Banking Integration in the European Economic Community: Impact on the Eurodollar Market

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I. INTRODUCTION

This Comment discusses the European Economic Community's (EEC) Second Banking Directive, which is designed to integrate banking activities within the EEC by the end of 1992, and the impact bank integration will have on the Eurodollar market. The banking systems of EEC Member States are being integrated in order to encourage competition. Increased competition is expected to cause a reduction in the costs of financial services provided within the EEC. The Member States believe that bank integration is an essential

1. Treaty Establishing The European Economic Community, opened for signature Mar. 25, 1957, entered into force Jan. 1, 1958, 298 U.N.T.S. 11. The aim of the EEC is to “promote throughout the Community a harmonious development of economic activities.” Id. at art. 2. The Treaty, also known as the Treaty of Rome, stated that the goal of the European Economic Community [hereinafter EEC] was “the abolition, as between Member States, of the obstacles to the free movement of persons, services, and capital.” Id. at art. 3(c). The EEC currently consists of 12 Member States: Belgium, Denmark, the Federal Republic of Germany, Great Britain, Greece, Ireland, Italy, Luxembourg, Portugal, Spain, and the Netherlands. Whitehead, Moving toward 1992: A Common Financial Market for Europe?, FED. RESERVE BANK OF ATLANTA, ECON. REV. 42, 43 (Nov.-Dec. 1988) [hereinafter Whitehead].


3. See infra notes 121-34 and accompanying text (defining Eurodollar and the Eurodollar market).

4. See infra notes 9-15 and accompanying text.
element in creating a single market throughout the community for goods, services, and labor. Creating a single market will enhance the economic performance of Member States, which has lagged behind that of the United States and Japan in recent years.\(^5\) Banking integration has proven to be a difficult process because the structures and traditions of banking systems within Member States are diverse.\(^6\) The Second Directive allows EEC based banks greater access than is currently permitted to the banking markets of other Member States. The Annex\(^7\) to the Second Directive lists activities that may be carried out by EEC based banks operating in other Member States under the new integrated banking system.\(^8\)

The Second Directive's approach to banking integration as well as the directive's impact on non EEC based banks are the topics under discussion in the second section of this Comment. The third section describes the international banking transactions that create Eurodollars. The fourth section provides an historical overview of the development of the Eurodollar market, compares the approaches to bank regulation taken by Great Britain and West Germany, and predicts how the Second Directive should change banking laws in both of these countries. The fifth section analyzes the impact banking integration will have on the Eurodollar market by examining the effects on depositors, borrowers, and banks.

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5. A comparison of several key economic indicators shows that the EEC has a higher rate of unemployment and a lower per capita GNP than either the United States or Japan. The EEC is exporting more goods to the United States than the United States is exporting to the EEC. However, the Japanese are exporting more goods to the EEC than the EEC is exporting to Japan. All figures are for 1988 and in U.S. dollars unless otherwise noted.

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<th>U.S.</th>
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6. See infra notes 193-254 and accompanying text.
7. See infra note 26 and accompanying text.
8. See infra notes 36-42 and accompanying text.
II. Banking Integration Under the Second Directive

A. The Objectives of Banking Integration

In 1985, the EEC adopted the Single European Act (SEA)\(^9\) as an international agreement among the Member States of the EEC.\(^{10}\) The SEA embodies the desire of EEC Member States to make "concrete progress towards unity."\(^{11}\) Member States recognize the need for open and efficient financial markets in an increasingly competitive global financial market.\(^{12}\) The Second Directive, effective January 1, 1993,\(^{13}\) states that there is an intimate link between banking liberalization and the free movement of capital and that banking activities should be coordinated with other directives liberalizing the capital markets.\(^{14}\) By allowing EEC based banks to provide financial services throughout the Community, the Second Directive should promote growth and efficiency in the banking industry making EEC banks stronger competitors within the EEC as well as in the world market.\(^{15}\)

Currently, the banking laws and regulatory systems established in each EEC Member State reflect such factors as geographic location, expertise of banking professionals, and the relationships between the central banks\(^{16}\) and their respective bank-
ing systems. Reflecting the individual differences in each Member State's banking traditions and regulations, the relationships between bank supervisors and central banks among the Member States are often inconsistent. The laws and regulations adopted by each EEC Member State for supervising foreign branches and foreign bank subsidiaries are often inconsistent as well. Each country's supervisory system emphasizes regulation of different aspects of the international lending process. The First Banking Directive attempted to centralize the supervision of EEC banking activities. However, Member States realized that implementing comprehensive uniform regulations throughout the EEC was impractical. Furthermore, due to the different regulatory policies of the Member States, uniformity was deemed impossible to achieve within a reasonable time period.

Unlike the First Directive, the Second Directive adopts an approach of mutual recognition whereby EEC Member States honor the...
banking laws, regulations and administrative or supervisory practices of other Member States. The Annex to the Second Directive lists those activities which credit institutions may provide throughout the Community. Essentially, the Second Directive is a passport for EEC based banks to operate in other Member States subject to the supervision of the bank's home country.

at 574. However, it is more accurate to state that the Second Directive requires mutual recognition by Member States of banking licenses issued in other Member States. Each Member State will continue to issue separate banking licenses. See Gruson & Nikowitz, supra note 15, at 213, stating:

Thus, the Second Directive does not create a European "federal" banking license; it decrees that each Member State's banking license shall be valid throughout the EEC. . . . The principle of mutual recognition gives credit institutions licensed in one Member State access to all Member States. This EEC-wide access creates an inter-Member State banking market, which differs from the single-state U.S. banking market.

Id. 25. Second Directive, supra note 2, at art. 1; see also Key, Integration of the Financial Sector, supra note 23, at 602 (mutual recognition prevents national laws from restricting bank access to Member States).

26. The Annex to the Second Directive lists "(b)usiness which is integral to banking and shall be included within the scope of mutual recognition." Second Directive, supra note 2, at annex. Those activities are:

1) Deposit-taking and other forms of borrowing
2) Lending ((i)ncluding in particular: consumer credit, mortgage lending, factoring and invoice discounting, trade finance (including forfeiting))
3) Financial leasing
4) Money transmission services
5) Issuing and administering means of payment (credit cards, travellers cheques and bankers drafts)
6) Guarantees and commitments
7) Trading for own account or for account of the customers in:
   a) money market instruments (cheques, bills, CDs, etc.)
   b) foreign exchange
   c) financial futures and options
   d) exchange and interest rate instruments
   e) securities
8) Participation in securities issues and the provision of services related to such issues
9) Money broking
10) Portfolio management and advice
11) Safekeeping of securities
12) Safe custody services.

Id. 27. A "credit institution" is defined as an "undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account." First Directive, supra note 21, at art 1. The use of the word "bank" is synonymous with the term "credit institution." While the Second Directive uses the latter term, this Comment will use the word "bank" throughout.

28. See Gruson & Nikowitz, supra note 15, at 211; Zavvos, Banking Integration, supra note 12, at 574.

29. Zavvos, Banking Integration, supra note 12, at 574. "All the activities of banks and other financial institutions carried out through branching or on a cross-frontier provision of services throughout the Community's territory, in principle, will be supervised by the competent authorities of the Member State of the institution's head office." Id.
The Second Directive does not create a uniform system of banking law throughout the EEC.\textsuperscript{30} Rather, the Second Directive creates a few essential regulatory and supervisory standards which will be uniform throughout the EEC.\textsuperscript{31} Harmonization of additional banking regulations and supervisory standards is an ongoing process and Member States disagree on the extent of supervision mandated in the Second Directive.\textsuperscript{32} In those areas where there is no agreement, each Member State will continue to regulate its respective banking system in the manner it deems most prudent.\textsuperscript{33} The Second Directive attempts to improve the efficiency of EEC banking through increased competition, with individual Member States continuing to supervise banks in areas not covered by the directive.\textsuperscript{34} This approach preserves stability and confidence in the banking systems of the Member States.\textsuperscript{35}

\textbf{B. Mutual Recognition of Banking Licenses and the List of Banking Activities Under the Second Directive}

The Second Directive no longer requires a bank seeking to open a branch\textsuperscript{36} in another Member State to obtain host Member State\textsuperscript{37} authorization.\textsuperscript{38} Instead, a bank wishing to establish a branch in

\begin{enumerate}
\item Id.
\item Gruson & Nikowitz, supra note 15, at 211.
\item According to one commentator:
Mutual recognition cannot simply be decreed among a group of countries with widely divergent legal systems, statutory provisions, and regulatory and supervisory practices. Mutual recognition of rules that differ as to what a country regards as essential elements and characteristics would be politically unacceptable. As a result, a crucial prerequisite for mutual recognition is the harmonization of essential rules. If member states consider certain rules essential but cannot reach agreement on initial harmonization, they may agree explicitly to exclude such rules from mutual recognition and home-country control until agreement can be reached.
\item Key, Integration of the Financial Sector, supra note 23, at 602.
\item Id.
\item Zavvos, Banking Integration, supra note 12, at 573.
\item Id.
\item A “branch” is defined as a:
place of business which forms a legally dependent part of a credit institution and which conducts directly all or some of the operations inherent in the business of credit institutions; any number of branches set up in the same Member State by a credit institution having its head office in another Member State shall be regarded as a single branch,
\item First Directive, supra note 21, at art. 1.
\item Second Directive, supra note 2, at art. 3. “Host Member State” is defined as the “Member State where a credit institution has a branch or into which it supplies services.” Id. at art. 1.
\item Id. at art. 5, ¶ 1. “Authorization” is defined as any “instrument issued in any form by the authorities by which the right to carry on the business of a credit institution is granted.” First Directive, supra note 21, at art. 1.
\end{enumerate}
another Member State shall give notification to the competent authority\textsuperscript{39} of the bank's home Member State.\textsuperscript{40} Home Member State authorization allows a bank to provide services on an EEC-wide basis if these services are permitted by the home Member State in the bank's license and listed in the Annex to the Second Directive.\textsuperscript{41} Therefore, a bank may conduct activities permitted by both the home Member State and the Annex in the host Member State even if the host Member State prohibits domestic banks from conducting that particular activity.\textsuperscript{42}

All banks wishing to establish a branch in another Member State must provide certain information to the home Member State.\textsuperscript{43} This information includes the name of the Member State where the bank intends to establish a branch,\textsuperscript{44} a list of the types of business contemplated, and the structural organization of the business.\textsuperscript{45} Banks that are opening a branch in another Member State for the first time must additionally notify the home Member State of the activities listed in the Annex which it intends to undertake in the host Member State.\textsuperscript{46}

Before establishing a branch, banks must also provide financial information about the amount of own funds\textsuperscript{47} and the solvency ratio\textsuperscript{48} to the home Member State.\textsuperscript{49} Banks must provide the business address in the host Member State where documents can be obtained and the

\textsuperscript{39} "Competent authority" is defined as the "national authorities which are empowered by law or regulation to supervise credit institutions." \textit{Council Directive of 13 June 1983 on the Supervision of Credit Institutions on a Consolidated Basis}, art. 1, 26 O.J. EUR. COMM. (No. L 193) 18 (1983) [hereinafter \textit{Supervision of Credit Institutions}].

\textsuperscript{40} \textit{Second Directive}, supra note 2, at art. 17, ¶ 1. "Home Member State" is defined as the "Member State where a credit institution is authorized... ." \textit{Id.} at art. 1.

\textsuperscript{41} \textit{Id.} at art. 16; see also Gruson & Nikowitz, supra note 15, at 213-14 (home Member State license only valid for activities enumerated in Annex); Zavvos, \textit{Banking Integration}, supra note 12, at 575-76 (banks must be authorized by home Member State and conduct activities in Annex to operate throughout EEC).

\textsuperscript{42} Zavvos, \textit{Banking Integration}, supra note 12, at 576.

\textsuperscript{43} \textit{Second Directive}, supra note 2, at art. 17, ¶ 2.

\textsuperscript{44} \textit{Id.} at ¶ 2(a).

\textsuperscript{45} \textit{Id.} at ¶ 2(b).

\textsuperscript{46} \textit{Id.} at art. 18, ¶ 1.

\textsuperscript{47} "Own funds" is defined as the "credit institution's own capital, including items which may be treated as capital under national rules." \textit{First Directive}, supra note 21, at art. 1.

