THE SECOND BANKING DIRECTIVE: CONFLICTS, CHOICES, AND LONG-TERM GOALS

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I. INTRODUCTION

On July 5, 1991, bank regulators in seven nations1 instituted enforcement actions against the Bank of Credit and Commerce International (BCCI) for numerous unsafe and unsound banking practices.2 As the corporate structure of BCCI3 and its past dealings illustrate, the proliferation of multinational enterprises engaged in the cross-border provision of financial services confounds territorially based sovereigns in their attempt to regulate that which no longer exists: a national, territorially based banking market.4

BCCI was an international banking conglomerate organized to evade bank regulation. The BCCI holding company was incorporated in Luxembourg, a jurisdiction that normally does not regulate holding company

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3. For a chart of BCCI's corporate structure, see BCCI and Mr. Pharaoh, WALL ST. J., July 8, 1991, at A6.

activities. The global banking structure of BCCI was composed of subsidiaries, which limited each national regulators' oversight jurisdiction to the subsidiaries organized within their respective territories. No single bank regulatory agency was in a position to oversee the consolidated activities of the BCCI holding company, apparently permitting BCCI to engage in a variety of fraudulent and secret transborder transactions.

The new European Economic Community (EC) financial services regulatory structure, which will be completed when the Second Banking Directive is implemented on January 1, 1993, will be able to prevent some, but not all, of the types of abuses engaged in by BCCI. The EC regulatory structure mandates certain minimum standards for authorizing institutions. It also centers regulatory control in one state. By defining the scope and location of regulatory competence based largely on the principal state of operation (Home state) of the credit institution the short-term goal is to create easily enforceable minimum standards regarding the conduct of financial affairs in Europe. The EC also seeks to facilitate the cross-border provision of financial services by creating a single banking license, with primary regulatory authority over all transborder financial services located in one Home state.


7. According to press reports, BCCI reportedly was a bank engaged in global fraud. Those fraudulent activities allegedly included "conducting secret shipments of guns and drugs, doing business for secret services (including the CIA), helping assorted dictators hide money looted from their national treasuries, and along the way dabbling in intimidation, blackmail and perhaps murder." BCCI Update, WALL ST. J., July 23, 1991, at A22 (citing Beatty & Gwynne, supra note 2, at 42). See also Nicholas Bray, BCCI Reportedly was Being Examined for Alleged Links to Terrorist Groups, WALL ST. J., July 22, 1991, at A6. For complete details regarding these allegations, see Beatty & Gwynne, supra note 2, at 42. On December 19, 1991, BCCI, acting through its receiver, plead guilty to various criminal charges in the United States. Liquidators Forfeit BCCI Assets in US, WALL ST. J., Dec. 20, 1991, at A4.


9. Id. art. 24(1).

10. Id. arts. 1(7)-1(8) (defining Home and Host member states).

By relying on economic rather than territorial factors to provide the legal basis for regulatory jurisdiction, the financial services regulatory system seeks to prevent or pre-empt conflict-of-laws relating to the conduct of cross-border banking business by providing clear, predictable, and pre-emptive choice-of-law rules before disputes arise.12 These choice-of-law rules13 provide one of the most helpful frameworks for analyzing14 the short-term and long-term goals of the EC in regulating transborder financial activity. Viewed from this perspective,15 the location of primary regulatory control in a financial institution's Home state, in concert with the harmonization of certain standards relating to the safety and soundness of that institution, suggests the long-term focus of the EC: coordination of monetary policy to facilitate economic and monetary union in Europe.16

This financial services regulatory structure indirectly lays the groundwork for monetary union in three ways. First, the regulatory structure creates a single banking license that will facilitate the transborder provi-

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12. Conflicts and choice-of-law rules are creations of national systems of law intended to deal efficiently and fairly with the collision of opposing legal principles in one sovereign's courts (conflict-of-law) or legislatures (choice-of-law). In general, choice-of-law rules reflect ex ante normative choices by sovereigns and private parties of the most desirable legal rules to apply in a specific situation. Conflict-of-law rules can be said to operate ex post by choosing between competing legal rules on a case-by-case basis. Conflict-of-law rules thus address a sovereign's judicial competence. Choice-of-law rules, on the other hand, address a sovereign's prescriptive competence. Neither set of rules directly address a sovereign's regulatory competence. However, both sets of rules address a sovereign's related powers to prescribe and enforce such rules of law. D. LASOK & P.A. STONE, CONFLICT OF LAWS IN THE EUROPEAN COMMUNITY 3-5 (1987).


13. "Scattered here and there [in the EEC Treaty] are the provisions which can be regarded as embryonic conflict rules, or perhaps as the ground from which such rules may develop in the van of the legal integration of the Community." LASOK & STONE, supra note 12, at 29.

14. "[A]s trading and payments cross national boundaries, issues of... [how] regulatory jurisdiction is distributed between the national jurisdictions [arise]... The appropriate analysis is a conflicts-of-law analysis where one attempts to balance the interests of the respective jurisdictions." Andrea Corcoran, Remarks at the American Society of International Law 83rd Annual Meeting (April 5, 1989), 1989 Am. Soc'y Int'l L. Proc. 54, 54.

15. Id.

16. The Second Banking Directive preamble specifically recognizes this link as follows:

Whereas there is a necessary link between the objective of this Directive and the liberalization of capital movements being brought about by other Community legislation; whereas in any case the measures regarding the liberalization of banking services must be in harmony with the measures liberalizing capital movements; whereas where the Member States may... invoke safeguard clauses in respect of capital movements, they may suspend the provision of banking services to the extent necessary for the implementation of the above mentioned safeguard clauses....

Second Banking Directive, supra note 8, pmbl., para. 22.
sion of financial services. The single license will increase the trans-
border flow of capital, through increased merger activity and daily
banking operations involving cross-border financing transactions. This
will create a single capital market in fact, if not in name. Second, the
structure specifically does not harmonize deposit insurance and monetary
policy matters. Since most other significant aspects of the banking busi-
ness will be harmonized by the Second Banking Directive, or other re-
lated financial services directives, this lack of harmonization will focus
attention on the need to coordinate related policies, thereby facilitating
efforts to create a more formal monetary union. The implications of the
BCCI closure will be used to illustrate the close links between monetary
and banking policies in the deposit insurance context. Third, the regu-
latory structure requires coordination and consultation between national
supervisory authorities regarding issues previously considered as purely
domestic. This could build a critical precedent for intergovernmental co-
operation that will be crucial as the movement toward monetary union
progresses.

Taken together, these three aspects of the financial services regula-
tory structure create the institutional backdrop for monetary union by
increasing both the financial interdependence among member states and
the scope of shared decision making regarding fiscal and monetary poli-
cies. In order to remain within the framework of the EEC Treaty, this
long-term goal can be accomplished only indirectly through financial ser-
vices regulatory legislation; formal monetary union would involve cessions
of national sovereignty which lie outside the binding obligations of the
Treaty.

In order to more fully develop these arguments, this article is divided
into three sections. Each section uses the BCCI example to illustrate the
strengths and weaknesses of the regulatory system set up by the Second
Banking Directive. Section II discusses the regulatory climate in which
the Second Banking Directive developed. Section III examines the efforts
taken by the EC to regulate the business of banking through key financial
services directives. It will particularly focus on initial authorization, regu-
lation of branching activities, prudential supervision of daily activities,

17. Id. pmbl., para. 8, art. 18(1).
18. TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY]. For a detailed
discussion of the EC's institutional organization and legislative process, see AUDREY WINTER ET AL.,
EUROPE WITHOUT FRONTIERS: A LAWYER'S GUIDE (BNA Corporate Practice Series, 1989). For a collec-

While a new treaty providing the legal framework for such a union recently was concluded, Alan
Riding, Europeans Agree on a Pact Forging New Political Ties and Integrating Economies, N.Y. TIMES, Dec.
11, 1991, at A1, this article will limit its discussion to the EEC Treaty and its limits, since the Second
Banking Directive derives its legitimacy from that earlier treaty.
and the importance of the Home versus Host state determination. Section IV considers the long-term intention of the EC to facilitate a formal monetary union through financial services legislation.

II. THE SECOND BANKING DIRECTIVE

The EC framers recognized the impact that increased economic interdependence would have on capital movements and financial activity.\textsuperscript{19} Although the explicit focus of the EEC Treaty was the creation of a common market for goods,\textsuperscript{20} the framers obligated treaty signatories not only to provide free movement of goods\textsuperscript{21} and persons,\textsuperscript{22} but also to provide free movement of services\textsuperscript{23} and capital.\textsuperscript{24} The true test of the Treaty comes now, as it expands its reach to regulate the second-order consequences of integration: increasingly international financial activity.

The growing volume of trade in goods requires a commensurate increase in the transborder payments and finance mechanisms which make trade feasible.\textsuperscript{25} National regulations designed to protect the safety and soundness of national financial services markets can impede this process by imposing different conditions on financial institutions seeking to conduct business in their territories. Facilitation of the cross-border provision of financial services will complete the common market and thus serve as a policy justification for the banking law reforms in the EC.\textsuperscript{26}

\textsuperscript{19.} With one exception, this recognition has so far been in the form of a regulation or directive. The one exception is a recommendation regarding deposit insurance. Commission Recommendation of 22 December 1986 Concerning the Introduction of Deposit-Guarantee Schemes in the Community, 1987 O.J. (L 33) 16 (1987) [hereinafter Deposit-Guarantee Recommendation]. Currently, most member states have such schemes, but they “differ widely in their legal structure and in their protective scope.” Michael Gruson \& Wolfgang Feuring, \textit{The New Banking Law of the European Economic Community}, 25 Int'l Law. 1, 37 (1991).

\textsuperscript{20.} As one commentator has stated, “[T]he law has been shaped to meet the economic expectation of free trade.” Lord Alexander of Weedon QC, \textit{Europe 2000: The New Frontier for the Law}, 5 J. Int'l Banking L. 225, 225 (1990).

\textsuperscript{21.} EEC Treaty arts. 9-37.
\textsuperscript{22.} Id. arts. 48-51.
\textsuperscript{23.} Id. arts. 59-66.
\textsuperscript{24.} Id. arts. 67-73.

\textsuperscript{25.} In the EC, the relationship between BCCI and the Gokal shipping firm is a good example of the nexus between international trade and the banking business. According to press reports, as one of BCCI’s first customers, the firm grew into “one of the world’s biggest shipping companies . . .” using loan proceeds from BCCI. Marcus W. Brauchli \& Peter Truell, \textit{Sink Hole: Family Shipping Firm is One Reason BCCI Lost So Much Money}, Wall St. J., Aug. 15, 1991, at A1. The firm’s subsequent inability to repay those loans and BCCI’s attempts to falsify its own accounting records to mask the non-performing status of the loans, however, “helped transform BCCI into a factory of financial fraud. Covering up the problem involved creating 750 phony accounts, through which passed roughly $15 billion in funds over 15 years . . . .” \textit{Id}.

