EUROPEAN ECONOMY

EUROPEAN COMMISSION

DIRECTORATE-GENERAL FOR ECONOMIC
AND FINANCIAL AFFAIRS

ECONOMIC PAPERS

http://europa.eu.int/comm/economy_finance

N° 171 - May 2002

Report by the Economic and Financial Committee (EFC) on EU financial integration

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ECFIN/194/02-EN This paper only exists in English.

ECONOMIC AND FINANCIAL COMMITTEE

Report by the Economic and Financial Committee (EFC) on EU Financial Integration

Executive summary

Despite progress in implementing the internal market programme and the introduction of the euro, **the EU still does not have a fully integrated financial market**. Much has been achieved on the road towards integration, but there is more work still to do.

The European Council at Lisbon set the key strategic goal for the EU to become by 2010 '*the most competitive and dynamic knowledge-based economy in the world'.* As recognised by Heads of State and Government, a crucial element to achieve this goal is a more integrated financial market which can act as a catalyst for growth across all sectors of the economy and enhance productivity[1]. As a result of further integration, **consumers will benefit from lower prices and better quality products; SMEs and other enterprises will benefit from lower borrowing costs and improved opportunities for risk-sharing**.

As stated by the European Council in Barcelona *'Only through an integrated and efficient European capital market will consumers and business alike reap the full benefits of the euro. Competitive financial markets will lead to increased choice and lower prices for consumers and investors, with appropriate levels of protection.'* **The principal channels for delivering the benefits of integration will be enhanced efficiency provided by larger and more liquid financial markets and greater competition among financial service providers.** Any quantification of the economic effects of financial integration will be surrounded by a margin of uncertainty. However, a study commissioned by the European Financial Services Round Table suggests that the potential for higher growth through financial integration could be 0.5% of GDP per year, or € 43 billion added annually to EU GDP.

Recent years have seen positive progress towards financial integration in the EU with the introduction of the euro and the implementation of single market legislation, including 26 measures of the Financial Services Action Plan (FSAP). The integration process has also been market driven, reflecting a trend towards more globalised investment strategies, made possible by technological advances and cross-border mergers and acquisitions. However, the transformation from a patchwork of 15 national financial systems to an integrated EU

[1] During the period 1996-2000, annual growth of labour productivity was 1.4% in the EU and 2.1% in the US (EC Economic Data Pocket Book, March 2002, Table 13).

financial system is not yet complete. Providers of financial services face numerous obstacles - legal, regulatory, competition, tax or technical - to cross-border activity within the EU (see Box 1). Moreover, protectionist pressures are still at work. **The full benefits of financial integration can only be delivered if the Ecofin Council and other actors forcefully implement a coherent and consistent policy for the integration of EU financial markets**.

Box 1. Examples of inefficiencies in EU financial markets

- Retail markets for financial services are still segmented. This reduces choice for consumers and enterprises. Financial institutions cannot market a financial product EU-wide, but have to design and market 15 different products for 15 different Member States. As suggested in the Key Issues Paper for the Barcelona European Council, the way to integrate financial markets is therefore to combine mutual recognition in legal matters with harmonisation of the rules of conduct essential for investor protection in a way which would allow institutions to market a single product EU-wide.
- Cross-border retail payments are expensive, and have not fallen over the past decade. In 1993, the average charge for an EU cross-border credit transfer of € 100 was € 23.93. In 2001, the average charge had risen to € 24.09. As part of the FSAP, the Council adopted a Regulation that will contribute to lower charges. The industry should now act to develop a single euro payments area.
- Labour markets in the EU are characterised by low mobility and high costs. Pension funds allowing cross-border portability enhance mobility. Efficient financial markets can help to reduce the non-wage cost of labour: a higher rate of return, by 1%, for investments could lower pension contributions by 5%. Higher returns will thus help ensure sustainability of the funding of pensions in an ageing society. The FSAP envisages the adoption of a pension funds Directive.
- Restructuring of the EU economy is happening in a piecemeal way. For instance, lack of agreement on the take-over Directive – an important element of the FSAP – hampers competition and prevents the EU economy from realising its full potential across the full range of economic activities.
- Large financial institutions are still confronted with multiple rules and reporting requirements. A typical large financial institution has to report to over 20 supervisors in the EU. Convergence of supervisory practices – through a consistent application of EU directives – will ensure a level playing field, enhance financial stability and reduce the administrative burden. Identifying co-ordinating supervisors for large financial institutions will also be helpful.
- Within the EU, evidence suggests that cross-border securities trades are far more expensive than national trades. Estimates of per-transaction income of the international Central Securities Depositories (CSDs), which process predominantly cross-border trades, may be in the order of 8 to 10 times higher than the per-transaction income of national CSDs, which process mainly domestic transactions.

To deliver the full benefits of financial integration to consumers and enterprises, it is time for policy-makers to intensify their efforts. Progress depends on the implementation of a coherent and consistent strategy, encompassing the design, implementation and enforcement of regulation, competition policy and consumer protection. In particular, policy-makers need to:

1) **Complete the Financial Services Action Plan (FSAP) according to the timetable endorsed by the European Council at Barcelona, including the adoption of 8 important legal measures this year.** The FSAP contains key measures to eliminate legal and regulatory barriers to the efficient provision of cross-border financial services. Its rapid completion is therefore a necessary condition for reaping the potential from EU financial markets. The Ecofin Council needs to be prepared to dedicate significant effort and commitment this year and beyond to deliver its part of the FSAP deal (see Annex 1 for the actions required in 2002). The FSPG and the EFC should identify at an early stage political obstacles to progress. Where needed, the Ecofin Council should be prepared to settle, or to provide guidance on, key issues.

   There is a risk that FSAP measures might be designed in a way that fails to promote the benefits of integration. Therefore, the Ecofin Council should test and judge individual measures against the key objectives of integration and efficiency. The Commission is currently preparing indicators which will help to monitor and assess progress after implementation of the FSAP.