\textsuperscript{48} \textit{See Proposal for a Council Directive on Solvency Ratio for Credit Institutions}, 31 O.J. EUR. COMM. (No. C 135) 4 (1988). Solvency ratios weigh assets and off-balance sheet transactions (those transactions that do not have to be reported in financial statements presented to regulatory agencies) according to the degree of credit risk. Solvency ratios play a central role in the prudential supervision of credit institutions and are directly complementary to the goals of the Second Directive. \textit{Id.} at art. 4.

\textsuperscript{49} \textit{Second Directive}, supra note 2, at art. 17, ¶ 2(c).
names of those responsible for controlling the activities of the branch.\textsuperscript{50} The home Member State will relay the above information to the competent authority of the host Member State within three months after receiving the information, unless the home Member State has reason to doubt the adequacy of the organizational structure of the bank.\textsuperscript{51} When the home Member State refuses to relay the above information to the host Member State, the home Member State is required to give reasons for its refusal to the bank seeking to open a branch in another Member State.\textsuperscript{52} This refusal may be appealed in the courts of the home Member State.\textsuperscript{53}

The Second Directive does not mandate that Member States allow their domestic banks to perform the activities specified in the Annex.\textsuperscript{54} However, failure by one Member State to allow its domestic banks to conduct banking activities which that Member State must permit other EEC based banks to conduct results in reverse discrimination against domestic banks.\textsuperscript{55} Banks based in those Member States which allow the banking activities contained in the Annex will have a competitive advantage over those Member States with more restrictive banking practices.\textsuperscript{56} EEC Member States will compete to adopt the most favorable banking measures, commonly referred to as "the race for the bottom."\textsuperscript{57} The force of competition should drive Member States with more restrictive banking regulations to adopt the less restrictive measures in the Second Directive.\textsuperscript{58} In time, all Member States will most likely issue banking licenses allowing those activities set forth in the Annex in order to eliminate the initial competitive advantage enjoyed by banks from Member States which currently permit those activities. The Annex, in combination with the race for

\textsuperscript{50} Id. at § 2(d), (e).
\textsuperscript{51} Id. at § 3. "Unless the competent authority of the home Member State has reason to doubt the adequacy of the organizational structure of the credit institution, taking into account the envisaged operations, it shall ... communicate the information ... to the competent authority of the host Member State." Id. This language is ambiguous because it does not state the criteria that a home Member State should use in determining whether there is reason to doubt the adequacy of the organizational structure of a credit institution.
\textsuperscript{52} Id. The home Member State must notify the credit institution within three months of its refusal to forward the information to the host Member State. Id.
\textsuperscript{53} Id.
\textsuperscript{54} Zavvos, \textit{Banking Integration}, supra note 12, at 576.
\textsuperscript{55} Id.
\textsuperscript{57} Gruson & Nikowitz, \textit{supra} note 15, at 217.
\textsuperscript{58} Zavvos, \textit{Banking Integration}, \textit{supra} note 12, at 576; Gruson & Nikowitz, \textit{supra} note 15, at 216-17.
the bottom, will promote the harmonization of banking activities throughout the Community.

C. Bank Supervision

The EEC intends to standardize selected bank regulations throughout the Community in order to facilitate banking integration. The home Member State is responsible for supervision of the activities of a bank operating in other Member States. Authorization for a bank to operate in a host Member State will not be granted by the home Member State if the bank's initial capital is less than five million European Currency Units. The competent authorities of the home Member State must monitor each bank to assure that the bank's own funds do not fall below the initial capital required upon authorization.

The home Member State must also supervise owners of banks operating in other Member States to assure that the banks are soundly managed. Home Member States must be informed of any physical or legal person who is considering a direct or indirect acquisition of

59. Second Directive, supra note 2, at second whereas cl. See also Gruson & Nikowitz, supra note 15, at 223 (EEC harmonization of essential supervisory standards); Bennett & Hakkio, supra note 56, at 9-10 (discussing Member States' supervisory functions). There will be three areas that will continue to be under the supervision of the host country. Banks will be subject to host Member State regulations for monetary policy purposes, for example, reserve requirements on various assets, supervision of securities activities, and primary responsibility to assure the liquidity of the bank. The purpose of providing certain minimum standards is to assure that bank regulations remain prudent and to maintain confidence in the banking market. See id. at arts. 2, 19, 2.

60. Second Directive, supra note 2, at art. 19, ¶ 1. Host Member States may require, for statistical purposes, that all credit institutions having branches in their territories shall report quarterly on their operations in the host Member State to the competent authority of that host Member State. See id. at ¶ 2.

61. Id. at art. 3, ¶ 1. "Member States may propose that initial capital be fixed at an amount lower than that provided for in paragraph 1 in the case of institutions whose scope of authorized business is restricted by law or statute." Id. at ¶ 2. The European Currency Unit [hereinafter ECU] is a composite currency that consists of fixed amounts of 10 European currencies. The quantity of each country's currency in the ECU reflects that country's relative economic strength in the EEC. A. Shapiro, MULTINATIONAL FINANCIAL MANAGEMENT 63 (3d ed. 1989) [hereinafter Shapiro].

62. Second Directive, supra note 2, at art. 8, ¶¶ 1, 4.

63. Id. at art. 9, ¶ 3. However, the Second Directive fails to define what constitutes sound management practices. Therefore, different Member States might disagree concerning the review of a credit institution's management practices.
a qualified participation and shall determine the suitability of that party. Banks must send to the competent authorities annual listings of individuals holding a qualified participation. Member States shall take appropriate steps to end a situation in which qualified participants exert influence on a bank in a manner detrimental to the sound management of the bank’s activities. To prevent conflicts of interest, the Second Directive places a ten percent limit on banks’ investment of its own funds in an undertaking which is not a bank or financial institution. The competent authorities of the home Member State must also ensure that each bank operates with “sound” administrative and accounting procedures as well as with “adequate” internal controls.

The harmonization of essential supervisory standards is consistent with the concept of mutual recognition and home Member State control. Costs incurred by complying with regulatory and supervisory requirements demand that banks increase the spread between the interest rates charged to borrowers and the interest paid to depositors. Banks from Member States with less rigorous supervision will

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64. *Id.* at art. 1. Qualified participation means a holding, direct or indirect, in an undertaking which represents 10% or more of the capital or of the voting rights or which enables the exercise of a significant influence. *Id.* Those with qualified participation must similarly inform the competent authorities if they propose to increase their qualified participation such that the credit institution would become a subsidiary. *Id.* at art. 9, ¶ 1.

65. *Id.* at art. 9, ¶ 2. The Second Directive fails to elaborate on the criteria the competent authorities might use in passing on the suitability of those seeking a qualified participation.

66. *Id.* The list includes the names of major shareholders and the size of their qualified participation, in accordance with the names registered at the annual shareholders meeting, or compiled as a result of complying with the requirements of a stock exchange. *Id.*


68. *Id.* at art. 10, ¶ 1. The credit institution might make unnecessary or improper loans to a company in which it has a large ownership interest. Therefore, this limitation is intended to prevent conflicts of interest. Gruson & Nikowitz, supra note 15, at 224.

A “financial institution” is defined as “... an undertaking, not being a credit institution, whose principal activity is to grant credit facilities (including guarantees), to acquire participation or to make investments.” Supervision of Credit Institutions, supra note 39, at art. 1. Credit institutions may own up to 50% of a financial institution. *Id.* at art. 4, ¶ 1.

The Second Directive also states that a credit institution can maintain a qualified participation of greater than 10% if the undertaking falls within “Article 43(2)(f) of Directive 86/635/EEC.” Second Directive, supra note 2, at art. 10. Article 43(2)(f) states that:

Where a parent undertaking is a credit institution and where one or more subsidiary undertakings to be consolidated do not have that status, those subsidiary undertakings shall be included in the consolidation if their activities are a direct extension of banking or concern services ancillary to banking, such as leasing, factoring, the management of unit trusts, the management of data processing services or any other similar activity.


70. See infra notes 143-45 and accompanying text.
have a competitive advantage over banks from Member States with stringent regulation and supervision.\(^7\) Over time, political pressure from banks operating at a competitive disadvantage should force Member States to eliminate regulatory disparities.\(^7\) Once the excess costs due to complying with regulatory requirements are removed, banks will be able to compete more efficiently in the marketplace.

Home Member State supervision of banks will result in indirect cost savings throughout the EEC.\(^7\) Presently, a bank must comply with the regulations imposed by each of the Member States in which it operates. After the Second Directive goes into effect, a bank will have to meet only one set of regulations.\(^7\) The elimination of overlapping and contradictory regulations will reduce the cost structure of banks in the European banking system.\(^7\)

D. Impact of the Second Directive on Non-EEC Banks

The benefits of the Second Directive also will be extended to Non-EEC banks.\(^7\) Under the Second Directive, subsidiaries\(^7\) of non EEC

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71. Bennett & Hakkio, supra note 56, at 10.
72. Id. See also Key, Integration of the Financial Sector, supra note 23, at 604, stating: (T)he Community assumes that over the longer run market forces will create pressure on governments that will lead to a convergence of additional national rules and practices that have not been harmonized at the EC level. Pressures for regulatory convergence within the Community would arise both from the absence of restrictions on capital movements and from the regulatory advantages enjoyed by branches of banks and investment firms from other member states and also by head offices of such banks and investment firms in providing services across borders.

Id.

73. Bennett & Hakkio, supra note 56, at 12.
74. Id.
75. Id.
76. See Creation of a European Financial Area, 36 Eur. Econ. 35 (1988) (benefits for non-EEC banks are same as for EEC banks). The article notes that: The Community's integrated financial market will be characterized:

i) by the freedom of establishment and the freedom to provide services within the Community;

ii) by coordinated rules relating to the access to or exercise of the profession of financial intermediaries, which are intended to ensure that all users of financial services enjoy the same protection;

iii) by coordinated systems of surveillance and control, designed to ensure the stability of the financial system.

Id.

77. Seventh Council Directive of 13 June 1983 Based on the Article 54(3)(g) of the Treaty on Consolidated Accounts, art. 1(a)-(d), 26 O.J. Eur. Com. (No. L 193) 1 (1983). A firm establishes a subsidiary if it controls another firm in the following areas:

a) has a majority of the shareholders' or members' voting rights in another undertaking; or

b) has the right to appoint or remove the majority of administrative, management
banks already established in a Member State will be able to operate on an EEC-wide basis in the same manner as EEC banks. Existing subsidiaries of non EEC banks will be treated as any other bank in the Member State in which they are incorporated. In contrast, branches of non EEC banks will not receive the benefits of mutual recognition of their banking licenses and therefore will be unable to operate on an EEC-wide basis. Branches of non-EEC banks will continue to be authorized and regulated separately by each EEC Member State, since branches generally do not have to meet all of the regulatory requirements of subsidiaries.

Requests from banks governed by the laws of a non EEC country for authorization to establish a subsidiary or to acquire a participation in an existing EEC bank will be subject to reciprocity. Reciprocity may be applied in one of two ways: "national" treatment or "mirror-image" treatment. National treatment occurs when regulations apply to both domestic and foreign banks in a nondiscriminatory manner, allowing all banks to compete on an equal basis. Mirror-image reciprocity means that each non EEC bank will be allowed to provide only those services which EEC banks are allowed to provide in that
non EEC bank’s country.\textsuperscript{85} Unless the non EEC country allows those services included in the Second Directive, non EEC banks will be at a competitive disadvantage compared with EEC banks.\textsuperscript{86} The European Commission has stated that it does not intend to apply mirror-image reciprocity.\textsuperscript{87} However, no general definition of reciprocity in domestic laws or international agreements\textsuperscript{88} presently exists; how reciprocity will be practiced after January 1, 1993, remains to be seen.

A non EEC bank will be prohibited from establishing or acquiring a subsidiary in any EEC country unless reciprocity is practiced by the bank’s country towards EEC Member States.\textsuperscript{89} However, the scope of the reciprocity requirement is not specified in the Second Directive; consequently, the ultimate impact on non EEC countries and firms is uncertain.\textsuperscript{90} The application of reciprocity has important consequences for non EEC banks attempting to establish a subsidiary in the EEC after January 1, 1993. Banks seeking to enter the EEC for the first time would not benefit from any of the advantages of mutual recognition and EEC-wide operations.