\textsuperscript{26.} Second Banking Directive, \textit{supra} note 8, pmbl., paras. 5 (referring to the Directive as “the essential instrument for the achievement of the internal market . . . from the point of view of both the freedom of establishment and the freedom to provide financial services, in the field of credit institu-
The ability of the EC institutions to declare laws regarding matters that traditionally have been left to national regulation (such as financial services regulation) requires a substantial shift of sovereignty from member states to EC institutions. Member states condone this shift because of their belief that the cession of sovereignty regarding common economic or monetary policies will serve individual national interests.

The conflict and choice-of-law prism again provides a helpful perspective for analyzing this rule-making process since those rules seek to provide a certain degree of comity or deference between the courts of different legal systems within a federal system. The EC legislative process takes on federal characteristics by forcing member states to engage in an interest-balancing process at the legislative drafting stage rather than at the implementation stage. This ensures that comity extends to all member states.

The Directive, in turn, derives its power from the EEC Treaty. EEC Treaty provisions are binding or directly applicable upon its signatories as a matter of public international law. Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331. Therefore, the Treaty obligates member states to provide freedom of establishment and freedom to provide services for all financial institutions incorporated in any member State. Secondary legislation promulgated by the EC (such as directives) defines the character and scope of these freedoms. Upon adoption through the EC law-making process, this secondary legislation legally binds member states to conform their individual national laws to the standards prescribed at the supranational level. EEC TREATY art. 189.

27. Classical legal theory has defined law as commands from a sovereign. "A law is a formal general command of the state or other organized body; the Law is the body of rules which the courts of that body apply in deciding cases." JOHN CHIPMAN GRAY, THE NATURE AND SOURCES OF THE LAW 110 (2d ed. 1972) (emphasis in original). Also, general rules of conduct "laid down by an administrative organ of a political (or other) organized body . . ." are seen as sources of law. Id. at 112. The EC and its secondary legislation fit squarely within this conception of "law-giver," even though its "sovereign" power to declare the law is mainly based on intangible legal and political obligations between independent states rather than on traditional control over a territorial area exercised by one (federal) sovereign. For a general discussion of sovereignty and law, see id.

28. See, e.g., Van Gend en Loos v. Nederlandsse administratie der belastingen, 1963 E.C.R. 1, 12, 1963 C.M.L.R. 105, 129 (1963). The EC harnesses the member states' national interests to create EC common policies that reflect the interstate nature of the Community. For legislation to be promulgated, the Council of Ministers must approve the legislation by a qualified majority. EEC TREATY art. 100a (as amended 1987). The legitimacy and enforceability of the EC's preemptive legal rules therefore extend only as far as the political will of the member states and their representatives to create and then comply with preemptive international rules. However, "[n]ational courts have no jurisdiction to declare that measures taken by Community institutions are invalid." Regina v. Minister of Agriculture, Fisheries and Food ex p. Federation Europeenne de la Sante Animale (FEDESA), 3 C.M.L.R. 661, 665 (Q.B. 1988).

29. See supra note 12 and accompanying text.

30. Because regulations, like treaty provisions, are directly applicable in the member states without requiring enabling legislation, EEC TREATY art. 189, any interests a member state wants to protect must be discussed at the drafting stage. Thus, automatic enforceability creates "harmonization" or uniformity of laws. However, since regulations require a high degree of political agreement, the integration process, when accomplished by regulation, is both time consuming and politically costly.

An alternate, less coercive, legislative tool is the directive, which is binding as to effect, but leaves the means of implementation to the discretion of national jurisdictions. Id. Thus, consensus is easier
states in the formulation of the rules so that implementation of those rules will not later be seen as intrusive.31

While such cooperation is commonplace in federal unions, the voluntary limitation of sovereign powers is unique in the international context, and runs counter to interstate practice in the EC.32 It can be inferred from the title of the Second Banking Directive, which emphasized the coordination of laws, that the avoidance or mitigation of conflicts between member states regarding bank regulation was of paramount importance.33 The coordination of sovereign authority can be seen in the BCCI example, where the United Kingdom assumed, without objection, the role of lead enforcer. It was more efficient, diplomatic, and convenient for the Bank of England to spearhead the enforcement action.34 Since the Second Banking Directive was negotiated almost two years earlier, it is reasonable to infer that its allocation of regulatory and enforcement competence provided the framework for this coordination. In that sense, the regulatory action taken against BCCI serves as a precursor to future EC enforcement actions once the Second Banking Directive is implemented.

As mentioned earlier, the territorial tie used by the Second Banking Directive to allocate primary regulatory jurisdiction centers on the principal place of business of the financial institution.35 Thus, allocation of regulatory jurisdiction is based primarily on economic rather than geo-


33. See supra note 8.

34. For example, "several times" during 1990 and 1991 (i.e., after promulgation of the Second Banking Directive, but before its terms became effective), Luxembourg authorities requested other states to take the regulatory lead regarding BCCI because "[w]e can't deal with it .... It is impossible for small countries with slender resources to do so." Forman & Hagerty, supra note 6, at A7.

35. Prescriptive authorities traditionally have chosen a territorial connection to allocate regulatory jurisdiction and have looked to the field of conflicts law to provide the appropriate rationale for that allocation. Comity among the member states regarding the extraterritorial reach of each others' laws and regulations is commonplace in the corporations law arena. Buxbaum & Hoft, supra note 12, at 63-70. See also id. at 63 nn.150-51. In fact, the European legal doctrine that allocates regulatory jurisdiction over transnational corporations to the territory in which that company does the most
graphic choices. The rationale is that the state where the majority of business occurs will be the most interested and the most efficient regulatory authority. These presumed efficiency gains arise from the certainty provided by clear rules allocating regulatory jurisdiction, the consolidation of information flows into one regulatory authority, and the elimination of conflicting informational requirements. These provisions also create a hierarchy of applicable laws which recognizes implicitly that territorially based regulations may be inappropriate in an industry whose operations are predominantly extraterritorial.

III. FINANCIAL SERVICES REGULATORY STRUCTURE

This section will outline four issues in the emerging EC regulatory framework: initial authorization, regulation of branching activities after authorization, prudential supervision of credit institutions, and the importance of the Home versus Host state regulatory authority. The dis-

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37. Outside the banking context, one commentator has framed the efficiency issue as follows: The elimination of the need to consider not merely which domestic laws may possibly have a bearing upon a given case, but also which systems of private international law may in some way come to be applied in the process of achieving a solution to the case, would produce a radical simplification of the calculations involved in the ordering of human and corporate affairs. Ian F. Fletcher, Conflict of Laws and European Community Law 5 (1982).

38. If the provision of banking and other financial services is not yet predominantly extraterritorial in scope in the EC, it soon will be. The EC's plan to liberalize the movement of services, capital, and persons generally can be seen from the perspective of the decreasing importance attached by financial actors to territorial affiliation. Their activities create EC-wide or global economic ties which cut across national boundaries. See generally John M. Kline, International Codes and Multinational Business (1985); Robert B. Reich, The Work of Nations (1991); W. Peter Cooke, Trends and Developments in Global Financial Services, Issues in Banking Reg., Fall 1990, at 20.

39. A comprehensive discussion of all key provisions relating to financial services is beyond the scope of this article. For an excellent and up-to-date overview of Community legislation in this area, see The Single Market and the Law of Banking (Ross Cranston ed., 1991); Gruson & Feuring, supra note 19; Rene Smits, Banking Regulation in a European Perspective, 1 Legal Issues of Eur. Integration 61 (1989).
discussion will focus on the First and Second Banking Directives and how they integrate with other banking legislation in the EC.

A. Market Entry and Initial Authorization

1. *The First Banking Directive.* The First Banking Directive represents the initial step toward creating common licensing and supervisory requirements of European credit institutions. This Directive, which took effect on December 12, 1977, is the logical starting place for any analysis of market entry requirements because the Second Banking Directive explicitly incorporates these provisions.

The First Banking Directive requires EC banking market entrants to fulfill straightforward informational requirements. At least two prospective managers, with “sufficient experience” and a “good reputation,” must submit a business plan providing for use of the owners’ own funds as initial capitalization. The Own Funds Directive standardizes the minimum amount of initial or start up capital required for authorization in any member state so that all regulatory authorities have confidence in the individuals applying for authorization to conduct a banking business. Banking authorities in both the United Kingdom and France require substantially similar qualifications in their national legislation.

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40. *See supra* note 11.
41. *See supra* note 8.
42. For a detailed, comprehensive, and technical analysis of the interrelationship between these Directives, as well as other relevant EC legislation, see Gruson & Feuring, *supra* note 19.
44. First Banking Directive, *supra* note 11, art. 3(2).
46. Smits, *supra* note 39, annex 2, at 85. Smits refers to this as the “four eyes” argument. *Id.*
47. Own Funds Directive, *supra* note 45, art. 2. In general:

Own funds ... can serve to absorb losses and therefore provide a yardstick for the regulatory authorities of the solvency of a credit institution; ... [they also] serve as the reference basis ... for a number of other supervisory standards like the capital adequacy, the limitations on large exposures, and the limitations of participation in nonbank entities. A credit institution’s own funds consist of its capital elements basically similar to the ones in the Basle Agreement and the risk-based U.S. Capital Adequacy Guidelines.

Gruson & Feuring, *supra* note 19, at 19 (citations omitted). Primary components of “capital elements” often include stocks and convertible instruments held by the bank, the bank’s surplus and capital reserves, and allowances for loan and lease losses. These and other components are often subject to applicability restrictions that vary from nation to nation and state to state. *Id.*

48. The Bank of England cannot grant a banking license when the applicant has not met certain minimum criteria for authorization. Banking Act, 1987, § 9(2), in Halsbury’s Statutes 538 (4th ed. 1987). Schedule 3 of the Banking Act requires as “Minimum Criteria for Authorisation” that the applicant be a “fit and proper person to hold the particular position ...” *Id.* Schedule 3, § 1(1), at 637. Paragraph 1(2) looks to such personal characteristics as probity, competence, and soundness of judgement, and diligence. *Id.* § 1(2), at 637. In addition, past conduct indicating dishonesty may be grounds for refusing entry into the banking business. *Id.* § 1(3), at 637. Finally, British law mirrors
These are hardly onerous or controversial requirements. Indeed, if the First Banking Directive was in force when BCCI sought entry into the EC banking market, its informational requirements could easily have been met. Upon expansion into Europe in the early 1970's, the BCCI founder, Mr. Agha Hasan Abedi, was a twenty-year international banking business veteran (based in Pakistan). His reputation was of a progressive banker concerned with modernization and building a deposit base. When regulators inquired into his reputation they would have found it impeccable; his associates included world leaders, military commanders, and many of the Mideast aristocracy.

