The EU's new financial services agenda

Alasdair Murray and Aurore Wanlin

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1 Introduction

A well-functioning financial services sector is vital for the competitiveness of the European economy. Easy access to capital is a pre-condition for the growth of new and innovative businesses, which the EU desperately needs if it is to keep pace with the economies of America, China and India. The integration of European financial markets would also make the EU's creaking pension systems more sustainable by encouraging more people to invest in equity-based private pension funds.

London Economics, a consultancy firm, estimates that the benefits from integrating Europe's wholesale capital markets could amount to €130 billion, or 1.1 per cent of EU GDP, over the next decade.[1] Increased cross-border competition between banks, insurance companies and investment firms would also benefit European consumers. At present the cost and availability of retail financial services varies hugely across the EU because national markets remain largely segmented.

[1] *London Economics, in association with PricewaterhouseCoopers and Oxford Economic Forecasting, 'Quantification of the macro-economic impact of integration of EU financial markets', November 2002.*

At the Lisbon summit in March 2000, EU heads of government signed up to an ambitious programme designed to achieve a single market in financial services by 2005. The financial services action plan (FSAP) was an attempt to reduce the legal obstacles which prevent businesses – whether retail banks, insurance companies or stock exchanges – from selling their products and services across the EU.

On paper, at least, the FSAP has been a success. The EU deserves credit for reaching agreement on virtually all of the plan's 42 measures, opening the way for businesses to provide cross-border

financial services across Europe. A single market in financial services is still far from realisation, however. Many countries still have to implement the majority of the FSAP measures. Businesses need time to adapt to the new rules. While the EU has made good progress in establishing a cross-border legal framework for the wholesale markets, such as securities, the retail market – which includes products such as bank accounts and mortgages – remains highly fragmented. Also, national regulatory authorities adopt widely differing approaches to the supervision of financial services firms, thus hampering the development of a smoothly functioning European market.

Many criticise FSAP legislation for being too heavy-handed, with overly detailed and excessively prescriptive rules. London-based investment banks in particular are increasingly critical of the quality of the legislation. They worry that cumbersome regulation could pose risks to the competitiveness of London as a global financial centre. All financial services companies across the EU – and not only London investment banks – want the drive to force open retail markets to avoid excessive red tape, and they hope for a more consultative approach.

The Commission appears to have taken some of these concerns on board. In its recent white paper on financial services, it sets out far more modest legislative ambitions. It also promises to consult extensively and conduct impact assessments before proceeding with any new measures.[2] The paper emphasises that it will only take action on a "carefully targeted, evidence-based, bottom-up" basis. This is surely correct as it will take time for member-states and businesses to implement previously agreed measures.

[2] *European Commission, 'White paper, financial services policy 2005-2010', December 1st 2005.*

Financial services are not about to slip down the EU's agenda, however. The white paper shows that the Commission still has to undertake a substantial 'tidying-up' exercise, including important new measures in areas such as cross-border payments, and clearing

and settlement services. It has also launched an investigation into retail financial services, which could lead to action to remove barriers to competition in the medium term. In the longer term, the Commission is likely to face pressure to take more radical action to open up Europe's retail financial services markets. Finally, the EU has much work still to do to encourage greater convergence between regulators.

2 A 'tidying-up' exercise?

The Commission, the European Parliament and EU governments have shown unprecedented determination in reaching agreement on the FSAP's 42 measures (virtually) on time. Member-states adopted the last substantial piece of legislation, the 'capital requirement directive', in October 2005. This key directive sets out how much capital a bank or investment firm must maintain in reserve to cushion against shocks.

However, businesses and some national administrations have complained that the fast pace of financial services reform is leading to 'legislative fatigue'. They argue that the EU needs time to absorb the existing programme – and check that it works – before embarking on any new ambitious agenda. There have certainly been less than satisfactory compromises on a number of key directives. For example, the member-states only managed to reach agreement on the 'takeover directive' in April 2004, after more than a decade of trying, by introducing several opt-outs. These mean that there is little chance the directive will achieve its original aim of encouraging more cross-border mergers and takeovers within the EU.

Commission officials privately admit that the demanding FSAP timetable resulted in some directives being pushed through too quickly. For example, in 2001 the Commission failed to consult sufficiently before issuing a draft 'prospectus directive', which establishes common rules for companies wishing to raise capital across the EU. Businesses complained bitterly about the original proposal, which was subsequently heavily amended in the European Parliament. The Commission has now promised to modify or scrap any measures which turn out to have unexpected

or damaging effects, and to complete a thorough economic and legal assessment of all FSAP legislation by 2009.

The Commission's recent white paper on financial services is designed to address these criticisms of the FSAP. The Commission has strengthened its commitment to consult widely and conduct proper impact assessments before proposing any new legislation. This is welcome. The frustration of some in the City of London over their lack of input into the drafting of legislation is probably justified. The need to ensure consistent regulation of capital markets has to be balanced against the risk that excessive or unnecessary regulation could drive business out of the EU.