The Second Directive has the potential of increasing international competition and growth. Some financial analysts anticipate the emergence of a new generation of “Euroinvestor” free to invest currency, including dollars, anywhere within the EEC.\textsuperscript{91} However, the reci-

\textsuperscript{85} Id. For example, since the United States does not allow credit institutions (domestic or foreign) to underwrite securities, the EEC will not allow U.S. credit institutions to underwrite securities in Europe even though it is allowed for EEC credit institutions. \textit{Id.}

\textsuperscript{86} Id. “National treatment would strengthen U.S. banks; but mirror-image treatment would severely limit the powers of U.S. banks operating in the EC.” \textit{Id.} For example, because the United States prevents EEC banks (and U.S. banks) from branching throughout the United States and from operating in the securities markets, a mirror-image application of the reciprocity requirement would prevent U.S. banks from operating throughout the EEC and from underwriting securities. However, under national treatment, all powers granted to U.S. banks are granted to foreign banks in the United States. Therefore, U.S. and non-U.S. banks operate on a non-discriminatory basis. The Second Directive would then grant U.S. banks the same powers as those granted to EEC banks. \textit{Id.}

\textsuperscript{87} Zavvos, \textit{Banking Integration}, supra note 12, at 585.

\textsuperscript{88} Id. at 584.

\textsuperscript{89} Key, \textit{Integration of the Financial Sector}, supra note 23, at 599. “Direct branches of non-EC financial institutions would not be subject to EC reciprocity requirements.” \textit{Id.} at 600.

\textsuperscript{90} Orr, \textit{Reciprocity and Regulation of Entry}, 2 U. Ill. L. Rev. 333, 338 (1988). However, EEC Member States disagree about reciprocity. The more developed financial markets such as Great Britain, West Germany, Luxembourg, and the Netherlands are skeptical about the effectiveness of reciprocity requirements, while France wants to strengthen and extend reciprocity requirements. \textit{The Bottom Line,} BANKER, Apr. 1989, at 80. See also Key, \textit{Integration of the Financial Sector}, supra note 23, at 600 (reciprocity provisions of Second Directive expected to serve as model for reciprocity provisions in other directives).

\textsuperscript{91} Crabbe, \textit{EC Law Shapes the Pattern of European Banking}, EUROMONEY, June 1989, at 61 [hereinafter Crabbe].
proximity requirement has the potential to create barriers to growth and international trade. One thing is clear, an integrated EEC banking system will dictate a reappraisal of the way 10,000 banks do business within the EEC.92


Non EEC banks seeking the benefits of operating in Europe must establish or purchase a fully incorporated subsidiary with its own capital in at least one Member State before January 1, 1993, or be subject to reciprocity.93 Non EEC banks must decide whether to establish a subsidiary thereby gaining the benefits of mutual recognition of banking licenses or whether they can afford being locked out of the most lucrative financial market in the world.94 The decisions non EEC banks will make depend upon the particular circumstances confronting those banks. For example, the decisions facing American and Japanese banks are different because of the way they operate in the EEC.

For most American banks, the recent trend has been to retrench from retail and commercial banking in Europe.95 American banks still present in Europe generally run their European operations as branches of their head offices in the United States.96 Few American banks operate subsidiaries in Europe; therefore, their legal structures are not compatible with the Second Directive.97 If most American banks choose to remain active in Europe, they will be at a competitive disadvantage unless they establish subsidiaries before the Second Directive takes effect.

In contrast to the legal structure of American banks operating in the EEC, Japanese banks in the EEC operate a subsidiary in at least one European financial center.98 Though they are not subject to the

92. Id.
93. Id. at 63.
94. Id.
95. Id. at 64. Except for Citicorp, which is committed to remaining in the European market, U.S. banks have withdrawn from Europe in order to focus on the U.S. market; others have sold subsidiaries to raise capital in order to offset losses sustained on international and domestic loans. For example, Bank of America has sold its Italian bank subsidiary to Deutsche Bank. Chase Manhattan has sold its 18-branch Belgian bank network to Credit Lyonnais, stating that it was going to concentrate on corporate finance activities in the EEC. Id.
96. Crabbe, supra note 91, at 64. "Although separately capitalised to meet local banking regulations, few of them [U.S. banks] have banking licenses in the EC." Id.
97. Id.
98. Id.
reciprocity requirement, Japanese banks are not looking to expand into new European markets at present. 99 Japanese banks have never operated an extensive retail banking business with many offices located in each EEC country. 100 Instead, they have geared their bank operations towards meeting the needs of sophisticated corporate clients, whose banking needs can be served from their existing offices located in EEC financial centers. In short, Japanese banks are less concerned about the impact of the Second Directive. 101

The issue of reciprocity is not applicable to a European bank. 102 However, the decision concerning whether to expand throughout the EEC or concentrate on the more familiar domestic market is as difficult for European banks as for non-EEC banks. 103 Additionally, EEC based banks will have to contend with increasing competition from other EEC banks entering their domestic market.

The mutual recognition of banking licenses will enable subsidiaries of banks operating in Europe, including non-EEC banks, to realize cost reductions. 104 The services allowed under the Annex to the Second Directive will most likely expand the powers of subsidiaries of non-EEC banks operating in Europe. 105 The Second Directive provides banks with an incentive to expand their operations so long as price differentials exist between Member States. 106 Banks choosing to expand will centralize lending operations reaping administrative cost savings. 107 The banking systems of Member States will operate more efficiently as bank expansion produces common distribution networks, managers, and support staffs. 108

2. Potential for Creation of Regional Trading Blocs

Regional trading blocs are by no means new to the international arena. 109 However, since the end of the Second World War, regional
economic integration and reduction of trade barriers on a global basis have contributed to the expansion of international trade. The EEC movement towards banking integration has raised concerns about the potential for creating protective trading blocs, which would create barriers against non bloc states, thereby retarding international trade. The Second Directive’s reciprocity requirement, if applied in a manner which protects EEC banks from competition by non EEC banks, could inhibit growth in international trade instead of encouraging competition.

If reciprocity is applied in a “mirror image” fashion, or in another manner which sharply restricts access to EEC markets, inefficient domestic industries will be protected and the citizens of the EEC Member States will be deprived of the benefits envisioned when the Single European Act was adopted. If protectionist barriers are raised by the EEC, non EEC banks are affected in two ways. First, non EEC banks may find it impossible to compete because of the additional cost of doing business. Secondly, barriers in the EEC would invite retaliatory barriers from other countries or trading blocs, segmenting the world financial markets and raising the cost of credit globally.

III. INTERNATIONAL BANKING CLASSIFICATIONS AND THE CREATION OF EURODOLLARS

A. International Banking Classifications

Banking activities can be classified according to the residency of both borrowers and depositors in relation to the bank and the

LETTER 1 (Aug. 5, 1988) [hereinafter Cheng]. Several trade blocs are in existence: the Committee on Mutual Economic Assistance (COMECON) consisting of eastern European nations; the European Free Trade Association for northern European nations; the Lome Convention through which the EEC provides special treatment to imports from African, Caribbean, and Pacific nations; the Latin American Free Trade Association and the Andean Group for South American countries; the Central American Common Market; the Caribbean Community; the free-trade agreement between the United States and Israel; the Association of South East Asia Nations (ASEAN); the free trade agreement between Australia and New Zealand; and the United States and Canada free trade agreement. Id.

110. Id.
111. Id.
112. Bennett & Hakkio, supra note 56, at 14; see also Cheng, supra note 109, at 1 (discussing possible trade barriers due to trade blocs).
113. See supra notes 85-87 and accompanying text.
114. See supra notes 9-12 and accompanying text.
denomination of the currency involved in the transaction. The distinction between different types of banking activities is not always clear when transactions involve borrowers, depositors, banks, and currency from different countries. However, classifying banking activities provides a useful starting point for understanding the nature and importance of today’s Euromarket.

Domestic banking consists of domestic currency transactions with borrowers and depositors who are residents of the country where the bank is located. Traditional foreign banking operations reflect the longstanding bank practice of providing services to nonresidents, or their agents, in the currency of the country where the bank is domiciled. This practice is commonly associated with international trade finance transactions.

In contrast, Eurocurrency banking activities occur when banks in one country perform transactions in the currencies of other countries. These foreign currency transactions involve either residents or nonresidents of the country where the bank operates. The term

<table>
<thead>
<tr>
<th>Currency:</th>
<th>Residents</th>
<th>Non-Residents</th>
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<tbody>
<tr>
<td>Domestic</td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>Foreign</td>
<td>C</td>
<td>D</td>
</tr>
</tbody>
</table>

- A Domestic Lending
- B Traditional Foreign Lending
- C+D Eurocurrency Lending
- B+D International Lending

116. Id. at 2. The relationship between the domicile of the borrower and the currency being borrowed in international transactions is illustrated by the following matrix:
117. Id. at 1.
118. Id.
119. Id.
120. Johnston, supra note 115, at 1.
121. Eurocurrency is money deposited by corporations and national governments in banks away from their home countries. The Eurodollar is only one of the Eurocurrencies, though it is the most prevalently used currency. J. Downes & J. Goodman, Barron’s Finance and Investment Handbook 252 (2d ed. 1987) [hereinafter Downes & Goodman].
123. Id. at 2.
“Euro” is usually retained even for deposits in accounts located outside Europe. Thus, any deposit of a currency outside that currency’s country of origin is called “Euro.”

International bank lending covers banking activities with non-residents in both domestic and foreign currency. International bank lending activities include all traditional foreign banking transactions. Additionally, international bank lending includes some Eu-

124. D. LOMAX & P. GUTMANN, THE EUROMARKETS AND INTERNATIONAL FINANCIAL POLICIES 4, 12 (1981) [hereinafter LOMAX & GUTMANN]. For example, dollars deposited in Canadian banks or Japanese banks are referred to as Eurodollars and are traded on the Euromarkets, even though the banks are not situated in Europe. There are Euromarkets in Luxembourg, the Cayman Islands, the Bahamas, Bahrain, Singapore and Hong Kong. Id.

125. For the purposes of this Comment, the deposits are located in Europe. The Second Banking Directive only affects countries of the EEC.

126. S. DAVIS, THE EURO-BANK, ITS ORIGINS, MANAGEMENT & OUTLOOK 39-40 (2d ed. 1980) [hereinafter DAVIS]. Few Eurobanks operate in each activity described below, the most common activity engaged in by a Eurobank is Eurocurrency lending and deposit taking which is necessary in order to acquire the funds to loan. The range of possible Eurobank activities includes:

1. taking of call, short date and fixed date Euro-currency deposits of up to several years from the interbank market and customers to fund the bank’s own loan portfolio and for relending in the interbank market;
2. exchange dealing in spot and forward Euro-currencies and often the local currency of the stockholder for the account of clients, the bank’s own position or to create deposits through the swap;
3. Euro-currency lending for the bank’s own book on a rollover or fixed rate basis from short dates to medium-term (the latter having exceeded ten years at various times in recent years) to governments and government agencies, corporations and individuals throughout the world on a secured or unsecured basis. Often lending activity in the local currency of the market in which the bank is located represents a significant portion of the portfolio;
4. management of Euro-currency rollover loans on an underwriting or best efforts basis to be placed with the stockholder group or a wider range of banks;
5. origination, management, underwriting and selling of publicly issued Euro-bonds and Euro-equities; provision of a secondary trading market in Euro-bonds;
6. arrangement of private placements of fixed-rate debt issues in a variety of currencies with international investors;
7. corporate finance activities such as project structuring, corporate restructuring and mergers and acquisitions;
8. provision of traditional trade finance or correspondent banking services through the opening of letters of credit, acceptance finance, money transfer and collection;
9. portfolio management for international investors;
10. arrangement of lease finance either with or without the use of a tax shield;
11. arrangement of export finance through one or more national export credit agencies;
12. the taking of equity participations either on an outright basis or in connection with the extension of a loan;
13. specialist project financing capability in sectors such as energy and shipping.

Few Euro-banks are active in all these sectors, and many limit themselves for practical purposes to Euro-currency lending and the deposit and exchange dealing necessary to support this activity. Id.

127. JOHNSTON, supra note 115, at 2.
128. Id.
tracurrency transactions; however, not all international lending is in Eurocurrency. The Eurocurrency market has consistently expanded, growing from a gross market size of $1,524 billion in 1980, to $4,461 billion in 1987. Although only a part of the international lending and Eurocurrency markets, the Eurodollar market is the most important because the dollar is the primary currency of international trade. Although U.S. banking policy helped create the Eurodollar market, the EEC policies embodied in the Second Directive will affect the future of the Eurodollar market.