After the BCCI debacle, one might express concern regarding uniform construction and application of the sufficient experience and good reputation requirements set forth in the First Banking Directive. National (Home state) officials might now be encouraged to conduct a more critical inquiry into the quality of an applicant's past management practices. This is especially true if an applicant such as Mr. Abedi was described as having "a world view that valued patronage and privilege above all. He never came to terms with the modern rules of the capitalist game."

However, this market entry analysis overestimates the importance of the initial authorization decision. Under the First Banking Directive, since each member state controlled access only to its own territorial banking market, the possibility for diverging national standards to affect an-
other nation's banking market was limited. The First Banking Directive did not require member states to recognize licenses granted by other member states. The member states were also free to impose their own solvency and monitoring requirements on branches seeking to conduct banking business in their territory. Territorially ambitious banks and other financial institutions (both EC and non-EC) faced compliance with up to twelve separate regulatory systems.56

The lack of license recognition created de facto branching restrictions and inhibited the growth of cross-border banking business. Any economies or efficiencies of scale gained through territorial expansion would be offset by the regulatory costs of expansion, thereby hampering the liberalization of capital and services contemplated by the EEC Treaty. To counter this effect, the Second Banking Directive mandates mutual recognition of banking licenses among the member states.57 Under the Second Banking Directive, additional licensing requirements imposed by member states regarding previously licensed or approved goods or services are impermissible barriers to trade and are actionable in a court of law.58

2. The Second Banking Directive. Providing for mutual recognition of banking licenses vests the Home state59 with significant control over access to the EC banking market. Despite differences between regulatory regimes, once a member state has authorized a credit institution, that authorization is valid in all other member states.60 Existing national regulatory structures are used to enforce EC standards.61 Thus, the Second Banking Directive does not create an EC-wide regulatory institution to issue the single license or to enforce the standards set forth in either the First or Second Banking Directives.62


57. Second Banking Directive, supra note 8, pmbl., paras. 12, 16. This concept was first articulated by the European Court of Justice in the now famous Cassis de Dijon case. Case 120/78, Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein, 1979 E.C.R. 649, 3 C.M.L.R. 494 (1979). Originally applicable only to goods, the case now stands for the general principle in EC law that licensing by one member state must be recognized as valid throughout the EC. Bryan Harris, Legal Rights of EEC Citizens, New L.J., Jan. 22, 1988, at 43, 43-44; Philip Webster, European Directives and the Construction Market, GAzetTE, Feb. 21, 1990, at 18, 24.


59. See supra note 10.

60. Second Banking Directive, supra note 8, art. 18.

61. Under the Directive, Host states cannot require authorization or endowment capital for branches of credit institutions authorized elsewhere in the Community. Id. art. 6(1).

62. Recently, a senior EC Commission banking expert, Paolo Clarotti, stated that "[n]obody wants to create an additional supranational bureaucracy . . . ." Forman & Hagerty, supra note 6, at
In addition to creating a *de facto* single banking license, the Second Banking Directive also harmonizes key economic and procedural aspects of the authorization process. These provisions include minimum initial capitalization of ECU 5 million (and exemptions from this minimum), informational requirements, grounds for refusal of authorization, and procedures for consultations between Home and Host states regarding holding company authorizations.

Under the standards set by the Second Banking Directive, Mr. Abedi might not have received authorization to operate BCCI. Such denial, however, would not result from the application of new or different standards. The pre-existing informational requirements under the First Banking Directive remain unchanged. Denial would most likely stem from increased vigilance following a scandal, consolidation of information in one Home state (rather than dispersal of information among different regulators), and a freer flow of information between regulators.

The Second Banking Directive does not interfere with the application in each home state of subjective standards such as good character and sufficient experience. These subjective standards include specific cultural assumptions about the propriety of certain activities. Irrespective...
of one's opinion about the application of culturally-specific standards, member states continue to retain prescriptive and enforcement powers over their own banking markets.\textsuperscript{69} The Home state also controls the application of basic principles of administrative law and judicial review regarding the exercise of power granted to it under the Second Banking Directive.\textsuperscript{70} Since the Directive does not specify which parties have standing to invoke review of this administrative decision, it is presumed that Home state laws control access to the courts as well.\textsuperscript{71}

Under the Second Banking Directive, a state must permit credit institutions to operate within its regulatory jurisdiction even if that institution received its initial authorization from a more permissive jurisdiction. This impairs the ability of a more vigilant Host state to protect its depositors from under-regulated institutions through market access restrictions.

B. Territorial Expansion Beyond the Home Market: Branching

Under the Second Banking Directive, approval for expansion by a credit institution beyond the territorial limits of its Home state rests with that state.\textsuperscript{72} All branching requests must be addressed to the Home member state, not the Host state.\textsuperscript{73} The information required for territorial

allegedly phony transactions conducted at BCCI into the official records of the global banking company." \textit{Id.} If evidence of these types of activities is readily available to regulators at the beginning, initial access to the EC banking market might not be granted so easily by a vigilant regulator in the wake of the BCCI scandal. For an excellent discussion of culture-specific authorization standards, see Marcus W. Brauchli, \textit{Satisfied Customers in Bangladesh, BCCI Still Elicits Gratitude for Development Help}, WALL ST. J., July 26, 1991, at A1.

\textsuperscript{69} Indeed, this has been a point of contention between those European states which permit universal banking (that is, those states that permit banks to engage in securities and/or insurance, as well as lending, activities) and those which do not. George S. Zavvos, \textit{Banking Integration and 1992: Legal Issues and Policy Implications}, 31 HARV. INT'L L.J. 463, 483 (1990). The Second Banking Directive partially resolves this problem. It should also be noted that considerable controversy exists regarding accounting standards and the need to harmonize those standards at least in Europe, if not internationally. However, a full discussion of these reciprocity issues (both bilateral and multilateral) is beyond the scope of this paper. Regarding conflict-of-laws and the territorial basis for prescriptive power, see generally A.H. Hermann, \textit{Conflicts of National Laws with International Business Activity: Issues of Extraterritoriality} (1982).

\textsuperscript{70} Second Banking Directive, \textit{supra} note 8, art. 19(3).

\textsuperscript{71} For example, in the United Kingdom, bank regulatory authorities enjoy wide deference regarding their actions as shown by the fact that no permanent tribunal or court exists to hear complaints regarding the exercise of administrative power: the Bank of England's tribunals are convened ad hoc, and for the limited purpose of resolving that specific dispute. Banking Act §§ 27-31, at 556-61. In contrast, the French administrative law system provides for a standing body (the Conseil d'Etat) to review administrative actions, including those actions by the Commission de Control. Bernard Schwartz, \textit{French Administrative Law and the Common Law World} 108 (photo. reprint 1991) (1954).

\textsuperscript{72} Second Banking Directive, \textit{supra} note 8, art. 19(1). However, "consultation with the competent authorities of the other Member State" is required regarding authorization expansions by the various operating units of a holding company. \textit{Id.} art. 7.

\textsuperscript{73} \textit{Id.} art. 19(1); Zavvos, \textit{supra} note 69, at 475.
expansion is similar to that required for initial authorization: the credit institution must "notify" its Home regulator of the intended location of expansion, its expected "programme of operations . . . and the structural organization of the branch," its mailing address in the Host state, and the names of branch management officers.

Thus, the Home state controls access to another state's territorial banking market. The Home state also controls the subsequent activities of the branch in that foreign market. It regulates significant measures of the branch operations such as "the amount of own funds and the solvency ratio of the credit institution." The Home state also exercises primary responsibility for the continued prudential supervision of that credit institution. Home state discretion, and consequent opportunities for divergence, are not as broad as the language of the Second Banking Directive might suggest. This is due primarily to the imposition of minimum applicable standards for many important EC regulatory areas.

The Second Directive would appear to favor expansion through branches rather than through subsidiaries by eliminating economic inefficiencies associated with territorial expansion through the use of subsidiaries. This policy choice is significant for two reasons. First, subsidiaries are separate legal entities formed under laws foreign or external to the Home state. Thus, the preference for branching has the effect of eliminating potentially thorny conflicts of laws between the national corporate

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74. Second Banking Directive, supra note 8, art. 19(1).
75. Id. art. 19(2)(a).
76. Id. art. 19(2)(b).
77. Id. art. 19(2)(c).
78. Id. art. 19(2)(d).
79. Id. art. 19(3).
80. Id. art. 13.
82. Separate capitalization is no longer required for cross-border branching in the European Community. Second Banking Directive, supra note 8, art. 6(1). Also, the single license is extended to subsidiaries so long as they "are covered by the consolidated supervision of their parent undertakings and meet certain strict conditions." Id. pmbl., para. 18. See also id. art. 2(3) (exempting any credit institution from the provisions of Articles 4, 10, and 12, without any mention of its legal form, that is affiliated to a central body. This exemption is conditioned upon the institution being subject to consolidated regulation.).
83. For an insightful analysis of the problems this duality can pose for territorial authorities seeking to regulate transnational actors, see DOUGLAS E. ROSENTHAL & WILLIAM M. KNIGHTON, NATIONAL LAWS AND INTERNATIONAL COMMERCE: THE PROBLEM OF EXTRATERRITORIALITY (Chatham House Papers No. 17, 1982).
laws under which a bank's subsidiary has been organized and the banking regulations of the Home state as harmonized by the EC. However, the Second Banking Directive eliminates this conflict of laws problem at the expense of the regulatory authority of the Host state.

Second, the policy preference for expansion by branching, when combined with the efforts in the EC to consolidate accounting and supervision, reflects the adaptation of the "economic unit theory" as the rationale for reallocating regulatory jurisdiction. To assess risk exposure and financial health of an organization more accurately, consolidated reporting and supervision ignore the legal status of the different entities within a larger corporate structure operating in different member states. In so doing, the EC attempts to erase territorially based legal differences by focusing on fluid economic relationships. The EC also recognizes that the usual method of international expansion is through branching.

Of course, in order to maintain public confidence, a minimum level of comparability between the regulatory systems of the member states must exist. This is accomplished through substantive choice-of-law decisions made at an EC level regarding consolidated supervision and accounting standards. This ensures that the transborder activities of a credit institution can accurately be reported and monitored. In addi-

87. Previously used in the antitrust and company law contexts, "[t]he economic unit theory ignores the separate legal status of parent and subsidiary corporations and treats the two as one united entity for the purposes of establishing jurisdiction." Note, Extraterritorial Subsidiary Jurisdiction, LAW & CONTEMP. PROBS., Summer 1987, at 71, 85.
88. For example, one treatise identifies the two central premises for harmonization of company and capital market law as follows:

The first assumes that companies are the most important economic actors within the individual member states, and that they are becoming increasingly active on a transnational basis. The second premise assumes the existence of a substantial connection between the harmonization of company and capital market laws and the advancement of economic integration . . .

