BYU Law Review

Volume 1990 | Issue 4 Article 11

11-1-1990

The European Community's Second Banking Directive and U.S. Banking Regulation: Preparing for a Multilateral Agreement for the Trade of Services

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I. INTRODUCTION

In February 1988, the Council of Ministers of the European Communities began considering what is known as the "Second Banking Directive."[1] The original version of the Second Banking Directive proposed significant structural changes designed to facilitate integration of financial markets of the European Community ("EC").[2] Article 7 of the original Second Banking Directive included a requirement of reciprocity as a prerequisite to extending privileges of the new changes to non-EC financial institutions.[3] Though "reciprocity" was not defined, the United States saw article 7's reciprocity requirement as contrary to its own "national treatment" standard.[4]

Largely due to U.S. opposition, the Council of Ministers modified article 7.[5] Reciprocity was reduced to a goal rather than a requirement.[6] The revised reciprocity provision currently appears in article 9 of the amended Second Banking Directive.[7]

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1. *Proposal for a Second Council Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-up and Pursuit of the Business of Credit Institutions and Amending Directive*, 31 O.J. EUR. COMM. (No. (84) 1 (1988)) [hereinafter *Original Second Banking Directive*]. A directive is not directly binding; rather, it obligates an EC Member State to enact its own legislation that implements the directive's provisions. Thus, a directive generally has no effect until appropriate implementing legislation has been enacted by the Member States. Deadlines for implementing such legislation, however, is binding on the Member States. Common Mkt. Rep. (CCH) ¶ 4902.21.

2. The term "European Community" (EC) is commonly used to refer collectively to the European Economic Community, the European Coal and Steel Community and the European Atomic Energy Community.

3. *Id.*

4. *See infra* text accompanying notes 57-58..

5. *The Effects of Greater Economic Integration within the European Community on the United States*, Report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate on Investigation No. 332-267 Under Section 332 of the Tariff Act of 1930, USITC Pub. 2204, at 13-13 (July 1989) [hereinafter ITC Report].

6. *See infra* text accompanying notes 40-41.

7. *Common Position Adopted by the Council on July 24, 1989 with a View to the*

As a result of the modification, U.S. banks will enjoy the same range of freedoms in the EEC as EC financial institutions.

In the United States, however, banking markets remain highly regulated. These regulations constitute an effective barrier to entry by foreign banks. Many commentators claim that the regulations are unnecessary and should be eliminated.[8] Eliminating unnecessary regulations would also foster multilateral discussions on trade in services, which in turn would greatly benefit the United States. Moreover, the EC's elimination of article 7's reciprocity requirement represents a good faith move toward freer trade and multilateral reciprocity, which is the goal of multilateral trade agreements.

Section II of this paper reviews the background of regulatory barriers to U.S. banking markets and EC moves toward financial integration, setting forth the context in which article 7 was introduced and later revised. Section III analyzes the United States' condemnation of article 7 and shows that such condemnation may be premature. Section IV analyzes reciprocity and national treatment as applied in existing multilateral agreements and reviews U.S. legislation similar to the EC's article 7. Section V argues, based on the prior sections, that the EC's modification of article 7 should be matched by the United states in deregulating its own financial markets.

II. BACKGROUND

A. *Competing Interests in U.S. Banking Regulation: Strict Regulation vs. International Competitiveness*

The United States maintains a comparative advantage in the trade services industries.[9] Thus, the United States accounts

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Adoption of the Second Council Directive on the Co-ordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive, art. 9 (1989) [hereinafter *Amended Second Banking Directive*].

8. Services that are traded internationally include banking and other financial services, as well as consulting, legal, accounting and other professional services. *See infra* note 9 and accompanying text.

9. "[T]he United States has been the prime exponent of including services in the new round of trade negotiations . . . largely due to a belief that the United States has a comparative advantage in many services and that it would be in the U.S. [sic] interest to liberalize trade in services." J. JACKSON & W. DAVEY, INTERNATIONAL ECONOMIC RELATIONS 992 (1986). "In the United States alone, the value of service exports increased to $42 billion in 1981, reflecting an increase of about 300 per cent since 1970." BROCK, *A Simple Plan for Negotiating on Trade in Services* 5 THE WORLD ECONOMY 229, 232-33

for much of the increased interest in establishing a multilateral agreement for trade in services.[10] However, attaining such an agreement may be difficult given EC complaints about the highly regulated nature of U.S. banking markets. EC complaints focus on three main barriers to access:[11] the commercial-investment banking distinction in the Glass-Steagall Act,[12] the prohibition against interstate banking in the McFadden Act[13] and the barriers at the state level.[14] Of the three, the Glass-Steagall Act has received the most attention.

The Glass-Steagall Act prohibits simultaneous participation in both commercial and investment activities by a single en-

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(1982).

10. *See* J. JACKSON & W. DAVEY, *supra* note 9, at 993-94: "The United States has been the prime proponent of negotiating in respect of trade in services at the new round [of GATT], a stance in the main supported by the [EC] and Japan, but opposed by a number of major developing countries, such as India and Brazil." *Id.* at 988.

11. *See* E.C. Releases 1989 Report on U.S. Trade Barriers [hereinafter E.C. Releases], Eur. Community News, May 3, 1989, at 39 (No. 10/89) (available through EC Office of Press and Public Affairs, Wash. DC):

> In the financial services sector the most significant obstacles to provision of services by EC financial institutions derive from regulations which, for instance, prohibit banks from entering certain securities businesses (Glass-Steagall Act), or restrict inter-state banking (McFadden Act), and the fact that the regulation of insurance is the exclusive competence of the States, with the ensuing requirement to obtain a licence in each State.