2) **Ensure consistent implementation and enforcement of regulation**. Efforts to remove distortions and obstacles resulting from inconsistent implementation and enforcement of regulation should be stepped up. The Ecofin Council should invite the Commission, appropriately involving relevant supervisory authorities and Ministries of Finance, to suggest by September 2002 appropriate arrangements for the practical implementation of financial services directives. A dialogue with the industry should be started on a structural basis to improve efficiency in the implementation of regulation in the EU.

3) **Enable effective competition.** Only if integration results in a genuine increase in the level of competition will efficiency gains translate into lower capital costs for borrowers, higher returns for investors and a wider array of financial products. In fostering a process of market-led integration, public authorities should ensure sufficient levels of competition, and ensure equal market access for all domestic and foreign providers to trading, clearing, and settlement systems. There may be a perception of uncompetitive pressures impeding cross-border M&As. The Commission should strictly apply competition policy rules to financial services and be fully prepared to respond to the evolving structure of the EU's financial markets as integration proceeds.

Efforts to remove other distortions and obstacles to competition, such as tax discrimination against ‘cross-border suppliers’ should also be stepped up. The Commission should continue to identify infringements, and take legal action where necessary.

4) **Enhance consumer confidence and provide consumer protection.** If consumers are to take advantage of new cross-border providers of retail financial services, they must have sufficient confidence in the procedures available for protecting their interests. But consumer protection mechanisms should not stifle the ability of financial integration to promote economic growth. Therefore, measures based on increasing information on available protection mechanisms to consumers should be used as developed by the Commission and the Member States in the Roadmap for a single retail financial market.

Box 2. Summary: Maximising the benefits of financial integration	
Objective	**Recommendation**
1) Eliminate legal barriers to cross-border provision of financial services	• Complete the Financial Services Action Plan (FSAP) by 2005, and 2003 for securities markets, including adoption of 8 important measures in 2002. The Ecofin Council must therefore dedicate significant effort in 2002 and beyond to deliver the FSAP. • Ecofin Ministers should also ensure appropriate and timely implementation of directives in their national laws. • The Ecofin Council should test and judge individual measures against the objectives of integration and efficiency.
2) Ensure a level playing field by consistent implementation and enforcement	• The Ecofin Council should invite the Commission, appropriately involving supervisory authorities and Finance Ministries, to suggest by September 2002 appropriate arrangements for the practical implementation of EU financial services legislation. • Involve industry in the convergence of supervisory practices. • The Commission should explore the possibility of reducing the administrative burden for the financial industry by streamlining reporting requirements and report on it by December 2002.
3) Enable competitive markets to deliver the benefits to consumers and enterprises	• The Commission should strictly apply competition policy rules to financial markets, including cross-border M&As, and be fully prepared to respond to the evolving structure of the EU's financial markets as integration proceeds. • Facilitate equal access to trading, clearing, and settlement systems and thus promote a market-led convergence. • The Commission should identify infringements by Member States with respect to unfair tax measures which discriminate against cross-border suppliers, and take legal action where necessary.
4) Enable consumers to take advantage of integrated markets	• The Commission and national authorities should enhance consumer confidence by increasing information for consumers about available mechanisms across the EU for protecting their interests and by harmonisation of rules essential for consumer protection. • Consult consumer organisations in the early stage of design of relevant FSAP legislation.

EFC Report on EU Financial Integration

Section 1: Introduction

1. The Lisbon European Council in March 2000 set the goal for the EU to become by 2010 '*the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion*'. It also recognised that a crucial element to achieve this goal is the creation of '*efficient and integrated financial markets',* since financial markets play a vital role for the economy, impacting on economic development and performance across all sectors and markets.

2. Reflecting their 'public good' nature, financial markets were historically established on a national basis, with national authorities playing a significant role in their development, functioning, regulation and supervision. So each Member State developed its own financial markets governed by its own particular legal system.

3. As markets started to develop internationally - both within the EU and globally - the institutions and rules that govern the markets have gradually adapted. External pressures for integration – whether from technology, product innovation, or mergers and acquisitions - have gone hand in hand with new policies. In the EU, significant policy developments - from capital account liberalisation (from the early 1980s to the early 1990s, depending on the Member State concerned) to the launch of the internal market programme, the introduction of the euro in 1999 and completion of more than half of the measures of the Financial Services Action Plan (FSAP) – have all promoted significant integration of the EU's financial markets.

4. However, despite progress, the transformation of 15 national financial markets to an integrated EU-wide financial market is not yet complete. The EU's financial market is still governed by 15 different legal systems, and many other obstacles to cross-border activity result in some degree of segmentation in most sectors.

5. The Barcelona European Council in March 2002 concluded that:

'O*nly through an integrated and efficient European capital market will consumers and business alike reap the full benefits of the euro. Competitive financial markets will lead to increased choice and lower prices for consumers and investors, with appropriate levels of protections*. *The European Council therefore:*

- *welcomes the agreement on the Lamfalussy proposals and urges their immediate implementation;*

- *reaffirms its strong commitment to implementing the Financial Services Action Plan (FSAP) and achieving fully integrated securities and risk capital markets by 2003 and financial services markets by 2005;*

- *asks the Council and the European Parliament to adopt as early as possible in 2002 the proposed Directives on Collateral, Market Abuse, Insurance Intermediaries, Distance Marketing of Financial Services, Financial Conglomerates, Prospectuses and Occupational Pension Funds and the International Accounting Standards Regulation.'*

6. Following the renewed commitment made in Barcelona to promote financial integration, this paper considers in more detail how further steps to facilitate financial integration in the EU – such as the completion of the measures in the FSAP – can best be implemented and complemented to deliver higher rates of growth and employment and help to meet the Lisbon strategic goal. In particular:

- Section 2 considers the likely economic impact of further financial integration;

- Section 3 assesses the need for further action in promoting financial integration, by taking stock of the extent of progress in integrating the EU's wholesale and retail markets and identifying obstacles to cross-border activity; finally,

- Section 4 makes recommendations for priority action by policymakers to maximise the benefits from financial integration, starting with the Barcelona FSAP commitments, and then moving on to additional policy areas where action will be required.