BUXXBAUM & HOST, supra note 12, at 167. See also ZAVVOS, supra note 69, at 471-72.
89. Smedresman & Lowenfeld, supra note 36, at 741.
91. Consolidated Supervision Directive, supra note 86, arts. 3-5; Consolidated Accounts Directive, supra note 85, art. 5. The combined effect of these Directives is to ensure that the transnational activities of a credit institution can be accurately reported and monitored. For insightful articles regarding the need for uniform accounting standards in general, see John Hatfield, Regional Recipes for Cooking the Books, 1213 INVESTORS CHRONICLE 61 (1991) (feature article discussing differing systems of
tion, these substantive choice-of-law decisions build opportunities for cooperation between regulatory authorities. The long-term goal is for a convergence of underlying policies in order to minimize normative conflict. Host member states sacrifice some sovereignty in favor of greater consistency and predictability in the rules regulating the financial sector.

For example, the entire BCCI organization, and not its individual member parts, would receive the attention of this new consolidated regulatory structure. This focus would, at a minimum, increase the possibilities for enforcement authorities to detect unlawful activities conducted by the organization. The BCCI example also raises difficult issues of relative enforcement competence and resources. The leadership role of the Bank of England in coordinating an international enforcement action against BCCI increased the perception of the British regulatory system as capable of arresting flagrant abuses of national and international banking norms. However, it simultaneously reduced confidence in the ability of Luxembourg to supervise complex international financial institutions. This perception may have positive repercussions if it leads to increased regulatory competence and resources in those member states with the fewest regulatory means.

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92. First Banking Directive, supra note 11, art. 7(1); Second Banking Directive, supra note 8, pmbl., paras. 14, 25; Consolidated Supervision Directive, supra note 86, pmbl., para. 6.


94. By prescribing binding rules regarding whose laws will dominate enforcement of EC norms, member states agree to cede both prescriptive and police powers regarding bank regulation. Thus, sovereignty is ceded through the legislative process, rather than lost in the enforcement process, since enforcement discretion remains with the member state.

95. Presumably all member states agree as to policies of "ensur[ing] the sound and prudent management of a credit institution" and the implementation of that policy by clearly delineating the scope of each state's regulatory competence. Second Banking Directive, supra note 8, art. 5. This normative choice regarding what the best rules should be becomes a conflicts provision as well. It seeks to prevent conflicts between key regulatory jurisdictions in the application of pre-emptive harmonized standards. Thus, the Second Banking Directive seeks to prevent normative collision as well as normative conflict. Normative collision occurs when there is federal pre-emption of state regulations which "would interfere unduly with the accomplishment of congressional objectives." Hill, supra note 93, at 243-44.

96. The interesting questions that emerge regarding the ability and willingness of regulatory authorities to enforce what seem to be emerging norms in the international financial arena, regarding off-balance sheet accounting, loans to affiliates, other disclosure requirements and, of course, measures of capital adequacy, are beyond the scope of this article.

97. See Forman & Hagerty, supra note 6, at A7.
C. Supervision of Daily Activities

Under the Second Banking Directive, the Host state may exercise limited oversight of local branch banking business conducted by financial institutions authorized outside its own territory. It may supervise the liquidity of the branches, but only “in cooperation with the competent authorities of the home Member State” and only “pending further coordination” measures by the EC.98 It may require that branches provide “the same information as they require from national credit institutions,”99 but such information may not be used as the basis for any enforcement actions; it may be used only “for statistical purposes.”100

The Host member state cannot automatically enforce its laws against noncomplying branches that are regulated by another (Home) state. Instead, the Host state must inform the Home state of the situation and await notification that “appropriate measures” have been taken.101 The Host state can, however, “in the discharge of [its] responsibilities [conduct] on-the-spot verifications of branches established within their territory.”102 This limited power vests the Home state with significant discretion regarding a request for action. The Home state defines the “appropriate measures” in a given situation, and must respond only “at the earliest opportunity.”103 In contrast, the Directive sets explicit deadlines for responding to merger104 and branching105 activities.

The Host state may, however, exercise its regulatory and enforcement powers in certain limited, well-defined situations, but only “after informing the competent authorities of the home Member States. . . .”106 These limitations do not prevent a Host state from taking appropriate

98. Second Banking Directive, supra note 8, art. 14(2). See also id. art. 21(1), which governs the periodic reports a Host state may require for statistical purposes from credit institution branches. Article 21(1) also mandates that Host states provide national treatment to branches regarding the information requested; that is, they may not request more information from branches than is requested of national credit institutions. Id.

99. Id. art. 21(2).

100. Id. art. 21(1).

101. Id. art. 21(3) (“The competent authorities of the home Member State shall, at the earliest opportunity, take all appropriate measures to ensure that the institution concerned puts an end to that irregular situation. The nature of those measures shall be communicated to the competent authorities of the host Member State.”).

102. Id. art. 15(3).

103. Id. art. 21(3).

104. Id. art. 11(1) (a maximum of three months).

105. Id. art. 19(3). Reasons for the denial of access to the Host’s territorial banking market must be provided to the rejected institution within three months. Non-action by the competent authorities in either case creates a cause of action for the rejected institution against those authorities in the local (Home state) courts. Id.

106. Id. art. 21(4) (providing that if an institution persists in violating the legal rules in force in the Host member state, the Host member state, may take appropriate measures to prevent or punish further irregularities).
measures to prevent or punish violations of state laws "adopted in the interest of the general good."\textsuperscript{107}

The extensive consolidation of regulatory control in the Home state ironically increases the power of a single territorially based sovereign over transnational business.\textsuperscript{108} The best examples of the profound extraterritorial reach of Home state regulation arise in the context of bank secrecy and deposit insurance laws. Neither of these areas are harmonized in the EC; however, both are closely connected to monetary policy issues. Each of these areas, and the potential for regulatory arbitrage, are discussed below.

1. Bank Secrecy.\textsuperscript{109} Presently, the laws regarding what information a bank must maintain as confidential, and the penalties associated with illegal disclosure, vary widely between jurisdictions.\textsuperscript{110} Consolidation of regulatory authority in the Home state will minimize potential conflicts between the disclosure laws of member states. However, it is not difficult to imagine a situation where a Host state broadly defines the term information and such information is required by that state "for statistical"\textsuperscript{111} or basic conduct of business purposes\textsuperscript{112} or for other permissible reasons. These informational requirements may force a credit institution to disclose information otherwise protected by the laws of its Home state.

If BCCI was based in a Home state jurisdiction where both the Second Banking Directive and strong bank secrecy laws were in force, consolidated reporting requirements and Home state bank secrecy laws would
Second Banking Directive

protect BCCI from disclosing information regarding its European activities. Obviously, this would hinder enforcement efforts and cause conflict between Host and Home member states. The issue of bank secrecy is raised here merely to illustrate the ease with which fundamental conflicts between bank regulatory jurisdictions can undermine the logic of reallocating regulatory power in the Home state.

2. Deposit Insurance. Deposit insurance systems are not harmonized by the banking Directives; they also vary between jurisdictions. For example, to safeguard local depositors, some jurisdictions might impose any number of additional requirements on a branch operating in its territory. Such requirements could include additional, independent reporting of financial and operating information and payment of insurance premiums to the Host state.

The Second Banking Directive vests the Home state with primary responsibility for prescribing the deposit-guarantee scheme applicable to branches operating outside its territory. But, since deposit protection is not yet harmonized in the EC, Host states may exercise considerable oversight over those branches through their exclusive jurisdiction over branch liquidity and monetary policy issues. Deposit insurance issues could qualify as a monetary policy issue within the meaning of Article 14(2) since the two issues are intimately linked. The monetary policy aspects of this issue will be discussed in greater detail in Section IV.

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114. For example, the United Kingdom uses increasingly complex rules regarding rights of access to British courts when one of the parties is foreign. See generally Peter Kaye, Jurisdiction of English Courts Based upon Choice of English Law, 133 SOLIC. J. 1537 (1989); Peter Kaye, Jurisdictional Discretion of English Courts (1), 134 SOLIC. J. 648 (1990); Peter Kaye, Jurisdictional Discretion of English Courts (2), 134 SOLIC. J. 683 (1990); Peter Kaye, Jurisdictional Discretion of English Courts (3), 134 SOLIC. J. 703 (1990).

115. It should be noted that the EC is working on harmonization of these rules as well. See Deposit-Guarantee Recommendation, supra note 19. See also Smits, supra note 39, at 80; Zavvos, supra note 69, at 505.


117. Id. art. 14(2).

118. The business of banking has long been recognized as incorporating a peculiarly public function: the maintenance of stability and prosperity in the monetary system as a whole. See generally KENNETH SPONG, BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION AND EFFECTS (2d ed. 1985). Until recently, the ambit of a bank's operation was primarily national in scope and the impact of systemic instability in the banking system affected only the national, territorial sovereign. Accordingly, the definition of safe and sound banking operations as measured by solvency and liquidity ratios, conditions for access to the industry, etc., was left to individual states. That parochial view of a bank's public function increasingly faces pressure in today's global capital markets. See STEPHEN Ax-
3. Regulatory Arbitrage.\textsuperscript{119} Although consolidation of regulatory authority will not eliminate all conflicts between jurisdictions, continued differences in supervisory vigilance\textsuperscript{120} should not encourage significant regulatory arbitrage in the post-1992 European banking market for several reasons.\textsuperscript{121} First, the Second Banking Directive specifically states that regulatory arbitrage is a permissible basis for denying or withdrawing bank authorization.\textsuperscript{122} However, most established credit institutions are unlikely to move their state of domicile due to differences in reporting requirements or bank secrecy laws.\textsuperscript{123} It is difficult to imagine a scenario where domestic EC institutions would relinquish decades (if not centuries) of accumulated administrative and political voice in their Home state for anticipated benefits from other jurisdictions. The same holds true for most foreign credit institutions, many of which have been established in the EC for many years. In short, these provisions will most likely apply, as a practical matter, to new entrants in the EC banking market.

\textit{ILROD, INTERDEPENDENCE OF CAPITAL MARKETS AND POLICY IMPLICATIONS (Group of Thirty Occasional Paper No. 32, 1990).}

\textsuperscript{119}. The Second Banking Directive defines the term as follows:

\ldots where factors such as the activities programme, the geographical distribution or the activities actually carried on make it quite clear that a credit institution has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State in which it intends to carry on or carries on the greater part of its activities \ldots

Second Banking Directive, supra note 8, pmbl., para. 12.

\textsuperscript{120}. The Second Banking Directive requires Home member states to mandate that \textquotedblleft every credit institution have sound administrative and accounting procedures and adequate internal control mechanisms.\textquotedblright Id. art. 13(2). Again, the delicate issues of soundness and adequacy are not defined by the Directive and, thus, are subject to national (Home state) interpretation. The Directive also requires member states to delegate to the \textquotedblleft respective competent authorities\textquotedblright in their jurisdiction the optional power to \textquotedblleft adopt or impose \ldots penalties or measures aimed specifically at ending observed breaches\textquotedblright of \textquotedblleft laws, regulations or administrative provisions concerning the supervision or pursuit of their activities.\textquotedblright Id. art. 17.

