financial practices which generate confidence in those who use their services. Furthermore, it is considered that the marketplace in determining the success or failure of an institution is capable of imposing an acceptable degree of discipline on its members. In this respect, the U.K. authorities try to reinforce disciplines inherent in the market process through the more frequent disclosure of information about the conditions of institutions, the existence of Consumers Guaranteed Systems which provide some indications that some institutions may be allowed to fail, the extensive regulatory provisions relating to sanctions imposed on institutions that engage in unsound business practices, and the informality of public intervention in problem cases.

According to the U.K. authorities a flexible supervisory system is effective, since it permits the adaptation of the system to the changing market practices, and is essential for fair supervision. The adoption of rigid rules that are applied uniformly to the supervised financial institutions with no regard to their considerable degree of diversity entails competitive inequalities. Even more important is the fact that the operation of a flexible supervisory system arises, from the authorities' perception of the need to adapt the prudential system in such a way so as not to stifle the benefits in terms of efficiency resulting from a more dynamic and competitive environment. The U.K. authorities take account on the one hand of the continuing tension and need to reconcile the objective of achieving a more efficient financial system through competition, and on the other hand of the absolute need to safeguard the financial stability of institutions and the public confidence in the system, and place emphasis on market discipline and "self-discipline" as complements to official prudential supervision.

However, the authorities of the continental European countries consider that flexible supervision on the day to day running of the institutions moves in a direction inconsistent with the objective of preserving the integrity of the financial system. In a highly competitive environment even honest management may engage in risky business, in a quest for higher profits or/and market share, with considerable repercussion for the solvency of the respective institutions.

Furthermore, the degree of emphasis that should be placed on market discipline as a complement to prudential supervision should depend on the extent to which market responses to signs of strains developing in an institution are developed in a direction consistent with the objective of preserving the integrity of the financial system. Considerable doubts have been raised about the reliability of the stabilization effect and concern has been expressed that reliance on market discipline might lead to further instability due to over-reaction by the market to changes in an institution's financial situation. The effect of market discipline depends on the perception of the authorities' responses to the prospects of failure of an institution. If it is commonly known that the authorities stand ready to intervene in problem cases not only the private control mechanism is weakened but also the potential for excessive risk taking is increased.

The conflict between regulation and competition in the financial system is one of the unresolved problems of economic policy and the continental European countries - in stark contrast to the U.K. -consider that the costs of regulation in terms of competition, prices, innovation and variety of services are outweighed by its benefits i.e. protection against the risk that some sizeable parts of the system as a whole may collapse. It is perfectly apparent that the differences in the supervisory philosophies are substantial and these reflect divergent interests.

It seems that the U.K. authorities place a great deal of emphasis on the interests of the shareholders rather than on those of the consumers and the public in general. The rules of the game as formulated by the present regulatory regime benefits the bankers and the insurers at the expense of the public. In addition, the process of consultation and dialogue between the authorities and the financial community enables the latter to influence and manipulate public policy in its favour. This community would express strong opposition against any move toward strengthening the prudential controls in the U.K.

Furthermore, the evidence suggests that the UK possesses a comparative advantage in the provision of financial services and the U.K financial industry seems particularly well placed to take advantage of any moves towards a single market. However, this comparative advantage seems to be based to a considerable extent on government control. One effect of harmonization of regulation within Europe would be to erode to a significant extent the comparative advantage in the provision of financial services that the U.K. has been enjoying for so many years with considerable repercussions for the industry and the economy as a whole.

In addition, the main reason often given for London's strength in finance is the low level of regulation in its markets. The possible outcome of the strengthening of the U.K. prudential controls, as a result of harmonization at the EC level, would be to put London's market on an equal footing with the rest of Europe and drive business abroad: not only to other European centres but also to other financial centres outside Europe. However, London as an international financial centre plays an important role to the benefit of the U.K. It makes a very substantial positive contribution to the favourable invisible balance and the U.K. has much to lose if EC introduces additional controls on the entry and operation of financial institutions that would undermine its prominent position in finance. The U.K. authorities have therefore substantial economic interests in opposing any trend towards tighter regulation.

