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Evaluation of the economic impacts of the Financial Services Action Plan

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EXECUTIVE SUMMARY

The Financial Services Action Plan (FSAP) was an ambitious programme with four key strategic objectives: developing a single European market in wholesale financial services; creating open and secure retail markets; ensuring financial stability through establishing state of the art prudential rules and supervision; and setting wider conditions for an optimal single financial market. The overall aim of this assignment was to measure the economic impact attributable to the FSAP as a whole at this point in time. It also sets out the baseline methodology for how future developments attributable to the FSAP can be assessed.

To meet these four strategic objectives, the FSAP introduced 42 measures each with their own operational objectives (such as increasing market confidence, harmonising information etc). We have structured our analysis around the impact these measures have on the banking, insurance and securities sectors and gathered data from a wide range of data sources including:

- Reviewing the operational objectives of the 42 measures that are included in the FSAP as they were set at the time of their introduction;
- Examining ex ante impact assessments of the measures as well as ex post evaluations focusing on particular measures (many of these are ongoing and we have sought to understand where data that is being collected in these assessments will be available in the future) or the FSAP as a whole;
- Interviewing European Commission staff responsible for the most significant measures regarding their assessment of the impact on the market, existing studies and issues that are specific to particular member states;
- Interviewing CEBS, CESR, CEIOPS and European industry associations regarding the measures that had the biggest impact on their industry, existing data and impact assessments and getting their advice regarding methodology;
- Conducting interviews with market participants including regulators, industry trade associations and individual providers in 12 member states. In total around 100 interviews were undertaken;¹ and
- Examining public and commercial data sources that allow us to understand the impact of the FSAP by comparisons over time or between geographies.

¹ We conducted face to face interviews in 12 member states. These were: Belgium, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Spain, Sweden, and the United Kingdom. Although the qualitative interviews are limited to these countries we have collected data on as wide a set of member states as possible.

Methodology of this study

The FSAP is a highly complex set of regulatory changes and developing the methodology for the assessment of its impact was a significant component of the assignment. It is important to remember that the objective of the report is to identify the impact of the FSAP as a whole rather than to examine market impacts of each individual measure. The resulting methodology has the following characteristics:

- Enabling measures: we have distinguished between measures that would have a direct impact on the market (whether they be regulations, directives or communications) and enabling measures. In Figure 1 we set out the measures we directly associate to market impacts in different sectors. It is important to note that this does not mean that enablers did not contribute to significant positive market impacts, only that it is difficult to identify a separate causation. Enabling measures could take different forms:
 - communications that started a debate from which a new directive was created, such as the communication on investment restrictions on supplementary pensions. In this case, this has been incorporated into our assessment of a later directive but where the subsequent directive falls outside of the FSAP we have excluded these impacts;² and
 - facilitating efficient regulation e.g. the creation of CESR. In this case, it is difficult to identify changes that resulted directly from the creation of the committee. Where the committee has improved the effectiveness of other measures, the impact would be captured in the effect of these other measures.
- Grouped measures: where measures impact the same set of indicators we have grouped them together. In this way all measures have been covered in the report. This is preferable to focusing only on a small number of large directives which is necessarily arbitrary.
- Identified the counterfactual: to allow us to assess the impact of the FSAP that is independent from other ongoing trends in the market we need to define the counterfactual. In practice, this has often meant that we have looked at trends before and after the introduction of the FSAP and compared the impact in different member states where we might expect the effect of the FSAP to differ. This needs to be done with care, for example, it is tempting to associate increased integration of financial markets to changes in the FSAP. However, if these trends are driven by improvements in technology this would be inappropriate. This would also miss impacts of the FSAP where they offset a change in the market that would have been unfavourable. This report sets out where we have been able to identify trends pre-FSAP or suggest alternative counterfactuals that allow us to robustly identify the

² We exclude all measures that are included in the Financial Services White Paper. This includes the Directive on consumer credit, the proposal for a Payments Services Directive, Solvency II and the Code on Clearing and Settlement.

impact of the FSAP. Where the FSAP and market trends impact the same indicator it has not always been possible to identify changes and ascribe them to the FSAP. This is especially the case where very large market trends coincide with what would be expected to be relatively modest impacts from the FSAP measures.

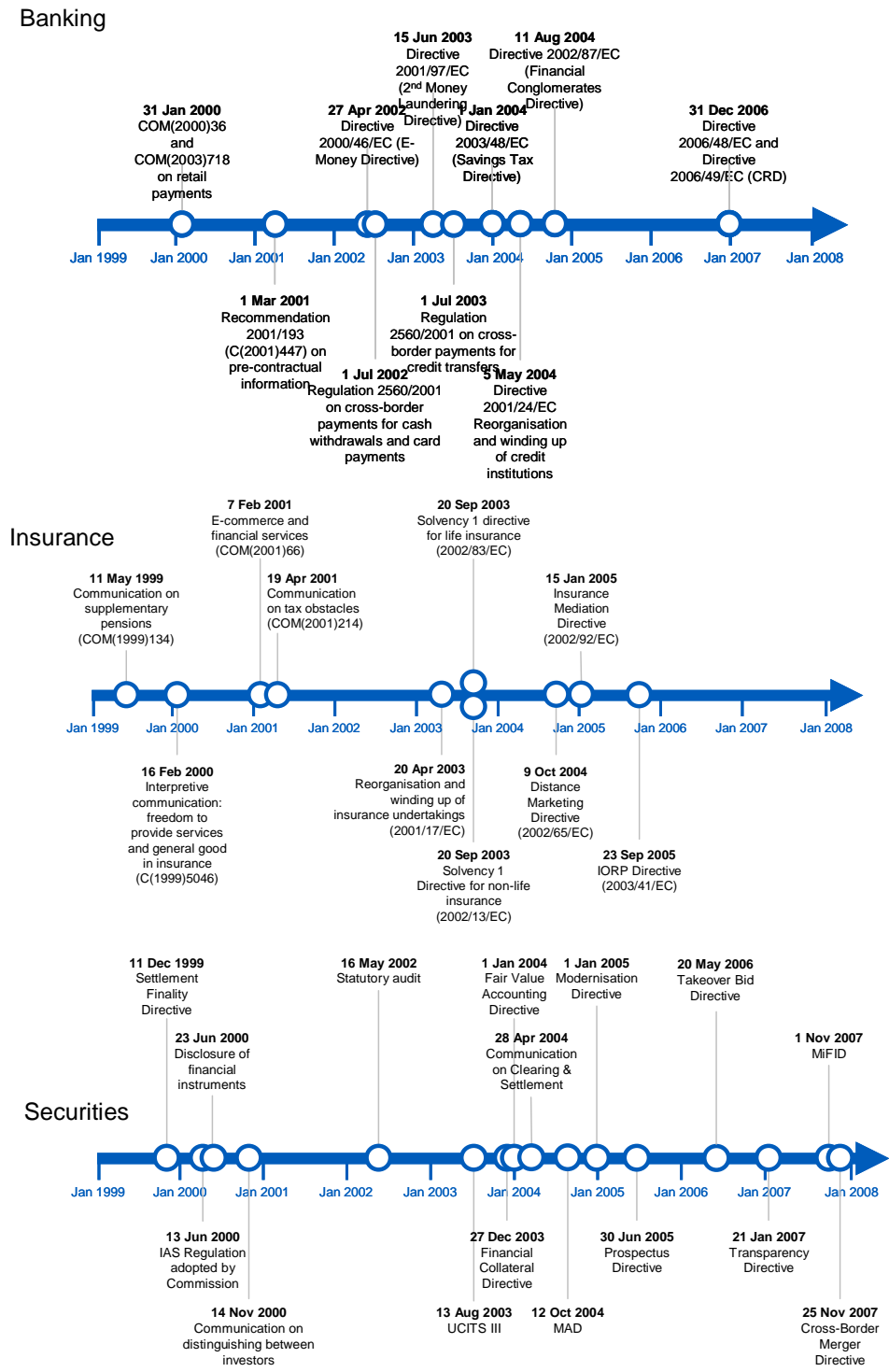
- Final outcome indicators and intermediate indicators: The ultimate objective of many measures is to reduce costs, increase consumer protection or increase cross-border activity. In many cases directly identifying these final indicators is challenging. For example there is no comparable measure of the price of insurance across member states or even over time in many member states. However, on the basis of intermediate indicators we can still draw conclusions on whether the FSAP had an impact on the competitiveness of insurance and whether this is likely to reduce prices. For example, we can look at the entry of new competitors, concentration or whether passports have been applied for as intermediate measures. It is important to note that where there is no impact on intermediate indicators this shows where the FSAP has not had a market impact but where there is evidence that intermediate indicators have changed this does not prove that there has been a market impact.

Throughout the report we have set out the expected impact of the FSAP measures through the use of a series of causality trees. In the sections below we use these to summarise the evidence regarding our conclusions as to which parts of the FSAP measures are impacting the market. In particular, the shaded boxes for intermediate and final indicators reflect where we have found evidence that the FSAP has impacted the market; we use semi-shaded boxes where we expect to be able to measure an impact in the future.

Impact by sector

Many of the measures within the FSAP primarily affect a particular part of the financial services industry. To conduct the data collection, interviews and analysis we have found it useful to associate measures to whether they had their most significant impact on banking, insurance or securities sectors. We first discuss the market impact of the FSAP for these sectors and then return to the strategic objectives.

Figure 1: Timeline of transposition date for the key FSAP measures affecting different sectors



Source: CRA analysis.

Overview

We find that the FSAP has resulted in observable market impacts in all three sectors we have examined. However, the degree to which we can observe an impact differs significantly between banking, securities and insurance. In banking, the most significant measures within the FSAP have occurred relatively recently and the ability to observe impacts is complicated by the current banking crisis. For securities, the number of measures means that the assessment is complex but there are clear market impacts and there is an expectation that these will grow over time. Insurance has been the least affected by the FSAP but we are seeing positive market impacts from a number of recent measures. In addition to the market impacts associated with the different sectors, there was general support that the FSAP had provided certainty regarding the direction of financial regulation and that this itself has been beneficial.

Table 1 below provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future (as well as the timescale in which such impacts could be observed).

Table 1: Current assessment of FSAP impacts

	Current observable impact	Expected to arise in the future
Banking	High number of IRB banks (market share at or above 80% in BE, FR, NL, SE, UK)	More risk reflective capital levels – changes to Tier I capital (3-5 years)
	Reduction in cost of cross-border payments (average charge for a payment of €100 fell from €24 in 2001 to €2.50 in 2005)	Higher number of e-money licences (3-5 years)
	High number of lending institutions signed up to Code of Conduct on pre contractual information for home loans (typically over 90%)	Increased use of e-money (3-5 years)
Insurance and pensions	More professional intermediaries (in FR, IE, IT, NL, PO, PT, ES, SE and UK)	Wider use of IMD passports (long-term)
	Reduction in the number of registered intermediaries (in BE, IE, NL, PT and SE)	Higher number of IORP passports (3-5 years)
	Increased quality of insurance advice	Change in asset allocation by occupational pension funds (3-5 years)
Securities		Lower costs and higher returns to occupational pension funds (long-term)
	Increase in number of Passported Prospectuses (from 432 to 960 for those sent and 1265 to 1962 for those received from between second half 2005 and first half of 2008)	Change in market abuse cases / increase in market cleanliness (3-5 years)
	Improved availability of comparable information on listed companies (through Prospectus Directive and some progress through Transparency Directive)	Higher number of MiFID passport notifications (3-5 years)
	Increased cost of listing on Regulated Markets (from Prospectus Directive and	Effective best execution policies in place (3 years)
		Increased quality of financial advice (3-5 years)

associated advisory costs)	Developed links between Clearing and Settlement providers (3-5 years)
Changes in listing (switching from EU Regulated markets to Exchange Regulated markets)	Increased cross-border trade in UCITS (3-5 years)
Creation of new trading venues (118 MTFs and 12 Systematic Internalisers as at December 2008)	
Consolidation of existing trading venues (Nasdaq OMX, NYSE Euronext, LSE/Borsa Italiana)	
Increase in trading volumes (increase in trading of 150% since 2000)	
Reduction in trading costs (reductions seen on all main exchanges and linked to MiFID)	
Number of clearing and settlement providers (slight consolidation of both)	
Reduction in post-trading cost (reductions seen from many providers)	
Use of eligible assets for UCITS (increase in flexibility of asset management)	

Source: CRA analysis. Note that for the indicators where impacts are expected to arise we have provided a suggestion of the likely timescale for impacts to be observed.

