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Retail financial services: overcoming remaining barriers A legal analysis

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This note is intended as an informal working paper for the "Forum Group 5" under the Financial Services Action Plan. It should at this stage NOT be considered as a formal communication of DG Internal Market.

1. THE CROSS-BORDER MARKET FOR RETAIL FINANCIAL SERVICES

The Financial Services Action Plan (COM (1999)232 of 11/5/99) announces a Commission report on "substantive differences between national arrangements relating to consumer-business transactions" (strategic objective 2, fourth action). The plan thus intends to open a debate on further developments of the retail end of the financial services Single Market.

a) The driving market forces: is there a business case?

This market is presently not very active. But it is important to develop and first of all to understand its potentials. The forces driving the Single Market in general can be derived from the basic concepts of international trade. Trade in goods between, say, Mediterranean and Scandinavian countries is driven by their different endowment with natural resources ("comparative advantages"). With financial services, a market analysis based on such basic concepts will not easily reveal similarly clear potential trade flows. A bank or an insurance company can be set up anywhere. The consumer¹ requiring basic financial products will find an appropriate range of "indigenous" offers in every Member State from Greece to Finland. This should not be taken to mean, however, that there is no business case for cross-border exchanges of these products and that, therefore, existing barriers could as well remain. Firstly, obstacles to cross-border services must be eliminated as a matter of principle, whether there is a high propensity to trade or not. Secondly, all this just means that the incentives to trade in the retail financial services field have to be considered in a more subtle way. ∴ A current "Forum Group" gathering representatives of the financial industry and of consumers is considering which financial products might have mass market potential in a cross-border dimension. From these discussions it appears

- that incentives to trade can stem from differences in 'financial techniques' (e.g. "Bausparkassen", Building Societies or Mortgage Banks each offer different products ; customers in the neighbouring countries might be interested in receiving housing finance based on a technique not used in their own country);
- that, however, an almost opposite approach is plausible as well: UCITS are more easily traded across borders than almost any other financial product, given that they are to a large extent standardised by the relevant EC Directive (85/611/EEC);
- that demand for financial services can also be expected from prospective investors in remote areas of the EU wishing to have access to a major financial centre; the experience and skills developed in some of these centres, often over decades, are "quasi-natural" resources giving them comparative advantages and thus inducing trade; this is of interest not just for professional market participants, but also, for instance, for private persons wanting to invest in financial instruments different from those prevailing in their own countries of residence (such customers will require, for instance, retail brokerage and custody services) or wanting to acquire private pension rights under innovative systems not available in their country of residence;
- that another segment of this market will consist of customers with second residences who may wish to have the house abroad covered against fire and household risks by the insurer in the country of their main residence, or who, on the other hand, may wish to have local banking facilities (accounts, payment cards etc.) at the place of their second residence;

¹ This paper refers to "consumers" rather than to "customers", even if the two terms are interchangeable in most instances. "Consumer", in any case, means "a physical person acting outside his professional capacity". While a distinction between the ordinary and the more "sophisticated" investor is being sought (see third action under strategic objective 1 of the Action Plan), the present considerations have the normal, non-sophisticated customer in mind. For SME customers, the reflection in this paper can apply to some degree, but not fully (e.g. SMEs are not covered by art 5 of the Rome Convention which, on the other hand, has important consequences for private customers).

- that cross-border trade in retail financial products can also be stimulated by other commercial transactions to which financial services are a natural component (this is true, for instance, for mail order trade in consumer goods which is usefully combined with offers of consumer loans);
- that price differentials will, of course, also play a role, especially for products which are fully and easily comparable (e.g. credit cards; on the other hand, insurance products are often tied to country-specific risk profiles, such as the frequency of accidents, which accounts for the differentials of premiums for car insurance);
- that, finally, there seems to be a rather clear demand for insurance services from “expatriates”, i.e. persons living outside their home countries, especially for professional reasons which can oblige them to move frequently from one European city to another and who would like to keep their basic packages of insurance services with the insurer with whom they have started.

b) Channels for trading financial services

Financial services are more easily moveable across frontiers than most other products. Indeed, retail financial services consist essentially of “*know how*” and *managerial techniques* which institutions put at the disposal of their customers. Banks, for instance, are most experienced in collecting and safekeeping cash savings, i.e. in running current or savings accounts. On this basis, they also have created systems to carry out payments, and they have a long-standing tradition in retail customer lending of all types. UCITS, on the other hand, are designed to invest money collected from consumers in ways which strike the right balance between profitability and risk spreading. Insurers provide coverage by pooling, within large portfolios, a high number of like risks. Such “know how” and techniques materialise essentially in contracts (e.g. insurance policies) and in structured information (e.g. bank account).