In stark contrast to the U.K., the authorities of the continental European countries attach priority in the interests of the public rather than those of the shareholders. In particularly, Germany represents the opposite extreme case and the security of the consumer and the financial system as a whole is maintained by strict supervision. The consequences of the lack of this type of consumer protection policy were revealed after the Second World War when consumers lost most of their savings. The authorities of the continental European countries would, therefore, oppose any trend towards loosening the prudential controls. They believe that the continental system provides protection for the consumers and that the U.K. system is weak. The events of the early 70's still live in their memory as proof that the consumer is inadequately protected.

Complete freedom of financial services would mean financial institutions being able to open branches and transact business anywhere in Europe on the terms approved by the home supervisory authorities. Without some harmonization of national supervisory standards some continental countries would consider the degree of protection provided to their residents as inadequate and unacceptable. Precisely because complete freedom of financial services requires this degree of harmonization it is difficult to be achieved. In the U.K. there is considerable opposition to any additional control. In the continental countries there is a strong belief that strict supervision is the only effective method of consumer protection. It is difficult to see room for compromise particularly within the timescale.

Against this background the EC Commission tries to bring about home country control before the end of 1992. However, the future is not free from areas of potential controversy between the U.K. and the continental European countries.

In the case of banking, the continental countries impose certain prudential limitations in the scope of permissible activities which banks may undertake directly or indirectly. The limitations arise as a response to prudential considerations and concentration of power. In the U.K. there are no such restrictions and the credit institutions get involved in the provision of certain "non-banking" products. To allow fair competition and achieve the adoption of the Second (draft) Coordination Directive there is a need to harmonize supervisory controls on the range of banking business. The adoption of the respective Directive would imply that foreign banking institutions may have wider or narrower fields of activity (unless this is invoked by the host Member State on grounds of "public good"): an arrangement which some Member States would greatly oppose.

For the purpose of monitoring banking solvency in the U.K. the capital base is defined to include elements (such as subordinated debt) which are not permanently available to meet current losses and which make British banks appear better capitalized than in fact they are. These elements are not considered as components of capital for supervisory purposes in the other European countries. Furthermore, the

Bank of England assesses banks' solvency on a case-by-case basis without setting any specific minimum solvency limit that the institutions should observe. The U.K. authorities make implicit judgements of whether funds are adequate in stark contrast to other European authorities which have adopted explicit measures of capital adequacy.

Freedom of banking services demands a certain degree of harmonization over solvency controls if the continental countries do not consider the degree to protection provided to their residents as inadequate and the UK to have an unfair competitive position. Given the large differences between the practical and philosophical approaches to solvency supervision it is hard to see how there would be significant advances towards harmonization in the foreseeable future.

As far as prudential controls on risk concentration is concerned, the Bank of England's policy is determined on a case-by-case basis taking into account the particular characteristics of individual banks in stark contrast to the other European authorities which impose strict statutory controls on banks' risks exposure. The lack of equivalent controls on risk concentration would constitute a formidable impediment on the way of granting parental supervision over foreign banks.

In the U.K. the control of banking liquidity takes place flexibly and in the context of regular discussion with the management, while liquidity ratios, setting statutory proportions between certain liquid assets and prescribed liabilities, are applied in a large number of continental European countries. Controls over liquidity are one of the most important difference between the U.K.'s and continental countries' supervisory systems and this difference would constitute a significant barrier to freedom of banking services in the years to come.

In the case of insurance of mass risks, the continental European countries impose strict prudential restrictions on premium rates. The authorities lay down the bases or assumptions to be used in the calculation of the premium and this results in virtually uniform premium rates. In the U.K. there are no such controls and insurance companies are allowed to offer policies at the rate they prefer. Without a certain degree of harmonization of premium controls the continental authorities would worry about competitive distortions and inadequate consumer protection.

The continental countries also control the policy conditions and the issue of policies requires prior authorization. In the U.K. there are no such controls and the range of policies is much wider. The freedom to supply insurance services across borders with respect to mass risks will be very difficult to be granted without first carrying out a sufficient harmonization of the prudential controls of policy conditions.