Banking

To understand the impact of the FSAP on the banking sector we have identified five causality trees. The most significant relate to prudential measures and payments.

Prudential measures

Although many of the banking measures occurred prior to 2005 the most significant measure within the banking sector is CRD which had to be transposed by 31st December 2006, and came into force in January 2008. As such there has only been a short time in which impacts could emerge because of the CRD.

However, the timing of CRD coming into force coincided with the sub prime crisis and the credit crunch which developed during 2007 and 2008 and which is still causing severe stress in the banking sector at the time of writing. Indeed, this crisis reached a very critical point in September and October 2008, requiring radical government intervention in many countries to stabilise the situation. It is therefore especially difficult at this stage to attempt a full evaluation of CRD using quantitative measures. It should also be noted that the interviews for this research took place during the spring and early summer of 2008 and were therefore conducted before the difficulties of September and October 2008. Furthermore, data that is currently available mainly relates to the period before CRD was implemented.

Although a full assessment of CRD will need to be undertaken in the future, the credit crisis itself indicates that the current framework has proved to be insufficient. The crisis

has revealed weaknesses with risk management approaches as inadequate disclosure of complex financial instruments and a failure of due diligence in understanding the risks such instruments imposed, especially during times of stressed markets, combined to lead to considerable write-downs of the value of assets. Capital requirements imposed on banks to mitigate against such risk also now appear to have been inadequate.

One of the aims of CRD was to make bank capital risk reflective i.e. banks which take on more risk should have more capital. A detailed understanding of the impacts of CRD will only emerge when it becomes possible to decompose the impact on Tier 1 capital ratios into the effects on the numerator (capital) and the denominator (risk weighted assets).

Tier 1 capital ratios declined during 2007 but evidence for 2008 is not yet systematically available. The numerator (capital) was impacted by profitability (affected by write-downs and retained income), the speed with which banks were able to raise fresh capital, and behaviour of "capital buffers" (capital held in addition to the minimum regulatory capital). Changes to the denominator arise from different risk weightings for different types of assets (e.g. lower weightings were applied to mortgages than previously), but also from changes in risk parameters such as the probability of default and loss given default which would both be expected to increase in a downturn. Data that will allow for a detailed examination of these issues will only be available in the coming years.

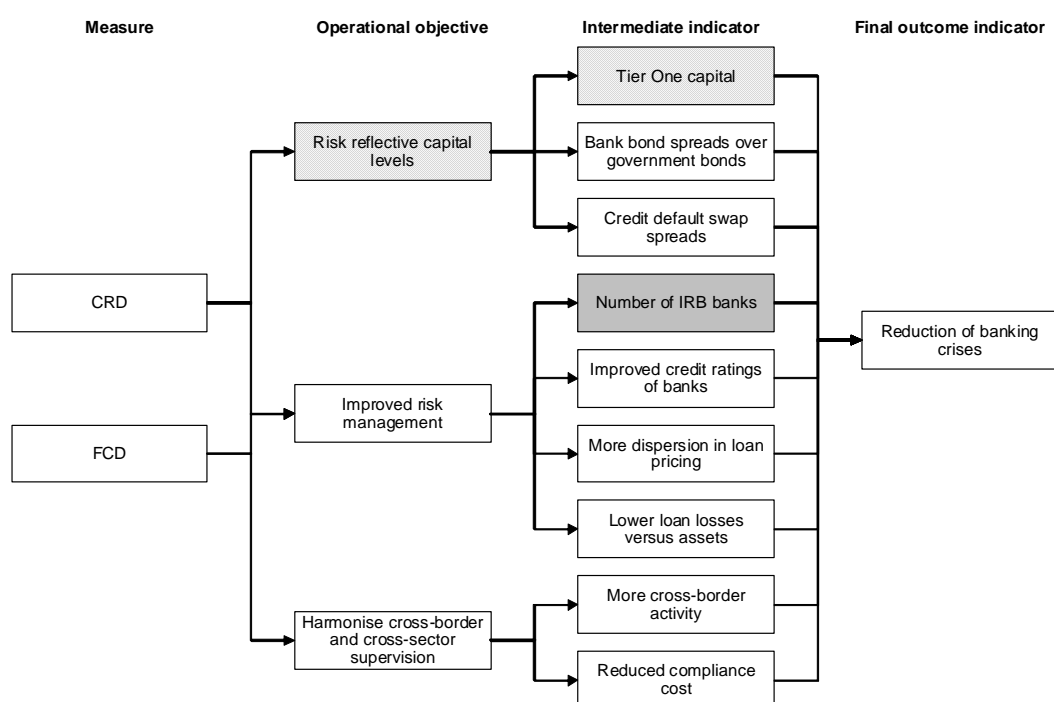
CRD has had a profound impact on the internal risk management capabilities of banks throughout Europe: leading banks accounting for a majority of assets in member states have gained IRB status following improvements to risk management procedures. Interviewees agreed that these improved capabilities were both important and beneficial to the financial system and that the systematic use of improved risk management systems across whole banks were primarily driven by the CRD. As noted above, however, even these improvements in risk management capabilities have not been sufficient to prevent the credit crisis from emerging as gaps in the framework have been exposed. It is likely that in the future further improvements will be needed in both risk management capabilities as well as in the overall prudential framework.

Loan pricing is not obviously changing, and loan losses and credit ratings both show bank vulnerability to the sub prime crisis despite all the efforts made in the implementation of CRD in recent years. The final indicator of the number of banking failures shows a number of very large government interventions to rescue failing banks in 2007 and 2008. All of these indicators will need to be reviewed over time in order to identify the overall impacts from CRD and any future refinements made to the prudential framework.

Limited gains have been made from cross-border harmonisation of regulatory regimes because CRD has not been implemented in a uniform manner between member states. Thus there have not been benefits as yet regarding reduced compliance costs or increased cross border activity resulting from harmonisation although CEBS is taking steps to improve harmonisation of requirements in this area.

Figure 2 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 2: Conclusion on prudential regulation measures in banking



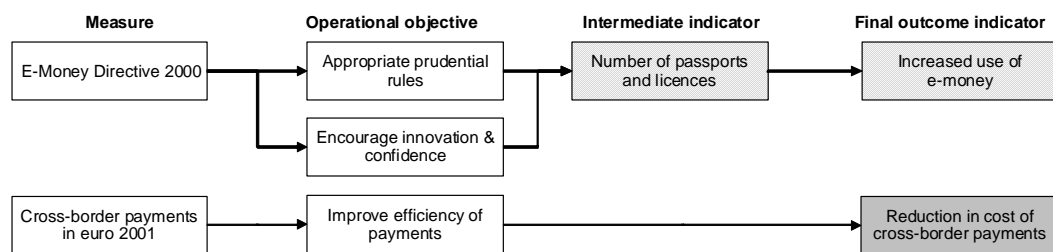
Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

Payments measures

There are two important payments measures in the FSAP: the Regulation on cross border payments in euro and the E-Money Directive. The impact of the E-Money Directive has been limited although it has enabled some non-banking providers to enter the market. There have been 20 e-money licences granted and 127 companies are operating under a "waiver." The amount of e-money issued by these institutions remains small relative to mainstream transaction volumes, but is growing rapidly from a small base. The relatively limited impact is due to the relatively high prudential requirements for e-money institutions (initial capital requirement of €1 million and limits on the activities that can be undertaken) and a lack of clarity regarding the legal framework which have hampered market developments. The EC is currently reviewing the legal framework.

By way of contrast, it is very clear that the Regulation on cross-border payments has had a substantial impact. When it came into force there were sharp reductions in the price of cross border credit transfers, as intended, and there is good evidence to attribute this change to the Regulation.

Figure 3 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 3: Conclusion on causality tree related to payments

Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

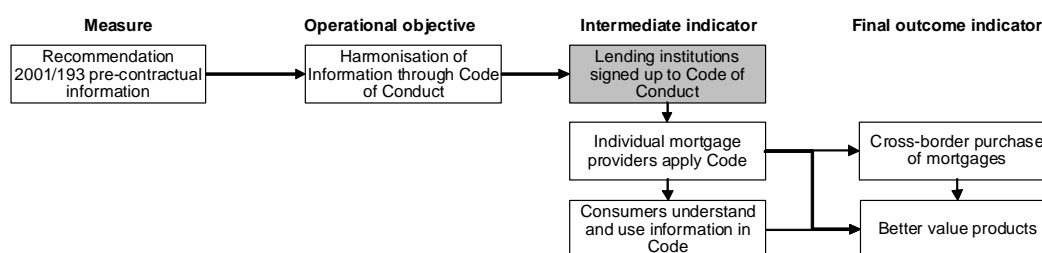
Mortgage measures

The only measure primarily affecting mortgages is the recommendation which encouraged the adoption of the Voluntary Code of Conduct on pre contractual information on home loans. In the Code of Conduct, lenders agreed to provide consumers with harmonised information.

Overall, while many banks have signed up to the Code of Conduct, the actual adherence to it has been much weaker. Not all lending institutions actually provide the European Standardised Information Sheet (ESIS) to their customers and as such there is limited evidence that customers are able to use the information contained in the ESIS or that they search around on the basis of it to obtain the best value mortgages. In addition, national legislation in some member states (e.g. Spain) requires different information to be provided to consumers and thus the ESIS is not used in those countries.

The extent of cross-border mortgages remains small but the regulators and industry representatives surveyed for this study did not ascribe this primarily to issues to do with comparable information disclosure. Instead, they argued that barriers to cross-border mortgages on the supply side arise from national differences in: property registers; laws regarding property repossessions; national product characteristics; and access for foreign lenders to national credit history databases. In addition, the regulators and industry representatives surveyed stated that from the consumer perspective language differences remain an issue.

Figure 4 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 4: Conclusion on causality tree related to information on mortgages

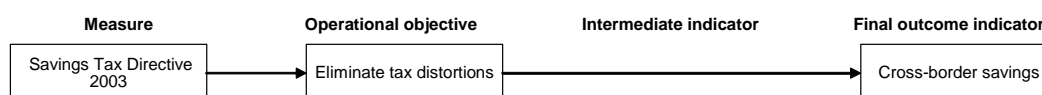
Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

Savings measures

The Savings Tax Directive seeks to eliminate the possibility of citizens in member states evading tax by placing their savings in another state with lower or no taxes on such accounts. Countries participating in the Directive agree either to share information with home states or to withhold tax on savings of foreign citizens which is then remitted to the home state. Information on the amount of withholding tax applied is limited but the sums involved are considered to be small.

The Commission is currently conducting a review of the Savings Tax Directive which has identified a number of “loopholes” in the Directive including the narrow definition of the savings products which it covers, the application of the Directive to individuals and not to legal entities such as foundations and trusts, and the movement of money to centres outside Europe and therefore outside the Directive’s territorial scope. All of these issues have sharply reduced the effectiveness of the Directive. The EC is moving to close these loopholes but the issues are technically complex and difficult to resolve easily. The current conclusion is that this Directive has not so far proved as effective as originally hoped.

