1992

Qz 06403 CONFIDENTIAL

Prime Minister

There is a good summary at the front.

CDP.

MR C POWELL

CAPITAL, BANKING AND FINANCIAL SERVICES: REMAINING RESTRICTIONS

Your minute of 19 June asked the Cabinet Office to put together with Departments a list of remaining restrictions on capital movements and financial services.

The attached papers by the Treasury (flag A) and the Department of Trade (flag B) contain a full analysis of the position. In each case an account is given of restrictions which have been removed; restrictions which are scheduled for removal; and restrictions not covered by existing Directives.

The commentaries included with the analysis draw attention to areas where it would seem unhelpful to press for removal of restrictions eg because the alternative would be unwelcome over-regulation or Community engagement in tax issues. More generally the Prime Minister will have in mind that in some cases the flows potentially involved are quite modest: and that in others a change of regime will be only achievable in the medium term.

Against this background the attached summary sheets identify (with paragraph references) issues noted in the papers by the Departments to which it may be right to give particular attention.

R G LAVELLE

23 June 1989

CAPITAL LIBERALISATION, BANKING ETC

From the Treasury analysis the following issues might be picked out:

1. Capital liberalisation: implementation (paragraph 7)

Removal of the principal remaining restrictions still imposed by France and Italy

2. Review of operation of Capital liberalisation Directive (paragraph 9)

There may be a case for a review covering such matters as:

(i) Variation of prudential controls of investments by insurance companies and of pension funds (paragraph 9 (i)).

(ii) Liberalisation of third country controls (paragraph 9 (v))

(iii) Limitations on issue of foreign currency bonds (paragraph 9 (vi))

3. Restrictions on financial techniques (paragraph 12 (i))

Early action to remove restrictions on product types through the Mortgage Credit Directive.

4. Policing of Banking Directive (paragraph 12 (ii))

Some flexibility in conduct of business arrangements would be in the UK interest but the operation of the Banking Directive should be adequately policed eg to remove persisting national discrimination in personnel appointments.

FINANCIAL SERVICES

From the Department of Trade analysis the following issues might be picked out:

1. **Investment Services Directive (paragraph 4 (i))**
Timely completion of the draft Directive, together with the related Directive on capital requirements, with implementation to match the recently agreed Second Banking Directive

2. **Life Services Directive (paragraph 5 (i) and 6)**
Timely implementation on a liberal basis. Early production by the Commission of a draft companion Directive on group and employment - related insurance.

3. **Takeover Directive (paragraph 7)**
Working Group discussion on the draft text has not yet begun

4. **Additional liberalisation measures (paragraphs 9 -12)**
Existing programme of insurance directives only represents a limited step to freedom of trade in insurance. Directives providing for full liberalisation in both life and non-life fields to be brought forward as soon as practicable. Scope for second-stage liberalisation in securities area (Investment Services and UCITS).

5. **Barriers to takeovers (paragraph 13-14)**
The Commission is already undertaking a study of barriers to takeovers. We look for a report and recommendations bearing on such issues as differential voting rights of shareholders at an early stage.

OBSTACLES TO A FREE MARKET IN EUROPE

1. The purpose of this note is to identify restrictions on:

   i. free movement of capital; and

   ii. a free market in banking and mortgage credit services

in the European Community. In each of these areas we outline first restrictions which have already been lifted; second restrictions due to be removed under Directives already agreed; and third, restrictions not covered by existing Directives.

i. FREE MOVEMENT OF CAPITAL

a. Restrictions which have been lifted

2. Over the last decade there has been a steady process of liberalisation of capital movements among EC countries encouraged by the broad obligations of the Treaty of Rome and the OECD Code of Liberalisation of Capital Movements.

3. A Directive agreed in 1960 provided for implementation of Article 67 of the Treaty which requires member states to 'progressively abolish among themselves all restrictions on the movement of capital.' Outstanding restrictions are reviewed annually by the Monetary Committee. The Directive did not establish a binding obligation to remove certain restrictions, notably those on short term movements, issuing of unlisted securities and non-commercial loans.

4. In line with those obligations, the UK abolished virtually all exchange controls in 1979. West Germany followed in 1981 (having abolished controls on outward movements in 1966), and the Netherlands followed in 1986 (having abolished controls on inward movements in 1983). Belgium and Luxembourg jointly maintain a dual exchange rate with separate official and free rates, but otherwise have no controls.

5. The Capital Liberalisation Directive agreed in June 1988 (which replaces the 1960 directive) requires removal of all remaining restrictions on movements of capital between member states. The deadline for most countries is 1 July 1990. Four states (Spain, Portugal, Greece and Ireland) are required to remove controls by 31 December 1992, but there is provision for this deadline to be deferred for up to three years by Greece and Portugal.

6. Already substantial steps towards liberalisation have been taken by several member states. Denmark abolished remaining exchange controls in October 1988. France removed remaining restrictions on commercial transactions in March this year. Ireland liberalised a number of exchange controls with effect from 1 January 1989 and Italy, anticipating the Directive, substantially relaxed exchange controls in June 1988. Spain has progressively dismantled exchange controls (subject to tightening of controls on foreign currency borrowing in June 1988) in order to comply with its Treaty obligations by the end of this year. Greece has taken several steps towards liberalisation in the last two years.

b. **Restrictions to be lifted under Directives already agreed**

7. The principal remaining restrictions to be removed by 1 July 1990 are:

France: restrictions on holdings of foreign and foreign currency bank accounts by residents.