By their nature, such contracts and information can circulate easily across borders and can be transmitted to consumers directly, sometimes via *intermediaries*², more often by *traditional mail* and increasingly via *electronic channels*. The fact that “know how” and managerial techniques are, by nature, dematerialised, means that they lend themselves particularly to distance selling and to fluid transmission between even the most remote geographical zones of the EU.

c) The status of branches

The considerations in this paper address operations directly out of the home base of the financial institutions concerned which contact customers abroad without using a local establishment in the customer’s country. This is indeed what the term “services” in the meaning of article 49 EC implies.

However, the present reflection will *mutatis mutandis* also apply to operations carried out via branches. Indeed, as regards supervision, the “European Passport” for financial institutions (see section 2 below) is valid for branches as well, in the sense that it frees them from local supervision and places them under “Home Country Control” (thus, for instance, expressly art. 18 of the Second Banking Directive 89/646/EEC). As regards the financial products sold via these branches, they should in principle benefit from the same freedom as products imported directly from abroad under the regime of freedom of services. Nevertheless, this basic principle may have to be qualified under certain aspects (under fiscal law, for instance, a branch is considered

² The status of intermediaries will not be considered in much detail in this context as it will be studied under other Actions (in particular Action 25; see also draft insurance intermediaries Directive XVI/2034/99). Arguments in this paper are potentially relevant to both independent *brokers* (acting in the best interest of clients) and *agents* (representing one or several financial institutions). The latter, i.e. “salesmen” offering financial products to customers in other countries in a face-to-face negotiations play an important role as one of the few potential channels for cross-border service business, the only other channel being “distance selling”.

a fully fledged seat of operations for tax purposes; the fact of being established might also be relevant in the context of international private law). Therefore, the following considerations will concentrate on trade in "services" in the meaning of the EC Treaty and in particular on e-commerce, it being understood that, in further debates, branches should be included, under the assumption that most of the arguments developed in this paper will hold true for their operations as well.

d) Why can 'substantive differences' hamper trade in financial services?

With the introduction of the "European Passport" under the Second Banking Directive, the third generation Insurance Directives and the Investment Services Directive, financial institutions can offer their services in other Member States while, in principle³, fully remaining under "Home Country Supervision". This means that barriers on prudential grounds have been waived and need not be considered here again⁴.

"Substantive differences" which need to be researched and analysed can however appear on other levels, in particular in the area of "marketing rules" and in the field of contract law. It is these which will be considered in the sections hereafter.

Of course, different tax laws also can seriously impair the single market for financial services; but this aspect will have to be tackled separately (see Annex).

There are of course many further "natural" barriers to trade, such as the practical need to use different languages and hence to translate much of the material used when financial contracts are being concluded or the natural inclination of consumers to turn to their domestic and more familiar financial institutions rather than looking for loans, investment possibilities or insurance coverage across the borders into neighbouring countries. These differences are given facts which cannot be changed by EC legislation and other Community measures anyway. They will therefore not be considered in this paper.

2. HOW TO OVERCOME OBSTACLES ARISING FROM "MARKETING RULES"

The term "marketing rules" is introduced here to designate standards which, on the one hand, determine the *pre-contractual behaviour* of suppliers and, on the other hand, rules which govern the *first stages of "contract-building"*. A prominent place among the former, i.e. among the pre-contractual rules, will be held by so-called "selling arrangements⁵" (e.g. provisions regulating advertising/canvassing or cold calling/inertia selling). The latter, i.e. the contract-building arrangements will indicate the ways in which offers should be made and accepted (e.g. provisions granting rights of withdrawal). It seems appropriate to treat selling arrangements and contract-building rules in the same way when it comes to the opening of frontiers by legal approximation.⁶

³ An exemption to this principle can be found in Article 11 (7) of the ISD (even if this concerns conduct of business rules, not prudential supervision in the stricter sense). As regards e-Commerce, the future legal framework Directive will however supersede the home country rule in art.11 (7) as far as trade via the Internet is concerned (see also Fn. 8).

⁴ It could be noted in this context, however, that art. 20 of the Second Banking Directive 89/646/EEC as well as analogous articles in the insurance Directives (e.g. art. 14 of the Second Non-life Directive) require prior notifications from institutions which intend to render services in other Member States to the authorities of these States. This is a remaining supervisory barrier; it has therefore been decided that this notification duty shall be eliminated, as regards the banking area, by a future modifying Directive (while insurance experts consider this an administrative duty only, which, if not fulfilled, would not nullify an insurance contract, so that a modifying Directive is not envisaged on the insurance side).

⁵ The term is taken from the "Keck/Mithouard" jurisprudence of the ECJ (in French "modalités de vente"; judgements 267 and 268/91 of 24/11/93). The Court, in further case law after the Keck decision, distinguishes between these "selling arrangements" on the one hand and "product-bound" rules on the other (cf. *Peter Oliver in "Common Market Law Review" 1999, p. 783, in particular pp 794 and following*).

