EUROPE – 1992 AND ALL THAT
A GOOD THING, EVEN FOR AUSTRALIA

by MICHAEL SUTTON

The ambitious vision of a unified European economy by 1992 has already cleared away many of the obstacles to efficient and frontier-less financial services. However, more hurdles remain to be overcome.

At the end of the classic little parody 1066 and All That, by Sellers and Yeatman, America is declared top nation and History comes to an end. The reason for this abrupt end is simple: England’s demise — and, it might be added, Europe’s too — after the Great War. Now, towards the end of the century, we are witnessing a determined effort on the part of the European Community’s member States to stave off their continent’s relative decline by forging their association into an organisation of a more far-reaching nature than that hitherto realised; i.e., essentially just a customs union armed with a protectionist common agricultural policy.

Thus the EC “internal market” program, which was launched in 1985, promises for the end of 1992 “an area without internal frontiers in which free movement of goods, services, persons and capital is ensured.” In view of the many official declarations and the attendant publicity that have held out 1992 as an epoch-making year, it appears that EC national governments have concluded that the cause of European economic and monetary union is not merely a pious aspiration but, in Sellar’s and Yeatman’s immortal brief words, unreservedly a Good Thing.

If the razz-ma-tazz is disregarded and a dose of scepticism is allowed about the realism of the end-1992 deadline for the implementation of the entire program, what does it mean for the securities industry? A cynical answer might be: Not much. After all, the internationally minded London Stock Exchange will continue to dominate the European stockmarket scene. And, in addition, EC law has ordained ever since 1962 that residents of all member States are free to acquire foreign securities quoted on their national stock exchange.

Yet this quick answer would be wrong. The uncontested pre-eminence of London and the long-established listing of foreign securities on the smaller stock exchanges of continental Europe are only part of the story. Important changes are now under way.

First, a sea-change is taking place in the regulatory framework for the EC financial services industry. The guiding spirit is provided by Completing the Internal Market, the seminal EC White Paper of June 1985. In this document, the earlier-pursued and over-ambitious idea of completely harmonising the national legislation of member States is abandoned in favour of an emphasis on a minimal coordination of rules to facilitate the exchange of what are termed “financial products.” All that need to be strictly harmonised, argues the White Paper, are certain basic prudential rules and essential surveillance standards. There should be mutual recognition of the way in which these standards are applied in different member States, and

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the way should then be paved for the application of the principle of "home-country control"; i.e., the principle that all the activities of a financial institution throughout the EC, whether carried out by a branch or by cross-frontier provision of services, are to be supervised by the authorities of the EC member State in which that financial institution has its head office or parent subsidiary.

In short, particularly as regards the supervision of on-going activities, the principle of "home-country control" should replace the more traditional practice of leaving such authority in the hands of the host country.

Apart from charting a general approach for completing the internal market, the 1985 White Paper lists some 300 proposals for tabling by the EC Commission and for adoption by the EC Council of Ministers before the end of 1992. The list itself takes the form of a timetable and, as such, it has usefully concentrated the minds of EC national governments.

Twenty-one of the listed proposals directly concern financial services (eight under the heading of "banks", nine under "insurance" and four under "transactions in securities") and a further three relate to capital movements. Their overall aim is clearly put in the White Paper itself: the ready access of firms and private individuals throughout the Community to efficient financial services, with the decompartmentalisation of financial markets boosting economic development by promoting the optimum allocation of European savings.

By the end of 1988, most of the proposals covering financial services, with some variations from the original plan, had been tabled by the commission, although a substantial number of them still awaited adoption by the Council of Ministers before becoming EC law. As for the liberalisation of capital movements, the commission's proposals — more ambitious than those originally presented in the White Paper — had not only been tabled but also adopted.

It is fitting, first, to consider briefly the intra-EC liberalisation of capital movements inasmuch as it is clearly the precondition of the free movement of financial services.

Ever since the early 1960s, capital movements have been virtually free of exchange control restrictions in West Germany and the Benelux countries (Belgium, the Netherlands and Luxembourg). Together, they have constituted what might be loosely termed a deutschmark currency area because in the past 15-year period of floating exchange rates the smaller countries' currencies have been closely pegged to that of Germany.

In 1979, which was the first year of Conservative government under the premiership of Mrs Margaret Thatcher, the United Kingdom abruptly dismantled its formidable battery of controls over capital movements to and from the country (though there was no decision to lock sterling into the EMS exchange-rate mechanism). Denmark largely followed suit in the matter of capital movement liberalisation, even if not dismantling everything, in 1983-85. However, still in 1985, France and Italy — not to speak of Greece and Ireland — maintained severe exchange control restrictions on capital movements. For two of the four largest EC national economies, therefore, the freedom of movement of capital was greatly limited.