In most countries the supervisory authorities control the investment policy in order to ensure the viability of the company and the security provided to policyholders. In contrast, the British companies enjoy the freedom to invest their fund virtually wherever they like. Again harmonization is needed if the U.K. is not considered to have an unfair competitive advantage and the policyholders are not deemed to be inadequately protected.

The dispute over composites seems to be a serious obstacle to insurance activities in the EC. Most of the continental countries would be unwilling to allow British composites to offer services in both classes in their countries while their indigenous companies could not. On the other hand, in the U.K. many of the leading companies are composites engaged in both classes of business. The U.K. authorities would be reluctant to reassess the permissible activities of their insurance companies.

The issue of fiscal harmonization is also important.

Freedom of insurance transactions and lack of harmonization with respect to taxation create a degree of distortion of competition and would lead to a de-nationalization of insurance and savings. Unequal tax regimes can give rise to competitive imbalances and therefore harmonization of tax regulations is a necessary prerequisite to freedom of insurance services. However, an acceptable degree of tax harmonization is rather difficult to be achieved. In the U.K. the authorities believe that there should be a low burden of taxation on business in order to encourage competitiveness and expansion of business, while other European authorities see the insurance industry as a major provider to tax revenue.

The Council of Ministers has reached agreement on a insurance services Directive with respect to "large risks" without any harmonization of controls over premium rates, policy conditions, investment policy and taxation. However, the same step cannot be taken with respect to "mass risks" without prior harmonization. The case for protecting policyholders against the consequences of bad bargains is much more persuasive in relation to individuals and small traders than it is to large buyers of insurance who have sufficient bargaining power to negotiate fair conditions and are able to obtain sufficient information about the solvency and reputation of any insurance concern whether domestic or foreign. Furthermore, the effects of the distortion of competition due to unequal tax regimes are much more important in the case of life assurance since it is in direct competition with the other forms of investment and savings.

Obviously the wide differences in national regulatory standards and the need for fair competition and prudence undermine the principle of mutual recognition upon which the success of 1992 heavily depends. The principle of home country control would clash with the wish of governments to ensure that they are in a position to protect their residents and the rival principle of host country control is expected to have a strong following.

In analyzing the rationales that exist for imposing restrictions on the entry, establishment, operation and market access of financial institutions in the case of a developing country such as Greece, it appears that those differ considerably from those of the developed countries. The placing of strict barriers to trade in international financial services is used mainly as support for protection of the domestic financial sector and financial protectionism, rather than as a means of consumer protection. Indigenous financial institutions are seen as not being sufficiently developed and equipped to withstand competition from more sophisticated foreign institutions. The enhancement of the local capital supply is considered to be of enormous importance to the developing countries as a means of supporting domestic economic development. The funds channelled into the domestic capital market can be used for investment in government securities and for financing specific projects in the private sector of the economy. For these reasons the authorities limit cross border international financial operations and keep control over the number and size of foreign institutions allowed to operate in the domestic market.

The Greek authorities are advocates of a strong state ownership in the financial system in order to effect the allocative efficiency of the market. Public ownership is essential to arrange the allocation of funds according to social priorities rather than criteria of short term private profits. However, these considerations are incompatible with the principle of an integrated financial market in which capital would flow to areas where the returns are the highest. In principle, the philosophy of control over the Greek financial system conflicts with the philosophy of a Common Market in financial services.

In the case of developing countries, given the degree of sophistication and development of the domestic market, the unification of the European financial sectors would imply a substantial reduction in the market share of the indigenous financial institutions and a considerable reduction in their business. The traditional structure of the large domestic financial companies which have never faced effective competition and with an extensive home base and a small number of establishments abroad would undergo drastic changes within an integrated European financial market. The national authorities have perfectly legitimate fears about the effects of the freedom of financial services on the domestic financial sector. This sector could be overwhelmed by complete freedom of competition.

