Introduction

The liberalization of international trade in financial services is a significant component of global and regional economic cooperation. Modern economies depend on well-functioning financial markets and financial markets benefit from the flow of financial services across borders. Financial institutions may engage in transactions with non-residents either directly from their headquarters or by establishing branches and subsidiaries overseas. This book focuses on services provided via the Internet by commercial banks (or 'credit institutions' in the EC terminology) and explores the potential contribution of electronic finance to meeting the objectives of financial integration in the single European market.

The notion of 'financial services' essentially refers to the full array of functions performed by financial institutions, including but not limited to the acceptance of deposits, lending, payment services, securities underwriting and trading, asset management, financial advice, settlement and clearing services.[1] In conducting these activities with *non-residents*, a financial institution engages in international trade in financial services. The modes of providing financial services across borders are basically four: first, the financial institution remains outside the territory of the client and the client remains inside his territory of residence and the service is supplied with the help of information and telecommunications technology (cross-border services). Second, the client physically moves from his country and receives the service in the location of the financial institution (consumption abroad). Third, the financial institution supplies the service to non-residents through a foreign affiliate, branch or subsidiary located in the country of the client (commercial presence). Finally, the financial service is provided by natural persons (as opposed to corporate entities) that move to the country of the client (presence of natural persons).

[1] See General Agreement on Trade in Services (GATS) (Marrakesh, April 1994) OJ 1994 No. L336/190, 23 December 1994, 2nd Annex on financial services, art. 5.

At the European level, the marriage of e-commerce and trade in financial services is a primary objective of policy reforms pursuant to the Financial Services Action Plan. With regard to international trade in the context of the World Trade Organization (WTO), one key factor driving the interest in the services component of the international trade negotiations is the increasing number of services that can be traded electronically without having to establish a physical presence in the importing country.

The EC Treaty[2] requires the establishment of a single European market comprising an area without internal frontiers in which the free movement of financial services and capital are guaranteed.[3] The legal and institutional framework must safeguard the elimination of direct or indirect trade restrictions in a diverse set of circumstances, including market entry through the permanent establishment of an agency, branch or subsidiary in the territory of another Member State;[4] the temporary presence of the bank's agents and staff in another Member State;[5] the temporary movement of the customer to the territory where the bank is established;[6] and the provision of the service at a distance, via the Internet or otherwise, with the bank and the customer being located in different Member States.[7] This last mode of providing banking services electronically is the subject of this book.

In chapter 1, the reader is introduced to the basic concepts and services relating to electronic finance and Internet banking. We will also discuss the importance of electronic finance for financial integration in Europe and recent market developments in this sector. I will also discuss my own survey of online banking activities in key European markets, which demonstrates that the actual contribution of the Internet to stimulating cross-border services has so far been limited, in contrast with the substantial growth of purely domestic Internet banking.

In chapter 2, I will examine the legal concepts and foundations of electronic banking activities in the three countries examined in the present book, namely the United Kingdom, France and Germany. In

[2] See Treaty Establishing the European Community (Rome, 25 March 1957); consolidated text at OJ 2002 No. C325, 24 December 2002.
[3] *Ibid*., art. 14(2).
[4] *Ibid*., art. 43.
[5] See Case C-222/95 *Parodi* v. *Banque H. Albert de Bary et Cie* [1997] ECR I-3899.
[6] See Case C-484/93 *Svensson and Gustavsson* v. *Ministre du Logement et de L'Urbanisme* [1995] ECR I-3955.
[7] See Case C-384/93 *Alpine Investments BV* v. *Minister van Financien* [1995] ECR I-1141.

chapter 3, I will explain how excessive regulation and legal uncertainty affect the cross-border provision of banking services via the Internet. There is a brief comparative survey of different regulatory models internationally and an introduction to EU policies affecting e-commerce in financial services in the single European market.

My normative arguments in favour of mutual recognition and 'home country' control as the overarching institutional framework for e-commerce in financial services are fully discussed in chapter 4. There I will outline the ongoing policy debate regarding the virtues of various alternative models of governance and I will explain why the model of 'home country' control is more functional and efficient than the alternatives and which conditions must be met before those benefits can be enjoyed.