\textsuperscript{121}. In fact, in a federal system, a strong argument can be made that a certain diversity and competition between jurisdictions is beneficial. Richard A. Epstein, Federalism and Exit, Paper Presented at the 1991 US-Canada Supreme Courts Conference on Constitutional Law (Apr. 4-6, 1991) (forthcoming \textit{LAW & CONTEMP. PROBS.}). See also J.J. Fawcett, \textit{Evasion of Law and Mandatory Rules in Private International Law}, 49 CAMBRIDGE L.J. 44, 50-53 (1990) (finding regulatory arbitrage objectionable only in cases where it creates fundamental unfairness or in cases where it operates against the national interest. National interest is defined as encompassing only rules expressing strong social or economic policies.).

\textsuperscript{122}. The Directive requires the competent authorities in each member state \textquotedblleft not to grant authorization or to withdraw it where \ldots\textquotedblright a banking institution engages in regulatory arbitrage. Second Banking Directive, supra note 8, pmbl., para. 12. See also supra note 119.

\textsuperscript{123}. This is especially true regarding nationalized French or Italian banks. For more information on the nationalization of the French banking sector, see Dominique Borde & William W. Eggleston, \textit{The French Nationalizations}, 68 A.B.A. J. 422 (1982). For more information concerning the new French regulatory structure regarding investment activities, see Alice Pezard, \textit{The New French Financial Regulations}, 134 SOLIC. J. 904 (1990).
Second, harmonizing key aspects of banking regulation in concert with other financial services legislation makes regulatory arbitrage less economically attractive. In other words, even though Host states retain a significant amount of discretion under the Second Banking Directive, the economic incentive to engage in regulatory arbitrage is minimized by the adoption of uniform standards, including uniform minimum levels of "own funds,”124 solvency ratios,125 reserves,126 the holding and acquisition of significant interests in credit institutions,127 and permissible activities.128 The economic incentive has also been affected by the creation of preemptive definitions regarding the corporate structure of financial institutions.129

Third, the consolidation of reporting requirements and supervisory authority in one Home state130 will serve to deny some credit institutions of benefits derived from their corporate structures. No longer can a credit institution like BCCI escape Home state regulation in the EC simply by altering its corporate form.

It is important to note that the Second Banking Directive penalizes only changes in corporate structure intended to evade existing applicable regulatory authority. It does not penalize the initial choice of a permissive jurisdiction as the point of entry into the EC financial services market.131 The inherent tensions created by the preference for branches in the Second Banking Directive and the allocation of regulatory jurisdiction among member states reflects the classic tension experienced by federal unions.132 The first-time entrant’s ability to choose between certain regulatory climates illustrates the flexibility a federal union must provide to its sovereign members.133 Under this scheme, the Second Banking Directive allows credit institutions already established in permissive states (such as BCCI in Luxembourg) to enjoy the more lenient regulatory environment,
if that were their principal place of business and if competition between regulatory jurisdictions did not induce the more permissive state to alter its laws.

Institutions established in permissive states also attain a significant amount of protection from the stricter standards of Host states where they operate branches. As noted, the onus of enforcing laws against fraudulent bookkeeping and reporting would fall on the permissive Home state, which acts with little accountability to the charging Host state.\(^ {134}\)

Since Host states hold only residual regulatory competence, their exclusive jurisdiction extends to regulating monetary policy measures,\(^ {135}\) "the form and content of . . . advertising,"\(^ {136}\) and to carrying out existing laws adopted "in the interest of the general good."\(^ {137}\) Thus, some regulatory arbitrage opportunities will continue to exist, albeit in very limited circumstances.

D. Determining Home v. Host State Status\(^ {138}\)

Because of the potential regulatory disparities between Home and Host states, determining Home versus Host state status is critical. For example, according to press reports, BCCI's principal place of business was London, vesting primary regulatory responsibility with the Bank of England.\(^ {139}\) However, if gross volume of financial activity in the wholesale interbank market, rather than deposit base, defines the principal place of business for a bank holding company,\(^ {140}\) a different answer emerges. BCCI's principal interbank operations were conducted in Luxembourg, and the Luxembourg unit faced an extensive interbank liabil-

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136. Id. art. 21(11).

137. Id. art. 21(5).

138. While this article will focus on the deposit taking function as the most logical indicator of primary residence, alternate indicators of a bank's residence for purposes of regulation include physical location and the location of the parent. Consolidated reporting requirements usually focus regulatory authority on the location of the head office. In addition, regulation of lending activities can also follow the location of the borrower, the lender, or the currency involved. Richard Dale, The Regulation of International Banking 3-4 (1984).

139. BCCI and Mr. Pharaon, supra note 3, at A6.

140. Smedresman & Lowenfeld, supra note 36, at 788.

141. In fact, most interbank business is conducted by multinational credit institutions operating in Luxembourg. Luxembourg's legislators and financial administrators have sought to promote continued use of this market in their territory by providing a number of preferential policies applicable to those multinational banks. See generally Salvatore Mastropasqua, The Banking System in the Countries of the EEC: Institutional and Structural Aspects 43 (1978).
ity exposure when regulators shut down the bank. Estimates concerning the extent of business conducted by BCCI in the United Kingdom vary, characterized as being both small and large.

If the Second Banking Directive was in force, regulatory and enforcement competence might have been vested in Luxembourg, not the United Kingdom. Given the more permissive regulatory climate in Luxembourg and the understaffed nature of its regulatory apparatus, the scandal might have taken longer to uncover, and international enforcement action might have been more difficult to coordinate. This latter point is true given Luxembourg's commitment to protecting the secrecy of its Home bank activities.

However, even if Luxembourg was the Home state, the exceptions to pervasive Home state jurisdiction (advertising, general good, and monetary policy) in the Second Banking Directive would still provide the legal basis for enforcement actions taken by the United Kingdom. The application of these exceptions to the BCCI scandal illustrates the wide discretion remaining in Host states and, of course, the large potential for conflicts of jurisdiction to exist even after extensive harmonization of essential standards. Since the advertising provision is not central to the BCCI example, the following discussion will focus on the remaining two exceptions: enforcement of Host state laws enacted for the general good, and enforcement of monetary policy measures.

1. General Good. Since the Second Banking Directive does not define general good, the possibility for liberal construction of Article 21(5) by national authorities is great. It can include the credibility of the Host state's banking, and regulatory, systems in its state and the prevention of fraud upon Host state depositors and bank customers. Thus, in the BCCI example, if the Bank of England followed the notification channels contemplated by the Second Banking Directive, its competence to act independently of Luxembourg would seem to be permitted. However, the Directive does limit the general good exception to truly idiosyncratic laws that "are not subject to equivalent rules under the legislation or regulations of their home Member States." For example, every EC nation


144. See Gagnon, supra note 109, at 674. See also MASTROPASQUA, supra note 141, at 48.

145. Luxembourg has a full-time bank surveillance staff of 40 that must oversee 180 banks with $350 billion in assets. Forman & Hagerty, supra note 6, at A7.

prohibits the activities in which BCCI allegedly engaged, a fact that would most likely preclude independent enforcement actions by the United Kingdom because its laws would not be idiosyncratic.

Actions taken by the United Kingdom in its capacity as Host state could still fall within the Article 21(5) exception for a more technical reason. The exception in Article 21(5) is broadly addressed to financial institutions. Unlike other provisions or paragraphs of this carefully drafted Directive, the exception is not limited to credit institutions.\textsuperscript{147} Therefore, when the welfare of Host state depositors and constituents might be adversely affected by the reluctance or inability of the Home state to adequately regulate Home credit institution activity, the Host state may enforce its own laws even if they are not idiosyncratic.\textsuperscript{148} Article 21(5) broadly permits:

Host member states to take appropriate measures to prevent or to punish irregularities committed within their territories which are contrary to the legal rules they have adopted in the interest of the general good. This shall include the possibility of preventing offending institutions from initiating any further transactions within their territories.\textsuperscript{149}

The other paragraphs in Article 21 do not clarify the reach of this provision. Only paragraph (1) of Article 21(5) specifically refers to credit institutions; all other sections of Article 21 refer more generally to an institution. This deliberate use of a general term, when a more specific one could be used, indicates the intended breadth of discretion available to Host states acting in the general good, especially with respect to credit institutions.

For example, the Host state also is authorized "in emergencies, [to] take any precautionary measures necessary to protect the interests of depositors, investors and others to whom services are provided."\textsuperscript{150} In such a case, the initiative and discretion for communicating information regarding action taken rests with the Host state.\textsuperscript{151} Thus, returning to the BCCI example, the Bank of England had an excellent basis for undertak-

\textsuperscript{147}. See id. art. 21(5). A credit institution is viewed as having an official monopoly on the deposit taking function. Id. art. 1(1); First Banking Directive, supra note 11, art. 1. A financial institution, in contrast, is defined as "an undertaking other than a credit institution the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in points 2 to 12 in the Annex." Id. art. 1(6). Its U.S. equivalent would be a holding company. For a discussion of the monetary policy implications and the rationale for this distinction in definition and treatment, see infra part IV.


\textsuperscript{149}. Second Banking Directive, supra note 8, art. 21(5).

\textsuperscript{150}. Id. art. 21(7).

\textsuperscript{151}. Id. ("The Commission and the competent authorities of the other Member States concerned must be informed of such measures at the earliest opportunity.").
ing enforcement action, even if it was only the Host state, since its depositors were put at considerable risk through the violation of its fraud and disclosure laws.

2. Monetary Policy. Under Article 14 of the Second Banking Directive, the Host state retains “complete responsibility for measures resulting from the implementation of their monetary policies.” This presents the most troublesome exception to the new regulatory scheme because a number of banking and financing activities directly implicate a nation’s monetary policies and its monetary stability.

The most direct nexus occurs through the protection of depositors since a failed credit institution requires national treasury or insurance fund compensation to promote confidence in the banking system. This is the reason for the distinction between financial and credit institutions in Article 21 of the Second Banking Directive. Indeed, the Second Banking Directive specifically states that the harmonization efforts in the EC financial services field are framed “with the intention, in particular, of protecting consumers and investors.”

Given the scope of the BCCI activities and their impact on depositors in the United Kingdom, the Bank of England easily could have asserted Article 14 as a basis for undertaking unilateral enforcement action against BCCI.

E. Preliminary Conclusions

As the BCCI example illustrates, the discretion remaining in Host states to apply local law raises serious questions regarding the reallocation of regulatory jurisdiction. Major discrepancies continue to exist between national regulatory regimes.

1. Benefits of Concentrating Regulatory Authority in One Home State. At first blush, the regulatory structure constructed by the Second Banking Directive seems to encourage a crazy quilt of overlapping authority that would leave regulators more concerned with observing the niceties of jurisdictional comity than actual regulation of banking activity. However, the concentration of regulatory authority in one state is logical. Such concentration places the burden of oversight on the state with the largest economic interest in the continued viability of the enterprise. In so doing, the EC recognizes the need for some territorial connection between the regulator and the regulated. In most cases, that territorial tie should be linked to the depositor base with respect to retail banking business.