Charlie McCreevy, the internal market commissioner, has responded to such concerns by saying that the Commission will focus on the essential, but less glamourous, task of fully implementing the existing FSAP measures. Indeed, the remaining obstacles to a fully functioning single market in financial services are as likely to arise from improper implementation or enforcement of FSAP measures as from the absence of appropriate rules. The Commission needs to ensure that governments implement the FSAP's measures on time and without adding national requirements (a practice known as 'gold-plating'). Additional member-state rules and regulations would lead to new distortions in the single market, adding extra costs for businesses and making them less competitive than their international counterparts.

The Commission's most recent implementation scorecard shows that most member-states are missing key deadlines for turning FSAP directives into national law. In December 2005, only six member-states – Austria, Denmark, Estonia, Ireland, Latvia and Poland – had implemented all the directives on time.[3] At the other end of the scale, Greece, the Netherlands, Luxembourg and Sweden still had five or six directives to implement. Surprisingly, the UK had a relatively poor record for a major financial centre, ranking only thirteenth for its transposition rate. The Commission has promised to take firm action against member-states that fail to implement financial services legislation in a timely and effective manner. For example, it has begun infringement procedures against no fewer than 16 member-states for their failure to implement fully the 'market abuse directive'. This directive seeks to ensure that EU countries have common rules against illegal practices such as insider trading.

[3] *http://europa.eu.int/comm/internal_market/finances/actionplan/index_en.htm#transposition.*

The current focus on implementation does not mean the Commission will not propose any new financial services legislation in the coming years. Subsequent chapters of this paper will look at the key issues of supervisory convergence and retail financial services integration. However, the Commission's white paper also outlines a series of 'tidying up' measures, tackling specific problems that were not fully resolved by the action plan. In particular, the Commission has proposed further work in the areas of clearing and settlement, the creation of a single payments area, and the retail investment fund market:

★ Clearing and settlement

The EU has not always resorted to legislation to create a viable single market in financial services. It has sometimes encouraged the private sector to find solutions. In particular, the Commission has so far resisted the temptation to legislate on cross-border clearing and settlement (C&S) – the costly 'back office' tasks of paying for shares and transferring the necessary paperwork.

National C&S systems in Europe require share traders to negotiate a raft of different practices, taxes and regulations when making cross-border purchases. The Giovanni group, a panel of experts advising the Commission on financial services, has identified 15 significant barriers ranging from different opening times to legal or technical differences in settling share trades. The cost of cross-border C&S in the EU is estimated to be between €1.6 billion and €5

billion a year higher than in the US (which uses just one company to carry out all C&S).[4] According to the Commission: "cross-border clearing and settlement costs can still be up to six times more than domestic settlements".[5]

[4] *Jacques de Larosière, 'Good news and bad news on Europe's financial markets integration', Europe's World, Autumn 2005.*

[5] *Speech by Charlie McCreevy, 'Fund management – regulation to facilitate competitiveness, growth and change', Luxembourg, September 13th 2005.*

The European Commission has become increasingly frustrated with the slow pace of progress in reducing the costs of C&S services in Europe. In September 2005, Commissioner McCreevy threatened to take action if Europe's financial services industry failed to cut the costs of cross-border trading within six months. Businesses have made some progress in agreeing common standards. For instance, the Society for Worldwide Interbank Financial Telecommunication, a financial industry-owned co-operative, published in October 2005 a draft communication defining common standards for opening hours and settlement deadlines. The members of this organisation are due to adopt this communication in March 2006. Euroclear, one of the two principal clearing houses for securities traded in the EU, has also started to define common market practices.

However, creating common standards is only a first step. All businesses across Europe need to follow them consistently. Furthermore, only governments can remove some of the barriers identified by the Giovanni group, and so far many have failed to do so. For instance, the French government has not overturned rules that require non-French investors to appoint a French agent to collect tax on securities in France. Reclaiming withholding tax in Italy is still a problem for foreign investors, while calculating and collecting stamp duty in the UK is so complex that retail investors cannot easily access that market.

Another obstacle to a more integrated C&S system is the ownership structure of the industry. Some exchanges continue to own C&S

operations. Most notably Deutsche Börse, which owns Eurex Clearing, has little incentive to give up this lucrative business. Exchanges may keep C&S prices high, or make it difficult for competitors to access the market, to maximise their profits. In 2004, the Commission proposed bringing forward a framework directive designed to remove the remaining C&S barriers.[6] However, the financial services industry is opposed to any new EU legislation. Banks fear that the member-states will add national requirements or get bogged down in endless rows, so it could take them years to agree on a new directive. In the meantime, the ensuing uncertainty reduces the incentives for businesses to develop common standards.

[6] *European Commission, 'Clearing and settlement in the European Union – the way forward', April 2004.*

However, businesses need to reinforce their efforts to integrate C&S organisations. Governments should also use competition law to ensure that companies have unrestricted access to C&S systems across Europe. Competition authorities in some member-states, such as Italy, and the European Commission have already started to investigate 'vertical' organisations, which bring together trading, clearing and settlement under a common ownership. If progress remains disappointing, the Commission will need to consider a new directive.

The Commission should also start a debate on the current structures of the C&S system. A 2005 City of London report argued that the EU needs a single pan-European central clearing counterparty (CCP) that would bring together the two biggest European clearing organisations, LCH Clearnet and Eurex Clearing. A CCP would act as "the buyer for all sellers and a seller for all buyers", consequently assuming the risk for all payments. It would also allow institutions to 'net' their trades. This means that rather than transferring sums for each individual trade, a financial company would settle the outstanding balance at the end of the day, greatly reducing the number of transactions and the amount of capital that needs to flow through the settlement system. Although

such a merger would reduce competition across the EU, the City of London argues that the creation of a single organisation would be the best way to reduce costs and increase the efficiency of clearing operations: "the more extensive the network of users and the more business they put through a single service the more effective the service becomes".