The ensuing chapters 5 and 6 are descriptive of the multifaceted process of legal convergence in the single European market. To the extent that mutual recognition of national laws and 'home country' control cannot operate without the prior minimum convergence of national laws around commonly accepted standards, it is expedient to examine the attained level of legal convergence of national laws relating to electronic banking activities. Chapter 5 discusses the convergence of prudential regulatory and supervisory standards, while chapter 6 examines the attained harmonization in the non-prudential legal requirements relating to marketing and advertising, consumer and investor protection and certain key types of banking and financial contracts.

Moving from the question of harmonization of national laws, the final chapters, 7, 8 and 9, examine in depth the applicable law and allocation of regulatory responsibility in cross-border electronic banking activities. More specifically, chapter 7 focuses on the implementation of the principle of 'home country' control in prudential and investor protection matters and examines the remaining regulatory, supervisory and enforcement powers of the 'host country', which continue to disturb cross-border financial services in Europe. The ensuing chapter 8 takes a closer look at the implementation of the principle of 'country of origin' of the E-Commerce Directive[8] and the extent to which this recent institutional reform safeguards the mutual recognition of non-prudential national laws on the basis of 'home country' control. Finally, chapter 9

[8] Council and EP Directive 2000/31/EC of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the internal market, OJ 2000 No. L178/1, 17 July 2000.

will examine the applicable law and jurisdiction in the contractual aspect of cross-border electronic banking activities, which remains unaffected by EU reforms in the field of financial services and electronic commerce and still subject to the general law established under the Rome Convention[9] and the Brussels Regulation on jurisdiction and enforcement of judgments in commercial and civil matters.[10]

It should be noted that legal barriers in the single European market are primarily imposed by national measures, while the effectiveness of liberalization and integration policies is measured by the extent to which legal restrictions embedded in national law are removed, particularly if market integration is pursued by means of Directives whose effectiveness relies on the quality of national implementation. For that reason, existing legal barriers and the political, economic and legal forces operating in the single financial market cannot be understood outside the context of applicable national laws. The book attempts to discuss and explain the law of Internet banking in the single European market in direct and constant dialogue with applicable national laws in England and Wales, Germany and France. This was not a random choice. The three countries are traditionally at the forefront of developments of new integration policies and institutional reforms. Their special economic, financial and political weight influences significantly the outcome of internal market negotiations. They often represent competing views on markets, regulation and free trade. They belong to different legal traditions. I concluded that a fair understanding of the interaction between EU law and the national laws of the three jurisdictions is the appropriate method of examining this still evolving area of financial law. The law is stated on the basis of materials available to me at 15 October 2005.

[9] Convention on the Law Applicable to Contractual Obligations (Rome, 19 June 1980); consolidated version at OJ 1998 No. C27/34, 26 January 1998.

[10] Council Regulation 44/2001/EC of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ 201 No. L12/1, 16 January 2001.

PART I

Introduction to electronic finance and Internet banking

1

Internet banking in Europe: basic concepts and recent trends

Since the late 1990s the Internet and other technological advances in telecommunications, information technology and computer software and hardware have transformed the provision of financial services and the structure of financial markets. By the end of the 1990s, electronic finance applications had influenced most aspects of the business of banking, with the exception perhaps of large-value corporate lending. Similarly in the field of capital markets, the Internet has transformed the financial landscape by enabling the seamless interaction among issuers, investors and securities firms.

The Internet as catalyst of international financial integration

The concept of electronic finance may broadly be defined as the provision of financial services and the creation of financial markets using information technology, telecommunications and computer networks. Although the advent of electronic finance has rightly been associated with the most recent application of advanced technologies in the financial services industry, in strictly technical terms e-finance predates the era of the Internet by several decades: the first era of electronic banking in the form of telegraphic fund transfers in the late 19th century gave rise to legal problems that would appear familiar to electronic banking lawyers today.[1]

The Internet and the banker–customer relationship

Electronic banking can be defined as the provision of banking services and the initiation and performance of payments through the banking system by electronic means and other advanced technologies. Electronic

[1] See *Bank of British North America v. Cooper*, 137 US 473 (1890) (liability for negligent performance of a transatlantic wire funds transfer).