Id.

12. The Glass-Steagall Act consists of five sections of the Banking Act of 1933, 48 Stat. 162 § 5, 16, 20, 21 and 32, ch. 89, 48 Stat. 162, 12 U.S.C. §§ 24 (Seventh), 78, 377-78 (1982 & Supp. IV 1986). These sections "limit the securities activities of commercial banks and the relationships that commercial banks may establish with investment banks and securities firms by prohibiting banks from underwriting securities and from affiliating with firms engaged in securities activities." Comment, *Destroying the Barriers Between Commercial and Investment Banking: Should Congress Repeal the Glass-Steagall Act?*, 45 WASH. & LEE L. REV. 1115, 1116-17 (1988).

13. Ch. 191, 44 Stat 1224 (1927) (current version at 12 U.S.C. § 36 (1982)).

14. *See* E.C. Releases, *supra* note 11, at 39:

> Most of the regulations adversely affecting EC financial institutions are to be found at the State level:
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> -in certain States, foreign banks cannot receive deposits from the public administration;
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> -some states do not admit the establishment of branches of foreign banks;
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> -specific requirements may be imposed for the authorization of non-US insurers;
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> -directors of EC banks' subsidiaries incorporated in the US must be US citizens, although under approval of the Comptroller of the Currency up to half the number of directors may be foreign.

Id.

tity.[15] Many commentators call for its abolition.[16] EC countries have no equivalent to Glass-Steagall. This disparity between United States and EC policies allows a single U.S. bank to exploit both types of activities in the EC, while in the United States an EC bank is restricted to one type of activity or the other.

The Glass-Steagall Act and McFadden Act are based on fears from the Great Depression era, which stem from the belief that the collapse of the banking industry in the mid-1930s was a direct result of the earlier stock market crash due to bank participation in investment activities.[17]

Although judicial and administrative overseers have loosened Glass-Steagall's tightly woven restrictions during the past decade, the distinction between commercial and investment banking remains intact.[18] Some commentators argue that even if Glass-Steagall played a role in protecting the banking industry in some earlier era, significant changes in banking and securities areas have eliminated the need for such protection.[19] They claim that recent exceptions to Glass-Steagall, which have been carved out by administrators and upheld in the courts, render Glass-Steagall ineffective in accomplishing its goal.[20] They argue that

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15. *Id.*

16. *See* Comment, *supra* note 12, at 1128 n.98 (citing various commentators and members of Congress who have called for repeal of Glass-Steagall); Isaac & Fein, *Facing the Future—Life Without Glass-Steagall*, 37 CATH. U.L. REV. 281, 285-90 (1988) [hereinafter Isaac & Fein] ("The Glass-Steagall war has been waged intensively for the past two decades before the banking agencies, the courts, and Congress, none of which has dealt it a fatal blow.").

Those who urge an abolition of Glass-Steagall claim it is currently unnecessary to protect the banking industry. *See* Isaac & Fein, *id.* at 281 (noting that the changes wrought by inflation, new competitors, and technological innovations since banking regulations such as Glass-Steagall and McFadden were enacted render those acts "largely irrelevant to economic realities"). *See also* Longstreth, *Glass-Steagall: The Case for Repeal*, 31 N.Y.L. SCH. L. REV. 281, 281-82 (1986) (arguing that from Glass-Steagall's inception it was unnecessary to protect the banking system since the catastrophes of the early thirties resulted from lack of public confidence, not bank participation in investment activities). *But cf.* O'Brien, *Financial Deregulation: The Securities Industry Perspective*, 31 N.Y.L. SCH. L. REV. 271, 276 (1986) (arguing that Glass-Steagall was necessary in the 1930s and is still necessary).

17. *See* Isaac & Fein, *supra* note 16, at 285-90. *See also* Hawke, *The Glass Steagall Legacy: A Historical Perspective*, 31 N.Y.L. SCH. L. REV. 255 (1986).

18. *See* Comment, *supra* note 12, at 1117 n. 7: "During the 1980s . . . courts have upheld banking regulators' liberal interpretations of the Glass-Steagall Act that have allowed banks to engage in securities activities." *Id.*

19. *See* Longstreth, *supra* note 16, at 287-88.

20. *Id.* at 284.

the exceptions are "as risky or riskier than the activities prohibited by the Glass-Steagall Act."[21]

Thus, Glass-Steagall's commercial-investment distinction arguably inhibits foreign competition without serving a valid domestic purpose. Failure to eliminate the distinction may impair U.S. bargaining power in multilateral discussions regarding an agreement for trade in services.

B. Banking in the EC

1. The First Banking Directive: Laying the groundwork for financial integration

In 1977, the Council of Ministers of the EC adopted the First Banking Coordination Directive[22] ("First Banking Directive") in which it laid the groundwork for integration and harmonization of banking laws throughout the EC. The First Banking Directive identifies five general categories for harmonization:

(1) rules abolishing barriers along Member State borders with respect to the provision of banking services,
(2) rules providing for the freedom of EC credit institutions to establish branches in other Member States,
(3) uniform rules concerning essential authorization requirements for credit institutions,
(4) uniform rules concerning essential supervisory standards, and
(5) rules providing for (uniform) treatment of non-EC credit institutions.[23]

The First Banking Directive does not bar a Member State from imposing authorization requirements on nondomiciled EC credit institutions[24] seeking to establish branches in that Mem-

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21. Comment, *supra* note 12, at 1128 (citing Note, *Restrictions on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation*, 97 HARV. L. REV. 720, 726 (1984) for the proposition that activities allowed under exceptions to the Glass-Steagall Act are as risky as underwriting corporate bonds).