B. Creating Eurodollars

Tracing a series of international transactions involving corporations and their banks illustrates how Eurodollars are created. The corporations, as bank depositors, seek the highest return on their deposits. Yet when borrowing funds, corporations desire to use funds deposited in banks at the lowest interest rate. Banks function as intermediaries, transferring the dollars of depositors to borrowers in need of dollars.

For instance, assume West German Corporation (WGC) sells a product to United States Corporation (USC) for one million U.S. dollars. WGC receives payment from USC in dollars drawn on USC’s bank, Citibank. Also assume WGC banks with Bank of America maintaining a typical non-interest bearing checking account. After completing the sales transaction, WGC’s bank account would increase by one million dollars, and Bank of America would show an increase in liabilities reflecting the amount owed to WGC. Bank of America

129. Id. See supra notes 115-20 and accompanying text.
130. World Financial Markets, MORGAN GUARANTY TR. CO. 1980 & 1987, reprinted in SHAPIRO, supra note 61, at 672. The Euromarket was measured in dollars for statistical purposes. But in the actual Euromarket, the amount of dollars as a percentage of the overall Eurocurrency market declined from 75% ($1143 billion) in 1980 to 66% ($2944 billion) in 1987. However, the dollar is still the predominate currency in the Eurocurrency market. Id.
131. A Eurodollar is “U.S. currency held in banks outside the United States, mainly in Europe, and commonly used for settling international transactions.” DOWNES & GOODMAN, supra note 121, at 252.
132. See infra notes 157-63 and accompanying text.
133. See infra notes 180-92 and accompanying text.
134. See infra notes 261-82 and accompanying text.
135. This section draws heavily from SHAPIRO, supra note 61, at 673-77, and from P. LINDERT, INTERNATIONAL ECONOMICS 500-02 (8th ed. 1986).
136. See infra notes 146-55 and accompanying text (discussing interest rate differentials and bank profits).
may now lend the additional one million dollars on deposit to borrowers.\textsuperscript{137}

Efficient cash management\textsuperscript{138} would require WGC to transfer the money held on deposit at Bank of America into an interest bearing investment such as an Eurocertificate of deposit.\textsuperscript{139} WGC writes a check on its Bank of America account and deposits the money in Barclays Bank, London, England. When the check is received by Bank of America, the dollar amount owed to WGC is reduced by one million dollars and the amount owed to Barclays is increased by one million dollars. Barclays in turn has now increased the amount owed to WGC and has one million dollars to loan.\textsuperscript{140}

Bank of America has not increased its total liabilities, rather, there has been a change in ownership of the deposit. Since Bank of America

\begin{center}
\begin{tabular}{|c|c|}
\hline
\textbf{WGC} & \\
\hline
\textbf{asset: demand} & \\
\textbf{deposit with} & \\
\textbf{Bank of America} & \\
\textbf{$1\text{mm}$} & \\
\hline
\textbf{Bank of America} & \\
\hline
\textbf{liability: demand} & \\
\textbf{deposit due} & \\
\textbf{WGC $1\text{mm}$} & \\
\hline
\end{tabular}
\end{center}

\textsuperscript{137} WGC would show an increase in assets of $1 million and Bank of America would show an increase of liabilities of $1 million. This transaction can be illustrated through the use of a T account used by accountants to keep track of amounts owed from others and amounts payable to others.

\textsuperscript{138} The Executive Course 69 (G. Germane ed. 1986). "Cash management involves managing the funds of the firm in order to obtain maximum cash availability and maximum interest income on any idle funds." \textit{Id.}

\textsuperscript{139} Eurocertificate of deposit: U.S. dollar denominated CDs issued by banks outside the United States. The CDs have their interest and principal paid in dollars. The interest rates of these CDs are usually pegged to the London Interbank Offered Rate [hereinafter LIBOR]. Dow\text{\'}es & Goodman, \textit{supra} note 121, at 252.

\textsuperscript{140} The dollars are physically located with Bank of America, but because Barclays has them on deposit in the account they maintain with Bank of America, Barclays can lend the dollars to corporations or governments who are in need of borrowing dollars. If Barclays has no corporation or government in need of dollars, it can lend the money to another bank which has a need for dollars at LIBOR. Barclays has recorded an asset, because Bank of America now owes $1 million to Barclays:
owes the one million dollars to Barclays instead of to WGC, Bank of America transfers the dollars into Barclays' account. WGC has not increased the amount of dollars it holds, but has merely transferred its original one million dollars to Barclays in order to receive interest on the deposit. The dollars on deposit with Barclays are now considered Eurodollars because the dollars have been deposited in a bank outside the United States.

Barclays Bank is now paying interest on the Eurocertificate of deposit held by WGC. Barclays will find a borrower for the one

<table>
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<tr>
<th>Bank of America</th>
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<tbody>
<tr>
<td>liability: Demand deposit due WGC</td>
</tr>
<tr>
<td>-$1mm</td>
</tr>
<tr>
<td>Demand deposit due Barclays</td>
</tr>
<tr>
<td>+$1mm</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Barclays</th>
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</thead>
<tbody>
<tr>
<td>asset: Demand deposit with Bank of America</td>
</tr>
<tr>
<td>$1mm</td>
</tr>
<tr>
<td>liability: Time deposit due WGC</td>
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<tr>
<td>$1mm</td>
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</tbody>
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<table>
<thead>
<tr>
<th>WGC</th>
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</thead>
<tbody>
<tr>
<td>assets: Demand deposit in Bank of America</td>
</tr>
<tr>
<td>-$1mm</td>
</tr>
<tr>
<td>Time Deposit in Barclays +$1mm</td>
</tr>
</tbody>
</table>

141. Major banks maintain deposit accounts with each other so that transactions such as this can be conducted on a routine basis. Barclays is free to withdraw the funds from its account with Bank of America or it can leave the funds there in case Barclays has to transfer funds back to Bank of America in another transaction.

142. See supra notes 131-32 and accompanying text.
million dollars it has as an asset against Bank of America. The
difference between what Barclays pays on Eurocertificates of deposit
and the amount it charges on loans made to borrowers is the margin
providing Barclays with its gross profit.¹⁴³ Barclays deducts its op-
erating expenses from gross profit to determine its operating profit.
Administrative expenses, such as complying with regulatory require-
ments, can be a significant operating expense to banks. Competition
in the Eurodollar market produces narrow margins between the cost
of obtaining deposits and the interest rate charged to borrowers.¹⁴⁵
Some banks have lower operating expenses than others because they
are more efficient, are located in Member States with less stringent
regulatory requirements, or a combination of these two factors. Banks
with lower operating expenses have a competitive advantage.

Even if Barclays does not have a client with an immediate need
to borrow dollars, Barclays must pay interest on the Eurocertificate
of deposit. Therefore, Barclays would make an interbank loan of
the one million dollars to another bank that does not have sufficient
dollars on deposit, but has a client wishing to borrow dollars. Suppose
Barclays lends the one million dollars to Belgian Bank. Barclays
would shift the one million dollars from its asset account with Bank
of America to an account for Belgian Bank which earns interest.
Barclays is then making the most efficient use of the money it has
on deposit with Bank of America.¹⁴⁷ Belgian Bank will have a liability
due to Barclays, but Belgian Bank will earn a profit on the margin

¹⁴³. The excess of the net revenue from sales over the cost of merchandise sold (in this
case the cost of the Eurocertificate of deposit or cost of funds) is called gross profit or gross
margin. It is called "gross" because operating expenses must be deducted from it. P. Fess &
C. Warren, FINANCIAL ACCOUNTING 120 (2d ed. 1985).
¹⁴⁴. Id. Operating Expenses can be grouped into selling expenses, those expenses incurred
directly and entirely in connection with the sale of product, and General or Administrative
Expenses, or those indirect expenses commonly known as overhead. Complying with supervisory
requirements are operating expenses. Id.
¹⁴⁶. Interbank loans exist because:
For any individual bank the inflow and outflow of funds from deposits and loans
will not always—or even usually—be matching. The bank can maintain a stock of
liquidity assets, cash or precautionary balances to act as a buffer between the inflows
and outflows of funds. Alternatively it can borrow or lend funds with other banks.
Thus, for example, if an individual Euro-bank receives new deposits unexpectedly it
will usually be able to lend these temporarily to other banks in the London interbank
market, earning a small return . . . .
Johnston, supra note 115, at 98.
¹⁴⁷. Barclays would prefer to lend the funds to a client at a rate greater than LIBOR, but
since Barclays currently does not have a client in need of dollars, Barclays can earn interest
at LIBOR by lending to Belgian Bank.
between the interest it pays to Barclays and the interest charged to its client.¹⁴⁸

The supply of Eurodollars has increased from one million to two million because WGC and Belgian Bank each own one million Eurodollars. This multiplier¹⁴⁹ turns small changes in bank deposits

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¹⁴⁸. The cost of the funds to Belgian Bank will be the amount charged in interest by Barclays. Interbank loans are generally pegged to a standard measure called the LIBOR, the interest rate that the most credit worthy international banks dealing in Eurodollars charge each other for large loans. LIBOR is the benchmark rate for Eurodollar loans to corporate or government borrowers possessing greater risk. DOWNE & GOODMAN, supra note 121, at 330-31.

Usually this rate is higher than the amount of interest Barclays must pay on its Eurocertificate of deposit, but even if Barclays is charging Belgian Bank less interest than it is paying to WGC, it is still better for Barclays to lend the funds and receive some interest income from Belgian Bank than it is for Barclays to receive no interest income while paying interest to WGC. The chain of ownership of the dollars would look as follows:

<table>
<thead>
<tr>
<th>Bank of America</th>
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<tbody>
<tr>
<td>liability: Demand</td>
<td></td>
</tr>
<tr>
<td>Deposit due</td>
<td></td>
</tr>
<tr>
<td>Barclays -$1mm</td>
<td></td>
</tr>
<tr>
<td>Demand deposit</td>
<td></td>
</tr>
<tr>
<td>due Belgian Bank</td>
<td></td>
</tr>
<tr>
<td>+$1mm</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Barclays</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>asset: Demand</td>
<td></td>
</tr>
<tr>
<td>deposit in Bank of America</td>
<td>-$1mm</td>
</tr>
<tr>
<td>Interbank Loan</td>
<td></td>
</tr>
<tr>
<td>to Belgian Bank</td>
<td>+$1mm</td>
</tr>
<tr>
<td>(at LIBOR)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Belgian Bank</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>asset: demand Bank of America</td>
<td>liability: Interbank loan</td>
</tr>
<tr>
<td>deposit in $1mm</td>
<td>due Barclays $1mm</td>
</tr>
</tbody>
</table>

¹⁴⁹. The “multiplier,” or “credit multiplier,” is defined as:
into large changes in the amount of outstanding credit and in the money supply. The U.S. Federal Reserve, through open market operations, influences interest rates by manipulating the money supply.

Strictly, the ratio of the change in the volume of lending by a group of deposit-taking financial intermediaries (and especially banks) to the change in reserve assets which initiated the change (this may be an increase or decrease). More commonly, in the traditional theory of credit creation by the banks, it denotes the ratio of change in bank deposit liabilities, caused by the increased extension of credit, to the initiating change in reserve assets. In this case it is sometimes called the 'bank deposit multiplier'. However applied, the size of the multiplier depends on the reserve ratios maintained by the institutions concerned, and the scale of leakages of reserve assets from these institutions induced by the credit change itself.


150. Pozdena, Eliminating Reserve Requirements, Fed. Reserve Bank of San Francisco, Weekly Letter (Sept. 8, 1989) [hereinafter Pozdena]. The traditional view of monetary policy emphasizes the use of reserve requirements for transaction-type deposits (usually checking accounts) as a way to influence the money supply, interest rates, and thereby indirectly control the overall economy. The central bank influences the quantity of transaction-type deposits by manipulating the supply of reserves to affect either the money supply or interest rates. Id. Large reserve requirements force banks to withhold money from the economy and interest rates rise, while low reserve requirements allow banks to lend more of the money they have on deposit and the increased supply of money lowers interest rates. Id.