Italy: restrictions on holdings by residents of lines of credit in favour of foreign countries and forward or option transactions in foreign exchange with foreign counterparties.

8. The principal restrictions to be removed by 31 December 1992 are:

Belgium and Luxembourg: dual exchange rate. The two countries have agreed to administer the system so as to ensure no notable or lengthy spreads between the two markets.

Greece: extensive controls on both inward and outward movements remain.

Ireland: restrictions on Irish punt lending to non-residents (other than for commercial transactions in which a resident is participating) and the buying of foreign currency other than for approved purposes such as trade or travel.

Portugal: almost all transactions in foreign exchange are subject to prior registrations with the Ministry of Finance.

Spain: restrictions remain on inward direct investment in certain sectors. Remaining controls on outward investment include ceilings on certain overseas portfolio investment and restrictions on short term foreign currency borrowing by residents.

c. Remaining Restrictions

9. The restrictions on free movement of capital which are likely to remain once the Capital Liberalisation Directive is implemented in full may be grouped under the following headings:

(i) Prudential Controls: Article 4 of the 1988 Directive allows Member States to take measures needed for prudential control of financial institutions, provided they do not impede capital movements. All EC states (including the UK) control investments by insurance companies for this purpose and most states control investments by pension funds.* Germany for example broadly limits overseas investments by pension funds and life assurance companies to 5% of assets and these investments must, in general, be held in securities listed in Germany.

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*See Annexes A and B

Comment: The UK recognises the need for prudential controls to avoid (among other risks) undue currency risk and country risk. However prudential controls designed to avoid currency risk are stricter in certain member states than they are in others. For example the UK requires that insurance companies should hold assets in one currency sufficient to match 80% of liabilities in that currency. Germany requires 100% currency matching. It might be difficult to persuade the Germans that their prudential arrangements are too restrictive: their argument would be that ours are too lax. Leaving currency risk aside, however, there should be no need in a Single Market to treat investments in other member states as necessarily involving higher credit risk than investments in the home state. There may be a case for the Commission reviewing this area, and in particular prudential controls to identify those which are not compatible with the Directive, but it is more likely that such a review would quickly run into the sand.

(ii) Tax Distortions: Tax incentives to invest in domestic instruments are widespread in the Community and distort capital flows. For example, Belgium, France and Spain offer income tax relief on certain purchases of shares in domestic companies. France and Luxembourg offer extensive tax reliefs on interest from domestic savings accounts. The UK offers tax incentives for investments in UK companies through PEPs and the Business Expansion Scheme and for savings through National Savings and Government debt. The Commission has declared that such distortions should be eliminated but is taking a pragmatic approach.

Comments: UK pressure to eliminate such distortions would require us to accept that PEP and BES investments should not be limited to UK firms, and that tax treatment of National Savings and Gilts should be reviewed.

(iii) Controls on Inward Investment: Most countries, including those which profess to have abolished all exchange controls, maintain restrictions on certain types of inward direct investment. For example Germany, Netherlands and the UK restrict

foreign investment in national airlines and ownership of flag vessels except through domestic companies. France requires authorisation for foreign investment in mining, oil refining, nuclear power and certain other sectors. (These restrictions are set out in reservations to the OECD Capital Movements Code). The UK also uses 'golden shares' to restrict foreign investment (eg in Rolls Royce).

Comment: UK pressure for action on this front would require review of our own restrictions.

(iv) Reserve powers: The 1988 Directive allows member states to take 'protective measures' where exceptional short term capital movements impose severe strains on foreign exchange markets. Hence member states may maintain domestic legislation to enable them to reimpose such controls.

Comment: Full freedom of capital movements would require elimination of such reserve powers. (However elimination of all reserve powers could require abolition of UK emergency powers legislation which was used for example to freeze the assets of Argentine nationals during the Falklands War.) This is unlikely to be a fruitful avenue for the UK to pursue.

(v) Third Country Controls: the 1988 Directive requires member states to endeavour to attain the same degree of liberalisation for movements of capital to or from third countries as is achieved within the Community. There is however no binding obligation.

Comment: Market forces will make any third country controls largely ineffective, as capital movements would simply be routed through those EC states (such as the UK) which have no such controls. (One exception to this would be controls on inward direct investment by non EC nationals such as those operated by the UK on investment in broadcasting). It would be reasonable therefore to press for a firmer commitment to liberalise capital movements erga omnes.

(vi) Hidden Controls: various regulatory controls remain even where formal exchange controls have been dropped. For example Germany does not allow residents to issue foreign currency bonds in Germany where the first purchaser is also a resident. Germany also restricts sales of certain types of Government debt to non-residents. In the UK, the Trustee Investments Act, which regulates investments by certain trusts, charities and public sector funds prohibits investments overseas other than through UK quoted securities and certain public sector debt.