★ Single payments area

At present, there are wide differences between EU member-states' payments systems in terms of legislation, technical standards, business practices and payment instruments. As a result, consumers face many extra costs and obstacles to cross-border payments. For example, EU citizens cannot use direct debits across borders. The Commission estimates that payment charges cost consumers the equivalent of up to 3 per cent of EU GDP each year.

Consequently, there is an urgent need to establish a 'single payments area'. This would make cross-border banking transfers and payments as cheap and easy as domestic transactions. In 2002, the banking industry – facing the threat of Commission intervention – promised to develop a Europe-wide payments infrastructure with common standards and products by 2010. The European Payments Council (EPC) has begun designing pan-European standards and infrastructure for cross-border euro payments and has devised a roadmap for their implementation. However, knitting together the various national payments systems is proving far from straightforward.

Not enough banks are applying the EPC's standards, in part because they remain voluntary. Banks fear that they will not recoup the high initial investment costs if competitors do not adopt the same standards. Moreover, banks often package payments with other more lucrative services, such as cash management or foreign exchange. Understandably, they are reluctant to see payments stripped out as a portable, and cheap, stand-alone service. Thus progress is slow, and the 2010 target is likely to be missed.

The slow pace of progress prompted the Commission to publish a draft proposal in December 2005 to establish a common legal framework for all electronic payments. The directive would apply to all member-states (not just the eurozone) and is designed to provide the legal foundations for a single payment area. For example, the directive stipulates that payments must be credited by the end of the next working day at the latest. It would also ensure that businesses other than banks have access to the new cross-border payments system and can compete for consumers. Commissioner McCreevy has added that if the financial industry does not speed up progress he might need to introduce further 'incentives' for the banking industry, although he has not specified what form these might take.

Some industries have expressed concerns about the scope of this draft directive. For example, the directive will apply to any payments made to, or from, any bank based in the EU. Therefore, it would apply to international transfers between EU and non-EU banks. Some businesses fear that such a requirement could make EU banks less competitive. Despite these concerns, there is no doubt that the directive is a step in the right direction. The impact assessment conducted by the Commission shows that a more efficient EU-wide payments system could save between €50 and €100 billion per year for businesses.

★ Investment funds

The Commission has also recently begun a review of the Union's framework for retail investment funds – known in EU jargon as UCITS. Estimates from the Commission show that there are nearly 29,000 funds in Europe, managing some €4 trillion of assets.[7] Investment funds are an increasingly important element of European financial markets, helping to mobilise household savings and channelling them towards productive investments. Investment funds are likely to play an even more important role in the future as EU member-states look to increase private pension provision.

[7] European commission, 'Green paper on the enhancement of the EU framework for investment funds', July 12th 2005.

The EU's current framework, which dates back to 1985 and was amended in 2001 and 2002, was intended to encourage the development of cross-border retail investment funds. But financial services firms complain that the existing legislation has failed to create a single market. Funds still need to be registered in every member-state where they are sold, while national tax rules often prevent the cross-border mergers of funds, which would help achieve greater economies of scale and cut management costs. European funds are just a fifth as large as their US counterparts, and the European Commission calculated that retail investors could save as much as €5 billion a year if EU funds were, on average, the same size as in the US.[8] Assets managed by EU funds amount to 45 per cent of GDP, compared with 70 per cent in US.[9]

[8] *European Commission, 'Green paper on the enhancement of the EU framework for investment funds', July 12th 2005.*

[9] *Speech by Charlie McCreevy, 'The EU framework for investment funds: a facilitator – not a straitjacket', Brussels, October 13th 2005.*

The Commission issued a green paper on investment funds in July 2005, proposing several steps to improve the current framework, such as clarifying the definition of the assets acquired by UCITS and simplifying the notification procedure for transferring funds across borders. It is also working closely with the Committee of European Securities Regulators (CESR) to forge a consensus on common enforcement practices to improve transparency in the market. Financial services firms have broadly welcomed these ideas. The Commission now needs to bring forward concrete measures which will foster a competitive and stable environment for European investment funds.

★ Hedge funds

Hedge funds – fast growing, lightly regulated investment vehicles – have become a major political concern in the last few years. Some European politicians have portrayed hedge funds as the unacceptable face of financial markets, claiming that their unorthodox investment techniques pose a threat to financial stability. German politicians were especially critical of the behaviour of the London-based hedge fund which helped orchestrate the resignation of the chairman and chief executive of Deutsche Börse in 2005. Franz Müntefering, then chairman of the German Social Democratic Party (SPD), described such funds as "locusts" intent on stripping German companies bare.

There is no doubt that hedge funds have become increasingly important players in the financial markets. They manage assets worth $1 trillion and account for between a third and half of all trading on the New York and London stock exchanges, and are therefore becoming essential to the liquidity of international markets.[10] However, the Commission says that it does not favour an EU regime for hedge funds, arguing that they make up too small a part of the market to be a source of systemic risk.[11] But it has set up a working group to investigate whether a common regulatory framework would help develop a pan-European market for hedge funds. The group will also explore how retail investors, who might not have a proper understanding of the risks, should be protected. This is the right approach.