152. Id. art. 14.
153. See supra note 149.
The essential nature of a credit institution is the acceptance of deposits and the use of those deposits in the mobilization of credit. Unlike the credit aspect of banking, the deposit taking function of credit institutions remains linked to a specific territorial location regarding retail depositors. Since the depositors rely on the prudential supervision of their local territorial sovereign to guarantee the safety and soundness of the banking system, those depositors will also turn to their government to compensate them for any losses associated with a failing credit institution.

This normative choice of a lead regulator reflects a concern for bank safety and soundness. Economic efficiency in the bank regulatory context includes in its cost-benefit calculus the benefits derived from high standards of prudential regulation.\(^\text{155}\) The clear choice of a lead regulator also promotes certainty and confidence in the system, while providing a method for resolving potential jurisdictional disputes. Since neither conflict nor choice-of-law provisions in the Second Banking Directive eliminate all differences, sovereign integrity in the different legal systems is preserved.

Thus, the state where the credit institution has the largest retail depositor base will be the state with the largest economic interest in regulating that credit institution in its territory. Should a conflict arise between two states (Home and Host) where the deposit bases are roughly equivalent, presumably the legally mandated cooperation and information sharing provisions would provide the mechanism for those states to broker their oversight and enforcement obligations. The system created by the Second Banking Directive, thus, will permit each member state to share in the regulation of EC financial affairs\(^\text{156}\) while letting the market freely achieve what regulation would otherwise coerce: concentration of regulatory authority in those territorial locations where most of the EC

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155. This view is to be contrasted with the view espoused by the Chicago school which advocates using "market discipline" to arrive at the appropriate level of regulation. See generally Albert J. Bord, Jr., Note, Banking Disclosure Regimes for Regulating Speculative Behavior, 74 CAL. L. REV. 431 (1980). But cf. Helen A. Garten, Banking on the Market: Relying on Depositors to Control Bank Risks, 4 YALE J. ON REG. 129 (1986) (presenting arguments against market discipline as a viable approach in the deposit insurance context). For an explanation of the balance struck between market and regulation in the Second Banking Directive, see Zavvos, supra note 69, at 472.

156. For example, the European Court of Justice has held recently that the First Banking Directive did not impair the power of member states to lay down rules on the legal status of credit institutions. Thus, Italy was permitted to classify employees of credit institutions as "public officials" or as "persons responsible for a public service" for purposes of the application of the criminal law of a member state. Case 422/85, Criminal Proceedings Against Graziano Mattiazzo, 1987 E.C.R. 5413, 5413, 2 C.M.L.R. 482, 482 (1989).
banks are located and where most business is conducted — France, Germany, Italy, and the United Kingdom.\(^{157}\)

2. Problems with Concentrating Regulatory Authority in the Home State. Concentrating regulatory authority in the Home state neither adequately addresses the potential inability of states to meet their allocated regulatory obligations nor permits scrutiny of a credit institution’s activities that have a direct impact on national monetary policy and stability. While logical, the system contemplated by the Second Banking Directive is at its weakest when the Home state is a small one, because the ability of that state to exercise the supervisory and enforcement powers allocated to it may be severely limited.\(^{159}\) This situation raises troublesome questions regarding the viability of the allocation of regulatory jurisdiction by the Directive.

Of course, in the BCCI example, British regulators could be seen as operating in conformity with the consultation provisions of the Second Banking Directive since Luxembourg requested and approved of British leadership in coordinating enforcement activities.\(^{160}\) Indeed, that type of diplomatic concession may become increasingly frequent as member states attempt to comply with the Second Banking Directive’s consultation provisions while also protecting their national interests.

Despite the opportunities for consultation and concession, the fragmentation of responsibilities can undermine the logic of consolidating information flows and oversight roles. The convergence of significant amounts of complicated financial information on understaffed regulatory authorities could mean that the same information is effectively denied to other regulators. Thus, even with diplomatic concessions, British authorities might not have had sufficient information to initiate a coordinated enforcement action.

When viewed in this light, the provisions of the Second Banking Directive become problematic if the state with the largest interest is not

\(^{157}\) Thus, the EC has made territorial connections central to the coordination of international bank regulation. This is consistent with choice-of-law rules that look to specific territorial ties such as the state where a contract was created or performed. See Convention on Jurisdiction and the Enforcement of Judgements in Civil and Commercial Matters, Sept. 27, 1968, 1972 O.J. (L 299) 32. Articles 52(1) and 52(2) base domicile for purposes of judicial jurisdiction on the law of the territory in which domicile is claimed. See id. arts. 52(1)-(2). However, Article 53 chooses the law of the forum to apply to businesses. See id. art. 53. For a thorough discussion of the Convention provisions, see Wendy A. Allwood, The Brussels Convention and International Jurisdiction, 131 SOLIC. J. 1234 (1987).

\(^{158}\) DIXON, supra note 49, at 23.

\(^{159}\) Because of Luxembourg’s lack of regulatory competency, Great Britain, the state with the greatest regulatory capacity, and domestic political interest via 120,000 small depositors, voluntarily assumed enforcement responsibility. Forman & Hagerty, supra note 6, at A7.

\(^{160}\) Id.
the state with the greatest capacity for enforcement. Such a situation could undermine the credibility of prudential supervision even if largely uniform standards govern the system. Although the economic efficiency of the single license is well-documented,\textsuperscript{161} banking regulation also seeks to promote public goods\textsuperscript{162} such as confidence in the banking system as a whole and monetary stability through prudential supervision.

Since conflicts between jurisdictions are not eliminated, the alteration of the traditional basis for enforcing what are now largely uniform standards in the EC must, therefore, seek to promote more than prudential supervision and free provision of services. This alternate focus reveals that two of the main reasons for exercising bank regulatory authority (depositor protection and monetary policy) remain outside the harmonization provisions of the Second Banking Directive.

IV. THE EC'S LONG-TERM AIM: EUROPEAN MONETARY UNION\textsuperscript{163}

The regulatory structure contemplated by the Second Banking Directive cannot be viewed in isolation from the larger economic and political objectives of the EC, including political, economic, and monetary union.\textsuperscript{164} Similarly, any analysis of bank regulations and functions would

\begin{itemize}
\item \textsuperscript{161} See generally The Extraterritorial Application of National Laws (Dieter Lange \& Gary Born eds., 1987) (Report of the International Chamber of Commerce’s Committee on the Extraterritorial Application of National Laws); Cooke, supra note 38, at 20 (adapted from Mr. Cooke’s statement before the U.S. Senate Committee on Banking, Housing and Urban Affairs, June 20, 1990).
\item \textsuperscript{162} See generally Ernst Baltensperger \& Jean Dermine, European Banking: Prudential and Regulatory Issues, in European Banking in the 1990s, supra note 49, at 17, 25-26.
\item \textsuperscript{163} “Monetary and financial integration involves three distinct but interrelated components: (1) the integration of capital movements; (2) the integration of financial services (including banking); and (3) the integration of monetary policy (including exchange rate policy).” Tommaso Padoa-Schioppa, Financial and Monetary Integration in Europe: 1990, 1992 \& Beyond 2 (Group of Thirty Occasional Papers No. 28, 1990). For a detailed bibliography and history of the movement towards monetary union in the EC, see Mike Cooper, The European Monetary System and Economic and Monetary Union, European Access, Oct. 1990, at 37 (bibliographic review). Monetary union has been defined as a currency area where economic policy is managed jointly. Two conditions must exist to create a currency area: (1) exchange rates must be irrevocably fixed or a single currency must exist; and (2) there must be complete and irreversible convertibility of currencies. Interview with Peter Bekx, Administrator, Directorate-General for Economic and Financial Affairs, Commission of the European Communities, in Durham, N.C. (Oct. 7, 1991).
\item \textsuperscript{164} In fact, the link between monetary policy and integration efforts in areas outside the bank regulatory context has been associated with company law. For example, the Draft Company Accounts (Amendment) Directive states, in Paragraph 10, that:
\end{itemize}
be incomplete without an inquiry into the monetary policy role and implications of future regulation in this area. Even though there is a close nexus between capital market activities and monetary policy, neither the EEC Treaty nor the capital market Directives provide the legal basis for forging a formal monetary union. However, the Second Banking Directive may indirectly create the preconditions for political, or formal, monetary union.

This section will discuss the movement towards formal monetary union in several stages. First, it will give a brief sketch of the capital markets and related monetary policy. Second, this section will focus on the EEC Treaty, pointing out that it does not provide the legal basis for monetary union. Third, secondary legislation, which does not expressly provide for formal monetary union, will be analyzed. Finally, the specific role of the new banking regulation scheme in creating a de facto monetary union will be examined.

A. Credit Institutions, Capital Markets, and Monetary Policy: A Brief Overview

The daily activities of a commercial bank implicate monetary policy in three ways. First, a bank mobilizes savings into income-producing loans; the interest rates charged to both activities directly affect the size of the money supply. Regulatory efforts to control this money-creating aspect of a bank’s business usually focus on the amount of reserves required of a bank (those funds, extracted from circulation, cannot contribute to money supply growth) and the interest rate charged to banks for short-term borrowing from the central bank or national Treasury. Second, a bank actively participates in the capital markets to hedge, or cover, the risks it assumes as a lender. Finally, to the extent that the first two
activities render the bank insolvent, the bank must rely on the government to compensate its depositors. Any payout to depositors will also affect the money supply and interest rates.

The existence of openly fraudulent or insolvent banks creates a serious credibility problem for national banking and regulatory systems. Regulatory efforts in this area usually seek to prevent a credibility crisis by providing for periodic review and disclosure of a bank’s financial activities. This information is used to assess any exposure to risk by the government and to estimate the amount of reserves required to counterbalance those risks. These latter regulations are the focus of recent international coordination and can be grouped under the general heading of “capital adequacy.”

The plight of depositors and customers of BCCI illustrates one of the real financial burdens created by under-regulated financial institutions. Whatever the allocation of regulatory jurisdiction, territorially based sovereigns remain responsible to their nationals who are their primary depositors. That responsibility takes two forms — creation of deposit protection schemes (implicit or explicit) and democratic accountability (unhappy depositors are unhappy voters).

In the United Kingdom, for example, the response to the BCCI debacle included a payout from the Deposit Protection Fund (estimated at costing a few hundred million pounds and covering about 40,000 depositors). In addition, initial press reports considered the imposition of a levy upon the United Kingdom’s Big Four clearing banks in an attempt to cover the costs of the payout. The British bankruptcy court charged with liquidating the operations of BCCI in the United Kingdom is considering a separate repayment plan.

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171. Truell & Bray, supra note 1, at A3.


173. Clearing banks stand at the center of the banking system in the United Kingdom. On top of handling deposits, loans, and money transfers, these institutions engage in corporate investment and money market operations and often run finance houses. BANKING STRUCTURES, supra note 49, at 80-82.