⁶ It must be recognised that the boundaries between "contract-building rules" and the law governing the actual content of a given contract will not always be easy to establish. Nevertheless, they clearly have different characteristics. Rights of withdrawal, for

a) Marketing rules in Community law

This is indeed what the proposed e-Commerce and Financial Services Distance Selling ("FS/DSD") Directives are doing: they provide for substantial steps towards the harmonisation of both marketing and contract building rules. The proposed FS/DSD as well as the proposal on certain legal aspects of *e-commerce* deal with issues which can partly be counted towards "selling arrangements" (e.g. the limitation of cold calling in the FS/DSD proposal), while, for another part, they concern contract-building aspects (e.g. the definition of the moment at which a contract is concluded in the e-commerce proposal; rights of withdrawal in the FS/DSD); together they can in any case be counted towards "marketing rules."

In this context, the provision of consumer information⁷ will hopefully find an appropriate solution, i.e. be subject to full harmonisation under the pending FS/DSD proposal.

Typical "selling arrangements" are dealt with in the Directive on *doorstep selling* (Directive 85/577/EEC) which applies to banking (while it does not cover insurance securities; this might however be reviewed) and those on *misleading and comparative advertising* (Directives 84/450/EEC and 97/55/EC covering all financial services). The Action Plan initiative on *consumer information* regarding financial services (following the pending mortgage dialogue) as well as sector specific consumer information rules included in insurance and in the investment funds (UCITS) Directives are addressing pre-contractual aspects which pertain to "marketing rules".

References to "marketing rules" can furthermore be found in the *ISD conduct of business rules*⁸. The "television without frontiers" Directive 89/552/EEC of 3/10/89 should also be mentioned in this in this context given that it guarantees free transmission of television broadcasts from Member State to Member State, including commercial communications which were made subject to detailed harmonising rules (art. 10-18 of the Directive) and which could concern TV advertisements for financial services.

b) Harmonisation of marketing rules

Most often, marketing rules applying to a given consumer / business transaction will have to be those of the host country, i.e. of the country in which the consumer has his residence. Indeed, selling typically takes place at the consumer end of a business relation. It is the consumer to whom an advertisement is presented; it is at his "doorstep" that a salesman appears. Thus, when operating in a national market, a supplier of financial services will often have to respect local marketing rules, and rightly so. However, this tends to fragment the Single Market.

instance, provide for specific possibilities given to consumers of stepping back from a contract which is still at its beginning; they have to be distinguished from the termination of a contract under conditions foreseen by the contract itself.

⁷ It can be quite difficult to fit information rules in one of the above categories. To the extent to which information amounts to *advertising*, it belongs to "selling arrangements" and falls under the rules of the future e-Commerce Directive. However, there is also more detailed *pre-contractual information* which consumers need before deciding on whether to opt for a specific product; this type of information is subject of the pending dialogue on a "Single Page Information Sheet" for mortgage loans and of art. 4 of the pending Distance Selling Directive. It does not seem necessary in the present context, however, to draw a very sharp borderline between these types of information as they both can be counted under the broader concept of "marketing rules" and be treated in the same way. Finally, "*contractual information*" (a term which might better be avoided anyway) is different: it consists in the "offer" and in contractual "conditions" and therefore belongs to the contract itself.

⁸ Especially art. 11 (1) indents 4 and 5. Most other indents refer to clauses which are not confined to "marketing" but determine the way of operation of ISDs in general. All these principles are likely to be reviewed in due course in the context of the future work on up-dating Article 11 of the Investment Services Directive (e.g. definition of the "sophisticated investor").

This fragmentation can best be overcome by harmonisation⁹. Indeed, it would be difficult to suggest that, without any approximation, consumers would have to accept marketing practices as they apply in other Member States. It would not seem fair, for instance, to propose that consumer information standards should simply be the ones of the country of origin whatever they are. Harmonisation would solve this difficulty in approximating country of origin and consumer country rules to the point where the choice between home and host country standards becomes irrelevant.

This said, it should be underlined that the measures quoted above (e.g. existing rules on advertising; present and planned rules on consumer information) already constitute a rather comprehensive harmonised framework for cross-border financial services trade. Once the current e-commerce and FS/DSD proposals will additionally have been adopted, a sufficiently solid basis for opening frontiers to selling and contract building arrangements from different Member States will have been achieved¹⁰.

In these circumstances, it would seem possible to proceed along similar lines as those followed in the context of the Single Market process of the mid-1980s when Member States were asked to indicate, with regard to the area of banking, which supervisory measures, at that stage (prior to the Second Banking Directive), remained to be harmonised before a "European Passport" system could start. The necessary measures (in addition to several banking Directives then already in place, these measures concerned the definition of own funds and the solvency ratio as well as deposit guarantee schemes) were then rapidly taken and, on that basis, the last supervisory barriers were waived by the Second Banking Directive. In a similar way, it should now be possible to list those "marketing rules" which, while corresponding to a "general good" still are substantially different from one Member State to another.