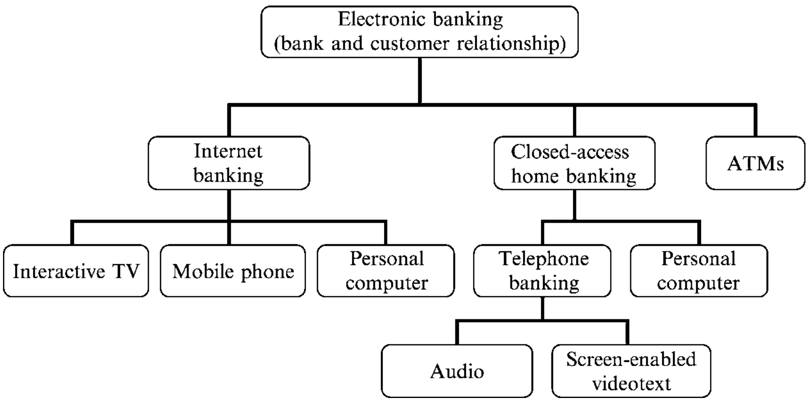

Figure 1.1. Communication methods and access devices in electronic banking.

banking is a conceptually generic term, which denotes banking services provided through a variety of access devices and links of communication (see figure 1.1).

Internet banking refers to the provision of electronic banking services via the Internet, commonly through a personal computer (PC) or other access devices with Internet capabilities. The concept of telephone banking refers to services provided via the ordinary telephone or more advanced screen-enabled terminals. Other terms are less technical. Online banking and Internet banking are often used interchangeably. Home banking would include any remote delivery channel, including telephone banking.

Internet banking gives customers the ability to access virtually any type of banking services (except cash) in any place and at any time. From an economic perspective, information technology and computer networks have enhanced the automation, speed and standardization in communications and internal administration, increasing customer convenience and functionality and reducing costs in back-office and front-desk banking functions.[2]

The same technological advances have stimulated financial innovation and improved efficiency in financial markets by enabling the seamless communication among issuers, investors, intermediaries and organized

[2] See Allen Berger, 'The Economic Effects of Technological Progress: Evidence from the Banking Industry' (2003) 35 *Journal of Money, Credit and Banking* 141.

markets.[3] Electronic trading, whether in organized markets or in alternative trading systems, can reduce costs, attract new investors and remove the physical limitations on how prices are discovered and trades are performed, thus improving the functionality, transparency and trading capacity of organized markets.[4]

Openly accessible and globally connected computer networks enable the two-way transportation of information between the bank and the customer. The basic function of the Internet Protocol (IP)[5] is to receive and transmit any information, which may take digital form. The primary Internet code enables the transmission of data from one computer unit to another, without it being necessary that the originator and the recipient of information share a direct network connection. Transmitted data are transported through a sequence of available connections and routes between otherwise unrelated servers and host computers. Crucially, no particular server or local network is an essential component of that chain. Although individual computers may be connected to the network or disconnected, at the will of their administrators or because of disruptive events, data transmitted over the Internet always discover open network routes through the remainder of available networks and servers. As a result, the Internet enables the unimpeded circulation of data, which may be retrieved by or transmitted to computers located anywhere in the world, without the process being affected by the territorial proximity, or the lack thereof, between the initial originator and the final recipient of data.[6]

In the context of the banker–customer relationship, data transmitted from the bank to the customer and vice versa may result in the establishment, alteration, exercise or termination of legal rights and obligations in accordance with the contract between the bank and the customer. In that respect, the Internet enables the initial establishment of the banker–customer relationship and the electronic delivery and performance of services thereafter, within the boundaries set by available technical and legal mechanisms of authorization and access control.

[3] See International Organization of Securities Commissions (IOSCO), *Second Report on Securities Activity on the Internet* (Madrid, 2001).