Comment: The UK interest in pressing for removal of such controls is not always clear cut. For example the German restriction on foreign currency debt issues in Germany helps to divert this business to London.

ii. BANKING AND MORTGAGE CREDIT

a. Restrictions which have been lifted

10. The First Banking Co-ordination Directive of 1977 created a basic right of establishment for branches of member state credit institutions (broadly, banks and building societies) and removed the right of a member state to refuse authorisation to a branch on the grounds that it had no economic need for more banks in its territory.

b. Restrictions to be lifted under Directives already agreed

11. The Second Banking Coordination Directive, on which political agreement was reached at ECOFIN on 19 June, will build on the First Directive by removing most remaining formal barriers to a single market in banking. Under the Directive, a credit institution authorised in one member state will be free to establish a branch in or provide cross-border services into, another member state on the basis of its home-state authorisation. This 'passport' will extend to a wide range of banking and investment services, provided by banks and (subject to special

conditions) their subsidiaries. (Investment services provided by non-banks are the subject of the separate Investment Services Directive, yet to be discussed.).

c. Remaining restrictions

12. Once the Second Directive and the related capital adequacy Directives are put in place a number of substantial barriers to a full single market will remain. Some are an inevitable consequence of differences in language and culture, and the distinctive identities of national markets and established client loyalties will continue to present difficulties for new players. The cost of establishing a new retail network (as opposed to securing an existing one by acquisition) will also tend to deter banks from operating in that way. Restrictions which could in principle be removed are:

(i) Restrictions on Financial Techniques: Some countries do not permit certain types of product which are common in the UK. For example Belgium does not allow variable rate mortgage lending. Denmark restricts the form mortgage lending can take. In Germany, only German banks may issue mortgage bonds.

Comment: The Commission proposes to deal with the issue of product types in the Mortgage Credit Directive, though the range of techniques it would harmonise is narrow and progress is uncertain.

(ii) Domestic Conduct of Business Rules: All EC member states control the way financial products are sold for consumer protection reasons. In the UK for example investment business done by banks is subject to rules draw up by SIB and the appropriate SRO under the Financial Services Act. Consumer lending is regulated by the Consumer Credit Act which governs advertising, quotations etc. UK banks operating in Europe will have to comply with corresponding local rules in overseas markets.

Comment: Some limited harmonisation of local rules is in progress (for example through the Consumer Credit Directive which lays down standard methods of calculating the cost of consumer loans). The UK will wish to press for removal of any rules which discriminate against firms (eg present German requirements for a German national to be at or near the top of any bank subsidiary in Germany). In principle any such discrimination is outlawed by the Second Banking Directive. However full harmonisation would be neither feasible nor desirable.

(iii) Institutional Barriers: Domestic institutional arrangements which inhibit takeovers make entry into European banking markets more difficult. Examples include cross shareholdings between German banks, and the cartel arrangement which until last year prevented foreign credit card companies from negotiating individually with German banks.

Comment: The UK is pressing for removal of barriers to takeovers. Commission study of barriers is underway. UK arrangements such as golden shares in privatised industries may come under scrutiny.

(iv) Differences in Legal structures: The law of contract differs substantially between member states so that for example the charge taken over property (mortgage) in certain states differs from our own. This makes it impossible to establish a fully unified European mortgage market. UK firms experience particular difficulties in the area of endowment linked mortgages.

Comment: Harmonisation in this area is almost certainly not feasible.

(v) Taxation: The tax treatment of interest on bank deposits varies between states. In the UK interest is generally paid net of CRT. In the Netherlands and Luxembourg it is paid gross. There is an incentive to deposit funds in countries which do not have a withholding tax, particularly if the depositor intends to evade tax.

Comment: The UK does not in general favour harmonisation of tax treatment of financial services.

ANNEX A

RESTRICTIONS ON INVESTMENTS BY PENSION FUNDS

Belgium requires pension funds to invest a minimum of 15% of assets in Government Bonds, and prevents direct real estate investment outside Belgium.

Denmark permits investment of a small proportion of the assets of company pension funds abroad, provided that the liabilities are guaranteed.

France requires pension funds to have 50% of their assets invested in French Government loans at the end of each year. In addition, exchange controls prevent investment in real estate in other countries, including other member countries.

In the **Netherlands** the huge civil servants pension fund (ABP) is permitted to invest only 5% of its assets abroad.

Spain requires pension funds to be invested in Spanish securities.

West Germany bans investments by pensionkassen in foreign countries other than through quotations on a German Stock Exchange or through German investment trusts, in which German investments dominate. There is also a 5% limit to the total of investment abroad. No exception is made for investment in other member countries.

Sources: National Association of Pension Funds, Bank of England

ANNEX B

RESTRICTIONS ON INVESTMENTS BY LIFE ASSURANCE COMPANIES

All EC countries (except the Netherlands) impose solvency requirements for life insurance companies which require liabilities to be covered by "prescribed" assets. Each country imposes a different definition of prescribed assets: these have the effect of limiting investments in different categories. The main features are:

* In Holland, insurance companies are required to provide a detailed account of assets and liabilities by currency to the insurance supervisor who can make recommendations. There are no regulations.