151. "Federal Reserve System" is defined as:
The system established in the USA in 1913 to discharge the function of a central bank and provide a strengthened framework of regulatory control over the commercial banking system. The System has a federal structure, comprising 12 Federal Reserve Banks each responsible for day-to-day operations within their Districts and acting as a two-way channel of contact between the System and the business community; and a Federal Reserve Board of Governors, located in Washington, which effectively if not formally controls the policy of the System. All banks registered under Federal laws are obliged to be members and observe the regulations of the System; for banks chartered under state laws membership is optional. The System is responsible for currency issue; holds reserve balances (other than vault cash) of member banks; acts as lender of last resort and provider of liquidity through discount facilities; operates on the volume of bank deposits and on the level and structure of interest rates by setting minimum reserve requirements for member banks and engaging in open market operations (under the Federal Open Market Committee); is responsible for monetary management and monetary policy within the USA and in conjunction with the Treasury for exchange rate policy and external monetary relations. Although a creation of government, with the Federal Reserve Board Governors (and the Chairman) being appointed by the President, the System has generally maintained a considerable independence in its own policy decisions, and in its comment on wider economic events and policies.


152. "Open market operations" are defined as:
Sales or purchases of marketable securities conducted in the open market by the central bank as an instrument of control over the monetary system. The immediate objective of such sales may be to influence the quantity of reserve assets held by the banking system, with the further purpose of affecting the volume of banks' lending and holdings of other assets: open market sales will contract the reserve base and compel a reduction in banks' loans and other assets. The further effect of this is to change the quantity of bank deposits and so the money supply. The traditional theory of the credit multiplier predicts that banks
In the Eurodollar market, the multiplier affects the supply of dollars in the same manner as in the U.S. domestic market. However, the Eurodollar market is beyond the control of the U.S. Federal Reserve because the dollars are deposited outside the United States. The effect of the multiplier in the Euromarket may offset U.S. Federal Reserve actions to control the domestic supply of dollars in two ways: 1) Eurodollar deposits held by domestic residents may partially substitute for the domestic money supply; and 2) Euromarket lending to domestic residents may offset the effects of monetary policy on credit.

The cycle of lending, depositing, and re-lending is the basis for the Eurodollar market. In the above example, the total amount of foreign controlled dollars in Bank of America remains constant at one million dollars, but because of the impact of the multiplier, many transactions can be funded. Eurodollar transactions differ from those occurring solely in the domestic market because they involve a chain of ownership between depositors and banks with changing control over the deposits. Deposits held domestically are owned by the depositor and funds are withdrawn from the depositor's demand deposit account to pay third parties. When this occurs, the liability to the depositor on the bank's books will be reduced. With Euro-
dollars, the initial liability remains, but the party to whom the liability is owed changes.

Banking transactions alone cannot explain the reasons for the development and growth of the Eurodollar market. The Eurodollar market developed because of the increased use of the dollars in financing international trade and the convenience to Europeans of holding dollars in Europe rather than in the United States. It is also necessary to consider how U.S. regulatory policy during the 1960s and 1970s unintentionally promoted the use of Eurodollars. Today, the market exists and continues to grow in large part because America continues to import more goods and services than it exports, and foreign corporations choose to deposit the dollars they receive into Eurobanks. The following section discusses how the Eurodollar market developed.

IV. THE DEVELOPMENT OF THE EUROMARKET AND A COMPARISON BETWEEN REGULATORY PRACTICES IN GREAT BRITAIN AND WEST GERMANY

A. The Eurodollar's Origin

After the Second World War, the United States exported more goods and services than it imported.157 By the late 1950s, a significant turnaround in the U.S. balance of payments158 occurred because the United States began to run trade deficits.159 As the volume of dollars flowing into Europe increased, European governments and corporations began using dollars to finance international trade transactions, greatly enhancing the dollar's role as the predominant international reserve currency.160

Prior to 1958, the vast majority of Europeans held their dollar deposits in U.S. banks. By 1958, as European holders of dollars began to recognize the ease of managing their dollar deposits in Western European banks, a European market in dollars became established.161 Additionally in 1958, most European countries agreed

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158. The balance of payments is the system which records all of the country's economic transactions over time. See DOWNES & GOODMAN, supra note 121, at 180.
159. JOHNSTON, supra note 115, at 9.
160. Id.
161. See EINZIG, supra note 145, at 31-32. (European governments and corporations found daily management of finances easier due to convenience of time zones and savings in communication costs).
to allow their currencies to be freely convertible into dollars for the first time since the end of the Second World War. Convertibility eased capital movements across national frontiers, promoting international trade transactions financed primarily with dollars.

1. The Need to Hold Dollars in Europe

The origin of the Eurodollar dates back to the Cold War. Communist Bloc countries, especially the Soviet Union, feared that their dollar deposits located in the United States might be frozen during a period of political tension. The Soviets also feared that creditors of Imperial Russia would attach growing Soviet deposits held in U.S. banks. Another version of the Eurodollar’s origin credits the Chinese with creating the Eurodollar. In 1949, the Chinese Communist government began depositing dollars in the Soviet bank in Paris. Later, the Soviets themselves began depositing dollars in Europe.

The Soviets’ financial motivation was the desire to prepare the ground for borrowing Eurodollars at a later stage. By establishing banking relationships in Europe, the Soviets hoped to borrow dollars to finance international trade transactions on occasions when they lacked dollar deposits. While other borrowers continued to hold

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164. The Cold War between the United States and the Soviet Union began in the years immediately after the Second World War. The warlike tensions between the two countries became known as the Cold War to distinguish it from a shooting or “hot” war. See G. Kennan, Memoirs 265-528 (1967), for an excellent discussion of the early years of the Cold War by this high ranking United States diplomat who was intimately involved in U.S.-Soviet relations at that time.
165. Johnston, supra note 115, at 10. For example, the United States could deny the Soviets access to their dollar deposits in retaliation for a Soviet aggression, or to influence Soviet behavior by threatening to prevent them from using dollars in financing international transactions. Id.
167. Simpson, supra note 162, at 109. See also Einzig, supra note 145, at 30 (Soviets may also have attempted to conceal dollar deposits from U.S. authorities).
169. Id.
170. Id. The author notes that:
At the beginning the rates they [the Soviets] were prepared to accept on the Eurodollar deposits were slightly below the standard rates, for the sake of establishing relationship with those Western European banks which until then were not prepared to have any dealings with them. Before very long they [the Soviets] were able to obtain standard rates.
Id.
dollars in the United States in anticipation of future borrowing, the Eurodollar market proved to be a natural alternative for the Soviets as U.S. banks were prohibited from lending to Communist countries. Thus, the Soviets began depositing their dollars in Soviet owned banks such as Banque Commerciale de l’Europe du Nord, in Paris, and Moscow Narodny Bank, in London.

2. The Emergence of London as a Eurodollar Center

In the years immediately after the Second World War, the foreign currency business of banks consisted of traditional foreign banking. The Pound Sterling remained the major currency of international trade, so London continued as the financial center of Europe. Eventually, the dollar began to replace the pound as the major currency of international trade. However, London continued as Europe’s dominant financial center “... thanks to its excellent technical organization and to the abundance of specialized personnel which were lacking in other markets. Consequently, the market which has come to be called the Eurodollar market developed in London.” During the late 1950s and early 1960s, London was the only financial center where both borrowers and depositors could complete dollar transactions at any time. In contrast, continental Eurodollar markets, with the exception of Frankfurt and Zurich, contained more borrowers than depositors.

Since the 1950s, dollars have increasingly flowed into the Eurodollar market. The internationalization of banking and the growth of the Eurodollar market has been stimulated by national regulatory policies in both Europe and the United States. During the 1960s and 1970s, U.S. banking policy unintentionally promoted the use of Eurodollars by European governments as well as domestic and multinational corporations.

171. Id.
172. Id. The cable address for the Banque Commerciale pour l’Europe du Nord was ‘Eurobank.’ Id.
173. See supra notes 119-20 and accompanying text.
175. EINZIG, supra note 145, at 8 (quoting French financial commentator Paul Turot in the April 1961 issue of BANQUE).
176. Id. at 14.
177. Id.
178. See supra notes 157-63 and accompanying text.
179. JOHNSTON, supra note 115, at 12.
3. Influence of United States Regulation

During the 1960s and 1970s, the United States adopted regulations applicable to domestic banks limiting the flow of dollars out of the country. The demand for international financing in dollars shifted to the Euromarket because domestic regulations did not affect foreign branches of U.S. banks or foreign banks. In 1968, U.S. regulations restricted the ability of American corporations to borrow dollars domestically for expenditures incurred overseas. Additionally, interest rate ceilings on deposits, imposed by the U.S. Federal Reserve, allowed overseas banks to attract dollar deposits because they offered accounts with no interest rate ceilings. The lack of reserve and regulatory requirements in the Eurodollar market allowed for high interest rates on Eurodollar deposits. Except for three month deposits in 1958, Eurodollar rates on time deposits were consistently higher than U.S. interest rates.

Although the United States has changed its regulatory policies as well as phased out interest rate ceilings, the Euromarket continues to grow. However, U.S. domestic banks are still subject to reserve

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180. Id. (regulations such as the Interest Equalization Tax (IET) and Foreign Direct Investment regulations).
181. Id.
182. SHAPIO, supra note 61, at 672-73 (regulations from United States Office of Foreign Direct Investment (OFDI)). American corporations began looking to the Eurodollar markets to finance international operations. Id. at 673.
183. Id. at 672 (interest rate ceilings were imposed in Regulation Q).
184. EINZIG, supra note 145, at 168. The IET, introduced in 1963 and later repealed, affected the early stages of the development of the Euromarket. The IET taxed interest on foreign debt sold in the United States, thereby raising to the cost of borrowing by foreigners in the United States to unacceptable levels. SHAPIO, supra note 61, at 672-73.
185. An example of the impact of Regulation Q on the early development of the Eurodollar market is that under Regulation Q the maximum interest rates American banks were permitted to allow on time deposits from 1957 to 1961 were 1 per cent from thirty to ninety days, 2 1/2 per cent from ninety days to six months, and 3 per cent over six months. From April 1968, they were permitted to pay 5 1/2 per cent from three months to six months, and 6 1/4 per cent over six months. Although Euro-dollar rates had their ups and downs, they were all the time—except in 1958 for three months' deposits—higher than any of these rates. Even after the virtual repeal of this restriction American banks were not permitted to pay interest on deposits for less than thirty days.
186. EINZIG, supra note 145, at 28.

186. Despite the repeal of the IET and OFDI regulations, and the fact that Regulation Q has been phased out for Certificates of deposits of over $100,000, the Euromarket has continued to expand.
requirements and regulatory expenses such as Federal Deposit Insurance Corporation\textsuperscript{187} fees.\textsuperscript{188} Since Eurobanks do not incur these expenses, a greater proportion of Eurobank deposits can be lent to borrowers. Therefore, the interest rate on each dollar lent can be lower than the interest rate charged by a bank which must hold a larger proportion of its deposits on reserve.\textsuperscript{189}

Governments and multinational corporations find it more convenient to participate in the Eurodollar market than in the U.S. domestic market. Well known to the lender, and regularly active in the Eurodollar market, these borrowers require less cumbersome paperwork\textsuperscript{190} and disclosure procedures than do borrowers of dollars within the United States.\textsuperscript{191} Eurobanks may lend dollars to borrowers which U.S. banks may not be willing to provide absent additional disclosure by the borrowers.\textsuperscript{192}

U.S. regulatory policy promoted the development of the Eurodollar market. Additionally, the regulatory policies of each EEC Member

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Market Size</th>
<th>Rate of Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>379</td>
<td>21%</td>
</tr>
<tr>
<td>1978</td>
<td>478</td>
<td>26%</td>
</tr>
<tr>
<td>1979</td>
<td>578</td>
<td>21%</td>
</tr>
<tr>
<td>1980</td>
<td>705</td>
<td>22%</td>
</tr>
<tr>
<td>1981</td>
<td>859</td>
<td>22%</td>
</tr>
<tr>
<td>1982</td>
<td>1285</td>
<td>50%</td>
</tr>
<tr>
<td>1983</td>
<td>1382</td>
<td>8%</td>
</tr>
<tr>
<td>1984</td>
<td>1430</td>
<td>3%</td>
</tr>
<tr>
<td>1985</td>
<td>1676</td>
<td>17%</td>
</tr>
<tr>
<td>1986</td>
<td>1979</td>
<td>18%</td>
</tr>
<tr>
<td>1987</td>
<td>2377</td>
<td>20%</td>
</tr>
</tbody>
</table>

\textsuperscript{187} The Federal Deposit Insurance Corporation [FDIC] is a federal agency which was established in 1933. The FDIC guarantees, within limits, funds on deposit in member banks and performs other functions such as making loans to or buying assets from member banks to facilitate mergers or prevent failures. \textit{Downes & Goodman, supra} note 121, at 258.