[10] *'Looking for trouble', The Economist, June 30th 2005.*

[11] *Speech by Charlie McCreevy, 'Pension funds and asset managements: a European perspective', Dublin, September 22nd 2005.*

A rush to introduce EU regulation could unnecessarily constrain the ability of hedge funds to innovate, and also drive some funds off-shore beyond the reach of any financial authorities. But the Commission and national regulators should watch hedge funds with special care, and in particular ensure that consumers are adequately protected. Hedge funds were initially sold only to the very wealthy and financially aware, such as fund managers. But they are increasingly touted as safe for relatively unsophisticated investors. Hedge funds are also becoming increasingly popular with banks or investment funds, which in turn exposes their own consumers to risk. If a big hedge fund collapses or if some hedge fund scandal hurts small investors, it is sure to provoke a fierce political backlash. This could then force the EU to rush forward inappropriate legislation, damaging the competitiveness of EU markets.

3 A retail financial services action plan?

The EU has made good progress towards creating a viable single market in wholesale financial services, such as securities trading. But so far it has secured only limited integration within the retail financial services sector. In theory, existing EU legislation, such as the second 'banking directive' agreed in 1993, should permit financial retail companies to compete across borders. In practice, substantial obstacles remain. For example, firms find it difficult to offer similar products, such as bank accounts or mortgages, in different countries because of incompatible consumer protection legislation. The tax treatment of financial products also varies widely.

Most notoriously, some member-states have used consumer protection or prudential banking rules to obstruct foreign takeovers or competition. Prudential banking rules are supposed to allow regulators to stop financially risky firms undermining the health of a country's banking system – not halt unwanted mergers or acquisitions. But firms complain that some national regulators suddenly dust off obscure regulations, or carry out 'midnight' inspections, in an effort to scare off unwanted foreign competition.

In 2005 the Italian central bank, and its then governor Antonio Fazio, came under intense scrutiny for apparently trying to block two foreign takeovers of Italian banks. In both cases – Dutch firm ABN Amro's bid for Banca Antonveneta and Spanish group BBVA's offer for Banca Nazionale del Lavoro – Italian firms emerged, initially at least, victorious.

The Commission took a robust line, warning Fazio that he would almost certainly breach EU law if he blocked the bids. It launched a formal infringement procedure against the Italian government, on the grounds that its banking laws were in breach of single market rules, because they failed to set out clear and transparent procedures for approving or blocking mergers.

Meanwhile, Fazio's position was further undermined by revelations of his close relationship with the chief executive of one of the successful Italian banks, Banco Popolare Italiano (BPI), which trumped ABN Amro's bid for Banca Antonveneta. Fazio (who had been appointed for life) finally resigned in December 2005, after coming under intense political pressure to step down following the arrest of BPI's chief executive for market manipulation. ABN Amro was able to take control of Antonveneta after BPI's bid collapsed – the first time a foreign bank has acquired an Italian rival.

Making the case for action

The European retail services sector is both large and highly fragmented, so there should be substantial economic gains from further integration. A more competitive single market should also benefit consumers through cheaper prices and greater choice.

However, there is at present a dearth of reliable evidence about the costs and benefits of retail financial services integration. The limited data available reveals much about the diversity of retail services across the EU, but does little to provide a clear basis for EU action. For example, the 2005 World Retail Banking report found in its survey of 19 countries that Italy was the most expensive place to hold a current account, with charges of an average of €252 a year. At the other end of scale, the UK, Netherlands and Belgium all have banking costs of less than €70 a year, with accounts in the Netherlands costing just €34 a year. However, the report cautions that such comparisons are crude because consumers use current accounts in different ways. For example, over half of Italians share their current accounts, greatly reducing the real cost. Allowing for this, the report estimates that Italians pay an average of €113 a year in banking charges. Similarly, British and Dutch banks offer cost-free current accounts in an effort to sell more lucrative products such as loans and mortgages.

Businesses and some national regulators argue that many of the obstacles to a single market in retail financial services, such as language, culture or spending and saving patterns, cannot be resolved through legislative action. Some fear that well-meaning EU action, such as common consumer protection standards for retail services, could lead to higher costs or force them to withdraw some long-standing products. Thus the Commission needs to conduct a thorough analysis of the obstacles to, and potential economic benefits from, the integration of retail services before taking any further action.

How to integrate

Even when the Commission has established a clear case for action in the area of retail finance services, it faces a dilemma about how it should proceed. The EU's usual method is to use legislation to force open markets: a directive lays out common minimum standards, and firms that meet these can operate anywhere across the single market. However, such is the huge diversity – and political sensitivity – of retail financial services that the Commission is rightly wary of using 'one size fits all' directives. The EU's few attempts to use legislation for retail financial services were not especially successful. For example, the 'consumer credit directive' – which seeks to establish common rules for firms offering financial loans across the EU – was agreed as far back as 1987 but has failed to create a cross-border market in loans and credit cards. The EU has now spent three years trying to revise the directive in an effort to make it simpler and more effective (the Commission published its latest proposals in October 2005).