[4] See Committee on the Global Financial System, *The Implications of Electronic Trading in Financial Markets* (Basel: BIS, 2001).

[5] The Internet Protocol is the method or code by which data is sent from one computer to another on the Internet.

[6] See Preston Gralla, *How the Internet Works* (Indianapolis: Que, 2004), ch. 1.

Electronic commerce and international financial integration

The archenemy of market integration is geography, not law. Historically, the most important causes of incomplete economic integration and partition of local markets have been geography, distance and poor networks of transportation and communications. Legal and regulatory obstacles to the circulation of goods, services and capital became apparent only after the improvement of means of transportation, shipment and communication provided a realistic setting for the expansion of international trade. In a similar way, the Internet eradicates the constraints of geography and distance in the movement of digital data which do not require storage facilities, packages, docks, motorways or airports to circulate. It provides an affordable medium for the circulation of any type of content or speech which can take digital form, thus facilitating communication and commercial relations across national borders. It was rightly observed that the single European market for goods and services could have been invented for electronic commerce and vice versa because they share a common point: the Internet brings down physical barriers, while the single market programme brings down legal barriers.[7] Although the production, distribution, marketing, sale or delivery of goods and services by electronic means are hardly new, on certain conditions the contribution of electronic commerce to international economic integration could be substantial. This is particularly true for European and international financial integration, because the intangible nature and effortless convertibility into digital data of cross-border capital flows and financial services are especially suitable for exploiting the potential of computer networks to break national boundaries in the circulation of any content that may take digital form.

Financial integration in Europe and beyond

According to the *Oxford English Dictionary*, integration is the action or process of integrating; the making up or composition of a whole by adding together or combining the separate parts or elements; and, crucially, the organization of economic activities so that national boundaries do not matter.[8] It is the process or state of affairs which involves the

[7] See E. Crabit, 'La Directive sur le Commerce Electronique. Le Projet Méditerranée' (2002) *Revue du Droit de l'Union Européenne* 749, at 753.
[8] See *Oxford English Dictionary* (2nd edn, 1989).

amalgamation of separate economies into larger free trading regions.[9] In Europe, the integration of national economies is described by the term 'internal market', which is characterized by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital.[10]

The global process of economic integration comes close to the popular notion of economic globalization. 'Globalization' can be defined as the free movement of goods, services, labour and capital, thereby creating a single market in inputs and outputs; and full national treatment for foreign investors (and nationals working abroad) so that, economically speaking, there are no foreigners.[11] Lindsey makes a crucial distinction between globalization as a political process, whereby government policies eliminate barriers to free economic movement, and globalization as an economic process, fuelled by developments in information technology and telecommunications. The political process of globalization through the reduction of legal barriers is the essential precondition for setting in motion the economic process of globalization.[12]

The core elements of economic integration, whether global, regional or bilateral, are two: first, the operation of economic and technological forces that facilitate the flow of goods, services, capital and persons; second, the operation of political forces that lead to elimination of legal barriers and liberalization of capital flows, trade in goods and services through internal reform and international legal agreements. In the long run, the gradual elimination of economic and legal frontiers is expected to result in the economies of independent states functioning as one entity.[13]

Financial integration is a species of 'economic integration'. It denotes the economic integration of financial markets and activities, in other words, *first*, the elimination of legal obstacles in the movement of capital, financial services and financial institutions across borders and, *second*,

[9] See generally Ali M. El-Agraa, 'General Introduction' in Ali M. El-Agraa (ed.), *Economic Integration Worldwide* (London: Palgrave Macmillan, 1997).

[10] See EC Treaty (Rome, 25 March 1957); consolidated Text at OJ 2002 No. C325, 24 December 2002, art. 3(1)(c).

[11] See Martin Wolf, *Why Globalization Works* (New Haven: Yale University Press, 2004), p. 14.

[12] See Brink Lindsey, *Against the Dead Hand: The Uncertain Struggle for Global Capitalism* (New York: Wiley, 2002), p. 275.

[13] See Willem Molle, *The Economics of European Integration: Theory, Practice and Policy* (4th edn, Aldershot: Ashgate, 2001), at p. 8.