\textsuperscript{188} \textit{Shapiro, supra} note 61, at 678.

\textsuperscript{189} \textit{Id.} For example, a three percent reserve requirement equates to about a 25 basis point cost disadvantage in the loan market at the interest rates prevailing in the American market in September 1989. Pozdena, \textit{supra} note 150.

\textsuperscript{190} A basis point is the smallest measurement of quoting yields on bonds and bank loans. One basis point equals 0.01%. \textit{Downs & Goodman, supra} note 121, at 183. If a borrower intends to borrow $1 million for one year paying interest monthly, an additional 25 basis points equates to an additional $30,000 in interest expense to the borrower over the course of the year. With multimillion dollar loan transactions, a few basis points can be the difference between one bank or another getting the client.

\textsuperscript{191} Because governments and multinational corporations present a lesser credit risk and borrow in the Eurodollar market on a more frequent basis than smaller sized corporations, there is less credit analysis and loan documentation done by banks than when smaller corporations borrow on the Eurodollar market.

\textsuperscript{192} \textit{Id.} at 168.
State affect the Eurodollar market in that country. A comparison of the banking laws of Great Britain and West Germany reveals how the Eurodollar market functions in different EEC banking systems.

B. A Comparison of Banking Regulations Between Great Britain and West Germany

Each EEC Member State has its own distinct financial system with unique institutional characteristics impacting on the country's approach to regulation. Some countries have highly concentrated banking systems with informal regulatory controls based on close institutional arrangements between regulators and bank management. Other countries have a more fragmented banking industry requiring formal methods and control. Despite attempts to coordinate regulation of banks among EEC Members, disparities and gaps remain in the regulatory system.

The decision to operate a bank in a particular European country is strongly influenced by the economic, regulatory, and financial market structure of that particular country. Legally related issues include the country's tax structure, exchange controls, ratio, and other requisite regulatory requirements imposed by the host country. Non-legal issues include the operating cost structure, the

193. R. D a l e , B a n k S u p e r v i s i o n A r o u n d t h e W o r l d (1982) [hereinafter D a l e ].
194. I d .
195. I d .
196. I d . For example, a gap in the regulatory structure exists because in many instances, neither the country where a bank branch is domiciled, nor the country where the parent bank is domiciled, monitors or regulates liquidity in the Eurocurrency markets. I d . at 3.
197. D a v i s , s u p r a note 126, at 35.
198. I d .
199. S e e s u p r a notes 143-45 and accompanying text discussing operating costs.

A bank's cost structure represents the expenses incurred by a bank in providing a loan to a borrower. The banks with the higher cost structures must charge more in interest to the borrower in order to earn the same 27.25 basis points spread on the loan. The following is an example of the cost structure of two banks:

<table>
<thead>
<tr>
<th>Loan Interest Rate*+</th>
<th>Bank A</th>
<th>Bank B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>9.0625%</td>
<td>9.3125%</td>
</tr>
<tr>
<td>Cost of Funds**</td>
<td>(8.44%)</td>
<td>(8.44%)</td>
</tr>
<tr>
<td>Administrative Costs</td>
<td>(.25%)</td>
<td>(.50%)***</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>(.10%)</td>
<td>(.10%)</td>
</tr>
<tr>
<td>Interest Rate Spread</td>
<td>.2725%</td>
<td>.2725%</td>
</tr>
</tbody>
</table>

* The Loan Interest Rate represents the closing LIBOR rate of 8.4375% for three month Eurodollar loans on March 2, 1990, as reported in the Wall Street Journal on March 5, 1990, plus an additional .625% for Bank A, and an additional .8725% for Bank B.
+ By comparison the U.S. Prime Rate was 10% on March 2, 1990, as reported in the Wall Street Journal on March 5, 1990. The LIBOR with the premium added by the banks is still
extent of barriers to accepting local deposit business, the availability of a professional work force, as well as the country’s time zone and communication capability in relation to other financial markets. These institutional factors dictate the regulatory climate and operation of the banking system, which in turn determines the international competitiveness of that country’s banks.

Great Britain traditionally has maintained one of the least regulated banking systems in the world. In contrast, the Federal Republic of Germany structures its banking system with more rigid controls. Because Great Britain and West Germany have divergent practices in the area of bank regulation, comparing their respective banking laws will assist in understanding the necessity for harmonizing banking laws throughout the EEC. This comparison is not intended to be an all-encompassing statement of the current banking laws in either country, but should illustrate how different historical experiences and institutional relationships among banks, regulatory agencies, and governments affect banking practices in each country. The banking practices of other EEC Member States will be noted where they differ significantly from the practices in Great Britain and West Germany.

1. Historical Development

The banking, financial, and commercial network of Great Britain is located in London, a financial center of great tradition and prestige in the world of finance. The Bank of England, established in lower than the benchmark U.S. lending rate, without consideration for premiums added to the Prime Rate by U.S. domestic banks.

** The Euro-CD rate banks pay to attract the deposits needed to fund loans is known as the banks cost of funds. The closing rate on March 2, 1990, was 8.44% for a three month Eurodollar deposit as reported in the Wall Street Journal on March 5, 1990.

*** Bank B incurs higher administrative costs or overhead either because it must meet more rigorous supervisory requirements in its home Member State, or because Bank A operates more efficiently than Bank B, or a combination of these factors.

200. DAVIS, supra note 126, at 35.
201. See FRIESEN, International Lending, (pt. 2), supra note 17, at 200-01.
202. This Comment only discusses the development of the West German banking system. The development of the East German banking system and the implications of East and West German reunification for the EEC are beyond the scope of this Comment.
203. See FRIESEN, International Lending, (pt. 2), supra note 17, at 200-01.
204. The other Member States which are active in the Eurodollar market and whose bank regulatory practices fall between the extremes of Great Britain and West Germany include Belgium, Luxembourg, and the Netherlands. See generally DALE, supra note 193 (describing bank supervision in these countries).
1694,206 is considered the world’s first currency issuing bank and holds a special place in the British banking system.207 By 1928, the Bank of England had acquired a monopoly on issuing currency, and in 1946 the Bank was nationalized.208 Since its nationalization, the Bank of England’s primary function has been to determine the country’s monetary policy in accord with the government’s Treasury Department; however, the Bank also carries out some ordinary banking operations.209 Traditionally, the British banking system has been characterized by a relative lack of laws.210 In fact, there is no legal definition of a bank and no official authorization is required before a new bank begins collecting deposits.211

In contrast to the long banking tradition of Great Britain, Germany did not develop modern banking practices until the nineteenth century, coinciding with the growth of industrialization in the new German state.212 The present organization of the West German banking system was put in place during the aftermath of the Second World War.213 In 1946, the pre-War central bank, the Reichsbank, was replaced by eleven regional currency issuing banks called Landeszentralbanken.214 These regional bank activities were coordinated by the Bank Deutscher Lander, following policies established by the British, French, and American authorities in charge of the territory

207. MASTROPASQUA, supra note 205, at 82.
209. MASTROPASQUA, supra note 205, at 83.
210. Id. at 81.
211. Id. at 83, 91. Supervision by the Bank of England is based on tradition, and banks starting operations should accept this supervision if they want recognition in the banking community. Id.
212. Id. at 99. The historical development of banking systems in other EEC Member States varies greatly. Belgium, like West Germany, did not form the National Bank of Belgium, Banque Nationale de Belgique, until the mid-19th century. Id. at 20. Luxembourg, due to its union with Belgium which has produced a joint monetary, foreign exchange, and foreign trade system, has no central bank at all. LOMAX & GUTMANN, supra note 124, at 142; MASTROPASQUA, supra note 205, at 40. However, the Netherlands, like Great Britain, has a banking tradition dating to the 17th century. The Netherlands continues to the present day to be an international banking center. Id. at 1.
213. See MASTROPASQUA, supra note 205, at 99. The Act of 21 June 1948 created the post-War banking system. Id.
214. Id.
which today is West Germany. In 1957, the eleven regional central banks were merged with the Bank Deutscher Lander to form the current West German central bank, the Deutsche Bundesbank.

The Deutsche Bundesbank is the central bank of West Germany. It issues currency as well as maintains the stability of the money supply by controlling the circulation of money and the granting of credit. The most recent revision of banking legislation covering bank supervision in West Germany was enacted in late 1984.

2. The Institutional Structure of Bank Regulation

Traditionally, bank supervision in Great Britain was flexible, with the monetary authorities regulating banks through the use of "moral persuasion" and "gentlemen's agreements". In response to the harmonization requirements of the First Directive, Great Britain adopted the Banking Act 1979, which for the first time provided a statutory basis for banking supervision. In order to improve the quality of bank supervision, Great Britain adopted the Banking Act 1987, which replaced virtually the entire Banking Act 1979. The Banking Act 1987, consistent with British tradition as well as the

215. Id.
216. Id. at 99-100. The Act of 26 July 1957 reorganized the banking system. The English translation of Deutsche Bundesbank is German Federal Bank, and the English translation is used when quoting German banking law.
217. Id. at 100.
218. MASTROPASQUA, supra note 205, at 100.
220. Id. at 81. For example, as with the tradition in the domestic market, there have been no limitations to the opening of branches abroad by British banks. However, the Bank of England wants to be informed when British banks open such branches, and it does not look favorably upon a British bank that conducts banking operations which are not authorized in Great Britain. Id. at 91.
222. DALE, supra note 193, at 58. The Banking Act 1979, granted the Bank of England primary responsibility for regulating and supervising deposit-taking business and for this purpose establishes two categories of institution: recognized banks and licensed deposit-takers. This two-tier system ... enables the Bank to maintain its traditional approach to the supervision of recognized banks based on direct contacts with management, while adopting more formal regulatory procedures in relation to licensed deposit takers.
Second Directive, liberalized the banking system by allowing more competition for consumer deposits.\textsuperscript{225}

The Bank of England is the monetary authority charged with supervision of banking activities in Great Britain.\textsuperscript{226} It reviews developments in the field of banking relevant to its supervisory function.\textsuperscript{227} After gaining authorization from the Treasury, the Bank of England may issue directives to any bank for the purpose of assuring that a recommendation is carried out by the bank.\textsuperscript{228} The Bank of England has opposed instituting a rigid system of bank supervision, such as requiring banks to maintain a minimum capital ratio.\textsuperscript{229} Rather, it prefers to advise each bank based on the relationship of the bank's capital and reserves to its banking practices.\textsuperscript{230}