22. *First Council Directive of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking up and Pursuit of the Business of Credit Institutions* 20 O.J. EUR. COMM. (No. L, 322) 30 (1977) [hereinafter *First Banking Directive*].

23. Gruson & Nikowitz, *The Second Banking Directive of the European Economic Community and its Importance for Non-EEC Banks*, 12 FORDHAM INT'L L. J. 205, 207-08 (1989).

24. Article 1 defines "credit institution" 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 Banking Directive*, *supra* note 22, art. 1, at 31.

ber State. Rather, it requires "national treatment"—authorization must be granted "subject to authorization according to the law and procedure applicable to credit institutions established on their territory."[25]

The First Banking Directive requires each Member State to report all authorizations given to non-EC credit institutions to establish branches in its territory.[26] Member States are barred from granting preferential treatment to non-EC financial institutions, but Member States are not prohibited from discriminating against non-EC financial institutions in favor of EC institutions.[27]

With this framework firmly in place, the Commission proposed the first version of the Second Banking Directive. The intent of the Second Banking Directive was to eliminate, by 1992, restrictions on inter-Member State banking services not addressed in the First Banking Directive.[28]

2. *Reciprocity in the original Second Banking Directive: Article 7*[29]

The original Second Banking Directive required each Member State to recognize the banking laws and licenses of other Member States. Any credit institution authorized in one Member State (home Member State)[30] could establish branches and

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25. *First Banking Directive*, *supra* note 22, art. 4(1), at 34. The First Banking Directive defines "authorization" as "an instrument issued in any form by the authorities by which the right to carry on the business of a credit institution is granted." *Id.*, art. 1, at 31. *See generally*, Gruson & Nikowitz , *supra* note 21 at 209.

26. *First Banking Directive*, *supra* note 22, art. 9(2), at 35.

27. *Id.* art. 9(1), at 35. Note that the national treatment requirement applies only to EEC Member States and not to non-EEC countries.

28. *See* Gruson & Nikowitz, *supra* note 23, at 209-10:

> After the implementation of the [First Banking Directive], three obstacles to freedom of establishment of branches in other Member States still remain for EEC credit institutions. First, an EEC credit institution wishing to set up a branch in another Member State still has to be authorized by the banking authorities of the host country; second, it remains subject to supervision by the host country and to restrictions in host country laws on the range of permitted activities; and third, in most Member States, branches have to be provided with earmarked "endowment capital," as if they were new banks. All of these restrictions would be removed under the Second Directive by the end of 1992.

Id.

29. "The Second [Banking] Directive . . . contains provisions regarding the establishment credit institution subsidiaries of non-EEC credit institutions and also takes the final step towards full implementation of the freedom to establish branches of EEC credit institutions." *Id.* at 209.

30. *First Banking Directive*, *supra* note 22, art. 1(7).

provide its services in another Member State (host Member State)[31] without being subject to additional authorization requirements.[32] The intent was "to achieve only the essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems, making possible the granting of a single licence recognized throughout the Community and the application of the principle of home Member State prudential supervision."[33] This principle of "mutual recognition" allows harmonization of banking service regulation without creating a separate body of banking law.[34]

The original Second Banking Directive would have extended the benefits of mutual recognition to non-EC credit institutions authorized by a Member State. However, authorization required a finding by the Commission that EC credit institutions enjoy reciprocal treatment in the home country of the non-EC credit institution.[35] This reciprocity requirement was contained in article 7.[36]

3. *The amended Second Banking Directive: Article 9*

Prior to the promulgation of the Second Banking Directive, the Council of Ministers revised article 7's reciprocity requirement. The revised version was a "response to international criticism" of a reciprocity requirement in the Second Banking Directive.[37] The current version appears in article 9 of the Amended Second Banking Directive Adopted as a Common Position by the Council in July, 1989.[38] The revised provision no longer re-

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31. *Id.* at art. 1(8).

32. *Id.* at art. 18(1).

33. *Id.* at 12th Whereas Clause.

34. *See generally, Amended Second Banking Directive, supra* note 7. The purpose of the "mutual recognition" principle in the Second Banking Directive is to ensure harmonization without imposing unnecessary regulations, as shown in the fourth "Whereas" clause, which prefaces the text: "Whereas the approach which has been adopted is to achieve only the essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems, making possible the granting of a single licence recognized throughout the Community . . . ." *Id.*

35. *Original Second Banking Directive, supra* note 1, art. 7.

36. *Id.*

37. Gruson & Nikowitz, *The Reciprocity Requirements of the Second Banking Directive of the European Economic Community Revisited*, 12 FORDHAM INT'L L.J. 452, 454 (1989).

38. *Amended Second Banking Directive, supra* note 7. Before the amended Second Banking Directive becomes effective, it must receive a second reading by European Parliament and then be adopted by the Council of Ministers. Treaty Establishing the European Economic Community, Mar. 25, 1957, art. 100, 1973 Gr. Brit. T.S. No. 1 (Cmd.

quires a finding by the Commission of reciprocal treatment by the third country prior to authorization. Instead, the Commission may at any time determine that a third country does not grant reciprocal treatment to EC institutions.[39] Upon a finding of non-reciprocity, a third country's only remedy, however, is to request a mandate from the Council of Ministers allowing the Commission to initiate negotiations with such country to promote reciprocity.[40] The Commission no longer has a direct role in authorizing the establishment or acquisition of subsidiaries by non-EC financial institutions. Also, the Commission may forego obtaining a Council mandate and initiate negotiations directly if it determines that EC credit institutions do not receive national treatment in a third country and are not given effective access.[41]

III. United States' Condemnation of Article 7: Premature?

The United States concern over the original Second Banking Directive's reciprocity provision in article 7 brought about a moderated, less threatening version in the amended directive. Nevertheless, reciprocity provisions still remain in some directives[42] and have been called a "club in the closet" by U.S. leaders, who feel that these provisions pose a threat to economic relations between the United States and the EC.[43]

5179-II) at 37-38; Single European Act, art. 18, O.J. L 169/1, at (1987).