This was despite Article 67 of the Treaty of Rome, the founding charter of the European Economic Community, signed 32 years ago, which enjoins the full liberalisation of capital movements "to the extent necessary to ensure the proper functioning of the common market." In fact, even in 1985, this treaty article had been only partially implemented; a long hiatus had followed the initial strides taken in 1960 and 1962.

One result of this, at the time the 1985 internal market program was launched, was that the mandatory liberalisation of capital movements had not been extended to all types of securities transactions, notably capital movements in connection with the actual issuing of securities on EC stock exchanges as well as investments in unlisted securities and in mutual funds or the like.

Another result was that capital movements in connection with banking, apart from short and medium-term foreign trade finance, had been liberalised scarcely at all under EC law.

The main reason for this halt of more than 20 years to the progressive implementation of Article 67 of the Treaty of Rome was the monetary turbulence generated, first, by the slow breakdown of the Bretton Woods system in the late 1960s and early 1970s and, then, by the advent of floating exchange rates in an international economic environment marked by a long-running energy crisis. It was only in the mid-1980s, at roughly the time the EC internal market program was in preparation, that it became widely perceived that the participants in the EMS exchange-rate mechanism had really succeeded in creating a zone of relative monetary stability — on an apparently lasting basis, to judge by their experience since 1979 — for a large part of the EC area and hence that there was room for new endeavour in the field of capital-movement liberalisation.

Advance in the implementing of Article 67, it should be added, was only part of the challenge. France and Italy — as well as Greece and Ireland — were in 1985 still maintaining restrictions on capital movements that should normally have been liberalised by virtue of the first directives adopted in 1960 and 1962 for the implementation of the same treaty article. In France, for instance, there was an investment currency premium system discouraging the acquisition of foreign securities, not to speak of a host of other restrictions on direct investments and personal capital movements.

Such restrictions on the part of these EC member States were given legal validity through permanent recourse to another article of the Treaty of Rome which allows a member State to take protective measures when it runs into balance-of-payment difficulties.

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The vigorous deregulation pursued by the Chirac government in its first nine months in office included the lifting of a range of exchange control restrictions, with the result that after December 1986 the only two major restrictions were on French residents' opening foreign-currency bank accounts abroad and on French banks' francdenominated lending to non-residents. In the case of Italy, the exceptional arrangements expired in principle at the end of 1987.

At the end of 1988 it was Ireland's turn, and it no longer has recourse to the balance-of-payments safeguard clause. Therefore, of the EC Ten, only Greece now has recourse to the clause, while Spain and Portugal — which joined the community at the beginning of 1986 — are largely exempt, by virtue of transitional arrangements written into their Act of Accession, from the obligation to liberalise capital movements (though this will start to change at the end of 1989 and, much more noticeably, at the end of 1990).

In step with the expiry of the exceptional arrangements for France and Italy, the task of fully implementing Article 67, in the wider framework of the internal market program, was resolutely taken up from 1986 onwards. Thus, November 1986 saw the adoption by the Council of Ministers of a directive extending the liberalisation of capital movements to all transactions in shares, bonds and UCITS (undertakings for collective investment in transferable securities) units as well as to long-term foreign trade finance. This directive entered into force at the end of February 1987.

Then, in June 1988, the final directive for implementing Article 67 was adopted. It extends the liberalisation of capital movements to mainstream banking activities (i.e., current and deposit account operations, financial loans and credits) and to money market investments (e.g., in treasury bills and negotiable commercial paper). For the original EC Six with the UK and Denmark, this liberalisation will become mandatory on July 1, 1990.

For Spain and Ireland, the full implementation of the directive may be delayed until the end of 1992 itself, while Greece and Portugal may be granted a further stay of three years.

This June 1988 directive lays the ground for a fully integrated EC banking area. The ensuing freedom to transfer bank funds anywhere in the community will no doubt facilitate the making of securities transactions on an EC-wide basis, especially on the part of the small, private investor whose horizon has been almost exclusively national.

The market for UCITS

UCITS in EC jargon stands for "undertakings for collective investment in transferable securities"; it is an umbrella term that covers mutual funds, unit trusts, investment trusts and French labelled SICAVs (or open-end investment companies).

A directive adopted in December 1985 by the Council of Ministers will allow any EC-based UCITS to market its units across the community freely from October 1, 1989. The provisions of this directive will be underpinned, of course, by the directive of November 1986 liberalising inter alia capital movements in connection with operations in UCITS units.

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For the financial sectors in a number of EC member States, the month of October 1989 will therefore be an important one. This is so of the UK, with its legions of unit trusts. It is also true of Luxembourg, where the tax regime is particularly favourable for mutual-fund and SICAV operations.

More important still, because of its wider scope, is the proposal for a "second banking coordination directive" that the EC Commission tabled in February 1988. The "first banking coordination directive", adopted in 1977, had established the main conditions for freedom of establishment. But the proposed new coordination directive is designed to transform, according to the spirit of the 1992 program, the regulatory environment for Western European banking.