It is suggested that once the proposed FS/DSD is adopted and gives an appropriate answer to the questions of consumer information and of the right of withdrawal, one of the few areas left would be information provision in face-to-face transactions¹¹. Work on a "Single Page Information Sheet" for mortgage loans and work of Forum Group 4 in general will cover this issue. In any case, Member States and the Commission should work towards a consensus under which the (supposedly very limited) harmonisation needs in the area of "marketing rules" are identified and solutions agreed which stipulate that financial institutions from one Member State may approach customers in the others in the same way as they do in their own country. The only other issues for which one could consider further harmonisation of marketing rules might arise in the areas which remain out-side both the e-Commerce and the FS/DS Directives, and which, as just mentioned, might concern cross-border "face-to-face" trading.¹²

3. BARRIERS IN CONTRACT LAW AND WAYS OF REMOVING THEM

The nature and the substance of any financial product are to a large extent determined by its underlying contractual conditions. For instance, the terms of bank loans (e.g. fixed or variable interest; duration; possibilities

⁹ Such harmonising measures should be based, as the case may be, on articles 47(2)/55 (when a specific obstacle to a service provision is at stake) or otherwise on article 95 (with, in the background, but not as a separate legal base, article 153(3)(a)).

¹⁰ It must be acknowledged, however, that many of the Directives pertaining to the field of consumer law and dealing with "marketing rules" provide for minimum standards, i.e. they do not prevent Member States from introducing or maintaining stricter rules on national level (c.f. art. 8 of Directive 85/577 on doorstep selling, art. 7 of Directive 84/450 on misleading advertising or art. 15 of Directive 87/102 on consumer credits). On the other hand, such "overshooting" parts of national legislation must of course not restrict imports of foreign financial products unless this is necessary in the interest of a 'general good'. Arguably, the said Directives have harmonised what Member States considered as essential for the protection of consumers at the period at which these Directives were negotiated, so that it may be relatively easy to demonstrate that the "overshooting" national standards are not absolutely required for preserving a 'general good' pertaining to the harmonised area.

¹¹ Of course, cross-border redress possibilities (one might call them "post-contractual conditions") also are of outmost importance to the consumer. They are subject to a specific initiative presently underway and therefore are not studied here.

¹² Such trading could occur when travelling salesmen representing financial institutions would approach customers in other countries.

of early repayment; guarantees to be made available by the borrower) will be shaped by such conditions. In many respects, the parties will be in a position to set their contractual arrangements freely by mutual consent. There will be clauses, however, which the parties cannot but formulate along predetermined legal formats. This is true, for instance, for insurance contracts. The definition of the risks covered, the amount and frequency of premium payments and other elements depend on general business conditions used by the insurance company and on individual agreements with a given customer. However, national insurance contract law (for which an attempt towards harmonisation was made in earlier years but which did not succeed) will provide for a compelling framework pre-setting many elements of such arrangements.

a) The concept of mutual recognition

Thus, contractual conditions determine the quality of a financial service much in the same way in which technical standards and industrial design are shaping physical goods. This points to a possible approach which the future Commission report should take: where deviating standards account for differences between financial products among Member States, free trade, as in the area of goods, should nevertheless be possible

- either because national standards not corresponding to a public interest are overridden by the relevant Treaty freedom (which, in the extreme, would have to be confirmed, for each case, by European Court decisions¹³),
- or because standards for which a public interest exists nevertheless are mutually recognised under an ad hoc Community instrument.

This instrument would have to aim at almost “pure” mutual recognition, without a high degree of prior harmonisation. While, in the area of “marketing rules”, it is possible to take a large number of pre-existing harmonisation measures as a starting point, work on contract law¹⁴ will have to try and achieve mutual recognition without such basis, for the following reasons:

- Contract law in the areas of banking, insurance and securities transactions is deeply interwoven with national civil law codes which would make harmonisation an almost impossible task.¹⁵

¹³ It should be noted that where contract law is subject to “open ended” harmonisation (i.e. Directives which are silent on the question whether or not Member States could introduce stricter rules, such as is the case with regard to the consumer credit Directives) art 95(3) nevertheless should be taken into account: as Single Market Directives have to aim for a high level of protection, there will normally not be a public interest for a Member State to impose a higher level still (this argument is in parallel to what has been said about marketing rules in footnote 10 above).