* Most countries require matching of assets with liabilities in the same currency. Exact matching is required in France and Germany (subject to permission of the insurance supervisor). Italy limits foreign currency assets to foreign currency liabilities. **The UK requires that 80% of a liability in any currency (including sterling) should be matched by assets in that currency.**

* All countries apart from the UK impose maximum or minimum limits on investments in different categories. For example in Belgium foreign transferable assets are limited to 25% of the total. Minimum investments in government stocks are prescribed in Belgium (15%) Greece (15%) and France (34%). Maximum investments in equities are laid down in all countries except the UK, France and Holland: Limits are 20% in Germany 15% in Italy and 25% in Belgium.

* All countries including the UK impose limits on individual investments. For example in the UK an investment in a listed company must not exceed 2½% of relevant assets. In Belgium, Germany, France and Italy

a shareholding must not exceed 5% of the capital of that company.

* In France, Belgium and Italy there are requirements to <u>notify</u> the authorities of (and in some cases seek approval for) disposal of assets.

Source: Committee European des Assurances Life Assurance Committee paper "Study on Choice of Investments" 1985

SINGLE EUROPEAN MARKET IN FINANCIAL SERVICES

Achievements to date

1 Agreed directives covering securities transactions include: Admissions Directive (1979) on criteria to be met by companies seeking a stock exchange listing; Listing Particulars Directive (1980) on information for investors in the listing particulars to be published when securities are admitted to listing; and Mutual Recognition of Listing Particulars Directive (adopted 1987 for implementation by 1990) on mutual recognition of listing particulars to be published on admission to official stock exchange listing. (Also covers reciprocal agreements with non-Member States).

2 UCITS Directive (1985) sets common minimum standards for regulation of unit trusts and their equivalents ('UCITS') providing them with a 'single passport'. Due to be implemented, except by Greece and Portugal, by October 1989.

3 In insurance, conditions of establishment under the Treaty were harmonised by the Non-life Establishment Directive (1973) and the Life Establishment Directive (1979). The Non-Life Services Directive (1988) provides a regulatory framework within which insurers may cover most non-life risks through the provision of cross-frontier services. Other agreed directives in the insurance sector cover motor insurance, co-insurance operations, credit and suretyship insurance, and legal expenses insurance.

Proposals under consideration

4 Securities

(i) Investment Services Directive (ISD). Commission

submitted text to Council in January. First Council Working Group discussions are expected in the Autumn.
The Directive would allow an investment firm authorised in one member state to provide services in other member states on the basis of its home country authorisation (ie provides 'single passport'). Investment activities covered include dealing as principal, brokerage, portfolio management and investment advice. Related directive on capital requirements of investment firms is at an early stage of Commission drafting.

Comment on Investment Service Directive

Important directive which will open Community markets to free trade in investment business. Complements Second Banking Co-ordination Directive. UK wants simultaneous implementation of Investment Services and Second Banking Directives to maintain 'level playing fields': UK securities houses and investment advisers would be disadvantaged if universal banks had passport under Banking Directive before ISD was implemented. Other member states are expected to give timely implementation a lower priority than UK does. Agreement on associated capital directive will also be difficult.

(ii) Insider Dealing Directive. Common position reached 19 June ECOFIN. Directive establishes minimum standards regarding insider dealing. Makes insider dealing unlawful. Provides for exchange of information for enforcement purposes.

Insurance

5 (i) Life Services Directive is the main proposal in insurance currently under discussion. Would allow residents of one member state to take out a life policy with a company established in another member state provided they did so on their own initiative.

Comment on Life Services Directive

Current proposal is not an effective liberalising measure, since the Directive only frees own-initiative business. UK is seeking to make Directive more liberal, while not impeding progress on other important measures (see para 6). We have support from Dutch and (less so) the Irish. Germany, supported by Portugal, Italy and Greece would prefer to see scope limited even further.

(ii) Contract Law Directive would harmonise various aspects of law governing non-life insurance contracts.

Comment on Contract Law Directive

UK opposed to directive as unnecessary for completion of Single Market. Some member states agree but opinion in Community sharply divided. Directive currently stalled.

(iii) Other measures. Third Motor Directive would extend the existing standard provisions for third party liability. Motor Liability Directive would extend to motor vehicle

liability the liberalising measures agreed for other forms of insurance in the non-life services sector. The effect would be to allow companies above a certain size to place their motor insurance with a company established in another member state. Winding-up Directive establishes harmonised framework of law relating to compulsory winding up of insurance undertakings. Accounts Directive would generally extend to insurance existing Community rules for company accounts.

6 The Commission propose to bring forward later this year a directive liberalising group and employment-related insurance on a similar basis to the Life Services Directive. Group pensions underwritten by insurance companies would be included.

Takeovers

7 Takeover Directive. Council Working Group discussions on the draft text have not yet begun. Directive aims to improve takeover regulation (and therefore freedom in financial markets).

Comment on Takeover Directive

Directive potentially beneficial. But there is risk that it will adversely affect operation of UK system (eg by increasing risk of litigation during bids) and may lead to overregulation. UK negotiating position not yet settled.

Consumer Credit

8 Directive on Annual Percentage Rate of Charge in credit

agreements will harmonise method whereby annual percentage rate of charge (APR) in credit agreements is calculated.