Commissioner McCreevy has said that he would prefer to find non-legislative solutions. In particular, the EU is examining the possibility of using its competition powers and the so-called 26th regime (see below) to encourage greater integration. However, some firms are likely to maintain pressure for the EU to use directives and regulations, arguing that the tried and tested legislative route offers benefits, such as legal certainty, which outweigh the extra costs of harmonisation.

★ Making greater use of competition powers

The Commission has begun to use its broad-ranging competition powers to force open national financial retail markets, especially by removing obstacles to cross-border mergers and takeovers. Compared to other sectors, there have been few major cross-border mergers or takeovers in banking (with the notable exception of the new member-states, where large parts of the banking sector are now foreign owned). A recent Commission paper found that between 1999 and 2004, cross-border tie-ups amounted to around 20 per cent of all financial services mergers and acquisitions.[12] This compares with a figure of 45 per cent for other business sectors. Moreover, the majority of financial services deals were between securities firms, rather than banks or insurance companies. The largest cross-border banking deal to date has been Banco Santander Central Hispano's €12.5 billion purchase of Abbey National, the UK's sixth largest bank, in 2004.

[12] *European Commission, 'Cross-border consolidation in the EU financial sector', October 26th 2005.*

Cross-border tie-ups may be attractive because they provide firms with a short cut into a new market, avoiding the costs and regulatory difficulties of trying to start from scratch. However, buying abroad often proves less financially attractive than a domestic merger, where cutting branches or merging back offices can allow substantial cost savings. Moreover, many of Europe's most successful financial services companies are looking to expand in fast-growing economies such as China, rather than investing in the EU's mature and sluggish markets.

The Commission established the principle that prudential rules cannot be used to block foreign takeovers during the ABN Amro/Banca Antoneveneta bid battle. It is now setting out to end any ambiguity by revising the relevant article (16) of the banking directive (and the equivalent article in the insurance directive). The EU should ensure that banking regulators in future make use of prudential rules in a fully transparent manner. For their part, regulators should state explicitly when and why they have turned to prudential rules, for example to block a bid.

Many financial services firms show no interest in acquiring a toehold in another European market by purchasing a rival. Thus the EU also needs to explore whether there are other obstacles to competition between financial services firms than those directly related to takeovers and mergers. The Commission recently launched a competition investigation into the sector. This should show whether regulatory obstacles, or even collusive behaviour, prevent new entrants from competing effectively for retail business. For example, financial services firms frequently complain that they do not have equal access to credit data – making it difficult to assess properly the risks of lending to customers. The Commission should focus on forcing member-states to revise any national rules and regulations that are unfairly preventing new entrants from competing for products such as credit cards and savings products. Such an approach should steadily reduce the obstacles to a functioning single market, without the need to use crude harmonising legislation.

★ The 26th regime

The Commission has promised to take a closer look at establishing common rules for certain products, such as loans and mortgages. The so-called 26th regime would sit alongside, rather than replace, the existing rules in the 25 member-states. Firms which choose to offer a product under 26th regime rules could then sell anywhere in the EU without also having to meet national

rules and regulations. Some firms favour the establishment of 26th regime rules, because take-up would be entirely voluntary and they would not force harmonisation on existing products. Thus a firm could offer a personal loan which meets 26th regime rules across the EU, but also continue to offer successful specialised national loan products in key markets. In theory, many regulators also support the creation of such rules as they would iron out cross-border legal difficulties.

However, the EU's existing attempts at establishing voluntary product rules have not proven very successful. The EU has yet to design a 26th regime which clearly meets an outstanding demand, whether from businesses or consumers. For example, few businesses have taken advantage of the EU's company statute, which was supposed to provide firms with the option of registering as a European company, rather than meeting the company rules of an individual member-state. Moreover, there is a risk that such rules could stifle innovation by too tightly defining what products can be offered on a cross-border basis. The onus is on the Commission to prove that a financial services product offered under the 26th regime genuinely meets an unfulfilled need. In the meantime, the EU should concentrate on removing the obstacles to fair competition in European markets.

Mortgages: A test case for action?

The mortgage market provides an economically and politically tempting focus for the EU's work on retail financial services. For example, in 2004 a high-level group led by Wim Kok, conducted a review of the EU's economic reform ('Lisbon') strategy. It suggested that measures to boost the private housing sector could play an important role.[13] The Commission's green paper on mortgage credit argues that a more efficient mortgage market would contribute to economic growth, aid labour mobility and help EU consumers to tap into

[13] High-level group chaired by Wim Kok, 'Facing the challenge – the Lisbon strategy for growth and employment', November 2004.

their housing assets to fund, for example, long-term care in their later years.[14]

[14] European Commission, 'Green paper: mortgage credit in the EU', June 17th 2005.

A report published by London Economics estimates that an integrated mortgage market could raise EU GDP by 0.7 per cent and reduce the average cost of servicing a €100,000 mortgage by €470 a year.[15] The report does not deny there would be substantial costs to introducing EU-wide mortgage rules – around €2.5 billion a year for businesses – but argues that they would be dwarfed by the overall gains to the market of around €85 billion.

[15] London Economics, 'The costs and benefits of integration of EU mortgage markets', August 2005.