Section 2: The macro-economic impact of EU financial integration

Financial integration = a more efficient financial market

7. A higher degree of financial integration will facilitate further the provision and purchase of financial instruments and services across national borders in the EU. The goal is a large, diversified and competitive EU financial market which will bring the following benefits:

- **competition** among financial service providers will increase, to deliver a **lower cost of capital for borrowers**, and a **higher rate of return for investors**;

- financial services providers will be better able to exploit **economies of scale and scope** emerging from the greater number of actual and potential customers;

- increased competition also implies wider scope for **innovation and diversification**, creating a more complete financial market able to respond to the changing needs of the economy, and to offer a wider **product choice** for consumers and enterprises;

- **increased liquidity and depth of capital markets** can also drive down the cost of capital, reduce transactions costs, and increase total returns for investors;

- an integrated financial market - with **an appropriate framework for regulation and supervision** to limit potential for contagion - can be more conducive to **financial stability**, as it enables diversification of risks and income and thereby reduces vulnerability to external developments;

- and a more rapid and uniform pass-through of official interest rate movements to retail interest rates could increase the **effectiveness of monetary policy**.

8. Through these channels, a more complete, efficient and integrated EU financial market should provide:

- **more investment**, reflecting higher returns for savers, lower costs for investors, wider range of instruments available, and wider opportunities to hedge against risks; and

- **higher productivity and technical progress,** as the average quality and profitability of investment rises, and more resources are made available for long-term, riskier and more specialised investments projects which tend to be more productive; and

- a side effect will be **higher foreign capital inflows**, and higher retention of EU savings, as the higher returns to investment boost the attractiveness of the EU as a destination for foreign investors.

9. Box 3 below considers in more detail the six main functions of financial markets. An example is provided for each function to illustrate how further integration can create a more complete, efficient and effective financial market in the EU.

Box 3. What are financial markets for?

The primary function of any financial market is to allocate economic resources, both across borders and across time, in an uncertain world. Viable investment projects are selected and funded, thereby contributing to the development of the economy. A more integrated and complete financial market would offer a wider range of financing options to meet the needs of enterprises, from start-ups and SMEs to mature corporates.

The role of financial markets can be sub-divided into the six basic functions considered below[2]. For each function, examples are given to illustrate the potential for improving the efficiency of the EU financial system.

1) **Allocating Resources across Time and Space**: Financial markets provide ways to transfer economic resources through time, across geographic regions, and among industries. *One example is the market for pensions, which in the EU remains inhibited and relatively undeveloped. But more efficiency should translate directly to lower pension contributions for households (see Section 3.2)*

2) **Clearing and Settling Payments**: Financial markets provide ways of clearing and settling payments to facilitate the exchange of goods, services, and assets. *The euro has improved efficiency in EU large value payment systems, but obstacles to efficient clearing and settlement remain, adding to the costs of transactions (see Section 3.1).*

3) **Pooling Resources and 'Subdividing' Shares**: Financial markets pool funds to facilitate large-scale enterprise, and subdivide shares in enterprises to facilitate portfolio diversification. *But several barriers to efficient EU equity markets remain, constraining both access to capital for enterprises and opportunities for savers (see Section 3.1).*

4) **Managing Risk:** Financial markets provide ways to manage uncertainty and control risk. Many financial products – from household insurance to swaps and derivatives - can play an important role to support economic stability in this respect. *But an EU-wide insurance market remains a distant goal (see Section 3.2).*

5) **Providing Information**: A liquid financial market provides price information to enable decentralised decision-making across the economy. The emergence of euro area indices such as EONIA (Euro Overnight Index Average) demonstrates the progress already made. *Deeper more liquid markets will allow businesses to plan more effectively and, by reducing 'liquidity premia', cut the cost of borrowing (see Section 3.1).*

6) **Providing Better Incentives**: Financial markets provide ways to deal with incentive problems occurring when one party to a financial transaction has information that the other does not, or when one party is the agent for another. *Lack of confidence in foreign financial intermediaries and the burden of accessing and assessing information about foreign financial firms and products prevent many consumers from taking advantage of opportunities available in the EU market (see Section 3.2).*

[2] Based on Merton and Bodie (1995)

A more efficient financial market = a better economic performance

10. In theory, therefore, the effects of integration in improving the efficiency of the EU financial market should be reflected in an enhanced economic performance. This theory is supported by the available empirical analysis and a recent review of the academic research in this area by the Commission services[3] echoed the conclusion of an earlier survey[4] that:

> '*a growing body of empirical analyses … demonstrates a strong positive link between the functioning of the financial system and long-run growth. There is even evidence that the level of financial development is a good predictor for future rates of economic growth, capital accumulation, and technical progress*.'

Box 4 overleaf considers in more detail the empirical evidence.

11. Quantifying the economic effects of financial integration is difficult, so that specific estimates of these effects are inevitably uncertain. However, recent studies have suggested the following striking examples of possible benefits from realising a more integrated EU financial market:

- according to the European Financial Services Round Table (Gyllenhammer Report)[5] **financial integration could boost annual GDP growth rates by as much as 0.5-0.7%** per year;
- a higher rate of return as a result of financial integration, by for example 1 percentage point, for investments **could lower households pension contributions by as much as 5 percentage points [6]**.

12. Therefore, both theory and empirical analysis suggest that accelerated financial integration will offer long-term benefits to the EU economy in terms of:

- **better performance of financial markets.** The role of the financial markets is to facilitate consumption and investment. Consumers, SMEs and other enterprises will all benefit from a better performance of this function;
- **higher rates of GDP growth and higher rates of employment**, reflecting a transition to a higher rate of investment and higher productivity.