174. Truell & Bray, supra note 1, at A3.

175. Bray, supra note 142, at A7; Vaz, supra note 148, at A13.
In other words, Host states can risk serious fiscal imbalances and electoral problems based on the transnational activities of credit institutions regulated by Home states that are insulated from similarly direct economic or political concerns. Both Home and Host states, of course, face the same monetary policy risks, but those risks arise from different sources. The concerns of each state will naturally be focused on local, not foreign, matters.

The provisions in the Second Banking Directive that liberalize capital movements and significantly shift regulatory responsibility expose Host states to considerable risks and require them to relinquish considerable control over their own monetary policies. Viewed from this perspective, it should not be surprising that the United Kingdom ultimately took the lead in coordinating enforcement actions against BCCI: the United Kingdom sought control over a situation that would have profound monetary and political repercussions in its own territory. Had the Second Banking Directive been in force, these actions would have fallen within Articles 14 or 21(5).

B. Treaty Provisions

As noted at the beginning of this article, the EC was created to serve both economic and political purposes through a customs union. Increasingly, free trade in goods implies free trade in financial services and capital movements along with the need to eliminate restrictions in all these areas. Indeed, "capital movements and financial services forge a

176. See generally Baltensperger & Dermine, supra note 162, at 26-33.
177. Brilmayer, supra note 31, at 20-21 (discussing the factors weighing against an extraterritorial application of national law).
178. See generally T.C. Hartley, THE FOUNDATIONS OF EUROPEAN COMMUNITY LAW (2d ed. 1988). As Jacques Delors recently observed, "We are building a Community whose member states jointly exercise a measure of pooled sovereignty through fully fledged common policies. . . . These are the foundations of a community which, because of them, is now moving towards political union, which is the ultimate objective of the Single European Act." Jacques Delors, European Integration and Security, in EUROPEAN ACCESS, June 1991, at 11, 13 (emphasis in original).
179. A customs union is an economic organization between sovereign states who agree to set uniform tariffs for imports from nonmember countries while simultaneously eliminating tariffs for similar imports from member countries. EEC TREATY art. 9. See also General Agreement on Tariffs and Trade, Oct. 30, 1947, art. XXIV(4), 61 Stat. A3, A67, 55 U.N.T.S. 194, 270.
180. Au fur et à mesure que le marché intérieur se consolide avec l'élimination de ces obstacles, le disparité des dispositions applicables à d'autres domaines de la vie économique peuvent porter préjudice à la réalisation des objectifs économiques et sociaux du Traité et rendre nécessaires des mesures communautaires de rapprochement des législations dans le cadre des compétences conferées par le Traité aux institutions communautaires.

Pipkorn, supra note 108, at 23. (Ed. trans.: As the internal market is consolidated by the elimination of these obstacles, the disparity of measures applicable to other economic areas can hinder the realization of the economic and social objectives of the Treaty and render necessary community measures of standardization in the context of competence conferred by the Treaty to the community institutions.)
The direct link between the balance of payments and domestic monetary policy." The legislative efforts in the EC banking sector relate to the EEC Treaty mandate to liberalize capital movements as well as its mandate to provide freedoms of establishment and provision of (financial) services throughout the Community.

The EEC Treaty does not, however, impose a directly binding obligation to achieve monetary union. Article 67(1) of the Treaty merely requires member states to abolish "progressively... all restrictions on the movement of capital... and any discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested." Article 67 covers movements of capital associated with financial operations, focusing on investment of those funds rather than on payments for goods or services. Article 106 covers current payments made in connection with transfers of foreign exchange that constitute consideration for a transaction. Before the late 1980s, efforts to liberalize capital movement were limited to promoting the trade oriented goals of the customs union. The Treaty permits large exceptions to the Article 67 rule for a member state to deal effectively with capital market fluctuations and balance of payment problems.

The traditional division between different types of capital movements and their relation to the financial services sector has blurred in recent years, potentially rendering the distinctions made by the EEC Treaty somewhat obsolete. The high mobility of capital and currencies conducted through credit institutions such as BCCI (transnational actors created to evade regulatory restrictions or oversight) has played a large role in clouding the formerly logical national boundaries. This is why the

181. PADOA-SCHIOPPA, supra note 163, at 2.
182. For an overview of the EC's efforts to liberalize capital movements, see generally EMANUEL GAILLARD ET AL., LE MARCHE UNIQUE EUROPEEN 233 (Editions A. Pendone 1989); Peter Oliver & Jean-Pierre Bache, Free Movement of Capital Between the Member States: Recent Developments, 26 COMMON L. REV. 61 (1989).
183. Case 203/80, Criminal Proceedings Against Guerrino Casati, 1981 E.C.R. 2595, 2637, 1 C.M.LR. 365, 397 (1982). See also GAILLARD, supra note 182, at 233 ("Les mouvements de capitaux ne font l'objet d'aucune définition dans le Traité de Rome, ni dans le droit communautaire dérivé. Cette méthode, consistant à réglementer sans définir, n'est pas propre au droit communautaire."). (Ed. trans.: The movement of capital is not defined in the EEC Treaty, nor does it derive from Community law. This method, regulating without defining, is not unique to Community law.).
184. EEC TREATY art. 67(1).
186. EEC TREATY art. 73.
187. Id. arts. 108-09. This also reflects the view that "[t]rès peu d'Etats se sont estimés assez forts pour prendre le risque, au dehors de toute obligation internationale, d'avoir... une monnaie totalement convertible." GAILLARD, supra note 182, at 235. (Ed. trans.: Very few nations consider themselves strong enough to take the risk, except under international obligation, of having a completely convertible currency.).
European Commission's Director General for Financial Institutions and Company Law recently could link capital movements with financial services despite the formal legal categories that seek to divide the two areas.  

The European Court of Justice (ECJ) has sought to extend the reach of the EEC Treaty provisions as far as possible in recent years, holding that transfers of currency within the EC in connection with certain service-oriented expenses (tourism, business travel, study, or health care) "constitute payments and not movements of capital, even where they are effected by means of the physical transfer of bank notes..." As such, the court ruled, service oriented expenses could not be subject to treaty based restrictions.

However, the ability of the ECJ to extend the reach of the EEC Treaty provisions to create a monetary union remains limited to linking capital movements to the trade in goods: "transfers of bank notes cannot be regarded as necessary for the free movement of goods since it is a method of payment which is not in conformity with standard practice." The perception of the status of standard commercial practice in this area by the ECJ has received mixed reviews by legal commentators. However, the limited holding reflects the EEC Treaty's self-imposed limitations regarding liberalization of capital movements. That is, liberalization of capital movements (upon which monetary union relies) must be concretely connected to trade transactions and, moreover, must impede such transactions before the EEC Treaty will protect or liberalize them. Thus, neither the ECJ nor the EEC Treaty can provide a sufficient legal basis for increased monetary and financial integration through capi-

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188. Our proposals to create a single market in financial services have two main components. First, the sine qua non of a free market in financial services is the complete liberalization of capital movements. . . . Second, we aim to open up the market for financial services by removing barriers to the cross-border marketing of financial services and the free circulation of financial products.


190. Id.


rules which require exporters to have foreign currency payable in respect of their sales paid through a bank and to exchange such currency on the regulated foreign exchange market and which as a result prohibit them from taking payment in banknotes, are not a barrier to the liberalization of payments connected with the movement of goods . . . .

Id. at 4393, 3 C.M.L.R. at 661.


194. See Oliver & Bache, supra note 182, at 73-81, for a more detailed summary of the Court's jurisprudence in this area, and for the conclusion that "[t]he case law of the Court has remained
tal movement liberalization. This is one reason why a separate treaty governing these issues was necessary.

C. Secondary Legislation

Since the EEC Treaty provisions relating to capital movements do not have direct effect in member states, they must be implemented by directives. Like the EEC Treaty, the directives categorized capital movements by referring to their relationship to the goal of achieving a common market for goods and services. Thus, the First Capital Movements Directive created four categories of liberalization. Ultimately, all categories were unconditionally liberalized, thereby laying the groundwork for "the removal of all obstacles to the execution of the capital transactions themselves" in the banking context as well as in the trade arena.

195. EEC Treaty art. 69. See also Casati, 1981 E.C.R. at 2614, 1 C.M.L.R. at 394; Gaillard, supra note 182, at 236-37.


197. First Capital Directive, supra note 196, Annex I, List A-D. The List categories generally follow the Treaty's distinction between current payments in Article 67 and financial operations in Article 106. Thus, wide ranging liberalization is required for presumptively legitimate investment activity in stock exchange transactions as well as for current transactions associated with trade. These lists were merged by the Second Capital Directive to promote financial and monetary integration. Second Capital Directive, supra note 196, art. 2. Of course, such distinctions were problematic from a conceptual viewpoint, since "aux sens large, les mouvements de capitaux se définissent comme des mouvements de fonds liés à une opération financière. Les transactions sont tantôt séparées, tantôt confondues." Gaillard, supra note 182, at 252. (Ed. trans.: In a broad sense, the movement of capital is defined as movements of funds linked to a financial operation. The transactions are at times separated and at times mixed.). For a full discussion of the background and implications of this merger, see Oliver & Bache, supra note 182, at 63-68.


199. Oliver & Bache, supra note 182, at 68.

200. The link between the banking and monetary context, especially with regard to the Fourth Capital Directive, has been articulated as follows in Gaillard: the Fourth Capital Directive ne saurait toutefois être considérée isolément: c’est grâce au jeu conjugué de la libre circulation des mouvements de capitaux et du libre accès aux produits et services financiers légalement offerts et, commercialisés que se réalisera la véritable intégration financière européenne, les États membres de la Communauté constituant alors un espace financier uniifié.

Gaillard, supra note 182, at 244. (Ed. trans.: should nevertheless be considered separately: thanks to the conjugated interplay of free circulation of capital and free access to products and financial
Even with the far-reaching consequences of the Directives, the EC cannot create monetary union by administrative fiat, because complete liberalization of capital movements implies significant shifts in sovereignty beyond the scope of the EEC Treaty. Since the EEC Treaty limits the EC in its efforts to create a monetary union, the Community must proceed cautiously. To stay within the terms of the EEC Treaty, the EC can create the foundation for economic and financial union only by broadening the reach of financial services Directives.

Increased financial interaction through the removal of branching restrictions and the elimination of duplicative administrative obligations will allow the market to create a measure of economic integration that the EEC Treaty cannot demand. The liberalization of capital markets and the consequent interdependence of financial markets can be characterized as a "mutual reinforcing process." Concentration of regulatory authority and financial information in the Home state makes the sharing of sovereign decision making a matter of legal obligation and habit. This, combined with increased cooperation between national regulatory authorities, created the institutional backdrop for formal monetary union.