Areas not addressed by Single Market programme

Securities

9 The Investment Services Directive does not fully cover stock exchange membership for banks, nor commodity futures and options, clearance and settlement systems, nor regulation of investment exchanges. It does not provide for harmonisation of "conduct of business" (COB) rules (covering advertising, selling etc).

Comment

Our main concern is the timing of implementation of directive (see para 4) rather than these omissions. Harmonisation of COB rules would be very difficult, since practice in member states varies widely. Without harmonisation, there is the possibility of market distortions through discrimination by host member states. We and the Commission will be vigilant about this, and discrimination can be challenged in the Courts.

11 'UCITS' Directive covers funds invested in listed shares and bonds; other types of funds have no right to 'passport'.

Comment on UCITS Directive

This cuts both ways. Extension of scope would be to the advantage of new types of fund (for investment in property, futures and options) soon to be permitted in UK. But it would jeopardise some features of

special tax-linked schemes like BES funds and certain types of PEP.

Insurance

12 Even if the current programme is completed satisfactorily, there will be only limited freedom of trade in insurance within the Community. In particular, member states will be allowed to maintain restrictions which will effectively make it impractical:

(i) to write non-life risks across frontiers in cases where the policyholder is not a company above the size laid down in the Non-Life Services Directive;

(ii) to undertake any active selling of life insurance across frontiers. In addition, the 'passport' will extend only to policies taken out on an 'own initiative' basis.

Comment on Insurance

The Commission are planning directives for full liberalisation in both life and non-life fields. They are unlikely to appear before 1990, and we expect strong opposition from other member states. The chances of getting liberalising directives agreed (far less implemented) by the end of 1992 are not good.

Annex 1 gives details of member states requiring policy conditions and premium rates to be approved.

Takeovers

13 At present, legal, structural, and political obstacles

prevent takeovers within Community. Many such barriers are difficult to address and will remain unaffected by Takeover Directive.

Comment on Takeovers

At UK's initiative, Commission is currently undertaking study of barriers to takeovers; report and recommendations due later this year. This could lead, for example, to adjustments to the EC company law programme to deal with such barriers as:

- differential voting rights of shareholders
- certain types of poison pill
- automatic proxy voting practices

14 DTI has commissioned a parallel study of UK companies' experience with aim of putting UK in best position to influence Commission work. Annex 2 gives examples emerging from this study.

DEPARTMENT OF TRADE AND INDUSTRY
JUNE 1989

ANNEX 1

INSURANCE

1 In Belgium, Denmark, France, Germany, Italy, Luxembourg, Portugal and Spain the supervisory authorities must approve policy conditions in some or all classes of insurance.

2 Premium rates for some or all classes of insurance require approval in Belgium, Denmark, France, Germany, Italy and Luxembourg. The rates are set by the authorities in Portugal.

3 In the UK, policy conditions and premium rates for some classes of insurance must be advised to the authorities (but not approved by them).

Source:

OECD Insurance Committee Study (1987)

ANNEX 2

BARRIERS TO TAKEOVERS

Availability of financial and commercial information

1. In Italy and Spain, markedly inferior in extent, reliability and timeliness. In Germany, there is no central registry of companies, and many important forms of business remain exempt from filing accounts.

Two-tier board structures

2. In Germany this can delay changes in management, or in the Netherlands frustrate any change at all.

Differential voting rights

3. In Germany non-voting shares can be issued for purposes of listing. In Germany and France shares may carry maximum limits to voting rights. In France double voting rights may accrue after two years' loyalty.

Poison pills

4. In the Netherlands, companies have powers to issue priority shares to safeguard the Articles, or to issue preference shares during an offer.

Anonymity of shareholding

5. In many member states, the use of bearer shares may mean lack of access to shareholders.

Power of certain institutions

6. In Germany particularly, automatic assignment of proxy voting rights to the institution where shares are deposited. As shareholders, and members of supervisory boards, the banks are extremely influential.

A'

OBSTACLES TO A FREE MARKET IN EUROPE

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2. Over the last decade there has been a steady process of liberalisation of capital movements among EC countries encouraged by the broad obligations of the Treaty of Rome and the OECD Code of Liberalisation of Capital Movements.

3. A Directive agreed in 1960 provided for implementation of Article 67 of the Treaty which requires member states to 'progressively abolish among themselves all restrictions on the movement of capital.' Outstanding restrictions are reviewed annually by the Monetary Committee. The Directive did not establish a binding obligation to remove certain restrictions, notably those on short term movements, issuing of unlisted securities and non-commercial loans.

4. In line with those obligations, the UK abolished virtually all exchange controls in 1979. West Germany followed in 1981 (having abolished controls on outward movements in 1966), and the Netherlands followed in 1986 (having abolished controls on inward movements in 1983). Belgium and Luxembourg jointly maintain a dual exchange rate with separate official and free rates, but otherwise have no controls.

5. The Capital Liberalisation Directive agreed in June 1988 (which replaces the 1960 directive) requires removal of all remaining restrictions on movements of capital between member states. The deadline for most countries is 1 July 1990. Four states (Spain, Portugal, Greece and Ireland) are required to remove controls by 31 December 1992, but there is provision for this deadline to be deferred for up to three years by Greece and Portugal.