Figure 5 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 5: Conclusion on causality tree relating to Savings Tax Directive

Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

Anti-money laundering measures

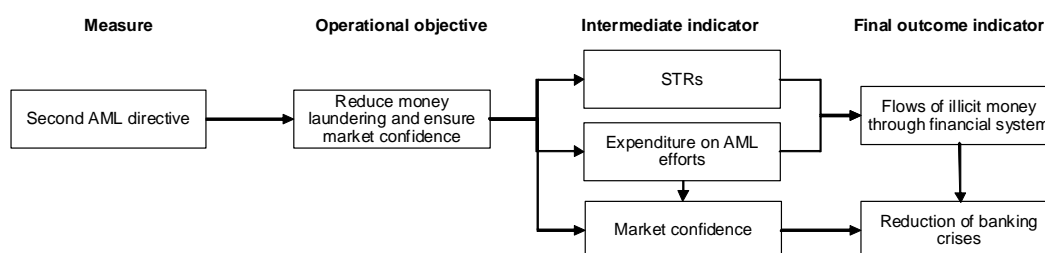
The majority of interviewees viewed the Anti-Money Laundering (AML) Directives as useful and effective in deterring money laundering from crime and terrorism as well as maintaining market confidence although it was difficult to identify specific impacts from these directives. There is evidence that expenditure on AML activities by banks has increased in recent years and that senior management in banks are more directly involved in AML activities than previously, although this appears to be due to the 3rd Directive rather than the 2nd Directive.

Banking associations and regulators in different member states did not highlight any concerns arising from a lack of confidence in the market or banking scandals because of money laundering. The lack of scandal is seen to be positive, although it is not possible to conclude that this represents an impact of the FSAP.

Changes in the numbers of Suspicious Transaction Reports (STRs) were believed to have resulted from changes in procedures within banks rather than being interpreted as linked to underlying trends in money laundering. Systematic data was not available on the number of convictions or the value of frozen assets which would be useful data to gather in the future. Evidence on the underlying flows of illicit funds is not available and therefore it may be more appropriate to focus on a wider range of intermediate indicators for any future reviews.

Figure 6 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 6: Conclusion on causality tree relating to anti money laundering



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

Insurance

To understand the impact of FSAP on the insurance sector we distinguish between measures affecting insurance and those directly focused on pensions.

Insurance measures

Out of the three sectors considered in this report, the FSAP has had the smallest impact on the insurance sector. This partly reflects the progress that had already been made in the third generation insurance directives but also reflects the fact that barriers in other parts of the insurance market (such as contract law and tax differences) which vary significantly between member states are national issues that are difficult to change.

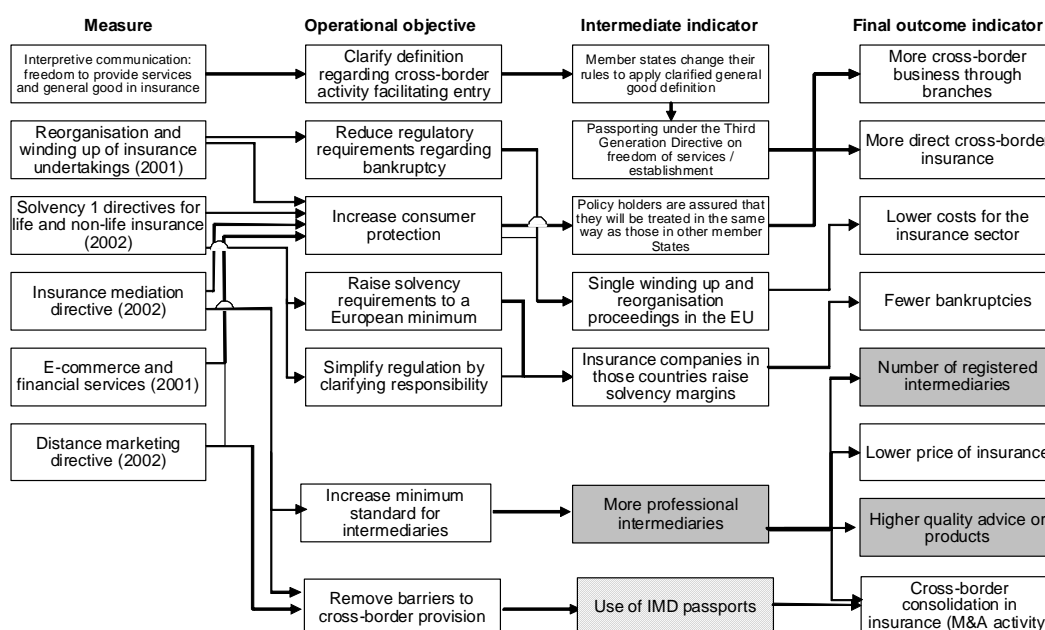
The FSAP measures were important as they consolidated some of the changes from the earlier directives. For example, the interpretative communication on the general good and Solvency I are seen as beneficial in that they added greater clarity, but they did not in themselves result in changes in the market. It is clear that Solvency II is expected to be much more significant than Solvency I.

The most significant insurance directive was IMD. The degree to which this had an impact on national intermediary markets depended on the pre-existing regulation of intermediaries. For some countries, IMD involved little change. However, in the majority of member states this raised professional standards, and increased both disclosure and consumer protection. Although it is difficult to measure with any precision, it is likely that this did reduce the number of insurance intermediaries, however, there is a surprising degree of consensus that this had a positive impact on the quality of advice and will raise consumer confidence in the longer term.

The use of IMD to encourage cross-border provision of intermediary services is much less certain. Indeed, although passports have clearly been used (there is no firm data on this however), the intermediary markets largely remain national. The benefit in terms of lowering the cost of provision on insurance on an FOS basis seems small. Intermediaries may be able to take advantage of this passport but this is an issue for the future (where we might expect changes in the next 3-5 years). In order to measure this, data on the number of passports, whether they are actually used, and the activities that are involved needs to be collected.

Figure 7 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 7: Conclusion on causality tree related to insurance



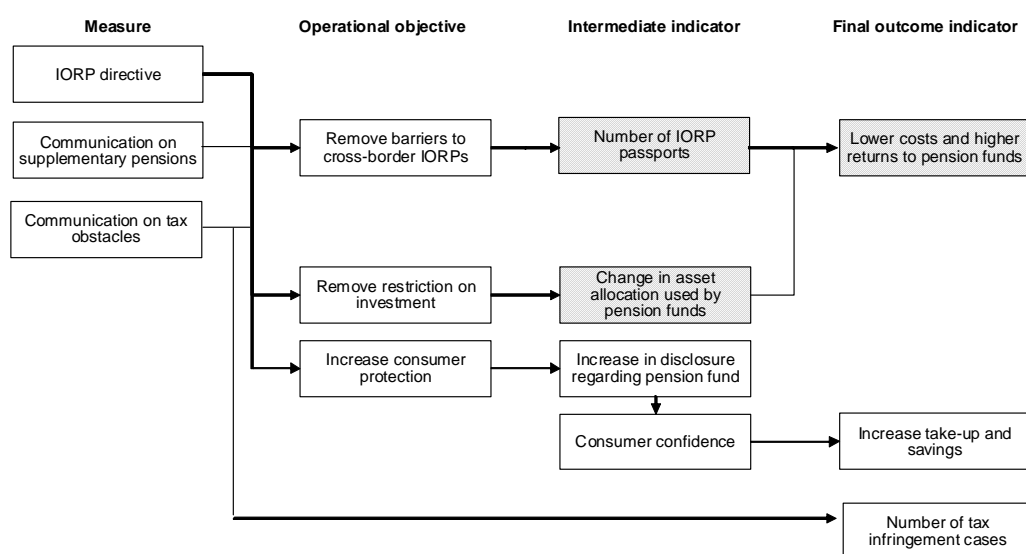
Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

Pensions measures

It is too early to assess the impact of IORPs. In terms of the number of cross-border pensions the impact on the market is undoubtedly small (but is likely to increase in the next 3-5 years). However, it is clear that different member states have seen this as an opportunity to compete internationally to provide pension services and this may prove successful in the future. It is also the case that IORPs removed restrictions on asset allocation in a number of member states with the result that pension funds can manage the assets appropriately given their liabilities. Interview evidence supports the case that over the longer term this should raise pension returns, and give European pensioners higher incomes.

Figure 8 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 8: Conclusions on causality tree related to pensions



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

Securities

The impact of the FSAP in the securities sector has been the most complicated to analyse. We have separated the analysis into five causality trees, although they share some of the same indicators.

Information measures

Overall, information disclosure measures within the FSAP have had a mixed impact on the market. There has been an increase in the number of prospectuses that have been passported into other countries which is directly linked to the Prospectus Directive. There is evidence that some of these passports are being used for tax reasons or represent round-tripping, but nonetheless the passport has made access to foreign markets easier.

The Prospectus Directive is also viewed as having resulted in harmonised information being available since it was a maximum harmonisation directive. Although the Transparency Directive has made progress towards harmonisation there remain numerous differences between member states which would need to be overcome in order to see impacts through this channel and hence no harmonisation impact has yet been achieved.

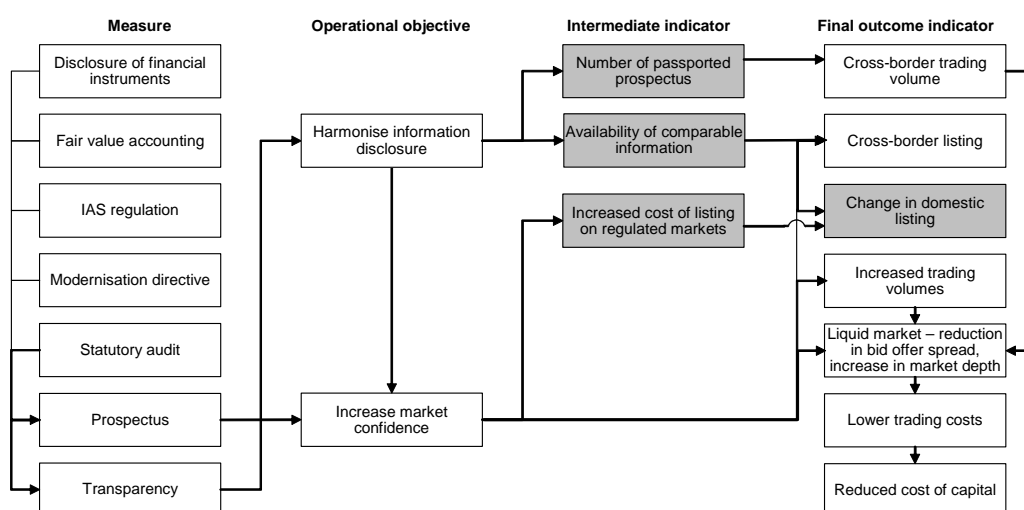
When considering the impact of the cost of regulation, the most significant effect appears to have been a switch in some countries from listings arising on the EU Regulated market to Exchange Regulated markets. This includes the markets themselves choosing to switch to, or set up as, Exchange Regulated markets. It is possible to interpret this trend in two ways. Firstly it could be seen as an important mechanism for avoiding the impact of regulation. Secondly, given that an alternative mechanism for listing exists (i.e. Exchange

Regulated markets) issuers are effectively able to choose the level of regulation appropriate for them - those that wish to be on EU Regulated markets gain from the higher level of regulation and quality mark from harmonisation but must also incur the higher costs. Even though the total listings may be unaffected, the markets on which listing is occurring have therefore changed.

Regulatory burdens in the US may have pushed some foreign listings to EU markets. However, less impact has been observed or is expected from the FSAP measures regarding cross-border listings with interviewees arguing that the home bias remains and that the need for cross-border listings is reduced when cross-border trade is possible.

Figure 9 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 9: Conclusion on causality tree related to information disclosure measures in securities



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen. Note that at this stage only final indicators related to listing have been assessed. The remaining final indicators will be considered in the next section.

Trading measures

The most significant FSAP measure affecting trading in the securities sector was MiFID which has far reaching consequences in the sector. Since MiFID was only recently implemented, the full implications are not yet clear. Nonetheless, already there are substantial changes being observed in the securities sector where MiFID, along with other FSAP measures, is credited as playing an important role.