West Germany has adopted a bifurcated bank regulatory structure, with the \textit{Deutsche Bundesbank} establishing policy and the Federal Supervisory Authority actually supervising West German banks in cooperation with the \textit{Deutsche Bundesbank}.\textsuperscript{231}

\begin{thebibliography}{99}
\bibitem{Banking Act 1987} Banking Act 1987, \textit{supra} note 223, at § 108, ¶ 2, sch. 7, pt. I. The notes to § 3 state: The Banking Act 1979 . . . established a system of recognition and licensing which distinguished between banks and other deposit-taking institutions. . . . The supervisory function of the Bank of England was intended to be more stringent in relation to recognized banks. However, events proved . . . that the two tier system of regulation did not guarantee effective supervision. This Act [Banking Act 1987] provides for a single system of authorization which in combination with stricter requirements as to the conduct of business is intended to lead to more effective supervision of banking practice. \textit{Id.} at § 3 notes.
\bibitem{Id. at § 1} \textit{Id.} at § 1, ¶ 1.
\bibitem{Id. at ¶ 2} \textit{Id.} at ¶ 2. The Bank of England “[a]s soon as practicable after the coming into force of this section . . . shall establish a committee to be know as the Board of Banking Supervision.” \textit{Id.} at § 2, ¶ 1.
\bibitem{Mastroppasqua} Mastroppasqua, \textit{supra} note 205, at 92. However, these powers have never been exercised, since the central Bank has always preferred to exercise its powers of control over banks and other financial institutions through voluntary and spontaneous collaboration. \textit{Id.} at 93. In the Netherlands, the structure of the bank regulatory system is similar to that of Great Britain’s. The \textit{Nederlandsche Bank}, like the Bank of England, is responsible for enforcing bank regulations. Although structured like Great Britain, the Dutch regulatory system is complex and rule oriented like the system in West Germany. The system of supervision is highly formal, involving detailed regulations on solvency and liquidity requirements. The \textit{Nederlandsche Bank} has broad powers to inspect banks and verify financial records through on-site inspection. \textit{See} Friesen, \textit{International Lending}, (pt. 2), \textit{supra} note 17, at 179, 202; Dale, \textit{supra} note 193, at 47, 50.
\bibitem{Mastroppasqua note 205} Mastroppasqua, \textit{supra} note 205, at 93. Another commentator notes that traditionally . . . [a] rule-based system has been viewed as unnecessary because of the small number of major commercial banks (Barclays, Lloyds, National Westminster, and Midland), the physical proximity of the Bank of England to each of the four, and the long-standing pattern of frequent extensive discussions between senior bank officers and representatives of the Bank of England. Friesen, \textit{International Lending}, (pt. 2), \textit{supra} note 17, at 200.
\bibitem{Feltzer & Brooks} Feltzer & Brooks, \textit{supra} note 219, §§ 6(1), 7(1) at 34. “The Federal Supervisory Authority supervises the credit institutions in accordance with the provisions of this Law.” \textit{Id.}, § 6(1) at 34. Further, “[t]he Federal Supervisory Authority and the German Federal Bank shall act in cooperation in accordance with this Law.” \textit{Id.}, § 7(1) at 34.
\end{thebibliography}
bank regulates the West German banking system by fixing the discount rate, imposing obligatory reserves on banks, and conducting open market operations.²³² Although the bank is a public institution which is required to follow the general economic policy of the government, it maintains complete independence in its operations.²³³ Banking operations cannot begin in West Germany without written authorization from the Federal Supervisory Authority.²³⁴ Authorization may be refused if the funds destined for the exercise of banking activities are considered insufficient or in cases where the promoters and directors do not possess the requisite professional qualifications.²³⁵ West German branches of foreign banks are supervised and regulated in the same manner as domestic banks.²³⁶ The Federal Supervisory Authority and the Bundesbank have broad powers to obtain information from banks.²³⁷ The Federal Supervisory Authority and the Bundesbank review bank financial reports in order to determine what regulations and financial requirements will be imposed on

²³² MASTROPASQUA, supra note 205, at 100.
²³³ Id. at 100-01.
²³⁴ PELTZER & BROOKS, supra note 219, § 32(1) at 62. "Whoever intends to conduct banking transactions . . . in the territory in which this Law is effective shall require a written licence from the Federal Supervisory Authority." Id.
²³⁵ Id., §§ 1(2), 33(1)-(2) at 31, 63. "Banking managers within the meaning of this Law shall be those natural persons who, according to statute, articles of association or partnership agreement, are appointed to manage and represent [authorization to bind the entity for which the person acts] a credit institution organized as a body corporate or a partnership." Id., § 1(2) at 31.
²³⁶ The license may be refused only "if there exist facts which indicate that the applicant or one of the persons referred to in § 1, paragraph (2), sentence 1, is not reliable;" Id., § 33(1) no. 2 at 63. The statute further states that:

The professional qualification of the persons named . . . to manage a credit institution requires that they have sufficient theoretical and practical knowledge of banking business as well as senior management experience. The professional qualification to manage the affairs of a credit institution shall as a general rule be deemed to exist if three years' service in an executive position with a credit institution of comparable size and type of business is proven.

Id., § 33(2) at 63.
²³⁷ Id., § 53(1)-(2) at 76.
²³⁸ Id., § 26(1), (4) at 57.
²³⁹ Credit institutions must prepare a balance sheet and profit and loss account (financial statements) within the first three months of the financial year in respect of the preceding financial year and file these financial statements and at a later date the approved financial statements and management report . . . with the Federal Supervisory Authority and German Federal Bank; explanatory comments on the financial statements shall be included in an annex to the balance sheet.

Id., § 26(1) at 57. "The Federal Minister of Justice can, in agreement with the Federal Minister of Finances and with the German Federal Bank, issue decrees setting out detailed provisions concerning the preparation of the financial statements . . . to the extent this is necessary to achieve the objectives of the Federal Supervisory Authorities. . . ." Id., § 26(4) at 57. See also Friesen, Lending Supervision, (pt. 1), supra note 17, at 1097 (supervisory authorities have broad powers to request information from banks).
each bank. These institutions base their decisions on annual auditors’ reports submitted by banks rather than conducting on-site inspections at each bank. After a consensus between the two is reached, the Federal Supervisory Authority issues detailed regulations on the financial requirements for banks. These regulatory requirements coupled with close supervision distinguish the West German banking system from that of Great Britain.

Because of its strict domestic banking laws, West German banks conduct many international and Euromarket transactions outside of West Germany. Since the Second World War, Luxembourg has adopted liberal banking legislation which has attracted both foreign banks and foreign investment. Luxembourg has therefore emerged as an alternative location for West German banks seeking to conduct international operations. If German banks had not operated in Luxembourg and avoided the reserve requirements, they would have been at a substantial disadvantage in the Euromarket.

3. Regulation of Foreign Banks

A foreign bank subsidiary in Great Britain is regulated in the same manner as a domestic bank. Determination of a subsidiary’s finan-

238. Peltzer & Brooks, supra note 219, § 11 at 41.
239. Id., § 27(1) at 59. “Before being approved, a credit institution’s financial statements with annex . . . shall be audited by one or more auditors . . . .” Id.
240. Id., § 10 at 36.
241. Belgium combines the supervisory structure of West Germany with the informal attitude towards supervision of Great Britain. Belgium’s supervisory structure places responsibility for bank policy with the National Bank with the supervisory function belonging to the Commission Bancaire (CB). Belgium differs from West Germany in that the CB prefers to act in an informal manner similar to the practice in Great Britain. Commercial banks form a small cohesive group which takes pride in its consultative relationship with the CB. Belgian banks operate in an environment relatively free of strict rules and regulations. See Mastropasqua, supra note 205, at 22; Dale, supra note 193, at 18. See also Friesen, International Lending, (pt. 2), supra note 17, at 153, 168, 169, 171 (discussing different supervisory methods).
242. Friesen, International Lending, (pt. 1), supra note 17, at 1105. “. . . [A] major problem for bank regulators in the Federal Republic of Germany was the large number of international loans made through foreign subsidiaries, especially in Luxembourg, that escaped effective regulation. Recently adopted rules on consolidation will end the practice of circumventing domestic regulation by making loans through subsidiaries.” Id.
244. Lomax & Gutmann, supra note 124, at 142-44, 146. A number of factors have combined to make Luxembourg attractive to foreign financial institutions. Luxembourg shares borders with Belgium, France, and West Germany, and as a result its population is largely trilingual. This language proficiency allows banks to conduct business for clients in any one of these countries from one cost efficient location. Historically, German banks have operated in Luxembourg, avoiding reserve requirements on international business imposed by West German regulators. Id.
245. Davis, supra note 126, at 35.
246. Friesen, International Lending, (pt. 1), supra note 17, at 1096. In the Netherlands,
cial stability is made independently of the foreign parent organization.247 Branches of foreign banks, however, are treated differently than subsidiaries.248 Authorization for branches to conduct banking operations is based on the financial strength of the foreign parent institution.249 Because branches are not required to meet separate capital requirements, it is much easier for a foreign bank desiring to conduct operations in Great Britain to establish a banking branch than a subsidiary.250 The Second Directive, however, substantially impacts the decision of whether to operate as a branch or a subsidiary after 1992.251

In West Germany, all foreign banks operating branches or subsidiary banks must be licensed by the Federal Supervisory Authority.252 Foreign parent banks operating in West Germany must supply branches or subsidiaries with an appropriate amount of initial capital.253 Although it is not difficult for foreign banks to begin operations, once established, they face the same strict supervision and limitations on their banking operations as do domestic banks.254

C. Anticipated Changes Due to the Second Directive

While banking regulations in Great Britain favor establishing branches, the Second Directive requires that non-EEC based banks establish a subsidiary before access is allowed throughout the entire EEC.255 Banks currently operating as branches in Great Britain must

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247. DALE, supra note 193, at 58.
249. Id. See also DALE, supra note 193, at 58. (the Netherlands requires foreign banks to provide information about ability of parent organization to supervise operations).
250. DALE, supra note 193, at 58; see also Friesen, International Lending, (pt. 1), supra note 17, at 1096 (branches not required to maintain separate branch accounts). By contrast, the Netherlands requires branches of foreign banks to maintain separate branch accounts, listing the amount of initial capital contributed by their parent organizations. DALE, supra note 193, at 48; see also Friesen, International Lending, (pt. 2), supra note 17, at 187 (branches of foreign banks maintain separate capital).
251. See supra notes 76-92 and accompanying text.
252. FELTZER & BROOKS, supra note 219, § 32(1) at 62.
253. DALE, supra note 193, at 30. This is a marked difference from the licensing of branches in Great Britain where capital from the parent is examined in determining whether to grant a license to a branch. Id.
254. FELTZER & BROOKS, supra note 219, § 52 at 75.
255. See supra notes 246-51 and accompanying text.
incure the expense of forming a subsidiary under the Second Directive\textsuperscript{256} or face the prospect of losing clients to banks which have established a subsidiary in Great Britain and have opened offices near their clients on the continent.\textsuperscript{257}

London can expect that its preeminent position in the Eurodollar market will be challenged by other EEC financial centers. As the differences in the regulatory requirements of Member States disappear, banks will have less reason to form subsidiaries in London rather than in other EEC financial centers. Even before regulatory distinctions disappear, bank subsidiaries located in London will open offices in other financial centers while benefiting from the comparatively lax regulatory requirements in Great Britain. These new offices will attract local business to the new financial center, and away from London.

Because of its rigid regulatory system, West Germany will see an influx of banks established as subsidiaries in other Member States as a result of the Second Directive. These new banks will be organized under the less restrictive laws of the home Member State and will be able to conduct the activities allowed by the home Member State and the Annex\textsuperscript{258} at a lower cost than West German banks. The West German banking authorities will have to respond to this increased competition by non-West German banks. The regulatory requirements for West German banks will have to be lowered in order for domestic banks to successfully compete with the non-West German banks. This lowering of regulatory requirements will provide a classic example of the race for the bottom.\textsuperscript{259}

The Eurodollar market in West Germany should grow in size as banks will be able to service the Eurodollar needs of West German clients closer to home. For example, a West German client will be able to contact the local office of its British bank in West Germany, instead of in London. Initially, non-West German banks should dominate the growing Eurodollar market in West Germany because

\textsuperscript{256} See supra notes 76-81 and accompanying text describing the minimum requirements for establishing a subsidiary.

\textsuperscript{257} An example would be a West German Firm currently depositing the dollars it receives from dollar denominated transactions in Bank A located in London where it earns a higher rate of interest than in West Germany. Such a firm may also have Eurodollar borrowing needs when purchasing goods in dollars. If Bank B, also located in London but organized as a subsidiary, opens an office in Frankfurt, the West German firm will desire to deposit its dollars in Frankfurt for administrative convenience and cost savings in communicating with Bank B.

\textsuperscript{258} See supra notes 36-42 and accompanying text.

\textsuperscript{259} See supra notes 54-58 and accompanying text.
of their lower cost structure. However, as West German regulatory restrictions are removed, West German banks will begin to compete successfully with non-West German banks and to gain an increased share of the market.

Competition in the Eurodollar market will increase as a result of the Second Directive. EEC based banks located in one Member State will open offices closer to their clients in other Member States to provide Eurodollar services. The volume of Eurodollar activity in the current financial centers such as London and Luxembourg should decline as offices are established in countries such as West Germany. Over time, domestic banks in countries with strict regulatory requirements will become more competitive as market pressures force their governments to adopt less restrictive bank regulations. Banking integration will produce changes in the Eurodollar market for depositors, borrowers, and lenders alike.