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Spain: restrictions remain on inward direct investment in certain sectors. Remaining controls on outward investment include ceilings on certain overseas portfolio investment and restrictions on short term foreign currency borrowing by residents.

c. Remaining Restrictions

9. The restrictions on free movement of capital which are likely to remain once the Capital Liberalisation Directive is implemented in full may be grouped under the following headings:

(i) Prudential Controls: Article 4 of the 1988 Directive allows Member States to take measures needed for prudential control of financial institutions, provided they do not impede capital movements. All EC states (including the UK) control investments by insurance companies for this purpose and most states control investments by pension funds.* Germany for example broadly limits overseas investments by pension funds and life assurance companies to 5% of assets and these investments must, in general, be held in securities listed in Germany.

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Comments: UK pressure to eliminate such distortions would require us to accept that PEP and BES investments should not be limited to UK firms, and that tax treatment of National Savings and Gilts should be reviewed.

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Comment: Full freedom of capital movements would require elimination of such reserve powers. (However elimination of all reserve powers could require abolition of UK emergency powers legislation which was used for example to freeze the assets of Argentine nationals during the Falklands War.) This is unlikely to be a fruitful avenue for the UK to pursue.

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ii. BANKING AND MORTGAGE CREDIT

a. Restrictions which have been lifted

10. The First Banking Co-ordination Directive of 1977 created a basic right of establishment for branches of member state credit institutions (broadly, banks and building societies) and removed the right of a member state to refuse authorisation to a branch on the grounds that it had no economic need for more banks in its territory.

b. Restrictions to be lifted under Directives already agreed

11. The Second Banking Coordination Directive, on which political agreement was reached at ECOFIN on 19 June, will build on the First Directive by removing most remaining formal barriers to a single market in banking. Under the Directive, a credit institution authorised in one member state will be free to establish a branch in or provide cross-border services into, another member state on the basis of its home-state authorisation. This 'passport' will extend to a wide range of banking and investment services, provided by banks and (subject to special

conditions) their subsidiaries. (Investment services provided by non-banks are the subject of the separate Investment Services Directive, yet to be discussed.).

c. <u>Remaining restrictions</u>

12. Once the Second Directive and the related capital adequacy Directives are put in place a number of substantial barriers to a full single market will remain. Some are an inevitable consequence of differences in language and culture, and the distinctive identities of national markets and established client loyalties will continue to present difficulties for new players. The cost of establishing a new retail network (as opposed to securing an existing one by acquisition) will also tend to deter banks from operating in that way. Restrictions which could in principle be removed are:

<u>(i) Restrictions on Financial Techniques</u>: Some countries do not permit certain types of product which are common in the UK. For example Belgium does not allow variable rate mortgage lending. Denmark restricts the form mortgage lending can take. In Germany, only German banks may issue mortgage bonds.

<u>Comment</u>: The Commission proposes to deal with the issue of product types in the Mortgage Credit Directive, though the range of techniques it would harmonise is narrow and progress is uncertain.

<u>(ii) Domestic Conduct of Business Rules</u>: All EC member states control the way financial products are sold for consumer protection reasons. In the UK for example investment business done by banks is subject to rules draw up by SIB and the appropriate SRO under the Financial Services Act. Consumer lending is regulated by the Consumer Credit Act which governs advertising, quotations etc. UK banks operating in Europe will have to comply with corresponding local rules in overseas markets.

Comment: Some limited harmonisation of local rules is in progress (for example through the Consumer Credit Directive which lays down standard methods of calculating the cost of consumer loans). The UK will wish to press for removal of any rules which discriminate against firms (eg present German requirements for a German national to be at or near the top of any bank subsidiary in Germany). In principle any such discrimination is outlawed by the Second Banking Directive. However full harmonisation would be neither feasible nor desirable.

(iii) Institutional Barriers: Domestic institutional arrangements which inhibit takeovers make entry into European banking markets more difficult. Examples include cross shareholdings between German banks, and the cartel arrangement which until last year prevented foreign credit card companies from negotiating individually with German banks.

Comment: The UK is pressing for removal of barriers to takeovers. Commission study of barriers is underway. UK arrangements such as golden shares in privatised industries may come under scrutiny.

(iv) Differences in Legal structures: The law of contract differs substantially between member states so that for example the charge taken over property (mortgage) in certain states differs from our own. This makes it impossible to establish a fully unified European mortgage market. UK firms experience particular difficulties in the area of endowment linked mortgages.

Comment: Harmonisation in this area is almost certainly not feasible.

(v) Taxation: The tax treatment of interest on bank deposits varies between states. In the UK interest is generally paid net of CRT. In the Netherlands and Luxembourg it is paid gross. There is an incentive to deposit funds in countries which do not have a withholding tax, particularly if the depositor intends to evade tax.

Comment: The UK does not in general favour harmonisation of tax treatment of financial services.

ANNEX A

RESTRICTIONS ON INVESTMENTS BY PENSION FUNDS

Belgium requires pension funds to invest a minimum of 15% of assets in Government Bonds, and prevents direct real estate investment outside Belgium.