In particular, the removal of the concentration rule and the clear focus towards increasing competition between trading venues has led to a number of new trading venues being set

up in recent times. Many of these venues have been established in London which would have been possible before MiFID, but MiFID is nonetheless partly responsible for these developments. Best execution requirements are currently perceived to have led to written policies being developed but little practical changes to trading decisions, although the impact of the best execution rules is linked to the availability of realistic alternative trading venues. Hence as new trading venues grow and become successful, best execution rules would be expected to have a greater impact over time in ensuring venues are chosen for trading which best meet the needs of investors. With rapid changes to the trading venues already being seen, practical changes linked to best execution are likely to arise within around 3 years. One of the consequences of the increased competition has been a reduction in trading costs, with MiFID one of the reasons for this.

One of the concerns expressed regarding changes arising due to MiFID was that the ability to trade on many different trading platforms would lead to data fragmentation and traders losing the ability to understand what is happening across all of the platforms. This issue was seen to be a particular concern in countries that previously had a concentration rule i.e. France, Italy and Spain, although it was also a concern in the UK because of the increase in the number of trading venues from which data needed to be gathered. Data providers and proprietary systems by investment banks are expected to solve these concerns over the medium term although all interviewees noted that it was too early to assess whether data fragmentation would be a concern in practice.

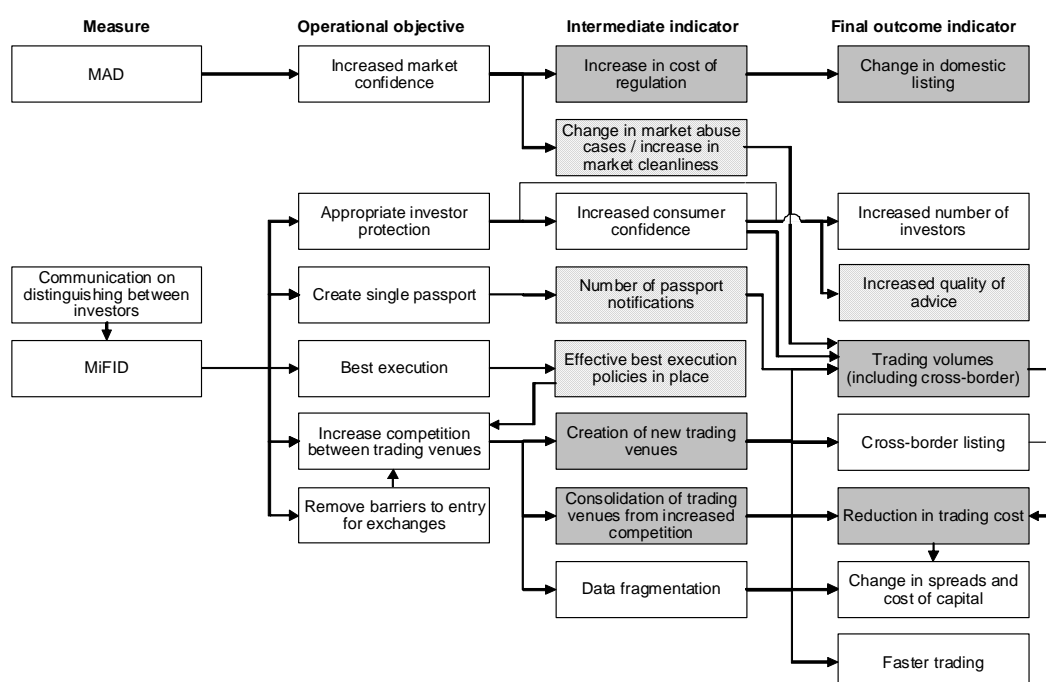
On the retail side there have been limited impacts thus far with MiFID mainly seen as leading to written processes being put in place but with few other changes thus far. However, there is an expectation that the quality of advice would increase in those member states where advice was not previously a regulated activity although this is likely to take 3-5 years to occur. Changes in consumer behaviour because of increased disclosure are likely to take considerably longer to occur.

Overall, the FSAP has played a role in the increase in cross-border trading, although market forces and the impact of the Euro were seen to be more significant than the FSAP.

Most market participants viewed MAD positively, believing that it had enhanced supervision. Where market cleanliness has been examined by member states there is some evidence of an improvement. Yet the evidence suggests that legislation alone is not necessarily sufficient to lead to changes in market abuse. Many interviewees see the importance of enforcement of the directive and believe that high-profile investigations and convictions will discourage abuse. Thus an increase in market abuse cases is likely to be viewed as evidence of enforcement although qualitative evidence will be essential to understand whether this is correct. Given the speed of some court systems it is likely that this will take some time to observe hence an assessment of this would be appropriate in 3-5 years time.

Figure 10 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 10: Conclusion on causality tree related to trading measures in securities



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

Post-trading measures

The increased protection and security in post-trading that arose because of the SFD and FCD were seen as positive, but this was thought not to have led to an increase in cross-border trade. These directives were seen as an important, and necessary, first step to increased integration in post-trading but on their own were not seen as sufficient to have impacted either trading costs or cross-border trading.

Overall, the market participants agreed that the post-trading measures should be seen as the first steps towards integration in the post-trading environment, but that the existing FSAP measures (with the exception of MiFID) would not have had much impact thus far and that future changes would still be required to make progress in this part of the market. In particular, significant barriers remain in the form of technological solutions to choosing the post-trading provider, the additional risk from doing so and the tax and legal barriers that would need to be overcome to facilitate this. The number of links between clearing and settlement providers are expected to develop over time and this will need to be monitored to identify which links are in place as well as where links are actually being used.

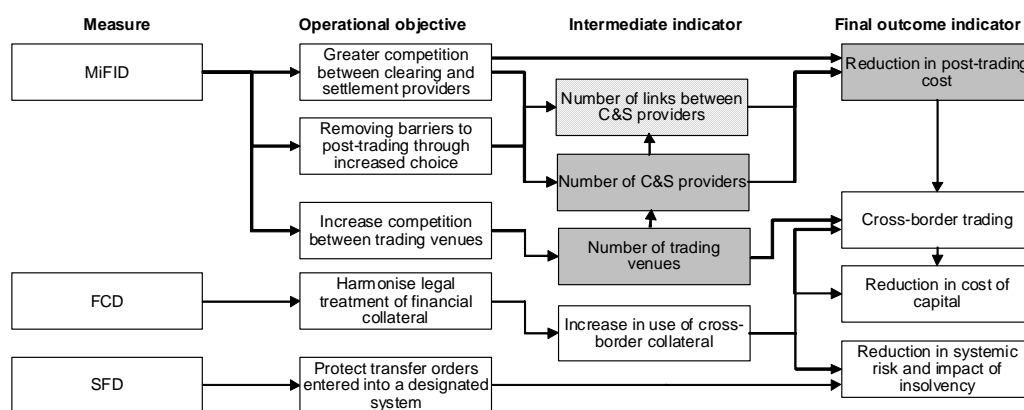
However, it is clear that MiFID is leading to increased competition in the post-trading environment. This has arisen both from increased competition between trading venues focused on the “all-in” price of trading and post-trading and also because of increased competition to offer post-trading services to trading venues. Both MiFID and the

transparency requirements of the Code of Conduct (outside the FSAP) are in part responsible for the reductions in post-trading costs that have been observed.

There have also been a number of regulatory developments (the Code of Conduct; Target 2 Securities; the LinkUp project; the mandate for the CESAME 2 group; the request by the EC for recommendations from CESR, in conjunction with ESCB, regarding post-trading and continuing progress to overcome the Giovannini barriers) outside the FSAP which may have much more significant impacts than either the SFD or the FCD. Furthermore, given the recent implementation of MiFID it is too soon to assess the full impact of MiFID on the post-trading environment.

Figure 11 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 11: Conclusion on causality tree related to post-trading aspects of the securities market



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

M&A measures

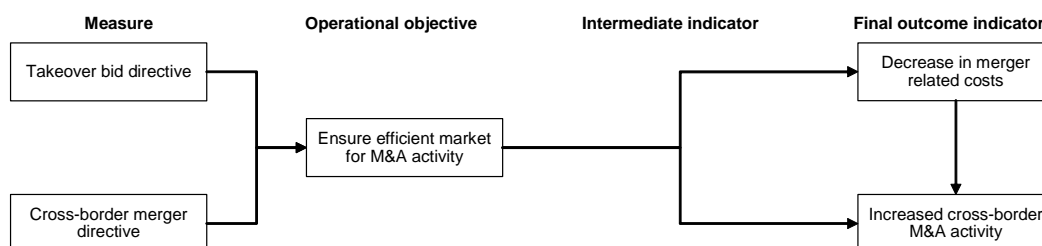
Given the recent implementation of the M&A measures (and their lack of transposition in some member states), data does not yet allow for a quantitative assessment of whether there has been an economic impact from these measures. However, interview evidence suggests that we should not expect such an impact. M&A is driven by strategic reasons rather than simply regulatory hurdles. The main potential gain from M&A related measures were reduced costs in the event of mergers although even these were believed to be small in comparison to other synergies.

Furthermore, the Takeover Bid Directive has been implemented in a differential manner in member states with some evidence that aspects of cross-border mergers had become

more difficult rather than easier. Differences in implementation between member states meant that the benefits that were hoped for were not in fact materialising.

Figure 12 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 12: Conclusion on M&A aspects in securities



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

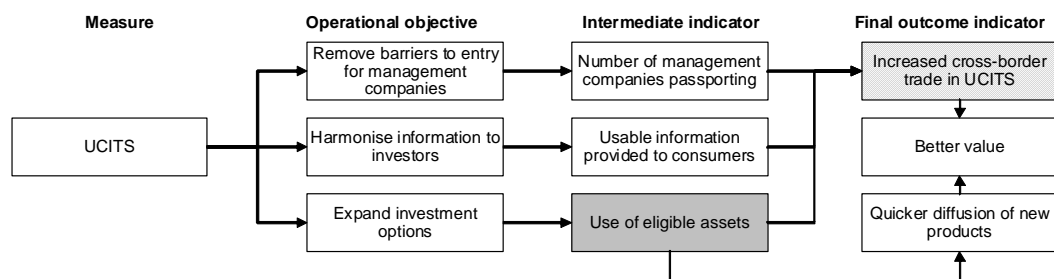
As is clear from Figure 12, currently there is no evidence of any impacts from the M&A measures within the FSAP although impacts may be seen over the longer term especially given the relatively recent implementation of directives and the evidence that implementation has not occurred in a number of member states.

UCITS related measures

Overall, UCITS III has had an impact on the market although not all components of UCITS III have been effective. In particular, there is currently no economic effect from the management company passport and there has been no cross-border impact from the Simplified Prospectus due to the differential manner in which it has been implemented and the tendency to treat it as a legal document rather than an information document for consumers.

However, the changes made to eligible assets have led fund managers to take advantage of the flexibility afforded. There has been growth in the use of fund of funds which the majority of interviewees attribute at least in part to the FSAP. There has also been a slight increase in the proportion of foreign notifications which is consistent with the impact expected from UCITS III. However, it is not yet possible to conclude that UCITS III has led to an increase in the cross-border trade, but if data becomes available on the funds that include eligible assets it may be possible to observe changes in cross-border trade related to these funds in 3-5 years. Figure 13 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 13: Conclusion on causality tree related to UCITS



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

Impact by strategic objectives

As explained above, the goal of the FSAP was described in terms of four strategic objectives:

- A single EU wholesale market;
- Open and secure retail markets;
- State of the art prudential rules and supervision; and
- Wider conditions for an optimal single financial market.