13. Looking forward, the gains from the creation of an integrated financial market may also be particularly sizeable in the context of EU enlargement, with benefits accruing to both accession countries and to present Member States (and not only to their financial service providers).

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[3] Thiel (2001)
[4] Levine (1997)
[5] Heinemann and Jopp (2002) (Gyllenhammer report)

Box 4: Financial integration and growth: the evidence.

The available empirical analysis supports the view that improved efficiency in financial services translates into economic growth and employment creation. An early attempt to quantify the effect was in 1988, when the Commission services estimated that an increase of 0.7% of GDP in the value-added of financial services in eight Member States analysed, could arise directly from financial market integration.[7] This estimate was based on relatively simple static analysis; dynamic effects were expected to have generated a higher figure. In February 2002, a new study commissioned by the European Financial Round Table[8] suggested that potential for higher growth through financial integration could be up to 0.5% of GDP per year, or € 43 billion (in 2000 prices) added annually to EU GDP. If correct, this would be a very significant gain.

Most recent research has tried simply to test whether financial development, promoted by integration, impacts positively on growth. Much of this confirms the assessment of this paper. The Lamfalussy Report on securities market regulation highlighted two studies[9], which found that stock market liquidity and other financial factors are related to growth, investment, and productivity; and which emphasised the importance of financial intermediary development.

Cross-country regressions (including recent OECD analysis[10]) suggest a positive correlation between financial variables, such as stock market capitalisation and bank credit, and growth of GDP, investment and, particularly, productivity. A fully integrated financial system is also shown to generate significant positive effects by offering the widest possible range of financial products. [11] Indeed, none of these studies suggest that bank-based systems or securities-based systems are relatively superior to one another; instead, systems which encompass both effective intermediaries and competitive markets appear superior for growth.

Results derived by these aggregate studies are inevitably subject to uncertainty. But supporting evidence comes from recent studies at the industry or firm level[12], which concluded that firms with access to external financing grow faster in a more developed financial system, in particular those relying on research and development. The Commission services have commissioned further studies which later this year should present additional evidence of the macroeconomic effects of financial integration.

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[6] ABP, the pension fund for government and education authorities in the Netherlands (1997)
[7] European Commission (1988) (*Cecchini Report')*
[8] Heinemann and Jopp (2002) (*Gyllenhammer report*)
[9] Levine and Zervos (1998) and Beck, Levine and Loyayza (2000)
[10] Leahy et al (2001) and Bassanini et al (2001), *both OECD Economic Department Working Papers*
[11] Allen and Gale (2000) and Merton and Bodie (1995)
[12] E.g. Carlin and Mayer (1999); Rajan and Zingales (1998)*;* Demirgüc-Kunt and Maksimovic (1998, 2000); and Cetorelli and Gambera (2001)

Section 3: Assessing the need for action

14. While theory and empirical studies are helpful in identifying the overall impact of financial integration, they cannot clearly identify specific measures needed to maximise the benefits from integration or provide a judgement on specific priorities. For this, one requires a more detailed examination of the extent of integration in the various sector of the EU's financial system, and how further integration should impact on the drivers of efficiency and innovation.

15. This section assesses the need for action, taking stock of the extent of integration in the EU's wholesale and retail markets and identifying obstacles to cross-border activity. The analysis here is not comprehensive, but highlights examples of areas where there is scope to reap the benefits from further integration.

Section 3.1: Wholesale markets

16. The wholesale markets are the sector of the financial system where professional players are active. Transactions here are by nature usually of a very high value, beyond the scope of households and many SMEs. Players can devote resources to access and assess information and often have the ability to overcome or circumvent the obstacles to integration, e.g. by buying legal expertise. However, overcoming the obstacles in this way is still very costly, and these costs are ultimately passed on to consumers and enterprises.

The euro has accelerated integration…

17. The introduction of the euro has already had a significant effect in accelerating integration of wholesale markets, although the degree of integration varies across different market segments.

18. TARGET, the real-time gross settlement system for the euro, made possible area-wide settlement in central bank money, and improved the soundness and efficiency **of cross-border payments** in the euro area. It co-exists with private systems which process large-value payments in euro to provide a competitive infrastructure for the money markets.

19. This new infrastructure has promoted rapid integration of **money markets**, particularly in the unsecured market. For example, the market for inter-bank deposits shows virtually complete convergence in very short-term interest rates, and convergence at somewhat longer maturities, so the 'law of one price' holds well. EONIA (Euro Overnight Index Average) and EURIBOR (Euro Inter-Bank Offer Rate) are now fully accepted price references. About 60% of total inter-bank activity of the largest participants in the market is cross-border. And the

euro-area derivatives market is highly integrated, reflected in very narrow bid-ask spreads and relatively large issue sizes.

20. There has also been significant further integration of securities markets in recent years. For example, the single currency has increased integration of the **euro-denominated bond market**. While the euro-denominated government bond market is comparable in size and issuance volume to that of the United States, the private bond market in euro remains relatively under-developed. Nevertheless, corporate issuance in euro has risen in the period since the introduction of the euro: the market share of private issuance is now about half of total issuance (more than quadrupling since 1998), average maturities have lengthened, and issue sizes have increased with tranches above € 1 billion now commonplace.

21. In addition to the consolidation of stock exchanges (e.g. the creation of Euronext, which merged the Amsterdam, Brussels and Paris exchanges in mid-2000, and has since been enlarged with the Portuguese exchanges and the London derivatives exchange (LIFFE)), the integration of **EU equity markets** is also visible in a change in perspective by investors. Professional investors have disbanded to some degree their country desks and reorganised their operations on a euro area- or EU-wide basis, focussing more on sectoral investment. Empirical evidence on equity price movements increasingly confirms this shift to more sectoral focus within a pan-EU investment strategy.