In particular, it will give effect to the principle of home-country control. On present showing, it seems likely to be adopted some time in 1990, although the date could be even a little later and its full application may be delayed anyway until the end of 1992.

What is pertinent to note for the securities industry is that EC banks — once they have been authorised through a new EC single banking licence — will be allowed, when there is appropriate home-country control, to engage in a very wide range of financial activities across the community (either by setting up branches in other member States or by providing cross-frontier services).

The commission itself has stressed that the list of permissible activities has been drawn up on a liberal "universal banking" model and that the most farreaching aspect of the list is the inclusion of all forms of transactions in securities. Thus, in the proposed second banking coordination directive, the "statement of business which is integral to banking shall be included within the scope of mutual recognition" includes the following:

- trading for own account, or for the account of customers, in securities and also in money-market instruments and in financial futures and options;
- participation in share issues and the provision of services related to such issues;
- portfolio management and advice; and
- safekeeping of securities.

This large freedom for the banking sector in the sphere of securities will serve no doubt to accelerate a development that has been evident in Europe for some time — namely, the leading banks' strengthening their position on the securities markets through the acquisition of major stockbroking firms.

As is well-known, it was a notable feature of the various changes associated with the "Big Bang" in London in October 1986. In Paris, to take another example, it is an ongoing process: both French and foreign banks have been taking shareholdings in Paris brokerage firms (at present the maximum permissible stake is 30 per cent but this will rise to 100 per cent on January 1, 1990), and, for those banks that have the patience, the monopoly enjoyed by these brokerage firms will anyway cease at the end of 1991.

Closely related to the second banking coordination directive, and indeed serving as an extension of it, is the proposal for a directive on "investment services in the securities field," which
was tabled by the EC Commission at the end of 1988. Basically, it covers the activities of non-bank securities firms and applies the same principles of mutual recognition and home country control. A draft of this proposal was discussed in Brussels at the end of June 1988, and it was already clear that it was bound to be a controversial one, notably because of the strong reticence it has provoked in the City of London. As a result of the Financial Services Act of 1986 and the creation of the Securities and Investment Board (SIB), the UK now has rules on capital adequacy and the conduct of securities business that are stricter than anywhere else in the community. But, in applying the principles of mutual recognition and home-country control, this draft directive raises the prospect of securities firms established in other EC member States (and possibly of non-EC origin) being able to compete in London under much less onerous supervisory requirements.

An additional worry for all EC non-bank securities firms is the more advanced state of the second banking coordination directive which could mean that banks would have a head-start in carrying out their securities business on a truly European basis. The commission, however, would like to see the two directives implemented simultaneously. **Problem of taxation**

Apart from the acute problem of the limits of the application of the principle of home-country control, another problem needs to be squarely tackled if a fully integrated European financial services area is to become a reality. This is the problem, once the final stage of the liberalisation of capital movements comes into effect, of the increased risk of tax evasion and — to use the French term — *délocalisation de l'épargne*, i.e., savings transfers of sizeable macro-economic dimension from one country to another that are dictated purely by tax reasons. The increased risk arises because residents of all EC member States will eventually have the right to pay investment income into non-resident bank accounts held elsewhere in the community; there will therefore be greater scope for these residents not to declare the income in question, and there might be significant shortfalls in tax receipts for some national governments. The risk is more in the case of income arising from interest from bonds or bank deposits than in that of income from dividends, and it is heightened by the frequent practice in member States of applying withholding taxes on interest income paid to residents but not on that paid to non-residents.

Because of this problem, the next few years may possibly see a decision by EC member States to introduce a generalised withholding tax, levied at a relatively low rate, which would be applied to all residents and non-residents alike, or at least to all community residents. **Sterling and the EMS?**

The final step of the liberalisation of capital movements, through its freeing of banking operations in respect of the French franc and the Italian lira, will also have major implications for the functioning of the EMS exchange-rate mechanism. It was partly for this reason that the EC heads of government decided at their meeting in Hanover at the end of June 1988 to set up a high level committee whose task will be to report back, towards the end of the first half of 1989, on concrete steps that should be taken before the end of 1992 to further European monetary union.

Given that monetary union is thus also an aspect of the internal market program, the question of sterling's participation in the EMS exchange rate mechanism — until relatively recently a bone of contention within the British government itself — is not one that can be easily shelved. If it were to prove possible to bring sterling into this exchange-rate mechanism, it is a truism to say that the volatility of sterling against the deutschemark and other EMS currencies would be greatly reduced.

The scope for such change is indicated by the accompanying chart which shows the volatility of sterling since the EMS's inception in March 1979. Sterling's full membership of the EMS —

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**Deutschemark Exchange Rate**

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Good Thing.