Here we review the impact of the FSAP according to each of these strategic objectives

A single EU wholesale market

With the exception of two measures relating to pensions, all of the measures aimed at this strategic objective impact the securities sector. Given the far reaching nature of this particular strategic objective, the European Commission grouped some of the measures together under an intermediate level of the strategic objective and hence we follow that approach here:

- Raising capital on an EU-wide basis – There has been mixed success regarding this aim. The passport available through the Prospectus Directive has made access to EU-wide markets easier for issuers but has primarily been used for debt securities rather than equities. However, the differential application of the Transparency Directive has led to little gains through this route. The costs of accessing EU Regulated markets has led to a switch in some countries from listings on these markets and towards Exchange Regulated markets hence issuers are effectively able to choose the level of regulation appropriate for them. There is little suggestion that this has impacted cross-border listings.
- Establishing a common legal framework for integrated securities and derivatives markets – The most significant impacts under the single EU wholesale market have

arisen under this intermediate objective. While MiFID was only recently implemented, there have already been significant changes in terms of setting up new trading venues and increasing competition between trading platforms as well as reductions to trading costs (partly also impacted by the Code of Conduct). Best execution policies are yet to have an impact in practice, but it is likely that their impact will increase over time, further strengthening competitive forces. Concerns regarding data fragmentation remain and while most interviewees believe that data providers will be able to provide consolidated data, it is too early to assess whether data fragmentation will be a concern in practice. When considering MAD, while most market participants viewed it positively, greater enforcement seems to be required before any market impacts are observed. Given the recent implementation of MiFID, the market impacts will continue to arise over many years to come and will need to be reviewed in the future.

- Towards a single set of financial statements for listed companies – Progress has been made in ensuring that there is comparable information provided by listed companies and there is agreement that new standards make accounts easier to compare across countries, competitors and sectors. The market impact of these measures is seen through the Prospectus and Transparency Directives which lead to this information being revealed to the market.
- Containing systemic risk in securities settlement - Increased protection and security in post-trading that arose because of the SFD and FCD were seen as positive, but this was thought not to have led to any market impacts. Nonetheless, these directives were seen as important facilitators for subsequent regulation in this sector such as the Code of Conduct; Target 2 Securities; the LinkUp project; CESAME 2; recommendations from CESR and continuing progress to overcome the Giovannini barriers. The impact of these developments will need to be reviewed in the future.
- Towards a secure and transparent environment for cross-border restructuring – Evidence suggests that there have been little gains in this area, as yet, since the Takeover Bid Directive has been implemented in a differential manner in member states.
- A single market which works for investors – Little impact has arisen under this aim. There has been an expansion of eligible assets used within UCITS funds, and a growth of fund of funds is partly attributed to the FSAP but there is no evidence of other impacts. In pensions, the removal of some national restrictions on occupational pensions (especially related to asset allocation rules) and barriers to cross-border activity has clearly enhanced the possibility of a single wholesale market in pensions. However, there is almost universal support that the impact of this will only be observed over the longer-term as companies and financial services providers exploit the new freedoms and there remain barriers in terms of differences in national rules and interpretations, tax rules, acceptance of investors.

Open and secure retail markets

Within the banking sector, the Regulation on cross border payments led to a sharp reduction in the cost of these payments although there has been little impact on cross border payments volumes. The Code of Conduct concerning pre-contractual information on mortgages has seen uneven implementation and is not believed to have brought about measurable impacts either on national or cross-border mortgages.

Overall, the most dramatic impact of FSAP in the insurance sector has been through IMD which has increased professionalism and is likely to have increased the quality of advice and through it the products that consumers eventually purchase. FSAP measures may have facilitated the trends in terms of cross-border insurance provision although this varies significantly by market and this appears to depend primarily on whether there are significant differences in contract law or tax that prevent cross-border activity.

State of the art prudential rules and supervision

Within banking, CRD represents a profound and fundamental revision of prudential regulation. The industry has invested heavily to implement the sophisticated risk management systems called for by the Directive and large banks in all countries have sought to gain IRB status. While it is widely felt to have improved risk management approaches, the credit crisis indicates that the current framework has proved to be insufficient for robust prudential management. In contrast, the E-Money Directive was regarded as having relatively high prudential requirements. This is one of the reasons why only a limited number of players (a total of 20 electronic money institutions and 27 waived institutions across the EU) have entered the market.

The 2nd Anti Money Laundering Directive is viewed as a laudable and necessary extension of the original regulation. Concerns were not raised regarding banking scandals arising due to money laundering. Although this is positive, it is not possible to conclude that this represents an impact of the FSAP. It is impossible to discern the impact precisely given that, by definition, the total amount of money laundering is unknown. Gathering evidence on the number of convictions, the value of frozen assets and a range of other indicators would be useful for any future reviews.

The winding up directive and Solvency I were intended to improve prudential regulation of insurance companies. The overall impact of both of these directives is small overall, but they had a bigger impact on a small number of member states who previously had lower prudential regulation and where the markets were fragmented.

Wider conditions for an optimal single financial market

The Savings Tax Directive attempts to eliminate tax evasion that occurs when citizens place their savings in foreign countries in order to avoid domestic tax. There is little evidence that it is having the desired effect in part because of definitions which seemingly permit evasion to continue to occur.

The Commission has encouraged countries to remove tax rules that affect the location where a pension scheme is being managed. The Communication was seen as helpful

clarification of the rules although in practice it is difficult to associate any particular market impact to this particular measure.

Implication for methodology and policy development

The final objective of the report was to set out the methodological implications for how the impact of the FSAP could be measured in future should this study be updated. It is clear that for many of the most significant FSAP measures such as CRD and MiFID it is currently too early to assess their full market impacts. Hence a complete assessment of the FSAP will only be possible after a further period of time. There are a number of lessons that should be taken into account in future studies of this kind:

- A holistic review allows the overlapping impact of different measures to be taken into account. This is particularly important where a number of different measures are aimed at achieving the same goals such as increasing cross-border trading volumes. It is also important for issues such as information disclosure where an individual assessment of measures could suggest positive market impacts, whereas the overall impact of increased disclosure could be to confuse the consumer. For example, this may have resulted from overlapping information disclosure requirements resulting from MiFID and UCITS.
- The practical difficulty of capturing relevant data increases quickly over time. The best case is that a set of baseline indicators is set out when the policy is initially assessed. Improvements in policy development have meant that a more formal assessment process has been undertaken for more recent measures and the result of this is better data to use as a baseline. The data collection that arises through CEBS, CEIOPS, CESR is a particularly useful initiative. In particular, setting out in advance the expectations of the likely impacts of measures will highlight the data that would be useful to capture during the policy development process in order to have available for ex post evaluations. Where such data has not been available for relevant indicators for the FSAP measures, this report has attempted to provide a baseline if possible or to suggest necessary data for future assessment.
- A combination of qualitative and quantitative evidence is required to undertake assessments of this kind. Interviews with experts within the market are essential to understand ongoing trends, changes in domestic regulation and definitional changes in the data. In some cases, the impact of market forces dwarfs any role of regulation, for example, mergers and acquisitions, and then qualitative evidence becomes even more important. We would therefore recommend a similar approach be taken to future assessments of both the FSAP and other measures.
- The impact of particular FSAP measures will vary significantly between member states. This is inevitable given the differences in regulation prior to the FSAP and the different market structures. Understanding the different market circumstances is fundamentally important to develop a balanced view on the impact of regulation.
- There is no one approach to setting out the impact of the FSAP. The approach should reflect the types of measures and the nature of the particular markets affected. It has been useful in this study to analyse how indicators have changed over time, across

member states, and between the US and Europe. A flexible approach should be maintained in the future.

- Geographical impacts can vary quite significantly depending on the types of measure being assessed. It is clear from this report that some of the markets under consideration are global, others European and many are still national. Assessments of this kind need to take this into account, including the fact that regulatory changes may alter the relevant geographic market. Regional integration or specialisation of certain activities in particular member states can both be successful market impacts even if activity going across all of Europe remains reasonably small. The impact of European regulation on the performance of the industry in the rest of the world also needs to be taken into account.

While the main objective of this study was not to produce policy conclusions for the European Commission, there are nonetheless lessons that can be drawn from the evidence collected for this study:

- Clarity over the operational objectives of the measure: The assessment of whether a measure has met its objectives is significantly easier where there are clear objectives at the outset. There has been a substantial improvement in the clarity of the objectives of recent measures and the market failures they address. Gathering additional data both to form a baseline and also to maintain data collection for future assessment would further enhance the ex post evaluation process.
- Maximum or minimum harmonisation: The FSAP contains directives that require maximum harmonisation and directives that set out minimum standards. Market participants offer support for both of these approaches but it is clear where the intention is to encourage a single market and cross-border activity – as in the wholesale market – maximum harmonisation is favoured as it prevents new barriers being introduced by differential implementation. In retail markets, where market structures are fundamentally different, minimum harmonisation may often be more appropriate. There is recognition, however, that in some cases minimum harmonisation may represent a useful stepping stone where significant changes are required, and that the role of CEBS, CEIOPS and CESR is helpful in this regard.
- Regulation and market forces: There is a significant tension in the relationship between market forces and regulation. In some cases, changes in regulation are clearly required to remove a barrier constraining market forces and subsequently we see an immediate impact on the market. Often these cases are seen as successful with clear market impacts. In other cases, regulation can change ahead of market forces and only over time will commercial organisations take advantage of freedoms that result. These are sometimes characterised as having costs with little beneficial market impact, but in practice they may allow markets or competitive forces to develop more quickly than otherwise. In addition, regulatory certainty from setting out a plan for regulation helps companies to plan on the basis of this regulation. This may also mean that market forces develop in advance of any regulatory change because market participants are able to identify the direction of travel of regulation.

There can be little doubt that the FSAP has changed the landscape of European financial services regulation although the impact arising from the various measures has been uneven reflecting greater progress that has been made in wholesale financial services. At the time of writing this report, some of the most significant measures within the FSAP had only just been implemented and hence the overall effect of the FSAP will continue to be seen in years to come with an increased movement towards a single market in financial services.

1. INTRODUCTION

The European Commission engaged CRA International (CRA) to conduct an “Evaluation of the Economic Impact of the Financial Services Action Plan (FSAP).” FSAP was an ambitious programme with four key strategic objectives: developing a single European market in wholesale financial services; creating open and secure retail markets; ensuring financial stability through establishing state of the art prudential rules and supervision; and setting wider conditions for an optimal single financial market. The overall aim of this assignment was to measure the economic impact attributable to FSAP as a whole at this point in time. It also sets out the baseline methodology for how future developments attributable to FSAP can be assessed.

1.1. APPROACH TO PHASE I - DEVELOPING A METHODOLOGY FOR EVALUATION OF THE ECONOMIC IMPACT OF THE FSAP

The first stage of the project was to develop the methodology for undertaking an economic impact assessment of FSAP. This involved a number of different steps including:

- Reviewing the 42 measures that are included in FSAP to determine the operational objectives. For each of the measures within FSAP we have examined the operational objectives and mapped these back to the high-level strategic objectives;
- Examining ex ante assessments of the measures and impact studies focusing on particular measures or FSAP as a whole (many of these are ongoing and we have sought to understand the data that is being collected in these impact assessments);
- Interviewing Commission staff responsible for the most significant measures regarding their assessment of the impact on the market, existing studies and issues that are specific to particular member states;
- Interviewing European industry associations regarding the measures that had the biggest impact on their industry, existing data and impact assessments and seeking their advice regarding methodology. We also constructed detailed questionnaires by industry sector which probed economic impacts based on all that we had learned in Phase 1 of the project; and
- Identifying data sources and investigating applicability to the indicators.

We have structured our analysis around the impact these measures have on the banking, insurance and securities sectors. We then focused on market failures such as: abuse of market power; lack of competition; information asymmetries for consumers; externalities; and barriers to the free movement of services and/or capital. This allows us to identify the extent of the problem that the FSAP was to help solve and provides historical indicators to use as a basis of comparison to assess the impact of the FSAP.