39. *Id.*, para. 3, at 16, which provides in relevant part:

> Whenever it appears to the Commission, either on the basis of the reports referred to in paragraph 2 or on the basis of other information, that a third country is not granting Community credit institutions effective market access comparable to that granted by the Community to credit institutions from that third country, the Commission may submit proposals to the Council for the appropriate mandate for negotiation with a view to obtaining comparable competitive opportunities for Community credit institutions.

Id.

40. *Id.*

41. *Id.* at para. 4:

> Whenever it appears to the Commission, either on the basis of the reports referred to in paragraph 2 or on the basis of other information, that Community credit institutions in a third country do not receive national treatment offering the same competitive opportunities as are available to domestic credit institutions and that conditions of effective market access are not fulfilled, the Commission may initiate negotiations in order to remedy the situation.

Id.

42. *See* ITC Report, *supra* note 5, at 13-10.

43. David C. Mulford, current Under Secretary for International Affairs and former Assistant Secretary of the U.S. Treasury for International Affairs, recently cautioned against insertion of reciprocity provisions:

The United States has put forth several concerns to justify its condemnation of the EC's reciprocity requirements. First, some commentators fear that the EC intends to invoke reciprocity whenever available to protect its interests, and perhaps even in areas other than the one in which the EC claims to receive less than reciprocal treatment.[44] For example, similar provisions already exist in insurance and securities directives.[45] U.S. failure to provide reciprocal treatment in banking services markets might result in EC retaliation in insurance or securities markets.

Second, U.S. leaders claim that a non-Member country whose trade practices are deemed non-reciprocal by a Member State would retaliate against the Member State.[46] Any such retaliation would be a drastic measure since it would be viewed as retaliation against the EC as a whole. The feared result would be a "spiral of damaging retaliation" by all Member states.[47]

Third, the EC has not expressly defined reciprocity, nor has

> Despite the softening of reciprocity [in the Second Banking Directive], the implied threat remains a potentially powerful instrument, which makes us uneasy. In considering the history of the improvement of the reciprocity provision, we cannot forget that it began as an extremely crude reciprocity effort. We are also mindful that the original, more restrictive version of reciprocity remains in the investment services and insurance directives.
>
> Moreover, once this "club in the closet" is on the books, there will be a temptation to use it, especially given the [EEC's] desire to promote changes in the U.S. financial system. If actually used—or rather "misused"--this would run the risk of provoking a retaliation action from U.S. authorities. We want to preserve our policy of national treatment because we believe it is the most sensible and pragmatic way to preserve free and open financial markets. However, there should be no illusions about the consequences of possible [EEC] actions. If U.S. firms are discriminated against in the [EEC], there would likely be consequences for [EEC] national institutions. An obvious first step might be to scrutinize the "better than national treatment" privileges which many European financial institutions currently enjoy in the United States.

Statement before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking Finance and Urban Affairs, TREASURY NEWS, at 3-4 (September 28, 1989)[hereinafter Mulford].

44. *Id.*

45. *See* ITC Report, *supra* note 5, at 13-10:

> A proposed directive on investment services in the securities field, COM(88) 778, in article 6, outlines the exact same procedures as those in the Second Banking directive's original article 7 for a foreign-based firm that wants to establish or acquire a securities investment subsidiary in the [EEC]. Substantially identical language is incorporated into article 9 of the Second life Insurance Directive. . . . Also, reciprocity provisions may be incorporated into additional directives in fields not subject to GATT agreements.

Id.

46. *See* Mulford, *supra* note 43, at 2.

47. *Id.*

it set forth standards by which behavior will be deemed reciprocal or non-reciprocal.[48] Thus, in transacting with a Member State, a financial institution from a non-Member country may be unable to anticipate whether or not its country's trade practices will be branded non-reciprocal. Therefore, the non-Member financial institution cannot adequately prepare for or prevent the unexpected barriers that "non-reciprocal" labelling by an EC country would interpose.

U.S. criticism may be premature and unjustified. First, the concerns listed above are based on a fear that the most extreme interpretations of reciprocity would be imposed—that of "mirror-image" reciprocity.[49] However, EC leaders have indicated that the provisions will be invoked only when EC credit institutions are discriminated against in non-Member countries.[50] EC officials have acknowledged that a mirror-image interpretation would not only be unwarranted under current conditions, but counterproductive for the EC.[51] Therefore, a mirror-image inter-

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48. *See* Gruson & Nikowitz, *supra* note 23, at 229-30 which, though referring to the original version of the Second Banking Directive prior to its modification, elucidates the concern of U.S. market participants over possible EEC interpretations of reciprocity provisions in other directives:

> If reciprocity means "absence of discrimination," reciprocity exists between the United States and the EEC. However, if the EEC intends to apply a kind of "mirror-image" reciprocity requirement, under which a foreign credit institution's access to a country's financial markets is conditioned on that country's own credit institutions receiving privileges in the foreign market identical to those in the home market, then difficult questions arise.

Id.

49. *See id.* at 229-40. *See also*, ITC Report, *supra* note 5, at 13-6.