…but obstacles remain…

22. However, in many respects the EU's securities markets remain fragmented. For example, despite progress in integration of the euro-area government bond market over recent years, persistent yield spreads remain between Member States. This reflects continued fragmentation, since government bonds are still issued by Member States with different procedures, timetables and instruments. To help to address this, and notwithstanding the progress already made, the EFC's group on bond and bills markets (the Brouhns group) is continuing its work to promote integration of government bond markets through greater co-ordination and transparency of issuance.

23. More significantly, in equity markets, evidence shows that investors in the EU still have a strong 'home bias'. This points to missed opportunities for diversification, and a potential to improve the efficiency of the EU financial system. Moreover, as noted in the FSAP and in the Lamfalussy report, a number of important legal obstacles continue to hinder cross-border securities issuance. So although markets are responding to the opportunities brought by the euro, barriers remain that prevent delivering the full benefits. Measures such as the planned Prospectus Directive are therefore important to address such problems.

24. More generally, just as other parts of the EU financial system, securities trading traditionally followed national lines. As a result, continued fragmentation reflects a host of national differences in market practices, regulation, tax and legal treatments. These are reflected in a number of ways, including in difficulties in the cross-border use of collateral, and in segmented national-based market infrastructures.

25. Fragmentation creates important practical difficulties in cross-border clearing and settlement, as highlighted by last year's report by the Giovannini Group. One symptom is the highly complex infrastructure in this area, e.g. 19 Central Securities Depositories and 2 International Central Securities Depositories. However, there is potential for facilitating a market led improvement of efficiency. This is an area whereby cross-border securities trading in the EU can be made both safer and cheaper by implementing measures in the Financial Services Action Plan. For example, the Directive for the cross-border use of collateral creates legal certainty for the provision of cash collateral as regards transactions on EU financial markets. The planned revision of the Investment Services Directive - which will create a clear framework for the proportionate treatment of professional investors - will also contribute to efficiency by allowing market participants to designate their preferred settlement location, and by enabling the regulated markets to make use of clearing and central counterparty facilities in other jurisdictions subject to prudential, technical and commercial safeguards.

…and so costs remain too high

26. Some studies show that US and EU costs are comparable, but that cost structures differ insofar as trading costs are relatively low thanks to the efficiency of European markets[13], whereas cross border clearing and settlement costs are more expensive in Europe. As a result of the obstacles, global costs in securities markets remain too high. For example:

- **Within the EU cross-border trades are far more expensive that national trades**. Evidence suggests that the per-transaction income (used as a proxy for settlement costs) of the international Central Securities Depositories (CSDs), which process predominantly cross-border trades, is very much higher (perhaps in the order of 8 to 10 times) than the per-transaction income of national CSDs, which process mainly domestic transactions[14];

27. Given the high volume of turnover in such markets, savings of hundredths of one percentage point can translate into vast savings for investors and enterprises. Therefore, by addressing the various obstacles to cross-border wholesale market activity, there remains scope for significant benefits. Delivering these benefits depends on implementing a coherent

[13] Lannoo and Levin (2001)
[14] The Giovannini Group (2001), Table 4.2

range of measures in the field of market practices regulation, convergence in supervisory practices, competition policy and taxation.

Section 3.2: Retail markets

28. Retail markets are the part of the financial system where consumers and many enterprises – including growth-enhancing SMEs - purchase financial services. In comparison with professional players, consumer households and many SMEs are generally less informed and have fewer resources to collect and analyse information. Business is often conducted locally and confidence in providers of financial services is crucial. Consumers do not have the opportunities or the resources of professional players to overcome or circumvent informational, tax and legal barriers to cross-border purchase of services. Therefore, retail financial services need to be subject to rules which ensure access to information for consumers, and prevent service providers from abusing their superior information.

Limited progress with integration…

29. With the introduction of the euro, financial intermediaries were expected to respond to potential economies of scale and scope. However, in the area of retail banking, for example, cross-border expansion of financial intermediaries within the EU (including via mergers and acquistions (M&A's)) remains the exception, and a large degree of fragmentation on retail credit markets remains. While cross-border M&A's have increased over the past three years, increasing the share of foreign ownership in national banking systems, a major part of these transactions has remained national. It has been alleged that the lack of such cross-border M&A activity reflects the (ab)use of national provisions, formally based on current legislative EU banking framework, in a protectionist manner. Retail insurance markets also remain segmented within the EU.

30. As a result, for example, according to the Commission services, in the Euro area less than 5 per cent of bank branches are owned by banks from other EEA countries. Moreover, despite the important role played by technology in promoting remote sale techniques (telephone, internet) within Member States (e.g. perhaps 40% of insurance sales in the UK occur by telephone or internet), EU cross-border activity by such methods remains limited. Since cross-border M&A's still represent the main vehicle for entering national markets, removing the remaining obstacles to them would be particularly influential.

31. The obstacles appear particularly significant in EU markets for financial products with a long-term time horizon - such as life insurance policies, pensions and mortgages. But these products are particularly important. For example, a unified and competitive market for long-term savings products would contribute to the long-term sustainability of funding old age

payments in the EU. And in terms of value, such long-term products tend to be associated with households' largest single purchases and investments in their lifetime.

32. The lack of integration of retail markets is reflected in limited convergence of consumer lending rates, both in terms of levels and in terms of movement, suggesting insufficient competition. Box 5 below considers the evidence.

Box 5. Have consumer credit rates converged in the Eurozone?[15]

With competitive financial markets, convergence of consumer lending rates in the eurozone might be expected. However, credit risks might still differ from country to country. In addition, markets still experience differences in national practices and tax regimes, as well as non-regulatory barriers, for example, cultural differences in consumer behaviour and preferences.