Denmark permits investment of a small proportion of the assets of company pension funds abroad, provided that the liabilities are guaranteed.

France requires pension funds to have 50% of their assets invested in French Government loans at the end of each year. In addition, exchange controls prevent investment in real estate in other countries, including other member countries.

In the **Netherlands** the huge civil servants pension fund (ABP) is permitted to invest only 5% of its assets abroad.

Spain requires pension funds to be invested in Spanish securities.

West Germany bans investments by pensionkassen in foreign countries other than through quotations on a German Stock Exchange or through German investment trusts, in which German investments dominate. There is also a 5% limit to the total of investment abroad. No exception is made for investment in other member countries.

Sources: National Association of Pension Funds, Bank of England

RESTRICTIONS ON INVESTMENTS BY LIFE ASSURANCE COMPANIES

All EC countries (except the Netherlands) impose solvency requirements for life insurance companies which require liabilities to be covered by "prescribed" assets. Each country imposes a different definition of prescribed assets: these have the effect of limiting investments in different categories. The main features are:

* In Holland, insurance companies are required to provide a detailed account of assets and liabilities by currency to the insurance supervisor who can make recommendations. There are no regulations.

* Most countries require matching of assets with liabilities in the same currency. Exact matching is required in France and Germany (subject to permission of the insurance supervisor). Italy limits foreign currency assets to foreign currency liabilities. **The UK requires that 80% of a liability in any currency (including sterling) should be matched by assets in that currency.**

* All countries apart from the UK impose maximum or minimum limits on investments in different categories. For example in Belgium foreign transferable assets are limited to 25% of the total. Minimum investments in government stocks are prescribed in Belgium (15%) Greece (15%) and France (34%). Maximum investments in equities are laid down in all countries except the UK, France and Holland: Limits are 20% in Germany 15% in Italy and 25% in Belgium.

* All countries including the UK impose limits on individual investments. For example in the UK an investment in a listed company must not exceed 2½% of relevant assets. In Belgium, Germany, France and Italy

a shareholding must not exceed 5% of the capital of that company.

* In France, Belgium and Italy there are requirements to notify the authorities of (and in some cases seek approval for) disposal of assets.

Source: Committee European des Assurances Life Assurance Committee paper "Study on Choice of Investments" 1985

SINGLE EUROPEAN MARKET IN FINANCIAL SERVICES

Achievements to date

1 Agreed directives covering securities transactions include: Admissions Directive (1979) on criteria to be met by companies seeking a stock exchange listing; Listing Particulars Directive (1980) on information for investors in the listing particulars to be published when securities are admitted to listing; and Mutual Recognition of Listing Particulars Directive (adopted 1987 for implementation by 1990) on mutual recognition of listing particulars to be published on admission to official stock exchange listing. (Also covers reciprocal agreements with non-Member States).

2 UCITS Directive (1985) sets common minimum standards for regulation of unit trusts and their equivalents ('UCITS') providing them with a 'single passport'. Due to be implemented, except by Greece and Portugal, by October 1989.

3 In insurance, conditions of establishment under the Treaty were harmonised by the Non-life Establishment Directive (1973) and the Life Establishment Directive (1979). The Non-Life Services Directive (1988) provides a regulatory framework within which insurers may cover most non-life risks through the provision of cross-frontier services. Other agreed directives in the insurance sector cover motor insurance, co-insurance operations, credit and suretyship insurance, and legal expenses insurance.

Proposals under consideration

4 Securities

(i) Investment Services Directive (ISD). Commission

submitted text to Council in January. First Council Working Group discussions are expected in the Autumn.
The Directive would allow an investment firm authorised in one member state to provide services in other member states on the basis of its home country authorisation (ie provides 'single passport'). Investment activities covered include dealing as principal, brokerage, portfolio management and investment advice. Related directive on capital requirements of investment firms is at an early stage of Commission drafting.

Comment on Investment Service Directive

Important directive which will open Community markets to free trade in investment business. Complements Second Banking Co-ordination Directive. UK wants simultaneous implementation of Investment Services and Second Banking Directives to maintain 'level playing fields': UK securities houses and investment advisers would be disadvantaged if universal banks had passport under Banking Directive before ISD was implemented. Other member states are expected to give timely implementation a lower priority than UK does. Agreement on associated capital directive will also be difficult.

(ii) Insider Dealing Directive. Common position reached 19 June ECOFIN. Directive establishes minimum standards regarding insider dealing. Makes insider dealing unlawful. Provides for exchange of information for enforcement purposes.

Insurance

5 (i) Life Services Directive is the main proposal in insurance currently under discussion. Would allow residents of one member state to take out a life policy with a company established in another member state provided they did so on their own initiative.

Comment on Life Services Directive

Current proposal is not an effective liberalising measure, since the Directive only frees own-initiative business. UK is seeking to make Directive more liberal, while not impeding progress on other important measures (see para 6). We have support from Dutch and (less so) the Irish. Germany, supported by Portugal, Italy and Greece would prefer to see scope limited even further.

(ii) Contract Law Directive would harmonise various aspects of law governing non-life insurance contracts.