Of course, one might argue that all these are the implications of the creation of a real Common Market and that if the developing countries are entitled to export light industrial goods then it is only right that other countries should be able in return to provide to the developing countries financial services. However, the developing countries are able to experience a relatively good export performance in light industrial good due to a strong domestic financial sector. Indeed, the financial sector is somehow different from industrial or commercial activities insofar as the financial sector plays a special role in the development of other sectors of the economy and in the attainment of national policy goals. This is the main reason behind the fact that freedom of trade in financial services lags so far behind trade in goods; and there are reasons why it might continue to lag behind in the future.

The elimination of restrictions on market access by foreign financial institutions not established in the country would have considerable repercussions for the economies of developing countries. The intensification of the shortage of foreign exchange and savings to finance investment will restrict the growth of potential GNP and employment. The development process will be halted at the time that the authorities try to achieve faster growth rates in order to match the level of economic development of other European countries.

On the other hand, the EC budget could play an important role as cushioning the impact of external pressures on the domestic economy. Indeed, the Member Sates have recently decided to increase to a considerable extent the EC resources for redistributive purposes. However, it is considered that the doubling of these resources over the course of four years is not adequate to alleviate the new process of integration. The size of the resources available for redistributive purposes might be an important determinant of the level of integration that can be achieved.

The analysis leads to the conclusion that the authorities of the developing countries would not be able to accept the disadvantages that arise from the need to implement the EC Directives designed to integrate the European financial markets. The EC Commission believes that the multilateral elimination of barriers within the EC would bring about a more intensive flow of reciprocal trade in financial services. However, it is considered that such an action would likely bring rather dubious results. The countries that are still in the process of development are traditionally importers of financial services and therefore are expected to expand these imports to a substantial extent after the elimination of their effective barriers. On the other hand, a multilateral dismantling of barriers would not bring about an expansion of export activities since its production of services is not yet in a position to export and any external barriers have almost nothing to stop. For the developing EC countries integration may only mean a uni-directional flow in services with no compensation.

Furthermore the study identifies and evaluates other factors that have a major influence in determining whether a country is prepared to operate in an unified financial market based on the principle of home country control in the not too distant future. These factors are mainly related to controls that range over a the whole spectrum of monetary and credit policies and are designed to achieve a variety of objectives including the promotion of industrial expansion and export activity and the finance of budget deficit.

Given the obvious domestic saving constraints, it is essential that developing countries have a financial system which is capable of allocating the scarce national surplus. As a result strong restrictions are imposed on portfolio policies of the financial institutions and affect the ability of the latter to compete at the international level. If foreign financial institutions were free to operate in the developing countries without complying with these restrictions, this would undoubtedly be deemed to constitute unfair competition against the indigenous institutions. The authorities of the developing countries could not therefore accept a measure which would bring about home country control in the near future.

It is considered that the effects of substituting the methods of mutual recognition for that of prior harmonization are rather unclear. This method obviously results in minimum harmonization and therefore brings into competition not only financial undertaking but also national regulatory regimes. According to the Commission, this competitive imbalance would force the strictly regulated States to reduce their regulatory constraints.

Obviously, the Commission considers that the government involvement within the financial markets are solely motivated by prudential considerations. However, a rationale for government involvement within a financial market can be constructed based not only on the stability of the financial system but also on the need to attain particular macroeconomic objectives. The Commission does not take into account that government regulation in the developing countries can be used to influence investment behaviour and promote macroeconomic stability. The harmonization of this kind of regulation will be very difficult to attain since it reflects vital national economic interests.

PROPOSAL FOR FURTHER RESEARCH

The present study is considered as overambitious in the sense that it attempts to provide a comprehensive analysis of the challenge to barriers in the way of the liberalization of financial services with reference to only two countries. The collection of the two countries does not offer an exhaustive treatment of the subject. In the U.K. case study impediments on the adoption of the home country control principle are identified and evaluated in the light of divergence of supervisory philosophies and practices between the U.K. and the continental European countries. However, different practical and philosophical approaches to prudential supervision exist also between the continental countries themselves. Obviously more case studies should be undertaken in order to achieve a more comprehensive analysis. Furthermore, the difficulty with case studies, is that they can lead to generalizations which might prove too simple. More case studies are necessary to test the conclusions.