However, the obstacles to creating an integrated mortgage market remain considerable. The size of the private housing market is dictated by a broad array of national regulations, such as tax incentives for home ownership, restrictions on lenders and support for the rental sector. As a result, the stock of mortgage debt ranges hugely across Europe – from 70 per cent of GDP in the UK to just 13 per cent in Italy. The EU average is 44 per cent.

The Commission's green paper suggests that the creation of a 'euromortgage' – a legal framework for a housing loan which is applicable across the entire EU – would be one possible way of encouraging a pan-European mortgage market. However, it is far from clear that demand for such a product exists. Understandably, consumers prefer to hold a mortgage, invariably their largest financial commitment, with well-established firms they know. Only a few foreign lenders have penetrated even the very liberal UK mortgage market, and cross-border mortgages – mainly for the purchase of second homes elsewhere in the EU – amount to just 1 per cent of all mortgage transactions.

Moreover, the establishment of a euromortgage would only make it marginally easier for lenders to offer their products across the EU. The cost and structure of a mortgage is dependent on an assessment

of the risks of payment default, which include factors such as the ease of repossessing (and reselling) a property. For example, it can take up to seven years to repossess a home in Italy, compared with an average of around two years elsewhere in the EU.

The EU should thus focus first on tackling specific obstacles to greater competition and innovation within markets, rather than rushing to try and create a common European mortgage. A 2005 report by Mercer Oliver Wyman, a financial services consultancy, argues that the real weakness of many EU mortgage markets is the poor availability, especially in Germany and Italy, of non-traditional mortgages, such as low equity loans or those aimed at higher risk consumers.[16] The EU should try to remove obstacles to lenders entering EU mortgage markets and developing new products. Moreover, many EU countries also restrict the sharing of credit information to mainstream domestic financial institutions, making it difficult for niche or foreign players to tap into new segments of the market. The EU should follow up the recommendation of its expert group on mortgage credit and encourage member-states to sign a memorandum of understanding on access to credit information. This action would help ensure that lenders have equal access to key information on risks.

[16] *Mercer Oliver Wyman, 'Risk and funding in European residential mortgages', April 2005.*

There is no magic formula for forcing open the mortgage market – or any other aspect of retail financial services. Europe's retail financial services markets are complex and diverse. Before taking action in this sector, the EU has to be certain that legislation will not damage consumer confidence, stifle innovation or inadvertently reduce competition by outlawing long-established products. Thus the EU should adopt a cautious strategy. The EU should focus on removing the most blatant obstacles to fair competition. The Commission's competition investigation should aim to unearth many national rules and regulations that breach the spirit – if not the law – of existing EU rules and regulations. It should then ensure that member-states swiftly remove or revise the offending rules from their national statute books.

This approach should slowly encourage greater cross-border activity, which in itself should further reveal barriers to a single market. At present, cross-border activity is so limited that many obstacles to fair competition remain invisible. In the longer term, the Commission may find that there is a compelling case for using EU legislation to further open retail financial markets. But such action will only be effective when there is a much greater degree of integration than exists at present.

4 Improving the Lamfalussy process

Increasingly, financial services companies do business on a cross-border basis, yet each EU member-state retains its own system of regulation and supervision. Financial services firms therefore find it complex and expensive to overcome regulatory differences.

Alexandre Lamfalussy, former head of the Belgian central bank, has described Europe's regulatory system as "a remarkable cocktail of Kafkaesque inefficiency that serves no one". Lamfalussy chaired an influential EU expert committee, which in 2001 made a series of important proposals to speed up EU financial services decision-making and improve co-operation between regulators. The Lamfalussy report sought to accelerate the passage of financial services directives by reducing the volume of legislation which needed to pass through the EU's long-winded co-decision procedure – where the Commission proposes draft legislation and the Council of Ministers and European Parliament jointly decide. Now the Council and the European Parliament are supposed to concentrate on reaching agreement only on the broad principles of new legislation. In parallel, the Commission prepares the detailed technical rules necessary to implement the new directives, assisted by four specialist committees of national regulators. These regulators are drawn from various national authorities dealing with securities, banking, insurance, and pensions and asset management.

This system aims to ensure the EU can respond swiftly to innovations in the financial services sector, such as new products, or resolve minor problems with rules and regulations. The new committees are also designed to ensure that national regulators implement EU rules consistently – and supervise cross-border groups efficiently and fairly. Now that the EU has completed the legislative

phase of the FSAP, attention is increasingly focusing on whether the Lamfalussy arrangements are sufficient to ensure effective cross-border supervision.

Businesses and regulators have generally given their backing to the new arrangements. For example, a review of the Lamfalussy process concluded that the new procedures had improved the quality of EU legislation and speeded up decision-making.[17] However, the EU still needs to address certain shortcomings such as the lack of a clear division of responsibilities between the Council and the Lamfalussy committees, the role of the European Parliament, and the insufficient involvement of consumers.