V. THE IMPACT OF BANKING INTEGRATION ON THE EURODOLLAR MARKET

A. Impact on Depositors and Borrowers

By creating a single market, the EEC will stimulate growth in industries other than banking. As economic growth occurs, international trade between the EEC and the rest of the world will expand, increasing the supply of dollars flowing into the EEC as well as the demand for dollars by firms financing international purchases of goods and services. Multinational corporations will continue their

260. Luxembourg will continue to have the facilities and trained personnel to compete in the Eurodollar market. But with the Second Directive opening access to other EEC Member States, particularly West Germany, Luxembourg should experience a reduction in Eurodollar deposits held and loans extended from banks operating in Luxembourg. Banks located in Luxembourg, because of the liberal banking environment, will open offices closer to their clients in other EEC countries. The volume of Eurodollar activity originating in Luxembourg should decline as a result of the Second Directive.


The completion of the internal market which will bring an expansion - sometimes considerable - of the market in which enterprises do business, provides scope for increasing the size of operations, and this can lead to considerable reductions in costs. The term "economies of scale", used generally to describe the effects of size on costs, covers a wide range of phenomena, from purely static economies of a technical nature to dynamic phenomena linked to experience.

Id.

262. See supra notes 157-63 and accompanying text.
cash management practices by placing more dollars in investments such as Eurocertificates of deposit. In addition to increased deposits by existing Eurodollar market participants, the Second Directive will permit banks to tap new sources of Eurodollar deposits in order to fund the increased demand for Eurodollar loans. Therefore, Eurobanks will see an increase in both the supply and demand for Eurodollars.

1. Depositors: Untapped Sources of Eurodollars

Traditionally, medium and small firms have not participated in the Eurodollar market due to their size or lack of financial sophistication. These smaller firms will have the opportunity to become "Euroinvestors."

For example, a British bank may open a branch in West Germany, accepting deposits in marks and other currencies such as the dollar. West German companies currently depositing dollars into local West German banks will have more banks competing for their dollar deposit business. Thus, it will be more convenient for medium and small size firms to deposit dollars in a West German branch office of a British bank than it would be to conduct business in London.

Banking integration permits banks from different EEC Member States with lower cost structures to compete directly with the local bank for dollar deposits. The banks with lower cost structures can offer higher interest rates on Eurocertificates of deposit, thereby attracting deposits while continuing to earn income on the bank's Eurodollar loans. Medium and small firms will have the same opportunity as multinational corporations to utilize the Eurodollar market for cash management purposes. As the interest rates on Eurodollar deposits climb, the margins on Eurodollar loans should decline.

2. Borrowers

If, as anticipated, economic growth occurs in the EEC, multinational corporations will have a greater demand for Eurodollars in

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263. For the Euromarket, the most important of the activities allowed under the Annex are deposit-taking and other forms of borrowing, lending, and trading for one's own account or for the customer in money market instruments (e.g., cheques, CDs). See supra note 26 (text of Annex to Second Directive).

264. See supra note 91 and accompanying text.

265. See supra note 199 and accompanying text.
order to finance international trade transactions. Additionally, medium and small firms which had not participated in international trade will have new opportunities to purchase goods and services from abroad. These firms, experiencing growth in their foreign trade, will require Eurodollar loans for the first time.  

Interest rates on loans are less in the Eurodollar market than in the U.S. domestic market. This interest rate differential, which should increase after the Second Directive is implemented, should result in increased Eurodollar borrowing. American corporate borrowers seeking to issue Eurobonds are finding that the European market is concerned over the borrower's credit quality and the prospects for corporate takeovers. Instead of issuing bonds, large corporations are borrowing on the Eurodollar loan market. Moreover, medium size U.S. firms, continuing the trend of the past five years, will increasingly borrow Eurodollars.  

Finally, sovereign borrowers, who once formed the backbone of the Eurodollar loan market, may find the reduced interest rates attractive and re-enter the market. Before the debt crisis of 1982, sovereign borrowing was the principle source of lending activity in the Euromarket. In recent years, sovereign borrowers representing good credit risks have raised dollars by other means. Today, sovereign borrowing makes up only four percent of the market.

266. Banks will charge the new high risk borrowers higher interest rates than less risky multinational corporations because they are either new to the market, or not as strong financially so there is a greater risk of the debt going bad. See also infra notes 279-82 and accompanying text (discussing banks going "down-market").  
267. See supra note 199 and accompanying text (LIBOR considerably lower than U.S. prime rate).  
268. See Kochan, Lenders Step Into The Breach, Euromoney, Dec. 1989, supp. at 23 [hereinafter Kochan]. "[Takeovers] have made the equity holders rich and left the bond holders on the sidelines." Id.  
269. Id.  
270. See id. at 24. Bank of America has specialized in bringing medium-sized U.S. corporations to the loan market over the last five years. Id.  
271. The debt crisis began in 1982 when Mexico announced it was unable to continue making payments on its international debt. See Bagdanowicz-Bindert, World Debt: The United States Reconsiders, 64 For. Aff. 259, 262 (1985-86) (excellent overview of events in mid-1970s leading to debt crisis and of United States response to crisis through 1985); Cline, Mexico's Crisis, The World's Peril, 49 For. Pol'y 107 (1982-83) (describing how debt crisis began in Mexico, but has worldwide ramifications for all debtor and creditor nations).  
272. Kochan, supra note 268, at 106; see also Moreno, supra note 153 (since 1982 debt crisis international investors prefer holding direct credit over Eurodollar deposits).  
273. Keller, Lend The Money, Then Sell the Debt, Euromoney, Aug. 1989, at 106 [hereinafter Keller] (Eurobonds and Euronotes have been the preferred financing device); see also Moreno, supra note 153.  
274. Keller, supra note 273, at 106.
However, with the Eurodollar loan rates expected to decrease, sovereign borrowers may re-enter the loan market taking advantage of the flexibility of Eurodollar loans.

B. The Market Risk for Banks

The effects of the Second Directive will result in "the possible reduction in costs of intermediation by banks . . . ."275 The Eurodollar market is already extremely competitive, and the Second Directive will force banks to adapt to an even more competitive environment. Banks wishing to continue operating in the Eurodollar market may have to accept what would otherwise be unacceptable risks to remain profitable.

Currently, banks are finding it difficult to operate profitably in the Eurodollar market because "interest margins and fees languish at rock bottom levels."276 But banks struggling to retain valued relationships with clients will get the deal done at any price.277 Sometimes a bank will sacrifice earning a profit on a specific Eurodollar loan if the borrower’s overall relationship with the bank is profitable. As banks begin operating on an EEC-wide basis they should centralize their administrative operations in order to fund loans at a lower cost.278 Only these banks will be able to lend to the strongest borrowers at the upper end of the market.

All banks in the Eurodollar market, especially those that are not able to cut costs,279 will compensate for the thin margins at the upper end of the market by moving down-market and lending to the higher risk borrowers.280 After the higher risk borrowers enter the market, Eurodollar loan rates should rise, but remain less than the market interest rate before banking integration.281 Additionally, lending at a

277. *Id.* at 100.
278. See supra notes 104-08 and accompanying text.
279. See supra notes 70-72 and accompanying text.
280. The Eurodollar loan market will be two-tiered. Borrowers at the upper end of the market, will continue to receive Eurodollar loans which are unprofitable to the banks, but necessary for relationship purposes. Borrowers at the lower end of the market must pay a higher interest rate because they represent greater credit risks to the bank.
281. The average interest rate for all borrowers in the Eurodollar market will indicate a reduction in the interest rate after banking integration. This can be shown graphically as
higher interest rate to riskier borrowers and earning higher income in effect subsidizes the banks' Eurodollar loans to the best borrowers. If banks manage their loan portfolios prudently, moving down-market should not be a problem; however, in moving down-market in search of profits, banks may start to overlook potential credit

follows:

![Graph showing supply and demand curves for Eurodollars.]

S1 equals the supply of Eurodollar deposits, and D1 equals the demand for Eurodollar loans. Let p1 represent the current price for a Eurodollar loan and q1 equal the quantity of Eurodollar borrowers.

The supply of Eurodollar deposits will increase because of more dollars flowing into the EEC and since previously untapped holders of dollars are beginning to deposit their dollars into banks more willing to utilize the deposit. The result is a shift in the supply curve from S1 to S2 and there is movement along the demand curve D1. The demand curve has remained constant, but because there are excess dollars, banks are actively lending the Eurodollars that they did not have before the supply of Eurodollars increased. The result is a decrease in the interest rate of a Eurodollar loan from p1 to p2.

Banks will compensate for this by locating borrowers who previously did not have a need or who were not actively engaged in the Eurodollar market. As new borrowers are added, the demand curve shifts from D1 to D2. The result is that the interest rate on a Eurodollar loan rises from p2 to p3.

This graph was designed without consideration for the cross-elasticity of demand for other currencies such as the mark or the pound. The interest rates of various currencies in relation to each other influence the supply and demand for those currencies. The "cross-elasticity of demand" is defined as "The responsiveness of quantity demanded of one good to a change in the price of another." ECONOMICS DICTIONARY, supra note 16, at 91.
risks. Banks must be careful that competition in the marketplace does not replace prudence resulting in large amounts of bad debt in the Eurodollar market.282

VI. Conclusion

The EEC's attempt to forge a single market of the Member States is ambitious when considering the historical, institutional, and legal diversity in the community. If the single market is to succeed, it is vital that the EEC achieve banking integration. The Second Directive, built on the mutual recognition of banking licenses and home Member State supervision, will improve the competitiveness of EEC banks, and lower banking costs throughout the EEC. In time, as Member States race for the bottom, the regulatory and supervisory differences are expected to disappear. Although London should continue as the EEC's financial center, as banks begin operating on an EEC-wide basis, other financial centers on the continent should grow appreciably.

EEC banking integration will significantly impact the Eurodollar market. Just as restrictive U.S. regulatory policies helped create the Eurodollar market, the EEC's banking integration will promote market competition as well as growth. Lawyers discussing these changes with American or European depositors and borrowers must be aware of the impact of banking integration in the EEC on their clients who interact in the Eurodollar market.

Depositors and borrowers operating in the Eurodollar market will find the market more competitive after the Second Directive comes

282. Large Eurodollar loans are made through loan syndications, in which several banks agree to fund a portion of the loan and assume part of the risk of the borrower defaulting on the credit. By spreading the risk among several banks, there is less chance that any one bank will absorb a large loss due to a borrower defaulting on a loan. See generally Shapiro, supra note 61, at 775 (discussing syndicated loans and country risk). The bank that negotiates the loan with the borrower and manages the relationship after the loan is funded is called the lead bank or syndicated loan manager. A lead bank usually earns an additional fee for arranging the loan.

The ten largest lead banks in 1988 are:

1) Citicorp
2) J.P. Morgan
3) Bankers Trust Company
4) Manufacturers Hanover
5) Chase Investment Bank
6) Chemical Bank
7) Barclays de Zoete Wedd
8) Midland Montagu
9) National Westminster
10) CSFB

Brady, Assets Must Earn their Keep, Euromoney, Mar. 1989, supp. at 35.
into force. The Eurodollar market’s size should increase, with depositors and borrowers experiencing unprecedented investment and borrowing opportunities. Initially, the interest rates on Eurodollar loans should decline due to a surplus in dollar deposits, but banks will compensate by accepting greater risk on their loans. Medium and small firms that previously did not require Eurodollar loan financing, or borrowers who previously would not have qualified for Eurodollar loans, will provide the banks with the income they need to stay in the Eurodollar market.

The Second Directive will apply only to newcomers, because the EEC does not intend to apply it retroactively. Therefore, lawyers advising non EEC banks planning to begin operating in the EEC should advise clients to form or purchase a subsidiary in an EEC Member State before the Second Directive takes effect. Entry into the EEC should be accomplished as quickly as possible to avoid the potential of additional costs and the reciprocity requirement of the Second Directive. The client should seek to establish a subsidiary in the country with the least restrictive regulatory supervision and then expand into the remainder of the EEC after January 1, 1993.

Non EEC based banks currently operating as branches in the EEC must decide whether to spend the capital necessary to form or purchase a subsidiary. If non EEC banks currently operating as branches choose not to form a subsidiary, they will not be able to participate in EEC-wide banking. Most American banks face this decision because the vast majority currently operate as branches rather than subsidiaries. All banks must contend with increasing competition and ever thinner profit margins.

Robert Lantz