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APPENDIX

Components of capital base

Funds included without limit

1 share capital
2 minority interest in consolidated subsidiaries
3 general reserves (including hidden reserves if permitted)
4 provisions

Funds included with limits (items included in this category must not exceed 50% of the total items included in A above less intangible assets)

1 Preferred shares that do not mature or mature on a fixed date and have an original maturity of at least 25 years
2 Subordinated debt that is available at all times to absorb losses, and provides that interest payments may be deferred if the issuer does not make a profit in the preceding period and/or pay dividends on common and perpetual preferred stock

Adjusted capital base

Deductions from the capital base of:

1 all intangible assets
2 investments in unconsolidated subsidiaries and associated companies
3 bank holdings of capital instruments of other banking organisations

The Risk Asset Weighting Structure

0% weight given to:

1 all domestic balances with and claims on Bank of England
2 domestic government guaranteed export and ship-building loans

10% weight given to:

1 short-term claims on the UK and Northern Ireland governments
2 short-term claims on discount houses, gilt-

edged market makers and Stock Exchange money brokers

25% weight given to:

1 cash items in process of collection - foreign and domestic
2 short-term claims on UK and Northern Ireland governments
3 all claims (including repurchase agreements) fully collateralised by UK and Northern Ireland government debt
4 all local currency claims on foreign central governments to the extent funded by local currency liabilities in that foreign country

50% weight given to:

1 all claims on UK and Northern Ireland government-sponsored agencies
2 claims on multinational development institutions in which the domestic government is a shareholder or contributing member

100% weight given to:

1 long-term claims on domestic depository institutions and foreign banks
2 all claims on foreign governments other than local currency claims on foreign central governments funded by local currency liabilities in that foreign country
3 net open position in foreign exchange
4 all other assets

Off balance sheet items

The face amount of these items would be multiplied by the credit conversion factors shown below and the resulting amount would be slotted in the appropriate risk category depending upon the identity of the obliger and the maturity of the instrument where appropriate.

1 "Direct credit substitutes" (financial guarantees and standby letters of credit serving same purpose and, acceptances outstanding) - 100% credit convention factor
2 "Trading contingencies" (for example,

commercial letters of credit, bid and performance bonds and performance standby letters of credit) - 50% credit conversion factor

3 Sale and repurchase agreements and assets sales with resource if not already included on the balance sheet - 100% credit conversion factor

4 Other commitments, for example overdrafts, revolving underwriting facilities (for example, RUFs/NIFs), underwriting committments, commercial and consumer credit lines. The credit conversion factors are:

10% - one year and less original maturity
25% - over one to five years original maturity
50% - over five years original maturity

Risk asset ratio

Adjusted capital base as percentage of Adjusted total of risk assets

Gearing ratio

Adjusted capital base as a percentage of deposits and other non-capital liabilities.

INTERVIEWS

Two officers of Directorate for Financial Institutions DG XV of the EC Commission

F Brener	Bank of England

An officer of the Bank of England

J Young	Lloyds Bank
D Green	Midland Bank
A Tret	Hessische Landesbank (in the UK)
T Bucci	Banca Commercialle Italiana (in the UK)

Three officers from the Bank of Greece

D Agelides	National Bank of Greece
N Gristou	Commercial Bank of Greece
A Xanthopoulos	Nat West Bank (in Greece)
J Roger	Barclays Bank (in Greece)
J Paizi	American Express Bank (in Greece)
A Portokalakis	Arab Helenik Bank (in Greece)
A Niuolaidis	Credit Commercial de France (in Greece)

An officer of the Chartered Insurance Institute

K Doerr	Commercial Union Assurance (ABI)
M Ayling	Aegon Insurance
P Maston	Eagle Star
E Samoull	Ministry of Trade

D Petras	Ethniki
L Laskaridis	Agrotiki
A Varsamis	Ioniki
T Papafilakis	Nationale Netherlande (in Greece)
D Traganou	Alico (in Greece)
P Danakis	Deutsche Victoria (in Greece)
V Paipetis	Cigna (in Greece)