[17] *European Commission, 'Inter-institutional monitoring group, third report monitoring the Lamfalussy process', November 17th 2004.*

The EU charged the specialist Lamfalussy committees with filling in the details of EU financial legislation, leaving governments to make the broad-brush political decisions. But the EU has so far found it difficult in practice to draw the line between the technical and the political. According to Nic Stuchfield, from the London Stock Exchange, member-states are leaving a number of "almost impossible" questions for the CESR (the Committee of European Securities Regulators). "Many of these decisions are political and the CESR is having to do the job politicians couldn't do."[18] That was the case in particular when CESR was in charge of framing the directive on financial instruments (known as MiFiD), which provides the legal framework for stock exchanges and investment banks conducting cross-border business. Member-states left the CESR to define whether a securities transaction is 'large' or not. This definition is important as it sets out how much supervision a firm must submit to.

[18] *Peter Norman and Tobias Buck, 'Europe to slow the pace of financial services reform', Financial Times, January 17th 2005.*

The European Parliament's legally ambiguous role in the Lamfalussy procedures poses a further problem. The Council, the Parliament and the Commission had agreed that the Parliament should have the right of 'call-back', that is the power to re-examine measures agreed

by the Commission and the Lamfalussy committees. MEPs only gave their assent to the Lamfalussy process on the basis that they would have this power to scrutinise legislation. However, the current inter-institutional agreement is subject to a 'sunset' clause, which means it expires in 2007. The draft EU constitutional treaty would have resolved this issue by permanently confirming the European Parliament's right of call-back. However, the ratification process is now frozen, following the rejection of the treaty in the French and Dutch referendums. The call-back procedure is needed to secure the Parliament's support and ensure the whole Lamfalussy system remains politically legitimate. Thus the EU urgently needs to extend the call-back powers to prevent the new system of financial services decision-making and regulation from grinding to a halt.

Businesses have largely supported the Commission's commitment to greater consultation on financial services issues. Similarly, the Lamfalussy regulatory committees are seeking to ensure that firms affected by their decisions have an opportunity to comment on new proposals. However, some businesses argue that consultations should take place earlier in the legislative process, and last at least three months. MEPs have rightly stressed that consumers are insufficiently involved in the legislative process. In a draft report, the Parliament's committee on economic and monetary affairs made clear that it "regrets the lack of input from consumers" and "asks the Commission and the member-states to promote and support consumer awareness programmes and education initiatives as well as the creation of specialised consumer initiatives in the financial sector".[19]

[19] *European Parliament, 'Draft report on current state of integration of EU financial markets', committee on economic and monetary affairs, rapporteur: Ieke van den Burg, January 2005.*

★ Better co-ordination

Financial services firms have repeatedly complained that national governments and regulators too often add extra provisions to, or simply incorrectly transpose EU, legislation, creating costly new distortions in the single market. The Lamfalussy committees were

designed to help rectify this problem. They provide a forum for national regulators to agree a common approach to the technical implementation of new directives, and are also supposed to review already implemented legislation to iron out any glitches. Thus, in theory at least, the committees should encourage greater supervisory convergence across the EU.

In practice, the EU still has a long way to go to achieve real convergence among national supervisors. The powers and resources of national regulators differ widely from one member-state to the other. Bulgaria, Denmark, Hungary, Ireland, Luxembourg and the UK, for example, have a single regulator for all financial services firms, but most member-states charge several different bodies with the task of supervision. National regulators also approach supervision with widely different philosophies: some place a greater emphasis on rules to protect consumers in the market, others emphasise the need to stimulate competition. As McCreevy has put it, "there can be as many supervisory practices as there are supervisors in the Union".[20]

[20] *Speech by Charlie McCreevy, 'Regulatory and supervisory challenges of financial integration', London, June 28th 2005.*

As a result, national regulators find it difficult to co-ordinate their actions and monitor the cross-border activities of financial companies effectively. This means financial services firms face extra costs – due to the need to duplicate information for different supervisors – and are also exposed to greater regulatory risks. Meanwhile, some financial authorities, and in particular the European Central Bank, worry that the complexity of the EU's regulatory system would make it difficult for the EU to react efficiently and quickly to a Europe-wide financial crisis. The fear is that the lack of effective supervisory co-ordination could result in poor scrutiny of cross-border firms, and hamper an effective pan-European response to any crisis.

At the root of the uncertainty in the current system is the legal division of responsibility between the country where a company has

its headquarters, the 'home' country, and other member-states where the firm may be active, the 'host' countries. Under existing EU rules, the home country is responsible for the activities of a 'branch', while the host country oversees the activities of a 'subsidiary'. This means that depending on whether a company is doing business through a branch system or a subsidiary, it will submit to different controls and procedures.

Home and host country regulators must co-operate closely to ensure a cross-border firm is supervised effectively. Duplicating supervisory function risks insufficient or excessive control by national regulators, because of gaps or overlaps in their responsibilities. However, it also requires mutual trust, which is often missing, with national regulators fearing that their counterparts will not do their job properly.

★ A single European regulator?

Such difficulties and ambiguities have led some businesses to propose the creation of a more centralised regulatory system within Europe. For example, in 2004 the European Financial Services Roundtable (EFR) suggested establishing not a single but a 'lead supervisor' to address these problems.[21] The current banking legislation allows regulators to delegate their responsibilities to the supervisor of the parent company. However, in practice, member-state regulators have rarely used this power. The EFR is proposing instead to go one step further and give the responsibility of supervising all the EU operations of a financial services firm to just one nominated supervisor. A 'college' made up of organisations from every EU member-state where the firm operated would in turn assist this lead supervisor. The college would carry out local inspections and provide information on the firm's overseas operations.