1.2. THE CONCLUSION OF PHASE I

The FSAP is a highly complex set of regulatory changes and getting the methodology right at an early stage was vital in order to focus the analysis in phase II on areas that were most fruitful for assessing the impact of the FSAP both now and in the future (when this study might be updated). Although we have reviewed all 42 measures under the FSAP, it is important to remember that the objective of the report was to identify the impact of the FSAP as a whole and not attribute market impacts to particular measures. There are a number of methodological issues that arise:

- Enabling measures: we have distinguished between measures that would have a direct impact on the market (whether they be regulations, directives or communications) and enabling measures. In Figure 1 we set out the measures we directly associate to market impacts in different sectors. It is important to note that this does not mean that enablers did not contribute to significant positive market impacts, only that it is difficult to identify a separate causation. Enabling measures could take different forms:
 - communications that started a debate from which a new directive was created, such as the communication on investment restrictions on supplementary pensions. In this case, this has been incorporated into our assessment of a later directive but where the subsequent directive falls outside of the FSAP we have excluded these impacts,³ and
 - facilitating efficient regulation e.g. the creation of CESR. In this case, it is difficult to identify changes that resulted directly from the creation of the committee. Where the committee has improved the effectiveness of other measures, the impact would be captured in the effect of these other measures.
- Grouped measures: where measures impact the same set of indicators we have grouped them together. It is not possible to look at the impact of all 42 measures and identify their individual impact. Indeed, this is the aim of ongoing ex post evaluations by the EC rather than this report. In this way all measures have been covered in the report. This is preferable to focusing only on a small number of large directives which is necessarily arbitrary.
- Identified the counterfactual: to allow us to assess the impact of the FSAP that is independent from other trends ongoing in the market we need to define the counterfactual. For example, it is tempting to associate increased integration of financial markets to changes in the FSAP. However, if these trends are driven by improvements in technology this would be inappropriate. This would also miss impacts of the FSAP where they offset a change in the market that would have been unfavourable. This report sets out where we have been able to identify trends pre-

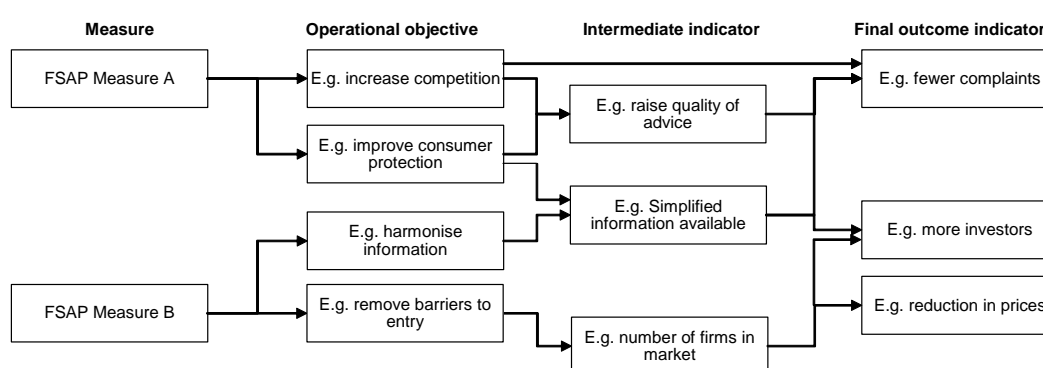
³ We exclude all measures that are included in the Financial Services White Paper. This includes the Directive on consumer credit, the proposal for a Payments Services Directive, Solvency II, the Code on Clearing and Settlement.

FSAP or suggest alternative counterfactuals that allow us to robustly identify the impact of the FSAP. Where the FSAP and market trends impact the same indicator it has not always been possible to identify changes and ascribe them to the FSAP. This is especially the case where very large market trends coincide with what would be expected to be relatively modest impacts from FSAP measures.

- Final outcome indicators and intermediate indicators: The ultimate objective of many measures is to reduce the cost of capital or increase consumer protection. In many cases directly identifying these final indicators is challenging. For example there is no comparable measure of the price of insurance across member states or even over time in many member states. However, on the basis of intermediate indicators we can still draw conclusions on whether the FSAP had an impact on the competitiveness of insurance and whether this is likely to reduce prices. For example, we can look at the entry of new competitors, concentration or whether passports have been applied for as intermediate measures. It is important to note that where there is no impact on intermediate indicators this shows where the FSAP has not had a market impact, but where there is evidence that intermediate indicators have changed, this does not prove that there *has* been a market impact.

The outputs of this report can be summarised in causality trees setting out the operational objectives, the intermediate indicators and the final indicators. This is illustrated in Figure 14 below. This is a key part of the methodology as this allows us to investigate the causality, as other trends and changes in the market could have been responsible for changes in the indicators. It also provides us with intermediate indicators that allow us to observe whether it is likely that FSAP impacted particular markets in the way that was anticipated (and that are useful indicators where the impact on the market is difficult to observe directly).

Figure 14: Methodology



Source: CRA analysis.

These causality trees were agreed with the EC's project team at the conclusion of Phase 1. We also set out the indicators to be collected, identifying the indicators that we should use to assess the impact of FSAP, the availability of this data or a methodology for collecting information.

1.3. APPROACH TO PHASE 2 - EMPIRICAL ASSESSMENT

In the empirical assessment phase we further developed the causality trees by gathering and mapping the necessary data onto them. We collected quantitative and qualitative evidence from country visits and analysed the impact of the FSAP by bringing together the various data sources, in particular:

- Interviews with CEBS, CESR, CEIOPS and European industry associations regarding the measures that had the biggest impact on their industry, existing data and impact assessments;
- Interviews with market participants including regulators, industry trade associations and individual providers in 12 member states. In total around 100 interviews were undertaken;⁴ and
- Interrogating public and commercial data sources that allow us to understand the impact of FSAP by comparisons over time or between geographies.

While this was a very challenging exercise because of the scope and complexity involved it was possible to find data which supported the indicators in most cases. A problem inherent to the assignment was the complex nature of the indicators. It was often challenging to define the counterfactual, and where there are obvious impacts appearing in the indicators these could be linked to factors other than the FSAP such as the advent of the euro, or, indeed, be the result of a combination of effects one of which could be the FSAP. In the final analysis we found the methodology, rooted as it was in the causality trees, to be robust and helpful in terms of disentangling the various possible effects. We believe, therefore, that we have been able to identify with some clarity the main effects of FSAP on our indicators and, by extension, the marketplace and have provided a methodology that is robust and replicable when FSAP is assessed in the future.

1.4. THE STRUCTURE OF THE REPORT

This rest of this report is structured as follows:

- Chapter 2 examines the methodological issues we face from a theoretical perspective;
- Chapter 3 applies the methodology to the banking industry;
- Chapter 4 applies the methodology to the insurance industry; and
- Chapter 5 applies the methodology to the securities industry.

⁴ We conducted face to face interviews in 12 member states. These were: Belgium, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Spain, Sweden, and the United Kingdom. Although the qualitative interviews are limited to these countries we have collected data on as wide a set of member states as possible.

2. METHODOLOGY FOR IDENTIFYING THE IMPACT OF FSAP

The overall aim of the project is to evaluate the impact of the FSAP as a whole. However, in order to understand the links between the FSAP and any economic impacts, it is necessary to identify the different effects that the FSAP measures have and to separate these effects from other drivers of economic impacts.

In this chapter, we set out our overall methodology for identifying the areas where FSAP would be expected to have an impact. In Chapters 3-5, we apply this methodology to different sectors.

There are a number of components to the overall methodology:

- Identification of market failures;
- Examination of the counterfactual;
- An economic model of the policy transmission mechanism and aggregating the impact of FSAP; and
- Identifying relevant indicators.

It is worth noting that the approach taken is a micro-economic based approach where the problems in the market are assessed, linked to the measures in the FSAP and the outcome compared to what would have previously been expected to arise. In particular, it is important to note that an implication of this is that economic benefits will only arise from financial regulation when there is a market or regulatory failure. So in assessing the impact of the FSAP, evidence regarding the extent of the market failure pre-FSAP is the natural starting point.

In addition, identifying an improvement in an indicator measuring a market failure that the FSAP sought to address is not sufficient evidence that the FSAP caused this effect. Instead, it is important to understand what would have happened in the absence of the FSAP interventions (the counterfactual) and also to set out a causal chain which demonstrates how the measures contained within the FSAP would have been expected to have an economic impact (particularly one which addresses the market failures identified).

The rest of this chapter further expands on the different elements of the overall methodology as listed above.

2.1. IDENTIFICATION OF MARKET FAILURES

It is well established that regulatory intervention should be aimed at addressing market failures rather than involve intervening in markets that are already well functioning. Benefits will therefore be expected to arise if measures address failures that are present

in the market.⁵ A reduction in market failures will be a clear indication of a successful intervention (subject to the rest of the methodology applying).

There are a wide range of different kinds of market failure that potentially arise within different markets and we consider these below. Identifying the type of market failure is important for the assessment as it suggests both the data that would need to be observed before the FSAP measures and also the indicators that are likely to show impacts after the FSAP measures.

2.1.1. Barriers to entry

Barriers to entry are obstacles that increase the cost of entering a particular market. There are a variety of causes of such barriers although one of the issues that is most pertinent to this report is that of regulatory barriers to entry. Such barriers could apply within national markets whereby entry in some countries is especially difficult because of particular rules or regulations in place.

However, one of the aims of the FSAP and the European Union more widely is the desire for a single European market (especially within the wholesale financial market). One of the key market failures that therefore needs to be identified is the extent to which there are different national barriers to entry. Such barriers have the effect of maintaining different national markets within the European Union. It may therefore not be the case that some member states have especially high barriers to entry compared to others, but rather that simply because member states have *different* barriers to entry this limits the ability to move towards a single market.

By contrast, as barriers to entry fall, the relevant market may increase such that rather than a series of primarily national markets, the European Union moves towards having one single market across all countries.

Thus in order to measure the impact of the FSAP it is helpful to:

- Identify potential barriers to entry that were in place before the FSAP and where the FSAP measures attempted to reduce or eliminate their effects;
- Identify whether there is evidence of either new entry being seen in new markets or an increase in cross-border activity;
- Examine whether convergence in the market outcome is observed in different markets; and
- Assess whether the economic impact of this is to exploit comparative advantage or exploit economies of scale allowing lower prices. Benefits would be expected to

⁵ In contrast, intervention where markets already work well will have detrimental economic effects i.e. will cause regulatory failures. However, in a market in which there is already considerable regulatory intervention, it is possible that some subsequent forms of intervention could then address previous regulatory failures and thus bring benefits.

arise because existing players are forced to be more competitive due to the threat of entry if they do not offer competitive products.

Given the strategic aim of the FSAP was to establish a single market in wholesale financial services, this will be a significantly bigger issue in wholesale market than in retail markets.

The removal of barriers to entry will tend to lead to enhanced economies of scale, lower costs, increased competition, and improved transparency. As such, we would anticipate that the removal of unnecessary barriers to entry will bring substantial benefits. However it should also be recognised that in some cases, barriers to entry are constructed in order to ensure that only “good” firms can enter a market e.g. capital requirements represent a barrier to entry but their total removal would bring concerns about defaults by banks. Thus there may need to be some consideration of whether the removal of a particular barrier increases risks.

It was noted above that two types of barriers to entry could be distinguished – those that apply only in individual member states and those that differ between member states. The difference between these types of barriers will impact the indicators chosen for measuring the effect of FSAP:

- Barriers to entry that apply to a particular member states and are addressed through FSAP are likely to see an impact in those member states. For example, in MiFID the so called “concentration rule” meant that trading could only arise on regulated stock exchanges and was applied in a small number of countries. The removal of this rule would therefore be expected to have a particular impact in those member states where it was previously in place.
- Barriers to entry that differ between member states and are addressed through harmonising measures in the FSAP are likely to see an impact in cross-border trading.

2.1.2. Market power

Linked to barriers to entry is the potential market failure that arises from companies that have large market shares that are able to raise prices and reduce output without competitive restraints preventing such prices rises from occurring. In the extreme, monopolies (if they are unregulated) will be able to set prices at a level that involves making excess profits.

Within the EU, DG Comp and National Competition Authorities (NCAs) have responsibility for assessing concerns regarding the abuse of market power and these responsibilities are unaffected by the FSAP measures. We would therefore anticipate that any evidence of market failures arising which are caused by an abuse of market would be appropriately dealt with by the competition authorities. Thus, identifying examples of such abuses will not be the focus of this analysis.