Because of these differences, consumer lending rates in the eurozone have not converged to a eurozone-wide-rate. Movement of eurozone interest rates in the same direction should be expected (co-movement), to reflect movements in the common yield curve for the euro. Competitive pressure should force banks to adjust consumer credit and mortgage interest rates more quickly to falling markets rates. However, the empirical evidence suggests that:

- The **market for consumer credit is still segmented**. Very limited evidence of co-movement of nominal consumer rates is found for some Member States. Furthermore, the speed of adjustment is very low, and appears not to have increased since the introduction of the euro;

- The **mortgage market is also still segmented**. Although nominal European mortgage rates follow developments in the money market, they do not yet exhibit a pattern of co-movement in most Member States;

- There are **some signs of a more unified market for corporate loans**. There is significant evidence of co-movement of corporate loan rates, and a more rapid adjustment to movements in money market rates. There is therefore evidence of greater **competition** in the market for corporate lending.

33. The scope for improvements in performance was highlighted by the need to address the high charges for cross-border payments in euro. According to the European Commission:

[15] Based on Kleimeier and Sander (2002)

- In 1993, the average charge for an EU cross-border credit transfer of € 100 was € 23.93. In 2001, the average charge had risen to € 24.09. For 15% of cross-border financial settlements, it still took more than a week before they were settled.

- Retail cross-border bank payments within the EU cost up to 20 times as much as payments within Member States.

34. The Council Regulation[16], adopted in December 2001, stipulates that customer-charges levied in respect of cross-border retail payments in euro shall be the same as charges levied in respect of corresponding domestic payments, thus making the concept of the euro zone as a 'domestic payment area' tangible to citizens. This Regulation will contribute to lower charges. But it may not be sufficient. Furthermore, European banks should adopt adequate standards and infrastructure to support an efficient EU-wide retail payment system. The Eurosystem, within its mandate to promote the smooth operation of payment systems, is aiming to assist the banking sector to address some of the obstacles resulting in the high costs currently charged.

…due to significant obstacles

35. Just like wholesale markets, retail markets suffer from many barriers to cross-border activity of a regulatory or legal nature. However, the problems appear magnified in this market and integration of retail markets remains far less than that of wholesale markets. Natural barriers to integration such as language and culture, and the importance of proximity for local business, imply that retail markets will probably remain more local than wholesale markets. That in itself is not a matter for policy concern, but barriers stemming from a fragmented rather than an open internal market are.

36. For example, a significant problem particularly associated with retail markets is information asymmetry. Sometimes consumers act on faith instead of knowledge. Alternatively, they are simply reluctant to take a chance, since they do not have the resources to research relevant issues such as the legal protection offered by the financial service provider’s Member State.

37. Currently consumer protection rules are largely based on ‘host country control’, with minimal harmonisation in consumer protection rules. As a result, foreign suppliers often do not reach consumers. The present system implies that financial institutions cannot market one financial product EU-wide, but have to design and market 15 different products in order to achieve an EU-wide reach. The approach of the FSAP, of mutual recognition in legal matters

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[16] Regulation 2560/2001 (December 19th 2001) on cross-border payments in euro. The regulation will take effect from first of July 2002 for electronic payments and July 1 2003 for non-electronic transfers.

applying the country-of-origin principle, can help to solve this problem. However, so that consumers are not faced with different product standards and hence with information and confidence problems, as stated in the Key Issues Paper for the Barcelona European Council, '*harmonisation of the rules of conduct essential for investor protection'* is also important to enhance consumer confidence.

38. Differences in the implementation of financial regulation – which in some cases reflect differences in financial infrastructure - may reduce efficiency in the EU-wide operations of (large) financial institutions, since they have to comply with these rules and also have to report to supervisors in different Member States. This increases the administrative burden for the industry and thereby limits the scope for realising economics of scale within the EU. There seems to be scope for efficiency gains in supervision. For example:

- There are 39 supervisory authorities responsible for prudential supervision in the EU[17]. A typical large financial institution has to report to over 20 supervisors in the EU.

39. The Gyllenhammer report contains further examples of the potential for progress from the viewpoint of the industry. It recommends making supervisory rulebooks more consistent across countries and enhancing the standardisation of reporting requirements. Along the same lines, the Commission services published a study concluding that the reporting burden for financial institutions could be reduced without impairing the legitimate objectives of supervision[18].

40. More broadly, the Lamfalussy report recommends for the securities market convergence of regulatory and supervisory structures within the EU. Enhanced cooperation between supervisors, as that of securities regulators within the Committee of European Securities Regulators (CESR), should be promoted.

41. Separately, in the markets for financial services with a long-term life horizon, the differential tax treatment (e.g. deductibility) along national lines is often an important factor that keeps markets segregated by discriminating against 'cross-border' suppliers. A recent Commission Communication highlighted that the elimination of tax obstacles, e.g. to pensions and life insurance products, would contribute to the efficiency of the internal market.

42. Therefore, there remains very significant scope to promote much further financial integration of retail markets. Like for wholesale markets, it is necessary to remove the technical barriers related to tax and legal differences, and measures such as the planned

[17] Pearson (2002).
[18] European Commission DG Markt (2001), 'Study contract on the identification and the comparison of prudential, statistical and other reporting requirements of credit institutions within the European Union, Final Report, Deloitte & Touche.

revision of the Investment Services Directive will help to remove obstacles to integration of retail markets. The ability to employ remote sale techniques and electronic banking channels (e.g. by telephone or internet) would promote an integrated retail market. However, progress in promoting an integrated retail market will also depend on the ability to improve confidence of consumers in 'foreign intermediaries' and thus the willingness of consumers to 'shop around' throughout the EU to get the best quality for the lowest price while maintaining essential consumer protection rules.