[21] *EFR, 'On the lead supervisor model and the future of the financial supervision in the EU', June 2005.*

One of the Lamfalussy committees, CESR, also proposed an alternative solution in the so-called Himalaya report published in

2004.[22] This suggested that EU governments give the committee power to set standards applicable to every national regulator across the EU, in cases where voluntary co-operation has failed to achieve the necessary level of convergence. Such a step would go beyond the mere voluntary co-operation that CESR was designed to encourage and would certainly improve the convergence between national regulators. However, it raises the question whether the committee should have the capacity to legislate while subject to only limited control from the EU institutions and governments.

[22] *CESR, 'Preliminary progress report: which supervisory tools for the EU securities markets?', October 2004.*

Some observers think that, while a lead supervisor would be a useful interim solution, ultimately the EU needs to create a true European supervisory authority, on the model of the powerful Securities and Exchange Commission (SEC) in the US.[23] The logic of a single institution to monitor and regulate Europe's securities markets is seductive. A EuroSEC could iron out differences in conduct of business rules, ensure a more uniform implementation of regulations, and provide investors with more equal protection across Europe. Such an idea has gained some support within the EU. For instance, Pervenche Berès, chair of the economics and monetary affairs committee of the European Parliament, called for the creation of a pan-European securities market regulator, saying: "You can't have a single market without a lead regulator overseeing it". [24]

[23] *Deutsche Bank Research, EU Monitor, 'Post-FSAP agenda: window of opportunity to complete financial market integration', May 6th 2005.*

[24] *Ruben Lee, 'Politics and the creation of a European SEC: the optimal UK strategy – constructive inconsistency', policy discussion paper, German Marshall Fund, Sciences-Po, July 2005.*

However, most financial services firms and regulators still argue that such centralisation could only take place in the distant future. There is a danger of putting the cart before the horse and straitjacketing diverse national financial services markets into a single model. Thus in the short-term the EU should focus on

pragmatic steps to improve the current framework of co-operation among national supervisors:

★ National supervisors need to strengthen the level of mutual trust by making more information available to each other. They should also publish national rulebooks explaining their respective practices and competences. To reduce the costs for firms, the EU should encourage national regulators to develop common data requirements and ideally use fewer languages. In future, firms should be able to supply data about their activities in a single form to only one supervisory authority, which would then share this data with other supervisors.

★ EU governments should strive to give comparable powers to national supervisors across the EU, or at least give them the means, financially or legally, to do their job efficiently. For instance, this could mean greater powers to conduct investigations or, in some member-states, more spending on training regulators.

★ Regulators should undertake frequent crisis management exercises, at both the national and EU level, to make sure that they are capable of responding in a co-ordinated and efficient manner. They should also develop joint teams ready to react to a major cross-border financial crisis. The EU should also co-operate more closely with non-EU countries, particularly the United States. In the long run, the European Central Bank should have a more clearly defined role in crisis management. According to Jacques de Larosière, former managing director of the IMF and governor of the Banque de France: "given the growing interlinkage between all segments of the securities markets and their financial intermediaries, systemic risk can only be dealt with at EU level with the involvement of the European Central Bank".[25]

[25] *Jacques de Larosière, 'Good news and bad news on Europe's financial markets integration', Europe's World, Autumn 2005.*

★ EU governments should launch a debate on the changing nature of systemic risk – that is risks which could affect the entire financial system. National regulators have tended to focus on the stability of the banking sector and have not taken sufficient account of the growing risks in other parts of the market, such as insurance companies and pension fund.

★ The member-states need to make greater efforts to co-ordinate the implementation of EU financial measures. For instance, to improve co-ordinated enforcement of EU legislation, national supervisors should conduct more joint investigations and keep common databases of the sanctions they apply.

★ The member-states should make sure that EU citizens receive a minimum education in personal finance, and that banks and other financial institutions provide households with proper financial advice. National regulators should take better account of the interests of consumers in their assessment of banks' activities.

It is too early to provide a definitive assessment of the EU's financial services action plan. Though EU governments have reached agreement on almost all of the 42 measures, a fully integrated single market in financial services is still far from becoming a reality. The EU will need to make significant efforts to ensure the proper implementation of the existing measures. Better co-ordination among national regulators is crucial. At present, there are several areas, from cross-border payments to retail markets, where the EU may have to take further action. However, the EU should proceed cautiously, and employ non-legislative solutions whenever possible. A rush to introduce new legislation, especially in the retail financial services sector, could damage competitiveness and undermine consumer confidence – rather than stimulating the development of a single market. The EU and national governments should also commit to a regular assessment of the measures introduced in recent years. In the longer term, member-states cannot avoid the thorny

question of whether the EU can create a true single market in financial services without addressing differences in consumer protection and taxation.

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CENTRE FOR EUROPEAN REFORM

working paper

After five years of intense law-making, the European Commission promises fewer financial services laws for the remainder of the decade. But there is still no fully integrated single European market in financial services. The EU will have to undertake a substantial 'tidying-up' exercise, including important new measures in areas such as cross-border payments. It also needs to ensure that Europe's financial regulators work together more effectively. In the longer term, the Commission is likely to come under pressure to make new legislative proposals to open up Europe's protected retail financial services markets.

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