50. In a statement made on October 19, 1988, the EEC stated that a "mirror-image" interpretation of reciprocity would not be applied. In addition, Sir Leon Brittan, Commission Vice-President over financial services, recently stated: "We will only seek to hit back if there is in effect national discrimination against us." European Community News, April 13, 1989, No. 10/89 at 1 (available through EEC Office of Press and Public Affairs, Wash. D.C.).

51. In a recent speech, Sir Leon Brittan stated:

> We do not merely tolerate foreign competition—we welcome it. . . . In fact, the European banking market is going to be *more liberal* and *less restricted* than the financial market here in the U.S. or in Japan. We believe we will gain from that and we are quite happy that you should come to us and compete in our markets. We say that because we believe that free trade is not an economic dogma but the surest foundation for jobs and prosperity through the 21st century.

Speech by Sir Leon Brittan, EEC Commission Vice-President over financial services, to the U.S. Bankers Association for foreign Trade Annual Conference, May 1, 1989 (as reported in European Community News, May 1, 1989, No. 12/89 at 1-2 (available through EEC Office of Press and Public Affairs, Wash. D.C.)).

pretation is not expected.[52]

Second, the original Second Banking Directive was formulated during the height of excitement about the U.S. Omnibus Trade and Competitiveness Act of 1988 (Trade Bill).[53] The Trade Bill arguably contains reciprocity provisions.[54] The original Second Banking Directive's reciprocity provision was inserted just prior to enactment of the Trade Bill and could be viewed as an attempt to pressure the United States into eliminating its own reciprocity provisions. However, EC pressure did not result in elimination of the Trade Bill's reciprocity provisions, but pressure from the United States did, as mentioned above, influence the EC's decision to revise the original Second Banking Directive's reciprocity provision.

The United States has also enacted other reciprocity provisions, including Section 126(b) of the Trade Act of 1974, which will be discussed below.[55] The EC's elimination of reciprocity provisions in light of the United States' recent inclusion of similar provisions must be seen as a substantial step by the EC toward freer trade of financial services.

Third, U.S. condemnation may have been premature because the reciprocity provisions may be only temporary—i.e., a means of protecting European financial markets and market participants only during the transition into economic integration.[56] If so, this attempt to maintain the status quo until the dust settles does not warrant condemnation by the United States as unfair, long-term protectionism.

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52. *See* ITC Report, *supra* note 5, at 13-6 to 13-7.

53. Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107 (1988) [hereinafter Trade Bill].

54. *Omnibus Trade and Competitiveness Act of 1988—Analysis*, Commission of the European Communities, 9 (Sept. 8, 1988). A notable example is the Primary Dealers Act of 1988, Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 1099 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 1107, § 3502. Though the Primary Dealers Act was clearly aimed at broadening U.S. access to Japan's government bond access, its language is broad enough that its reciprocity requirements can be applied to any foreign country. *See* Gruson & Nikowitz, *supra* note 23, at 240 ("It is a great pity that the United States set a very unfortunate precedent by enacting a reciprocity requirement in the Primary Dealers Act of 1988"). For a general discussion of the Primary Dealers Act, *see* Comment, *Using Legislation to Open Japan's Financial Markets: An Analysis of the Trade Bill's Primary Dealer Provision*, 1989 B.Y.U. L. REV. 579.

55. *See infra* text accompanying notes 81-84.

56. *See generally* Gilibert & Steinherr, *The Impact of Financial Market Integration on the European Banking Industry*, 8 CAHIERS BEI/EIB PAPERS (March 1989) (indicating that financial integration in the EEC will pose many short-term, temporary problems, some of which cannot yet be anticipated).

Finally, U.S. condemnation may be premature because no multilateral trade agreement has yet established an appropriate reciprocity standard for services, including banking services. The recent concern over the amended directive merely adds momentum to the move to establish a multilateral standard for regulating services.

IV. International Standards: Reciprocity vs. National Treatment

A. United States and EC Interpretations

In condemning the EC's reciprocity requirements,[57] the United States has encouraged the principle of national treatment in the area of banking services. The United States has taken a position that reciprocity and national treatment are mutually exclusive. This position is based on the interpretation of multilateral trade agreements that unconditionally require a national treatment standard.[58] The EC, on the other hand, argues that the principles of national treatment and reciprocity are not mutually exclusive, but rather, that reciprocity requirements may be used to exact "genuine [i.e., de facto] national treatment" from other countries.[59]

These two opposing interpretations illustrate a fundamental weakness in current multilateral trade agreements: "[T]he central concepts of reciprocity, national treatment and right of establishment lack concrete definitions and may be interpreted differently in different contexts."[60] This fundamental weakness must be overcome before a multilateral agreement regarding services can be effective. A short review of reciprocity and national treatment in the General Agreement on Tariffs and Trade (GATT)[61] may clarify the issues and help determine how these terms would be defined in the services context.

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57. *See*, ITC Report, *supra* note 5, at 13-8. Private firms are particularly concerned about the retroactive effect the EEC's reciprocity provisions may have on current activities.

58. *Id.* at 13-7.

59. *Id.*

60. *Id.* at 13-6.

61. The General Agreement on Tariffs and Trade [hereinafter GATT] is applied through the Protocol of Provisional Application to the General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. pts. 5-6, TIAS No. 1700, 55 UNTS 308.

B. Reciprocity and National Treatment in the GATT

Currently, multilateral trade negotiations are primarily concerned with trade in goods and have not yet addressed trade in services.[62] As mentioned above, the United States would benefit by such an agreement.