Section 4: Policy Recommendations

43. A higher degree of financial integration in the EU is expected to result in a stronger economic performance, with more and better investment reflected in higher levels of output and employment. It is also a necessary element for meeting the European Council's strategic goal. However, despite progress in recent years, the evidence is clear that the EU's markets are still far from integrated, with respect to both wholesale and retail financial services.

44. Existing market trends – both economic (e.g. cross-border activities including mergers and acquisitions) and technological (e.g. use of the internet) – will continue to advance financial integration in the EU, just as integration is progressing globally. However, without decisive policy action, progress in the EU will continue to be insufficient to deliver the potential benefits necessary to meet the strategic goal set by Heads in Lisbon.

45. Therefore, the ball is in the court of public policymakers to play their part and remove the most detrimental obstacles to achieving a more efficient integrated EU financial market. Action is required on a number of fronts.

4.1 Complete the Financial Services Action Plan <u>on time</u> and <u>in the right way</u>

46. The FSAP, launched in 1999, is the principal blueprint for financial integration in the EU, being based on a programme of 42 measures to develop and improve the Single Market for financial services. The FSAP contains key measures to deliver an integrated market. Its completion is therefore a necessary condition for reaping the potential from the EU's financial markets.

47. So far, 26 of the 42 original measures have been finalised. This is a notable achievement. However, the measures in the remainder of the package are crucial. The Barcelona European Council in March 2002 renewed the commitment of Heads of State and Government to the FSAP, calling for full implementation by 2005, and for every effort to be made to foster an integrated securities market, and risk capital market (via completion of the Risk Capital Action

Plan), by the end of 2003. In particular, by the end of this year, the Council and the European Parliament should adopt under co-decision a further 8 legislative measures: the proposed Directives on Collateral, Market Abuse, Insurance Intermediaries, Distance Marketing of Financial Services, Financial Conglomerates, Prospectuses and Occupational Pension Funds and the International Accounting Standards Regulation (particularly relevant in light of the *Enron* case). The Commission should also deliver some legislative proposals (e.g. on Take-Over Bids and the revision of the Investment Services Directive). These measures are essential for the success of the FSAP as a whole.

48. Although further legislative measures beyond the FSAP may well be required in due course, meeting the targets of the FSAP identified by Heads in Barcelona is a necessary first step for reaping the benefits from financial integration. It will also require significant effort from all involved, relying on the effective use of the legislative procedure established in line with the recommendations of the Lamfalussy Report. **The Ecofin Council therefore needs to be prepared to dedicate significant effort and commitment this year and beyond to help to deliver its part of the FSAP deal.**

49. It will not, however, be sufficient simply to reach agreement on the list of measures in the FSAP. If not designed appropriately and adjusted to reflect market developments since 1999, there is a risk that FSAP measures might be implemented in a way that limits the benefits of integration. Therefore**, it is essential to ensure that the detailed measures agreed by the Council and European Parliament are designed in the right way** so that they will clearly contribute to higher growth and a better economic performance in the EU. In particular, the individual legislative measures of the FSAP must be tested and judged against the objectives of integration and efficiency.

50. Without prejudice to the need to preserve financial stability and protect the consumer, individual measures should aim to:

- reduce the costs of raising capital for companies, particularly growth-enhancing SMEs;
- increase potential and actual rates of return for investors and savers, including for pensions;
- engender genuine cross-border market access and competition between providers of financial services; and/or
- facilitate a wider provision of financial services and products for both investors and savers.

51. Such aims might, for example, be promoted with appropriate differentiation between the treatment of professional and retail investors; proportionality of market rules; and sufficient flexibility of definitions to allow future market development and innovation.

52. Finally, it will also be necessary to assess progress against the high level objectives of efficiency and integration following the implementation of the FSAP. A set of relevant quantitative indicators are currently being developed by the Commission services. These should help to facilitate such ex post evaluation and determine whether or not financial integration has delivered its potential benefits.

4.2 Ensure a level playing-field

53. A level playing field is a prerequisite for fair competition. Regulation needs to be efficient and effective to support financial integration. **Consistent implementation of regulation will contribute to a level playing field.** The Commission's enforcement role, in checking Member States' compliance with EU legislation, and taking legal action against Member States suspected of breach of Community Law (e.g. under level 4 of the Lamfalussy proposals for securities markets) is therefore essential.

54. Moreover, other measures, such as streamlining reporting requirements, will also be helpful. A study by the Commission concluded that the reporting burden for financial institutions could be reduced without impairing the legitimate objectives of supervision. The Commission is invited to explore by December 2002 proposals to reduce the administrative burden by streamlining and enhancing consistency of reporting requirements, and a dialogue with the industry should be started to improve efficiency in the implementation of regulation in the EU.

55. The 4-level regulatory approach for securities markets, proposed by the Lamfalussy Report and endorsed by the Council, has an important role to play in the field of supervisory convergence. Therefore, consideration might be given to specify its application to banking and insurance, given the implementation of the Basle II proposals in banking and the Solvency II proposals in insurance as a part of FSAP. The Ecofin Council should invite the Commission, involving relevant supervisory authorities and Ministries of Finance, to suggest appropriate arrangements for the practical implementation of financial services directives by September 2002.

4.3 Enable effective competition

56. Completion of the FSAP is necessary but not sufficient to ensure that further financial integration promotes higher growth. Only if integration results in a genuine increase in the

level of competition will the potential economies of scope and scale be able to translate into lower capital costs for borrowers, higher returns for investors and a wider array of financial products. Therefore, to accompany the transition to an integrated financial market**, the competent competition authorities must be fully prepared** to respond to the evolving structure of the EU's financial markets, including by addressing uncompetitive structures and arrangements resulting from the inheritance of national markets in financial services. It must also, of course, be ready to address any anti-competitive behaviour by providers of financial services and the Member States.