Comment on Contract Law Directive

UK opposed to directive as unnecessary for completion of Single Market. Some member states agree but opinion in Community sharply divided. Directive currently stalled.

(iii) Other measures. Third Motor Directive would extend the existing standard provisions for third party liability. Motor Liability Directive would extend to motor vehicle

liability the liberalising measures agreed for other forms of insurance in the non-life services sector. The effect would be to allow companies above a certain size to place their motor insurance with a company established in another member state. Winding-up Directive establishes harmonised framework of law relating to compulsory winding up of insurance undertakings. Accounts Directive would generally extend to insurance existing Community rules for company accounts.

6 The Commission propose to bring forward later this year a directive liberalising group and employment-related insurance on a similar basis to the Life Services Directive. Group pensions underwritten by insurance companies would be included.

Takeovers

7 Takeover Directive. Council Working Group discussions on the draft text have not yet begun. Directive aims to improve takeover regulation (and therefore freedom in financial markets).

Comment on Takeover Directive

Directive potentially beneficial. But there is risk that it will adversely affect operation of UK system (eg by increasing risk of litigation during bids) and may lead to overregulation. UK negotiating position not yet settled.

Consumer Credit

8 Directive on Annual Percentage Rate of Charge in credit

agreements will harmonise method whereby annual percentage rate of charge (APR) in credit agreements is calculated.

Areas not addressed by Single Market programme

Securities

9 The Investment Services Directive does not fully cover stock exchange membership for banks, nor commodity futures and options, clearance and settlement systems, nor regulation of investment exchanges. It does not provide for harmonisation of "conduct of business" (COB) rules (covering advertising, selling etc).

Comment

Our main concern is the timing of implementation of directive (see para 4) rather than these omissions. Harmonisation of COB rules would be very difficult, since practice in member states varies widely. Without harmonisation, there is the possibility of market distortions through discrimination by host member states. We and the Commission will be vigilant about this, and discrimination can be challenged in the Courts.

11 'UCITS' Directive covers funds invested in listed shares and bonds; other types of funds have no right to 'passport'.

Comment on UCITS Directive

This cuts both ways. Extension of scope would be to the advantage of new types of fund (for investment in property, futures and options) soon to be permitted in UK. But it would jeopardise some features of

special tax-linked schemes like BES funds and certain types of PEP.

Insurance

12 Even if the current programme is completed satisfactorily, there will be only limited freedom of trade in insurance within the Community. In particular, member states will be allowed to maintain restrictions which will effectively make it impractical:

(i) to write non-life risks across frontiers in cases where the policyholder is not a company above the size laid down in the Non-Life Services Directive;

(ii) to undertake any active selling of life insurance across frontiers. In addition, the 'passport' will extend only to policies taken out on an 'own initiative' basis.

Comment on Insurance

The Commission are planning directives for full liberalisation in both life and non-life fields. They are unlikely to appear before 1990, and we expect strong opposition from other member states. The chances of getting liberalising directives agreed (far less implemented) by the end of 1992 are not good.

Annex 1 gives details of member states requiring policy conditions and premium rates to be approved.

Takeovers

13 At present, legal, structural, and political obstacles

prevent takeovers within Community. Many such barriers are difficult to address and will remain unaffected by Takeover Directive.

Comment on Takeovers

At UK's initiative, Commission is currently undertaking study of barriers to takeovers; report and recommendations due later this year. This could lead, for example, to adjustments to the EC company law programme to deal with such barriers as:

- differential voting rights of shareholders
- certain types of poison pill
- automatic proxy voting practices

14 DTI has commissioned a parallel study of UK companies' experience with aim of putting UK in best position to influence Commission work. Annex 2 gives examples emerging from this study.

DEPARTMENT OF TRADE AND INDUSTRY
JUNE 1989

ANNEX 1

INSURANCE

1 In Belgium, Denmark, France, Germany, Italy, Luxembourg, Portugal and Spain the supervisory authorities must approve policy conditions in some or all classes of insurance.

2 Premium rates for some or all classes of insurance require approval in Belgium, Denmark, France, Germany, Italy and Luxembourg. The rates are set by the authorities in Portugal.

3 In the UK, policy conditions and premium rates for some classes of insurance must be advised to the authorities (but not approved by them).

Source:

OECD Insurance Committee Study (1987)

BARRIERS TO TAKEOVERS

Availability of financial and commercial information

1. In Italy and Spain, markedly inferior in extent, reliability and timeliness. In Germany, there is no central registry of companies, and many important forms of business remain exempt from filing accounts.

Two-tier board structures

2. In Germany this can delay changes in management, or in the Netherlands frustrate any change at all.

Differential voting rights

3. In Germany non-voting shares can be issued for purposes of listing. In Germany and France shares may carry maximum limits to voting rights. In France double voting rights may accrue after two years' loyalty.

Poison pills

4. In the Netherlands, companies have powers to issue priority shares to safeguard the Articles, or to issue preference shares during an offer.

Anonymity of shareholding

5. In many member states, the use of bearer shares may mean lack of access to shareholders.

Power of certain institutions

6. In Germany particularly, automatic assignment of proxy voting rights to the institution where shares are deposited. As shareholders, and members of supervisory boards, the banks are extremely influential.