U.S. officials have already chosen the GATT as the forum in which to address the issue.[63] In light of recent U.S. condemnation of EEC reciprocity provisions, its choice of the GATT seems inconsistent because the GATT is based on reciprocity: "The GATT is based on a principle of overall reciprocity—trade liberalization is achieved by the granting of concessions by all member nations in such a way that the balance of benefits to each is mutually advantageous."[64] The GATT's goal of multilateral reciprocity does not refer to a single market sector, but rather to a country's overall portfolio vis-a-vis the portfolios of other signatory countries.[65]

1. Multilateral reciprocity in GATT: Most-Favored-Nation (MFN) treatment

Pursuant to its goal of multilateral reciprocity, the GATT is based on the principle of Most-Favored-Nation (MFN) treatment.[66] MFN treatment was common to trade agreements prior

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62. Although GATT contains only a few miscellaneous provisions relating to services, prior GATT discussions have considered more extensive provisions relating to services, including Article 53's Havana Charter of the International Trade Organization, which was never ratified. *See* J. JACKSON & W. DAVEY, *supra* note 9, at 993-94. For a discussion of other GATT considerations of trade in services, see R. KROMMENACKER, WORLD-TRADED SERVICES: THE CHALLENGE FOR THE EIGHTIES (1983).

63. GATT has been held out as a more appropriate forum than either the Organization for Economic Cooperation and Development (OECD) or UNCTAD since "it is the only international body that seriously negotiates binding agreements." Schott, *Protectionist Threat to Trade and Investment in Services*, 6 THE WORLD ECONOMY 195, 212-13 (1983). For a contrasting view, see Gibbs, *Continuing the International Debate on Services*, 19 J. WORLD TRADE L. 199 (1985) (arguing that negotiating regulation of trade in services under a GATT framework would raise such difficult issues as: whether retaliatory measures currently allowed for violations of GATT principles relating to goods would be allowed for GATT violations in the services areas and whether GATT's "country of origin" rules for trade in goods would be workable in regulating trade in services).

64. *See* ITC Report, *supra* note 5, at 13-6.

65. "Indeed, the GATT allows for retaliation by a member state for the impairment of trade opportunities in one market to take the form of withdrawal of trade opportunities for the offending party in a completely different market." *Id.*

66. GATT, *supra* note 61, art. I, para. 1:

> With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international trans-

to GATT and was originally developed in bilateral agreements. In effect, each signatory country promised its partner that any trade benefit granted to any third country would extend simultaneously to that partner. Each country sought to "make sure that each signatory obtained the best possible treatment from his partner."[67] In the bilateral context, if a MFN clause was violated by one of the signatory countries, the other country could simply retaliate by refusing to accord preferential treatment.[68]

When applied in a multilateral context, MFN treatment assumed an even greater role as an assurance against multilateral retaliation that might result from a single act of discrimination. The following excerpt describes the importance of MFN in multilateral trade agreements:

> In its multilateral context, however, the significance of the [MFN] clause goes deeper [than in a bilateral context] and is the most essential element in the basic idea that runs through the first experiment in multilateral cooperation in the field of trade. That idea is that *discrimination in any form is likely to lead to more discrimination*, and that *in the long run all countries will suffer from the inevitable distortion of trade patterns which will arise out of discrimination, even though they may be the temporary beneficiaries.* However, because there are undoubted benefits that can be obtained in the short run from reciprocal discrimination, the only way to prevent a country or a pair of countries from making the move that will set off this chain reaction is to obtain the simultaneous pledge of

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fer of payments for imports or exports, and with respect to the formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III, any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

Id.

67. John W. Evans, Director Of Commercial Policy of GATT in 1956, from a speech given at the Bologna Center of the School of Advanced International Studies of Johns Hopkins University, Feb. 20, 1956, quoted in G. CURZON, MULTILATERAL COMMERCIAL DIPLOMACY: THE GENERAL AGREEMENT ON TARIFFS AND TRADE AND ITS IMPACT ON NATIONAL COMMERCIAL POLICIES AND TECHNIQUES 67-68 (1965) (cited in J. JACKSON & W. DAVEY, *supra* note 8, at 434).

68. For a history of the development of Most-Favored-Nation Treatment, see *Executive Branch GATT Studies, No.9, The Most-Favored-Nation Provision*, Compilation of 1973 Studies by the Executive Branch for Subcomm. on Int'l Trade, Senate Comm. on Finance, 93rd Cong., 2d Sess. (Comm. Print 1974).

> the largest possible number of trading partners that they will not discriminate against each other.[69]

Thus, the multilateral MFN treatment in GATT seeks to avoid multilateral retaliation.[70]

2. *National treatment in GATT*

In Article III, the GATT imposes a national treatment standard in certain contexts, the most important of which are internal taxation and government regulation.[71] National treatment, like MFN treatment, is based on discrimination. "In the case of MFN, however, the obligation prohibits discrimination as between goods from different exporting countries. The national treatment clause, on the other hand, attempts to impose the principle of nondiscrimination as between goods which are domestically produced, and goods which are imported."[72]

The policies underlying the two standards are distinct:

> National treatment obligations generally are designed to reinforce the basic policy of trade liberalization—minimizing government interference and distortion of transactions which cross borders. One objective of these obligations is to prevent government practices which evade the tariff obligations. MFN, on the other hand, has the objective of causing governments to treat other governments equally, even if they treat imported goods differently from domestically produced goods.[73]

Reciprocity and national treatment are not opposites under GATT. Each plays an important role in GATT's overall approach to liberalization of international trade. MFN treatment promotes reciprocity at the border by encouraging equal treatment of imports regardless of origin. National treatment, on the other hand, promotes fair treatment of products once inside the border by encouraging equal treatment of imports and domestically produced goods. Both standards, therefore, promote multi-

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69. G. CURZON, *supra* note 67, at 67-68 (emphasis in original).