However, it is possible that as a single market is developed, companies that previously had national monopolies find themselves subject to competitive restraint from companies

in other countries as cross-border trading becomes more common. Similarly, other companies that have large market shares may also have been in a position where they can use bargaining power to exploit their market position, but a movement towards a single market reduces their ability to exploit such power.

Examples where national markets show evidence of becoming contestable to cross-border supplies will therefore be useful information in reducing the ability of companies to exploit market power. It may also be useful to examine information on concentration ratios and on pricing in order to establish whether increased competition leads to lower prices.

2.1.3. Asymmetric information

Many markets, particularly retail financial services markets suffer from the problem of asymmetric information in which consumers do not know as much information about products, services and prices as the companies which are supplying these products.

The effect of this is that consumers may be unable to make the best decision regarding their purchasing. In particular, price competition may suffer if customers are unable to compare supplier prices across the whole market. Weakened price competition could lead to higher costs than would be present in a perfectly competitive situation. Not only would this lead to higher prices but also to the supply of products or services being lower quality than it otherwise would be.

Even reasonably sophisticated firms may suffer from asymmetric information. For example, investors may seek to gather data on firms that they wish to invest in, but either a lack of data or a concern about the reliability of such information may change their willingness to make the investment.

Asymmetry of information may also arise from the firm or supply side perspective where firms rely on information to be given to them. For example, in the insurance market, insurers depend on information about customers and the risks they face in order to set a price that fairly reflects the chance of a loss. If insurers cannot determine the nature of a risk then the market may become inefficient because the insurer may have to incur considerable transaction costs in order to identify information about the client or, in the worst case, the market may disappear.⁶ Similarly, it may be the case that in the absence of regulation, firms may have to incur greater transaction costs in monitoring counterparty risk.

Due to the concern of asymmetric information, consumers often rely on intermediaries. Such intermediaries have greater information about the marketplace than the customer and are therefore able to reduce the transaction costs for customers in accessing the market. However, the result of using an intermediary is that once again the consumer

⁶ See Rothschild, Michael and Joseph Stiglitz. (1976) "Equilibrium in competitive insurance markets: an essay on the economics of imperfect information" *The Quarterly Journal of Economics*, Vol. 90, No. 4, pp. 629-649.

suffers from asymmetric information, but this time it is with respect to the intermediary rather than the insurer.

Asymmetric information may also generate different forms of risk that may not be adequately taken into account in the absence of regulatory intervention. Systemic risk is considered below in section 2.1.4, but other forms include the risk of default or operational risk. In the case of banking, such risks arise because of asymmetric information between the lender and the borrower (in the case of default risk) or because of asymmetric information between the lender and its employees (in the case of some forms of operational risk).

To overcome the problems associated with asymmetric information, financial regulators may:

- Require the disclosure of information in a prescribed manner in order to have consistency and comparability between different firms facilitating better decision making;
- Regulate the products to prevent particular products being sold to consumers where these are inappropriate or prevent product proliferation confusing consumers;
- Regulate the sales process that intermediaries use or clarify the conflicts and incentives they face;
- Enforce a complaints procedure or compensation scheme, so consumers have access to redress when things go wrong; and
- Educate consumers to try to reduce the asymmetry.

Given one of the strategic aims of the FSAP is to create open and secure retail markets, much of the FSAP has focused on consumer protection. Measuring the impact of improvements in consumer protection is difficult although there are a number of theoretical measures:

- Consumer complaints;
- Consumer sophistication;
- Financial crisis driven by issues such as mis-selling of particular products; or
- Consumer take-up of products (since mis-trust may be identified as the reason consumers do not use financial products).

The market impact associated to these measures often takes time to emerge and may be observable from the absence of events (such as mis-selling crises) or may be counter-intuitive (e.g. complaints go up as consumers know they can now complain). Hence understanding both the economic model expected to bring impacts and also the context of any market impacts is essential to the interpretation of information.

2.1.4. Externalities

Externalities arise when a particular action has an effect on a third party that is not directly involved in a particular transaction. As such those who are directly involved in the transaction do not bear all of the costs or benefits. Externalities can be positive – where other parties gain from the transaction, in which case there is likely to be an under provision of the particular good or service (since the parties to the transaction do not take into account the benefits that accrue to others). Alternatively, externalities can be negative – where other parties face a cost from the transaction, in which case there is likely to be an over provision of the particular good or service (since the parties to the transaction do not take into account the benefits that accrue to others).

Market failures can therefore arise in the case of both positive and negative externalities whereby the level of transactions absent any intervention is either under or over provided. It is therefore important to understand whether markets have externalities associated to them and, if so, the nature of these externalities since the impact of intervention will be affected by this element of the market. Network effects and contagion are both examples where externalities are typically present.

Network effects

Many markets such as payments and exchanges are characterised by network effects whereby the advantages to both buyers and sellers from trading in a particular market increase as the number of participants in the market increases. This brings potential advantages and disadvantages.

Network effects can be positive in the short run because bringing more buyers and sellers onto the same platform can increase the benefits to both. This is particularly seen in trading related markets such as exchanges. In these cases one of the key advantages of exchanges is that they bring together buyers and sellers. The more buyers and the more sellers that use an exchange, the better the liquidity position of these exchanges and the better prices that both buyers and sellers would expect to receive.

Examining any consolidation of exchanges or other platforms (such as securities depositaries) therefore can be a way of increasing positive externalities and bringing benefits to end users. By contrast if there is fragmentation of trading venues there is a danger that negative externalities result with lower liquidity and worse prices.

There is, however, a danger that network effects could be negative over a longer period of time because the cost of moving away from these particular platforms are substantial since they would affect such a large number of customers. Any new rival platforms may face difficulties in entering since even if these new platforms offer better services, the switching costs could be substantial. Thus there is a risk that dynamic competition is reduced.

Contagion

A particular form of externality that is of considerable importance in the financial services sector is the potential for contagion or systemic risk. The concern regarding this lies

directly behind the FSAP objective of strengthening the rules on prudential supervision. This is especially important in the banking sector where there is a danger that the failure of one bank can cause customers to withdraw funds from other banks because of fears that their bank may also suffer the same fate as the first. This becomes self-reinforcing as the demands from customers to withdraw any money they have deposited at different banks means that these banks may need to find more money than they have available on call. The runs on these other banks then end up causing problems for the customers of other banks. Indeed, the recent credit crunch has demonstrated some of the dangers of contagion in member states.

The cost of such events is widely recognised to be very substantial indeed. For example, such banking crises often lead to a reduction in lending, and the failure of businesses who are unable to meet obligations that, in more “normal” times they would not have had difficulty in discharging. For example, the cost of crises in Japan, Norway, Spain, Sweden and the US range from 3-17% of GDP.⁷ Reducing the risks of contagion can therefore be of substantial benefit to an economy, although difficulties exist in relation to establishing the risk of contagion in the first place.

The difficulty of observing the market failure caused by contagion leads directly to a difficulty observing a positive market impact. For example, it is possible to observe that better prudential supervision allows financial services companies to use their capital more efficiently and use more sophisticated methods for determining the capital they require. However, it is much more difficult to determine where the risk of a banking crisis has increased or decreased. For this reason, we will often focus on intermediate indicators in this area, which we discuss further below.

2.2. COUNTERFACTUAL

One of the key elements in understanding the impact of the FSAP is to examine what would have happened in the absence of the FSAP i.e. what the relevant counterfactual is. In undertaking assessments of market impact the counterfactual is commonly investigated by looking at:

- Indicators before and after the introduction of the regulatory change (implicitly assuming that other things remained the same during this period); and
- Markets that were and were not affected by the regulation (as they already had the regulation in place, were exempt, or introduced the regulation later).

There are a number of factors that mean it is difficult to identify the counterfactual when looking at the impact of the FSAP and that need to be taken into account. We consider these below.

⁷ See World Economic Outlook, IMF 1998, as quoted in Matthews and Thompson, *The Economics of Banking*.

2.2.1. International regulation

Financial services regulation in Europe does not occur in a vacuum but rather must be examined against regulatory changes that are arising globally. However, this poses a difficulty in terms of understanding the appropriate counterfactual for assessing the impact of the FSAP. There are various measures within the FSAP which reflect international regulatory changes including:

- Code of Conduct on Business taxation and the Savings Tax Directive, the impetus for which at least partly came through discussion at the level of the OECD regarding harmful tax competition;
- Regulation on the application of International Accounting Standards (IAS) which introduced the IAS into the EU;
- Financial Action Task Force on Money Laundering (FATF); and
- CRD which implemented within the EU the global requirements under Basel II.

In each of these cases, it is arguable that changes or political pressure on a global level would have brought about changes in member states even if the measures above had not been taken within the EU. Thus even if the FSAP had not included these measures, it is possible that similar effects could have been caused through global decisions.

However, in each case it is impossible to know what alternative regulatory approach each member state would have taken, the degree to which this would have varied within Europe, or when it would have taken such a measure.

Since there is uncertainty regarding whether (or how) such measures would have been implemented within the timeframe for the FSAP, it is not practical to assess the FSAP compared to these unknown alternatives. For this reason, we consider the appropriate counterfactual to be that of no change in regulation rather than an alternative form of regulation based on the international standards. Alternative approaches would be to assume that:

- The full effect of these measures exactly replicated the effects that would have arisen had the measures been implemented only through the international legislation. This would then lead to the conclusion that the FSAP had no economic effect in these areas (since the effect arose because of the international measure); or
- International regulation was followed but this was not harmonised within Europe. In some cases, it may be possible to use the development of markets in non-EU countries as examples of what would have happened absent the FSAP in the EU (since, by definition, they did not implement the FSAP), but this would not be likely to capture the differential approaches taken by different member states and thus the lack of effect regarding cross-border trade which may have been expected from harmonisation.

For the purposes of this project we therefore assume that the appropriate counterfactual is the absence of the measure rather than a different measure.

2.2.2. Regulations in other countries

In determining whether the development of financial markets in other countries could form a useful counterfactual for the assessment of the FSAP, it is also important to note that in the same way that EU member states faced the FSAP, other countries may have faced alternative regulatory measures or conditions which will have affected their national markets.

For example, in the case of the US, Sarbanes-Oxley brought considerable regulatory intervention which may have led to US financial markets not developing as quickly as would otherwise have been expected. For this reason, comparing indicators in the EU with those in the US would be likely to give a mis-leading view of the counterfactual for the EU.

Similarly, in this particular case, one of the effects of Sarbanes-Oxley may have been to cause business that would have occurred in the US to relocate to being conducted in Europe. For example, it is noted that before Sarbanes-Oxley, New York attracted nine out of ten of the largest international Initial Public Offerings (IPOs), but in 2006 attracted only one out of ten.⁸ If it is the case that Sarbanes-Oxley caused business to migrate to Europe, then this effect would need to be taken into account in the counterfactual since to ignore this effect would be likely to lead to an overstatement of the growth in IPOs if this is a relevant measure for assessing the impact of the FSAP.

For the purposes of this assignment we will therefore tend to favour counterfactuals from within Europe. Comparisons with other market, most importantly the US, will be most useful for assessing the importance of global trends in the securities market.

2.2.3. Trends

In understanding the counterfactual, it is also necessary to understand the trends that were arising in various parts of the financial services market before the FSAP measures had any effect and that are likely to have carried on even in the absence of the FSAP. In the absence of understanding these trends, the impact of the FSAP is likely to be overstated where the trends were moving the market in the same direction as the FSAP measures, and to understate the impact of the FSAP where the trends were moving the market in the opposite direction as the FSAP measures.

Some of the trends that need to be taken into account include technological developments which may have affected a number of different areas including:

⁸ Selling the City Short? A Review of the EU's Financial Services Action Plan, Open Europe in association with Keith Boyfield Associates, November 2006.

- The willingness of retail consumers to purchase through remote distribution channels and hence the opportunity for retail financial services companies to offer cross-border services; and
- Improved speed of transactions in trading which may reduce one element of transactions costs in trading and therefore increase the ability to trade or the demand for trading.