¹⁴ In parallel to contract law, there are also provisions pertaining to international private law which determine, often in a compelling way, the competent jurisdiction for disputes between a supplier of financial services and his customer. This is true, in particular, for the 1968 Brussels Convention which, in its section 4, makes it mandatory for service suppliers to sue consumers in the countries of the latter (while giving a choice of jurisdiction to consumers when they sue suppliers; the Convention in its section 3 separately contains detailed rules on jurisdiction for the insurance area where the location of the risk is often decisive). According to these rules, consumers may only be sued in their own countries, at least if they have signed a contract in that country and if « *in the State of the consumer's domicile the conclusion of the contract was preceded by a specific invitation addressed to him or by advertising* » (art. 13(3) of the Convention). The proposal for a new Regulation intended to replace the Convention (COM(1999)348 fin of 14/07/1999) changes the present article 13, and, in a new article 15, refers to contracts which have been “...concluded with a person who pursues commercial or professional activities in the Member State of the consumer's domicile or, by any means, directs such activities to that Member State...” (art.15(1), sub-para.3 of the proposal). More recently, the European Parliament in search of a more flexible solution intended to refer to the possibilities of choice of laws when a distance contract was concluded following instructions on a web-site. All this amounts to saying that providers of retail financial services will have to accept that, in cases of disputes with customers, they can be taken to Court in any country in which they offer retail financial products. This aspect will not be discussed more in depth in this paper, as it is the subject of a separate and specific debate; the problem must however be noted as a background element in the present context.

¹⁵ Of course, harmonisation in the contract law area, amounting in a way to a standardisation of financial products is not excluded altogether. Indeed, the *Directives on consumer credit* and on the “annual percentage rate of interest” brought about a high

- As was pointed out in section 1(a) above, the incentives for trade in retail financial services from the vantage point of a comparative cost analysis are not always obvious. Standardisation of financial products, as it would result from a harmonisation of contract law (thus creating, for instance, the European type of mortgage contract or of life insurance policy) would level comparative advantages and disadvantages in these markets, take away its diversities and thus make cross-border trade even less attractive¹⁶
- It seems advisable, in this context, to follow the precedent of insurance contract conditions. While an attempt of harmonising *general insurance contract law* failed in earlier years (1969/1979)¹⁷ it nevertheless became possible, with the “third generation” insurance Directives of 1992, to abolish the prior authorisation of policy *conditions* (e.g. art. 8 and recital 20 of non-life Directive 92/49/EEC). Indeed, on the grounds that supervision was sufficiently harmonised to be confident that only solid players acted in the markets, it was possible to allow these players to offer their products in “home country version” throughout the EC (what has however remained are certain duties of information¹⁸).

b) Mutual recognition and “general good”

Globally speaking, a “general good” is at stake when objective risks for the public arise (epidemic diseases, organised crime etc...) against which the authorities of a Member States are bound to act. In the area of financial services, the “general good” will typically be threatened when insufficiently supervised or unscrupulous players expose the public in general (market stability) or consumers individually either to immediate financial losses (fraudulent investment offers) or to unfair contractual bonds (loans at usury rates; unreliable insurance coverage etc...)¹⁹.

Rather than perceiving this “general good” as a principle in opposition to open frontiers and to free markets, it is vital to understand it as an intrinsic social value on which a Single Market has necessarily to be built. Overcoming barriers cannot imply that the public must accept higher risks. In any case, if the public at large perceived transactions with foreign financial institutions generally as being more risky than those with domestic ones, a Single Market for retail financial services would simply not get underway.

degree of “product standardisation” in their particular fields. The 85/611/EEC *UCITS Directive* is another typical example of “product harmonisation”. On the other hand, attempts of producing similar results in the *mortgage* area have failed in the past; and are not likely to be brought to the fore again, even if the possibility, for instance, of standardising the calculation of interests and annuities is sometimes still being considered. As regards *insurance*, see remark under 2(b), third indent, above and footnote 17 below (the difference between UCITS and insurance is that the UCITS Directive introduces a certain degree of product harmonisation, whereas the insurance Directives achieve free trade of insurance products without standardising insurance contracts).

¹⁶ The high propensity of cross-border business in the real estate credit sector is rather striking in this context. Mortgage institutions are in the forefront of financial service providers when it comes to planning activities in neighbouring countries. This cannot only be due to business created from the acquisition of secondary residences (other financial services should benefit from such mobility as well); it rather points to the fact that the fundamentally different financial techniques used by mortgage banks, Bausparkassen, building societies and other specialist institutions attract interest exactly because of their diversity.

¹⁷ It should be acknowledged that new suggestions to reconsider the possibilities of harmonisation of insurance contract law have been made in 1999 by the industry and by some national delegations. Possible subjects for such harmonisation could pertain to areas such as the proper declaration of accidents and the consequences of non-payment of premiums.

¹⁸ Art. 30 (2) of Directive 92/49/EEC (third damage insurance) and title IV of the third life Directive 92/96/EEC; indent 4 of the annex to the pending e-Commerce Directive provides an exemption precisely for these duties of notifying host countries.