201. Les mouvements de capitaux (c'est-à-dire les opérations financières qui possèdent leur finalité propre et ne correspondent pas nécessairement à une contrepartie sous-jacente) posent également des problèmes redoutables pour l'imperium étatique. La liberté des paiements en capital peut compromettre la stabilité des taux de change ou déséquilibrer la politique économique monétaire interne des États... Bien que le Traité n'inclus la liberté de circulation des capitaux parmi les libertés de circulation fondamentales, elle n'est pas sur le même plan que celles qui concernent les marchandises, les personnes ou les services.

GAILLARD, supra note 182, at 232. (Ed. trans.: Capital movements (that is financial operations that have their own finality) also present serious problems for the imperium of states. The freedom of capital payments may compromise the stability of exchange rates or destabilize states' internal monetary policies. Although the Treaty included the free circulation of capital among the fundamental freedoms of circulation, it is not on the same plan as those regarding goods, people, or services.).

L'intégration financière de la Communauté devrait conduire les États membres à accepter à terme une intégration monétaire poussée. Seul l'adoption d'une monnaie unique ou de parités fixées entre les devises des États membres, la conduite d'une politique monétaire commune avec la création d'une banque centrale européenne... permettrait en effet de réaliser une véritable Europe monétaire.

Id. at 261. (Ed. trans.: The financial integration of the Community should eventually drive the member states to accept substantial monetary integration. Only the adoption of a single currency or fixed exchange between Member States, the development of a common monetary policy with the creation of a central European bank, would permit in effect, the realization of a true European currency.)

202. See PADOA-SCHIOPPA, supra note 163, at 5 ("the convergence of national regulatory systems... should be brought about by market forces or, to be more precise, by the interaction between market forces and national regulators"). See generally Wilfried Guth, EUROPE IN THE NINETIES: PROBLEMS AND ASPIRATIONS 4 (Group of Thirty Occasional Papers No. 30, 1990) (delivered at a meeting of the European/Atlantic Group in London on March 21, 1990).

203. Interview with Peter Bekx, supra note 163.
As early as 1969, the EC realized the importance of such cooperation, asserting that "consultation should cover any important measures contemplated by a member state which might have a substantial impact on the economies of the other Community countries." The recent remarks of Sir Leon Brittan reflect this broader perspective:

The rapid and reliable movement of goods or services across frontiers must be matched by an equally efficient provision of payment in return if the internal market is to become a reality, particularly for smaller businesses. Furthermore [sic], the progressive move towards economic and monetary union highlights the need for the development of payment and settlement systems which transcend national currency boundaries, so that individuals, tourists or travellers can benefit from lower charges and better services.

Coherent and coordinated monetary policy requires increased cooperation and shared information as "necessary preconditions" for further integration. The Second Banking Directive seeks to promote such policy coordination with the long-term goal of facilitating monetary union.

D. Banking Legislation and De Facto Monetary Union

Just as cooperation between trade authorities and common tariff policies provided the backdrop for EC banking regulation, existing banking and capital movements legislation creates the framework for monetary union by increasing the interdependence of each member state's economy upon cross-border (EC) financial activity through the single license; institutionalizing detailed and regular cooperation between monetary authorities of the member states; and centralizing and consolidating data collection in specific member states.


207. For example, United Kingdom Prime Minister John Major recently articulated a three point British agenda for monetary union. Major's third point was that "... the development of monetary cooperation must depend on much greater progress towards economic convergence between member states. The gaps at present are simply too wide. To rush forward and ignore them would be to risk economic failure." John Major, *The Evolution of Europe, Speech Delivered to the Konrad Adenauer Foundation in Bonn, Germany (March 11, 1991)*, in *European Access*, June 1991, at 7, 9.

Point One stressed the importance of price stability as the "prime objective of monetary policy," *id.* at 9, and Point Two stressed the importance of "free and open markets ... the Community must devote the same energy to its program for the single financial area as to proposals for subsequent stages of the EMU process." *Id.*

208. Alternatively, these can be categorized as harmonization, mutual recognition and Home country control or supervision. Fitchew, *supra* note 188, at 9. In fact, the EC Monetary Policy Committee identified the importance of "greater coordination and consistency of national rules governing financial markets ..." in guiding capital market liberalization efforts in 1985, long before the Second
1. Second Order Consequences of a Single License. On its face, the Second Banking Directive seems to avoid monetary policy issues. But the very avoidance of those issues against a backdrop of comprehensive harmonization suggests separate, more political, rationales for the exclusion.

The political will to coordinate monetary policy and share sensitive national treasury information coalesced as recently as late 1991. The member states implicitly recognized that, to the extent that financial services integration and capital market liberalization create economic interdependence, national attempts to regulate previously national economic sectors will be overrun. The tensions created by that interdependence compel political recognition of irreversible economic ties, creating the political consensus for monetary union.

The Second Banking Directive, then, is likely to create or exacerbate certain jurisdictional conflicts by removing deposit insurance and monetary policy from harmonization. This will occur as financial institutions' cross-border financing activities increasingly put domestic depositors (and national treasuries) at risk. The need to resolve these conflicts is likely to create the requisite consensus to coordinate monetary policies and then formulate a monetary union. This link between coordinated policy and the avoidance of conflicts was identified in the 1982 Monetary Policy Committee Report as a means of furthering capital market liberalization.

2. Monetary Cooperation. Monetary union cannot be created in a vacuum. The pursuit of common monetary policies implies extensive cooperation between nations. It also implies trust in the communications from, and intentions of, participants in the monetary policy dialogue. Trust and candor cannot be created overnight. Nor can they successfully be mandated by law or treaty. Even with a certain degree of de facto

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209. See discussion of Article 14, supra part III.D.2.
210. At the end of September, the EC's Finance Ministers reached agreement in principle on the trickiest points regarding economic union. EC member states would be invited to join the Economic and Monetary Union beginning in 1997 based on meeting certain specific criteria: (1) they must have low inflation rates; (2) their currencies must have fluctuated within a narrow one percent band for at least three years; (3) their deficit to GDP ratio must not exceed three to four percent and (4) there must be convergence in interest rates. Those member states not meeting these criteria would be permitted certain "derogations." The United Kingdom retains the right to decline membership. Interview with Peter Bekx, supra note 163. In early December, the member states concluded a formal treaty concerning these issues in Maastricht, Netherlands. See supra note 18.
211. Interview with Peter Bekx, supra note 163.
212. EUROPEAN COMMUNITIES MONETARY COMMITTEE, TWENTY-THIRD REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE 8, 35 (1982).
economic integration, the process of building trust and the common poli-
cies necessary for realizing monetary union must be a gradual one. In
addition, given the constraints of the EEC Treaty, the coordination of
monetary policies must also be indirect.

The EC possesses two tools for indirectly achieving a coordinated
monetary policy: harmonizing prudential regulation of the banking busi-
ness213 and increasing cooperation between monetary and bank regulatory
authorities.214 As discussed above,215 the Second Banking Directive
creates the framework for communication, consultation, and coordinated
action between bank regulatory authorities. Since many bank regulatory
authorities are also national central banks, the Second Banking Directive
institutionalizes open channels of communication and cooperation re-
garding economic and monetary policy. Of course, the existence of an
institutional framework alone does not guarantee its efficacy. The success
of the system requires considerable political will among the separate
states, and much patience.216

The political will (and legal obligation) for such cooperation can be
found not only in the new treaty and banking Directives, but also in the
capital market legislation. The Fourth Capital Directive directly ad-
dresses the link between banking and monetary activities. Article 2 of
that Directive requires national regulatory authorities to notify the Com-
mission, via the EC Monetary Committee and the Committee of Gov-
nors of the Central Banks, of regulatory efforts regarding liquidity
measures.217 Moreover, Article 2 of the Fourth Capital Directive empow-

213. "A free capital market with maximum harmonization of legal provisions would promote the
development of a unified internal market within the Community." EUROPEAN COMMUNITIES MONE-

214. GAILLARD, supra note 182, at 241 (The Commission's goals in the banking arena are as
follows: "La Commission a souligné qu'une 'liberalisation plus poussée des mouvements de capitaux
dans la Communauté devrait servir trois objectifs: donner au marché unique une dimension
financière, assurer la stabilité monétaire, favoriser le développement économique de la Communauté
en assurant une répartition optimale de l'épargne européenne.' "). (Ed. trans.: The Commission has
stressed that a greater liberalization of movements of capital in the Community should serve three
goals: (1) to give a financial dimension to the single market; (2) to assure monetary stability; and (3)
to aid economic development of the Community by insuring an ideal distribution of European
Savings.).

215. See supra part III.

216. For example, the member states spent three years trying to coordinate their actions vis-à-vis
BCCI. This is a problem endemic to the nature of communication between bureaucracies and other
actors seeking to further their own parochial interests. Crovitz, supra note 67, at A9; Kenneth A.
Bacon, Multinational Banks Are Likely to Face Stricter Oversight in the U.S. and Europe, WALL ST. J., Aug.

217. Fourth Capital Directive, supra note 196, art. 2. It should be remembered that the liquidity
measures at issue (capital adequacy requirements, limits on the type and quality of risk exposure, etc.)
are the same as those dealt with by the Solvency Ratio Directive, supra note 81, and the Basle Ac-
 cords, supra note 170.
ers the Commission to decide whether such measures taken by national bank regulatory authorities are necessary for the purpose of monetary regulation.  

V. CONCLUSION

The Second Banking Directive seeks to facilitate monetary integration by creating clear lines of regulatory authority. To that end, it also creates clear rules for sovereign cooperation and joint decision making over matters with a strong monetary component. These rules eliminate some of the regulatory discrepancies which BCCI manipulated to escape effective oversight for many years. They also indirectly promote the formation of a monetary union.

Merely eliminating branching restrictions by creating a single license would not provide the certainty and cooperation between government officials that is necessary to form the foundation for monetary union. As the BCCI example illustrates, significant monetary policy issues remain outside the reach of the Second Banking Directive. The development of clear rules regarding prescriptive and enforcement competence promotes the long-term goals of the EC in the financial arena by making commonplace the sharing of sovereignty over regulatory and monetary matters.

218. Fourth Capital Directive, supra note 196, art. 2. It should also be noted that the European Commission plans to set up two committees to study the payments system in the EC: one will focus on technical issues, and the other will represent the banking sector (including banking customers). Thomson, supra note 205, at 22.

219. As one commentator has noted, "[T]he distinction between provisions designed to ensure bank solvency on the one part, and to regulate monetary policy on the other, is not always an easy one to make." Marc Dassess, Retail Banking Services in 1992, in THE SINGLE MARKET AND THE LAW OF BANKING, supra note 39, at 51, 65.

"It is true that [monetary union] will mean transfers of sovereignty, particularly with the creation of a European Central Bank. But this is not so much a great leap forward as a logical consequence of the success of the European Monetary System... [European union] cannot be achieved unless the Community acquires a distinct political identity and the influence derived from economic strength. The two are intimately linked.

Delors, supra note 178, at 13.