70. The fear of multilateral retaliation is not, however, as great as it once was, at least as to markets expressly covered by the GATT. Bilateral retaliation is allowed by GATT when a signatory country has been injured by discriminatory treatment in another signatory country. Retaliation is limited to the imposition or increase of tariffs. The injured country may retaliate in a different market than the one in which the injury occurred. *See* discussion in ITC Report, *supra* note 5.

71. *See* GATT, *supra* note 61, art. 3.

72. J. JACKSON & W. DAVEY, *supra* note 9, at 483.

73. *Id.*

lateral reciprocity. A country can adhere to MFN requirements at the border while denying national treatment within.

The GATT's national treatment provision in Article III is not so strict as to bar the incidental discriminatory effects of domestic legislation designed to promote legitimate health, welfare and certain economic goals.[74] But allowable exceptions in these areas can be abused, and such abuse constitutes protectionism.[75]

3. *National treatment and reciprocity in the context of banking services*

Article 7 of the original Second Banking Directive attempted to impose a sectoral reciprocity standard that is generally not provided for in GATT.[76] The United States has applied its banking regulations equally to EC banks; therefore, no MFN principle has been violated. The regulations are also applied equally as between domestic and foreign banks, and in certain circumstances foreign banks are even given more favorable treatment.[77] Thus, no technical violation of national treatment has occurred.

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74. *Id.* at 484-85: "Article XX of GATT containing the 'general exceptions' to GATT obligations has language that imposes a somewhat looser national treatment obligation in certain exceptional cases allowing for government regulation etc. which is deemed justified on social welfare and similar grounds."

75. *Id.* at 485.

76. Recall that GATT promotes overall reciprocity, not sector-by-sector reciprocity. *See supra* text accompanying note 64. *See also* ITC Report, *supra* note 5, at 13-6:

> [I]n an October 19th statement on reciprocity, the [EEC] Commission stated that third countries may benefit from the single market "to the extent that a mutual balance of advantages in the spirit of GATT can be secured.". . .
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> . . . .
>
> . . . Although the October 19th statement suggests a concept of overall reciprocity, other factors indicate the application of sectoral reciprocity. First of all, for the [EEC], economic stability will be a concern since liberalization is being broadened in the financial sector. Also, moving towards [EEC]-wide government procurement policies will be politically sensitive. Most specifically, the 1992 directives call for reciprocity in the cited sector and activity, e.g., establishment of subsidiaries. . . .
>
> . . . .
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> . . . Sectoral reciprocity may also serve as a tool of international trade liberalization, encouraging the opening up of foreign markets with the promise of reciprocated market access. This use is cited by European officials as the major objective of the [EEC] in its reciprocity provisions.

Id. at 1306 to 13-7.

77. *See* Gruson & Nikowitz, *supra* note 23, at 229 and n.133 ("U.S. banks are subject to even more stringent limitations than foreign banks with respect to their ability to

However, the United States has not made concessions which would allow foreign banks greater access to its financial services markets. In other words, it has ignored GATT's ultimate goal of voluntary multilateral reciprocity even though it has kept within GATT's technical requirements. It is precisely the negative effects of technical compliance without concession that the EC sought to avoid through article 7.[78]

C. The "Free-Rider" Problem of MFN Treatment

The United States claims that sectoral reciprocity is not within the "spirit of GATT."[79] However, the EC's interest in reciprocity here is compelling: many of the benefits of financial integration negotiated by EC Member States will soon be granted to U.S. banks under the nondiscrimination principle, yet no corresponding benefit will be accorded EC banks in the United States' highly restrictive banking markets. This loophole in GATT is called the "free-rider" problem of unconditional MFN since a country can "get a free ride" on trade agreements negotiated by other countries.[80]

The United States protected itself against free-riders when Congress passed section 126 of the Trade Act of 1974 (section 126).[81] Section 126 allows the President to deviate from MFN requirements "in terminating or denying trade concessions towards a 'major industrial country' which fails to make concessions which provide equivalent competitive opportunities for United States goods as exist in the United States markets for goods of that country in connection with trade agreements entered into under the Act."[82] This approach is quite similar to the original Second Banking Directive's article 7.[83]

The Report of the Senate Finance Committee sets out the reasoning behind the article 126 approach:

> Reciprocal Nondiscrimination
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> The Committee feels that the "unconditional" [MFN] principle has led, in the past, to one-sided agreements. . . .
>
> *The Committee believes that the nondiscriminatory*

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engage in non-banking activities").

78. *See supra* note 48.

79. ITC Report, *supra* note 5, at 13-7.

80. *See infra* text accompanying note 84.

81. S. REP. No. 93-1298 § 126, 93d Cong., 2d Sess. 94 (1974)[hereinafter section 126].

82. J. JACKSON & W. DAVEY, *supra* note 9, at 476.

83. *See supra* text accompanying notes 29-36.

treatment principle as it applies to multilateral trade negotiations . . . should result in concessions by other major industrial countries which provide competitive opportunities in their markets substantially equivalent to those provided in the U.S market. . . . *It is the intent of the Committee to close [the "free-rider"] loophole by requiring that the [United States] have as its objective that each major industrial country make a contribution to the lowering of trade barriers substantially equivalent to that made by the [United States],and that no major industrial country receive benefits from the negotiations substantially in excess of the concessions it has granted.* . . .