¹⁹ Particularly relevant financial services cases hitherto decided by the ECJ include the *German insurance case* (205/84: insurance companies cannot be forced to set up an establishment in the host country on the grounds that this would be required for supervisory purposes; however, the integrity of the taxation system can justify such requirement); the *Alpine Investments case* (384/93: the Netherlands were entitled to stop cold calling activities of Alpine out of the Netherlands on grounds of the good reputation of the Dutch market) and the *Svenson/Gustafson case* (484/93: Luxembourg must not limit tax deductibility of mortgage interests to loans from domestic providers).

It is equally important to note, as a starting point, that each and every Member State can protect its residents against financial risks as efficiently as its political system ever decides to protect them. At the outset, therefore, individual countries do not need the Community when it comes to finding the right balance between *'caveat emptor'* and the *'nanny state'*. However, within a Single Market this balance has to be determined by common accord among all Member States. Indeed, if the levels of consumer protection were to vary strongly between them, this would firstly distort competition and secondly create problems with exports of financial services from less consumer minded countries to those with higher levels of protection.²⁰

"National arrangements" which prevent foreign financial institutions from selling certain of their products to consumers in a given Member State are normally in conflict with the freedom of services as guaranteed by the Treaty. It is true that such arrangements may in some cases take precedence over this freedom for reasons of consumer protection, such protection being recognised as a "general good" by European Court jurisprudence. However, a general reference to a consumer interest will not suffice to justify these arrangements. In any case, such arrangements must not exceed what is objectively necessary to avoid consumer risks ("proportionality test") and they must take into account protective features which the financial product in question may possess anyway under the rules of its country of origin ("mutual recognition")²¹

c) How to achieve mutual recognition in this context

The latter remark shows that "mutual recognition" will amount to what is often termed "home country rule". Indeed, mutual recognition implies that Member States accept a product, tailored to the legal environment of a given country, as fit for being in free trade within the entire Single Market. They should recognise, in particular, that it does not expose the consumers in other countries to undue risks, even if, in the legal environment of the other country, risk protection is achieved in other ways. This recognition in the same time will imply that the choice of the contractual law which (as was said in section 2(b) above) shapes financial products can be made freely, even with regard to provisions which otherwise would be compulsory in terms of art. 5 of the Rome Convention (see section 3(c) below).

A typical example arises with loans for which, under the laws of certain Member States, the borrower must be given the possibility of early repayment. In other Member States, it is usual to arrange such loans in ways which make it difficult for the borrower to pay the loan back before its term. In such cases, the consumers in "early repayment countries" should, of course, be warned that, if they take out a loan from an institution in a "long-term country", they will not be able to withdraw from the contract as early and easily as they could when borrowing from a local bank. They might, for other reasons (e. g. long-term fixed interest rates) nevertheless decide for the foreign long-term, non-repayable product, thus benefiting from a welcome diversity between

²⁰ The consolidated EC Treaty in its article 153 paragraph 5 takes this clearly into account. It runs as follows: "*Measures adopted pursuant to paragraph 4 shall not prevent any Member State from maintaining or introducing more stringent protective measures. Such measures must be compatible with the Treaty. The Commission shall be notified of them.*" Art. 153 paragraph 4, to which this clause is pointing, refers itself back to paragraph 153(3)(b), and not to paragraph 153(3)(a). This is of great significance, given that it means that the minimum clause in Art. 153(5) is limited, deliberately, to specific policy measures in the consumer field (153(3)(b)) and does not cover the approximation of laws necessary for the establishment and functioning of the internal market (art. 153(3)a in conjunction with art. 95). In the context of this approximation, a high level of consumer protection has to be taken as a starting point (thus expressly art. 95 para.3). In order to meet the single market needs, *full* rather than *minimum* co-ordination should be planned on this high level. Given, as is said above, that every Member State is absolutely capable, by itself, of protecting its own consumers, the only added value which the Community dimension can bring in this area consists in making sure that every country protects its citizens with equal strength, thus not only keeping open the intra EC frontiers to trade but also achieving a truly common consumer policy.

²¹ "Mutual recognition" in this context is not to be taken in the technical meaning of Article 47 (1) (ex-57) EC which deals with the recognition of diplomas to be achieved by specific Directives. Much rather, the underlying concept here is in close parallel to the ideas expressed by the Commission in its Communication 299/99 of 16/6/99 on the "Mutual Recognition in the context of the follow-up to the Action Plan for the Single Market" (see also the E.P. draft report, Garcia-Margallo, esp. its sec. 7 9, discussing the Commission Communication and mentioning the possibility of a consumer protection/financial services Directive).

markets and products of different countries. Excluding this option altogether would not seem necessary in the interest of preserving a “general good”, given in particular that the consumers in the “long-term country” will, often for decades, be used to contracts without early repayment possibilities and this, apparently, not to their disadvantage.