57. It will also be necessary to ensure equal access to market infrastructure, such as trading platforms, clearing and settlement systems. Special attention should also be drawn to the need to rationalise, where necessary, such infrastructure and to ensure more dynamic, efficient and effective EU arrangements. The forthcoming Commission Communication and second report by the Giovannini Group regarding clearing and settlement should be helpful in identifying actions how to overcome barriers and promote a market-led convergence of technical requirements and market practices to provide for inter-operability between national systems. Moreover, the ESCB and the CESR have recently established a committee to conduct work in the field of securities clearing and settlement with a view to establishing common standards in this area. Such common standards should contribute to create a more level playing field for the providers of such services.

58. Other distortions and obstacles to competition, beyond the explicit legal and regulatory obstacles addressed by the FSAP, still need to be removed. Of particular importance in this regard is the removal of unfair tax measures (as well as non-tax administrative measures) which represent discrimination against cross-border suppliers. Insofar as such discriminatory tax measures are inconsistent with Treaty obligations, the European Commission should continue its work identifying specific cases of such infringements, and be prepared to take the necessary legal action against the Member States concerned.

4.4 Enhance consumer confidence

59. Whilst integration under the FSAP is based on mutual recognition of legal matters, applying the country-of-origin principle**, harmonisation of rules essential for consumer protection is also important** for both supply- and demand-side reasons. Cross-border providers of financial services can face additional costs to market entry due to national differences in consumer protection. Moreover, if they are to take advantage of new cross-border providers of retail financial services, consumers also need to have sufficient confidence in and familiarity of the procedures available for protecting their interests.

60. It is important, however, that legitimate concerns about consumer protection are not abused to impede the integration process. An appropriate balance must be found between

those legitimate concerns and integrating measures that promote growth. For example, measures based on increasing information to consumers and other ways of enhancing transparency can be used to help to generate consumer trust, and provide adequate protection, without adding to the costs of market participants. In this regard, the Commission and the Member States have developed a Roadmap for a single retail financial market. An important achievement of the Roadmap is the establishment in 2001 of FIN-NET – an EU-wide network of financial services complaints bodies. In co-operation with European consumer representative organisations, further initiatives to increase the awareness of consumers should be explored.

4.5 Maintain financial stability

61. Finally, the benefits of an integrated financial market can only be realised if it is complemented with appropriate, efficient and effective arrangements **to preserve financial stability**. Whilst a deeper and more liquid EU-wide capital market is likely to be inherently better able to absorb shocks, it is equally essential that supervisory arrangements are properly designed and equipped to prevent and manage financial crises, with potential cross-border spill-over effects.

62. Many specific prudential rules are addressed in the FSAP. In addition, the two EFC 'Brouwer' reports on financial stability and financial crisis management took stock of the overall frameworks for EU-wide policy in this area, and raised associated issues of supervisory convergence.

Annex 1: FSAP measures to be agreed in 2002

FSAP measures to be agreed in 2002 *as requested by the Barcelona European Council*		
Measure	**Indicative timeframe**	**Key concerns**
Directive on Collateral	• Second reading in European Parliament ongoing • Final adoption June 2002	
Directive on Market Abuse	• First reading in European Parliament finalised	• Definition of false or misleading information in order to cover the situation of journalists. • Definitions must not restrict legitimate activity, and the regime must be properly balanced by robust safeguards to protect the innocent.
Directive on Insurance Intermediaries	• Second reading in European Parliament ongoing • If few amendments then adoption shortly • If many amendments then adoption second half 2002	
Directive on Distance Marketing of Financial Service	• Second reading in European Parliament ongoing. Plenary vote in May. • If few amendments then adoption in June 2002 • If many amendments: conciliation and adoption before end year	• How it fits together with E-commerce directive • Level of harmonisation of consumer protection rules
Directive on Financial Conglomerates	• First reading in European Parliament finalised • Political agreement in Council in June • Second reading in European Parliament this autumn • Adoption December	• Definition of the scope of the Directive ensuring that all systemically important financial groups are covered
Directive on Prospectuses	• First reading in European Parliament finalised • Political agreement in Council in June • Second reading in European Parliament this autumn • Adoption December 2002	**A number of difficult issues remain to be resolved**, among these are: • The treatment of SMEs • Eurobonds • The competent authority • The annual updating of information
Directive on Supplementary Occupational Pension Funds	• First reading in European Parliament finalised • Political agreement in Council in June • Second reading in European Parliament this autumn • Adoption December 2002	**A number of difficult issues remain to be resolved**, among these are: • The investment rules • The technical provisions
Regulation on International Accounting Standards	• First reading in European Parliament finalised • Adoption in May after one single reading	

Annex 2: The EFC Working Group on EU Financial Integration

This EFC report was prepared by an ad hoc EFC working group on EU Financial Integration. It was then discussed and finalised by the EFC. The ad hoc working group was chaired by Kees van Dijkhuizen, Treasurer General of the Netherlands Ministry of Finance, with the following members:

Hervé Carré, Director, DG Ecfin, European Commission
Robin Fellgett, Director, HM Treasury, UK
Alberto Giovannini, Chairman, Unifortune Asset Management
Daniel Gros, Director, Centre for European Policy Studies
Lars Heikensten, First Deputy Governor, Sveriges Riksbank
Thomas Mayer, Director, Goldman Sachs & Co
Xavier Musca, Chef de Service, Ministère de l'Economie, des Finances et de l'Industrie, France
Tommaso Padoa-Schioppa, Member of the Executive Board, European Central Bank
Fabrizio Saccomanni, Central Director for International Affairs, Banca d'Italia
Jean-Claude Thébault, Director, DG Markt, European Commission
Niels C. Thygesen, Professor, University of Copenhagen
Juan José Toribio, Director, IESE Business School, Madrid

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Eric Mink, Ministry of Finance, The Netherlands
Dirk Schoenmaker, Ministry of Finance, The Netherlands
Christopher Scicluna, DG Ecfin, European Commission
Peter Wierts, Ministry of Finance, The Netherlands

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