[T]he Committee agreed to provide expressly that nontariff barrier agreements may be entered into discriminately—on other than [MFN] basis—to assure that a foreign country which receives benefits under a trade agreement is subject to the obligations imposed by the agreement. . . .

No industrialized country should be given a free ride in this negotiation. Nor should any industrialized country provide protection to its industries while expecting others to lower barriers for their exports. The concept of equivalent competitive market opportunities should be a key guide to this negotiation. No industrialized country should expect to have the best of both worlds anymore. *The United States should not grant concessions to countries which are not willing to offer substantial equivalent competitive opportunities for the products of the United States in their market as we offer their products in our market.* . . .

Under [section 126], the U.S. negotiator would not seek special advantages for U.S. products in any developed country but *reciprocal* benefits. The Committee believes this was the original intent of the *Reciprocal* Trade Agreements program initiated in 1934. . . .

For these reasons, the Committee adopted a "reciprocal" nondiscrimination principle. Under this principle industrialized countries would not get a free ride in this negotiation. *The President would be required to determine at the conclusion of all negotiations. . . whether any major industrial country has failed to make concessions under trade agreements which provide competitive opportunities for the [the United States] in such country substantially equivalent to the competitive opportunities provided by concessions made by the [United States]. The objective would be overall reciprocity—substantially equivalent market access or competitive opportunities on an overall basis.*

The Committee feels that only when there is fairness and

> reciprocity in commercial relations among the major industrial countries will the groundwork be laid for the continued movement toward freer trade. The Committee's "reciprocal nondiscrimination" principle should not offend any country which is willing to trade with the [United States] on the basis of equity and reciprocity. Only if a country insists on gaining advantages for its exporters in the U.S. market without being willing to offer U.S. exporters comparable advantages in its markets would it have grounds for concern over this provision.[84]

No distinguishable difference exists between the free-rider problem addressed in section 126 and that addressed in the original Second Banking Directive's article 7. The language supporting section 126 is equivalent to that put forth by the EEC in support of its reciprocity provisions. Yet the United States condemns the EC versions.

The EC's attempt to accelerate moves toward reciprocity in banking services is not a heinous violation of GATT. The EC's only mistake, if any, was not one of direction toward reciprocity, but rather, the desired velocity of that move. By its moderation of the Second Banking Directive, the EC acknowledged its hastiness and altered its approach accordingly. Yet while the United States points its finger at the EC and cries foul, the United States reserves power in itself through section 126 to impose the same type of standard on other countries.[85] This is a double-standard.

This double-standard is even more acute because section 126 expressly applies to GATT negotiations. The United States complains that similar EC reciprocity provisions are bad precisely because they violate the "spirit of GATT." But in light of section 126, the United States is not in a proper position to complain.

V. The United States' Turn to Deregulate

The EC has not yet complained of the double-standard created by section 126. Rather, EC complaints have centered on the United States' failure to peel away regulatory barriers to U.S. financial markets. Since the United States has chosen GATT as the forum in which to promote international regulation of services, of which banking is an important part, the United States

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84. Section 126, *supra* note 81, at 94-95 (emphasis added).
85. *Id.*

must prepare for voluntary deregulation of its own banking markets to provide "equivalent competitive market opportunities"[86] to EC banks. Voluntary deregulation would further the "objective that each major industrial country make a contribution to the lowering of trade barriers substantially equivalent to that made by others."[87]

The EC has acknowledged U.S. concerns that deregulation might destabilize the U.S. banking industry, and it has indicated a willingness to be patient. The EC has also, however, indicated an expectation that the disparities be eventually harmonized.

The EC's recent modification of the Second Banking Directive places the ball in the United States' court since it was principally the United States' complaints which caused the modification. Having now afforded U.S. credit institutions with relatively unrestrained opportunity in the single market, the EC's interest in U.S. reciprocation is based only on faith, not on any provision.

The United States is left with two important choices: maintain the status quo, ignoring the disparities of opportunities and enjoying the short-term benefits of a "free ride,"[88] or begin making unilateral moves toward deregulation, attempting in good faith to match the EC. The latter is the clear choice if the United States is committed to promoting freer international trade. The former will be a short-term alternative at best, because U.S. failure to make unilateral changes will not be ignored by the EC. The EC could retaliate, even in non-banking areas.

Perhaps abolition of Glass-Steagall would be the most effective place to begin immediate deregulation of U.S. financial markets. Vigorous congressional discussion on the subject has already begun.[89] Regardless of which of the three areas complained of by the EC is addressed first,[90] some step should be taken soon to regain EC confidence in the United States' commitment to multilateral reciprocity, and perhaps more importantly, to assure fair treatment of EC financial institutions in the United States. Such a move will also strengthen the U.S. bargaining power in discussions regarding a multilateral agreement on trade in services.

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86. *Id.*
87. *Id.*
88. *See supra* text accompanying note 84.
89. *See supra* notes 11-21 and accompanying text.
90. *See supra* notes 11-14 and accompanying text.

VI. Conclusion

Article 7 of the EC's original Second Banking Directive has sparked a vigorous discussion about international trade standards. Though article 7 has since been modified, the issues raised in the discussion remain important to United States-EC relations and to the growing interest in striking a multilateral agreement for international trade in services.

The EC's recent moderation of article 7 exhibits a "good faith" move toward multilateral reciprocity in financial services. However, U.S. banking markets remain highly regulated, creating a barrier to access by EC and other foreign banks. The United States should follow the EC's lead and begin deregulating its own banking laws. Such a move will renew U.S. commitment to freer trade in financial services, ensure continued favorable treatment of U.S. interests in evolving EC policies and strengthen the United States' bargaining power in ensuing multilateral discussions on trade in services.

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