The “early repayment” example which was given above demonstrates, of course, that “mutual recognition” will not be a workable proposition without full and fair consumer information. Another initiative under the Action Plan (Actions 21 and 22) is concerned with that aspect. Consumer information standards might require further harmonisation, which is indeed envisaged in the context of the FS/DSD (see also footnote 7).

It should be added that the option for mutual recognition is not simply aiming at wider business opportunities and the ensuing economies of scale for suppliers. It must not be overlooked that often suppliers are legally bound to design their products in line with the standards imposed by the law of their country of origin. Were they to fulfil diverging host country standards at the same time, there could arise incompatibilities between home and host country rules which would block any trade, unless recognition (or harmonisation, which however can only be envisaged in the very long term, if at all) is achieved.

In conclusion, “marketing rules” on the one hand and contract law on the other will have to be dealt with differently; the emphasis will either be on “pure” mutual recognition (contract law shaping products or “financial techniques”) or on a certain degree of prior harmonisation (ways of marketing products; selling conditions).

- With regard to *selling arrangements*, it is particularly important for the consumer not to be exposed to unfamiliar techniques and practices used by suppliers in other countries. Therefore, mutual recognition (which paves the way to the application of home country standards) must, in this area, be based on a certain degree of harmonisation. Such harmonisation, however, is already achieved to a large extent, either by general Directives on advertising and other consumer measures, or by legislation which is presently underway (in particular on Distance Selling).
- With regard to *contract law*, mutual recognition should be in the foreground; it should only exceptionally (UCITS, consumer credit) be based on prior harmonisation; the preferred approach should be similar to the one followed by the third generation insurance Directives, which would have to be extended to other areas (e.g. to mortgage lending²²).

d) The “Rome Convention”²³

Mutual recognition would be the best way to tackle problems arising from differences in contract law; this however raises questions with regard to rules on the choice of laws. This choice, in the first place, will be made by the parties. These, however, are not always free in their options. In particular, the “Rome Convention

²² In principle, the Second Banking Directive was intended to bring about mutual recognition for all financial products and techniques coming under its scope, including mortgage credit techniques (see recitals 11, 12 and 16 and art. 18 of Directive 89/646/EEC). However, this mutual recognition did not bring the expected practical results, partly because the implied mutual recognition of contract law (while the Directive deals with prudential supervision) was not sufficiently explicit in that context.

²³ It must be noted, that, for the insurance sector, the Rome Convention does not apply, at least as far as direct insurance is concerned (art. 1 para. 3 of the Convention). The applicable law has to be determined following art. 7 and 8 of the Second Damage Insurance Directive 88/357/EEC as well as art. 4 of the Second Life Directive 90/619/EEC. Under these rules, the applicable law for damage insurance will in most cases be the one of the country where the risk is situated. Should the insurance customer however have his residence in another country, the parties may choose between the country of the risk and the one of the customer’s residence. If no choice is made, the likely legal order applying will again be the one of the location of the risk (art. 7 (1) (h), last sentence). For life insurance, in most cases the country of the insured person’s residence will apply. The pending e-Commerce Directive provides for exemptions to preserve these choice of law rules.

on the law applicable to contractual obligations”, and especially its Article 5²⁴ can make host country consumer protection clauses inescapable. Indeed, financial institutions which place advertisements abroad or contact consumers in other countries by direct mail shots, let alone by travelling salesmen or via branches (see section 1(b) above), and which, in consequence, get contracts signed by these consumers, must accept that binding host country contract law protecting these consumers will apply. This is not only true for traditional ways of canvassing. While the proposed Directive on certain legal aspects of e-commerce is deliberately silent on this aspect, the fact that a consumer receives advertisements via the Internet rather than by paper mail, or that he signs a contract electronically at his PC rather than on paper, does not change the nature of the problem: Article 5 of the Rome Convention will in most cases limit the free choice of law and make certain contractual consumer clauses apply to the financial product sold electronically²⁵. As contractual standards determine the contents and the characteristics of financial products, this makes it difficult to sell these products in their “country of origin version” to consumers in other Member States.

It is generally recognised, however, that basic principles enshrined in the Treaty take precedence over the provisions of the Rome Convention. This means that the entire chain of arguments, demonstrating that, under article 49, trade in financial services must be free from any restriction except from those for which a Member State can invoke an objective public interest, comes into play again (see section 3(a) above). This can lead to the conclusion, that, where the application of article 5 of the Convention prevents a given financial product from being sold in a particular host country, the Convention is nevertheless overridden by article 49 of the Treaty.

However, it would be rather cumbersome to demonstrate, with regard to each and every financial product, and in relation to each one of the 15 national legislations (let alone to individual clauses contained in these legislations) that a given obstacle flowing from contract law must be waived. A more general and pervasive approach is called for. It should consist in the adoption of Community legislation providing for mutual recognition, on the lines of what has been said in section 3(b) above. In the same vein, such legislation could and indeed would have to override the Convention globally, with regard to all aspects which would fall under

²⁴ Article 5 of this convention stipulates that “...a choice of law by the parties shall not have the result of depriving the consumer of the protection afforded to him by the mandatory rules of the law of the country in which he has his habitual residence, ... if in that country the conclusion of the contract was preceded by a specific invitation to him or by advertising, and he had taken in that country all the steps necessary on his part for the conclusion of the contract ...” .

²⁵ This is why the proposed e-commerce Directive exempts consumer contracts from its Article 3. It should be underlined, however, that this only goes for contractual obligations, not for pre-contractual steps (e.g. not for advertising).

its scope (following the convention's article 20²⁶) in stipulating the freedom of choice of the parties even with regard to compulsory provisions in the law of the customer's country.

The question will arise, of course, what will fall into the area of "contract law" chosen by the parties. If, for instance, a customer accepts that his mortgage loan is designed along the lines of the law applicable in the country of the supplier, this would, under the approach suggested here mean that the possibilities of early repayment (see the example in section 3(b) above) follow the provisions of the law which the parties could freely chose. On the other hand, legal provisions pertaining, say, to the possibilities for minors to sign such contracts will have to remain those of the customers country. As a general rule, the choice of law will concern those legal rules which pertain to the specific financial service in question and shape the contractual conditions of the product concerned.

4. CONCLUSION

The best way of dealing with "substantive differences between national arrangements relating to consumer / business transactions" is, on the level of contract law, to work towards a Directive which lists specific financial products as well as the national contractual standards governing them. Such a Directive should then globally stipulate that Member States will open their frontiers mutually to trading these products under contract law freely chosen by the parties.

As regards "marketing rules", one should firstly aim at demonstrating that there is a sufficiently broad basis of harmonised law protecting adequately consumers who purchase financial products from other Member States. Only where, exceptionally, "marketing rules" still differed substantially, further harmonising building blocks would have to be added to that basis. This could be done within the same legal act as the one providing for mutual recognition of product standards under contract law.

Under a measure of this kind, the European Passport available for financial institutions since the early 1990s, should, in the early years of 2000, be completed by a European Passport for financial products.

Dr. Peter TROBERG

²⁶ Article 20 refers to "provisions .. in relation to particular matters" and places "acts of the institutions of the EC" above the Convention. Thus,, Article 20 could open the way towards mutual recognition in recognising that, for instance, Directives based on Article 95 will override the Rome Convention. See in this respect the Commission's interpretative Communication to the Second Banking Directive, O.J. C 209 of 10.7.1997, in particular section C, page 21. In the same time however, the specific choice of law rules contained in the insurance Directives (see footnote 23) would also have to be adapted.

Annex: Tax aspects – an overview

Tax law can seriously distort competition, it can make foreign offers sufficiently unattractive to bar them the access to a given foreign market altogether. Therefore, the impact of divergences in fiscal laws cannot go unmentioned when studying barriers to retail trade in financial services, even if it is a specific problem, requiring further consideration in other fora (Points 39 and 41 of the FS Action Plan).

It should be pointed out, firstly, that only taxes levied on the customer side, rather than on the supplier's side seem relevant here, as only they will have a direct impact on the competitive position of the financial product concerned (*indirectly*, of course, patterns of trade in financial services can be distorted by tax incentives given to suppliers; this problem is addressed in the context of the code of conduct on business taxation).

Indirect taxes on financial products

In the light of what has just been said, it is not necessary, for instance, to study whether a discount broker offering services on the Internet will have to pay taxes in destination countries in which his Web-Site can be seen. Of interest, much rather, will be the question of whether and to whom customers buying securities via this broker will have to pay "*stamp duties*".

Analogous questions will arise with regard to VAT and para-fiscal duties which, in all countries, are levied on *insurance premiums*. These taxes have to be paid to the host countries (art. 46 of Directive 92/49/EEC and art. 44 of Directive 92/96/EEC) and Member States may even require that a fiscal representative of the service provider is established in that country.

Such specific duties of course have a clear and direct impact on the price, and hence on the competitive position of a given financial product. Questions from this area will be addressed in the Tax Policy Group (Action 41).

Direct taxes on customers

Aspects pertaining to general income tax levied from the customer, in particular the tax deductibility of interest or premium payments, also will have clear competitive consequences. As an overall harmonisation of direct taxation is not in view, these problems have to be tackled in making sure that tax discrimination is eliminated (typical cases concern the tax deductibility in favour of domestic financial products²⁷). The problem of taxation of savings will, of course, continue to be addressed (Action 39).

²⁷ See European Court cases *Bachmann* (C204 and 300/90, judgement of 28.01.1992), *Wielockx* (C80/90, judgement of 11.08.1995) and *Safir* (C118/96, judgement of 28.04.1998).