In addition, technology may itself impact the effectiveness of some directives. For example the Distance Marketing Directive may not have been needed or may not have had a significant effect if technological developments had not enabled distance marketing to take place.

Trends in areas such as pensions where governments across the EU are gradually reducing the generosity of public pension provision through the state and are instead encouraging individuals to make their own provision is likely to lead to a greater demand for pension provision irrespective of the FSAP measures aimed at improving this part of the market.

The importance of taking into account trends depends on whether the indicators likely to be affected by the FSAP are the same indicators that are trended. For example, it is clear that merger and acquisition (M&A) activity was increasing the integration of European insurers prior to the FSAP (probably aided by previous EU directives) and therefore associating a high level of M&A in the late 1990s and early 2000s to the FSAP would be inappropriate. Hence trends in market integration and market structure need careful examination.

2.2.4. Subsequent measures

Regulatory measures taken by the EC have not arisen only during the period of the FSAP. Instead, measures existed before, and other measures have been developed alongside the FSAP or subsequent to the FSAP implementation period. Separating the effects of the FSAP measures from other measures, especially those that have arisen after the FSAP is not a trivial exercise. There are a number of examples where subsequent measures are particularly important:

- In the insurance arena, Solvency I is being replaced by Solvency II;
- In respect of payments, the FSAP contained the proposal for a New Legal Framework for Payments (NLF) which has subsequently led to the Payment Services Directive (PSD) although the PSD is substantially different from the original proposals within the NLF; and
- In the post-trading area, there have been a number of subsequent regulatory developments including the Code of Conduct and Target 2 Securities.

Equally there are measures where the FSAP regulation re-stated a position that had already been established under previous directives. The subsequent measures that have been pursued therefore complicate the question of disentangling the impact of the FSAP

from the counterfactual. For example, it is not likely that the PSD would have arisen in the absence of the NLF, however, now that the PSD has occurred, it may no longer be possible to identify the impact of the NLF as opposed to its replacement through the PSD.

2.2.5. Timing

The final component of establishing the counterfactual is one of timing. The FSAP contains 42 different measures, the development of which arose over a period of time and the implementation of which occurred at different times for different measures. As such, it is not sufficient to consider the relevant indicators at the beginning of the FSAP and compare these to the indicators at the end of the FSAP.

Instead it is important to consider when different measures would have been expected to have an effect and to examine the counterfactual from that point onwards in particular areas. Understanding this timing will vary between different measures and is not as simple as examining when measures were transposed into domestic legislation. In some cases, firms may start to operate in line with FSAP measures in advance of this being a requirement in which case we would expect to see the effect arise before legislation takes effect. In other cases, however, firms may be unable to change their behaviour until the legislation is in place. For example in the case of a measure which removes a barrier to entry, firms will only be able to enter the market at low cost once this has been removed and not before. It should be noted that there could be examples where costs are incurred in advance of the implementation of measures as systems are changed in preparation for new requirements, but where market impacts do not arise until afterwards (see discussion in section 2.4.4 below regarding compliance costs).

Where countries adopted FSAP measures at differential speeds this may be useful in examining the impact of FSAP.

Furthermore, the impacts of the FSAP will continue to work themselves out over the course of many years. This is especially the case for those measures which have only recently been transposed into domestic legislation. Thus impacts which are observed during the course of this report may not be the totality of impacts that will ultimately arise from the FSAP.

2.2.6. Interviews

The final component of the methodology in respect of identifying the counterfactual that should be noted is that an empirical analysis alone does not enable us to disentangle the counterfactual. It is essential that information is gathered from different parts of the financial services industry itself in order to establish the behaviour of firms in the absence of FSAP measures and how this was affected by the FSAP. In the Appendix we set out the interviews undertaken in this project.

For example, the IMD brought in requirements regarding the regulation of insurance intermediaries and might have been expected to have led to a reduction in the number of intermediaries in many member states. However, in some member states the number of registered intermediaries increases dramatically following the IMD. Absent other

information, this could be interpreted as suggesting that IMD led to entry. In practice, however, it reflects the changing scope of the register in some member states where intermediaries who would not previously have been registered are brought under regulation.

Thus the overall impact of FSAP can only be robustly identified by a mixture of quantitative and qualitative analysis.

Choice of member states

We undertook face to face interviews with regulators and industry participants in 12 member states: Belgium, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Spain, Sweden, and the United Kingdom.

There are a number of factors that have led to this selection of member states including:

- Regulation pre-FSAP: In France, Italy and Spain, the concentration rule applied before MiFID suggesting that these countries should be included as we might expect to see the most significant impact where a barrier to entry has been removed. Similarly, in the insurance sector, investment restrictions were removed in France.
- The impact of other effects. The effect of the introduction of the Euro is highly significant and will have had a substantial impact on cross-border investment decisions. Including countries such as the UK and Sweden which have maintained a national currency may enable some of the Euro effects to be taken into account.
- Method of implementation: For example, in the insurance and pensions arena, Belgium, Ireland, Luxembourg and the Netherlands are seen as the jurisdictions that have tried to take advantage of the opportunity for pan-European pensions
- Structural differences: In the banking sector there are considerable differences between member states. Some member states, such as Germany and Italy, have a highly fragmented banking structure with a large number of small banks. Similarly, the insurance industry was fragmented in Poland and Spain. Other member states have a much more concentrated banking sector (such as France, the Netherlands, and Sweden). We would therefore expect both the impact of CRD and the various measures relating to payments to vary between member states of these kinds.
- Relative size of financial services markets: France, Germany, Italy, Spain and the UK have the largest economies and largest financial services markets in the EU 15. Recent research also found that these member states contributed most significantly to EU wholesale finance. Since many of the more significant measures in the FSAP have been focused on wholesale markets we might expect to see significant impacts in these countries.
- Cross-border consolidation: Consolidation has been observed in the securities markets in Belgium, France, the Netherlands and Portugal with the creation of Euronext.

- Speed of implementation: The speed at which countries introduced some insurance directives varied significantly. For example Germany implemented IMD later than other countries which may allow for a comparison between Germany and other member states. In other countries, such as Poland, we need to be careful regarding whether the FSAP directives were implemented prior to joining the EU.

Although the qualitative interviews are limited to these countries, where possible we have collected data on as wide a set of member states as possible.

2.3. AN ECONOMIC MODEL OF THE IMPACT OF THE FSAP

It is important to set out exactly how the various FSAP measures would be expected to have an impact on different parts of the financial services market. In order to do this we set out a causality tree which explains how the FSAP measures cause other effects which ultimately impact the market. This is for two reasons:

- First, it provides a rigorous micro-economic based reason for why we would expect measures to have a theoretical impact on the market and hence provides us with confidence that this is not driven by other factors; and
- Second, it allows us to observe the impact along the causal chain. This provides intermediate indicators that the measure impacted the market which is especially important if it is not possible to observe the final indicator, or providing evidence that the chain of causality is broken at some stage explaining why there is little ultimate impact.

For example, UCITS III contained provisions for a management company passport enabling management companies to operate throughout the EU. The aim of this was to reduce the costs of entering different markets, thus the chain of causality could be as follows:

- UCITS III allows for a management company passport;
- Companies use the management company passport;
- This reduces the cost of managing funds domiciled in other member states and so would be expected to increase cross-border trade; and
- In turn this results in greater efficiency and lower prices for investors.

Thus, it would be possible to assess whether companies have actually taken advantage of the management company passport. If this has not happened (as appears to be the case) this would eliminate any subsequent steps in the chain, as we can already observe there is no impact from this particular measure.

Other examples where FSAP measures require the disclosure of information would depend on similar chains whereby firms comply with the regulation, consumers (or other firms) obtain and understand the information, and consumers then change their behaviour

on the basis of this information. Again, if any of these steps are missing, we would not expect FSAP measures to have an effect.

In this regard, it should be noted that the extent to which the chain of causality is fulfilled could vary over time. For example, it may be the case that at present consumers do not understand information that is disclosed, but that over time, the efforts made by various regulators to improve financial capability lead to greater understanding which would then be expected to lead to a greater economic impact in the future than can currently be identified.

SE Regulation on the statute for a European Company

The Regulation regarding operating as a European Company (Societas Europaea or SE) is one example of a measure aimed at reducing barriers to entry between member states. The statute gives companies which are established in more than one member state the option to operate throughout the EU under a single set of rules as a European Company. The chain of causality that would be expected would therefore be that operating as an SE allows companies to avoid administrative and legal costs associated with having to abide by several national laws. Since this reduces barriers to entry we might expect to see more entry into other member states by companies that have an SE status. However, in practice, few companies have currently chosen to become a SE and hence we do not need to consider the impact of this particular measure any further.⁹

Code of Conduct on business taxation

The Code of Conduct on business taxation flowed from discussions at the OECD regarding harmful tax competition. The Code was designed to detect measures that unduly affect the location of business activity by giving non-residents preferential tax treatment over what is usually available in a member state. It was aimed at providing a “political commitment” for member states to curb harmful business taxation practices. However, in practice the Code is not legally binding and the effects are understood to have been limited. For these reasons we do not consider this Code further in the report.

2.4. IDENTIFICATION OF INDICATORS

The final aspect to the methodology is to identify the indicators through which the FSAP effect can be observed. In order to do this, it is particularly important to link together:

- the state of the market before the FSAP measures – which combines the effects of both the market failures and the counterfactual; and
- the expected impact of the FSAP measures – which combines assessing the effects of the different types of measures that were undertaken and the causal chain that explains the mechanism by which the FSAP measures would have an effect.

⁹ In 2008 the EC commissioned a specific study on the impact of the SE regulation. See: http://ec.europa.eu/dgs/internal_market/calls_en.htm (call for tender MARKT/2008/19/F).

Although this is challenging to undertake, differences between member states or non-EU countries can be especially valuable. For example, member states may have suffered from different market failures before implementation of the FSAP and thus measures which would have been expected to address these particular market failures would clearly have the greatest effect in those particular member states and a somewhat smaller impact in the member states that did not suffer from the market failure in the first place.

2.4.1. Communications compared to directives

Within the FSAP there are different measures ranging from regulation, to directives, communications and recommendations. There are clear differences in the implications for member states of these different measures and as such we might expect different impacts to be observed from these measures. For example:

- Regulations are applicable in all member states without additional legislation - the Regulation on cross-border payments in Euro did not need to be transposed by member states;
- Communications would typically set out the EC's views on an issue which may include recommendations for future action - the Communication on Article 11 of the ISD made proposals for how client categorisation should occur although this ultimately had an impact in MiFID;
- Directives (which make up the bulk of the measures) specify what has to be done at member state level although there is typically freedom in some of the details of this. These have to be transposed into each member state which may therefore arise at different times and lead to different interpretation; and
- Recommendations do not have the same force of law as Directives and thus member states may have more flexibility in their response to them.

However, from an impact assessment perspective it only matters whether the measures resulted in a change in the behaviour of regulators, firms or consumers.

2.4.2. Enablers

There are a number of measures within the FSAP that could not be considered to have an effect in themselves but rather ensure that other measures within the FSAP have the effect that was intended or may affect the way in which other measures are pursued. We refer to these as "enablers". These include:

- Retail financial services – overcoming remaining barriers;
- Creation of a Securities Committee and the Lamfalussy process;
- Exchange of information with third countries;
- Action Plan to prevent fraud; and

- Corporate Governance Action Plan.

Retail financial services – overcoming remaining barriers

The European Commission published a report examining the legal barriers in retail financial services. The publication of the report itself fulfilled the requirement under the FSAP to report on the substantive differences between national arrangements relating to consumer-business transactions.

In and of itself, the publication of a report regarding legal barriers in retail financial services has no economic impact. The report identifies a number of issues surrounding marketing rules and contract law.

- In the case of marketing rules, it was noted that financial services providers often have to respect local marketing rules and since it would be difficult to apply marketing practices from other member states, the report recommends overcoming fragmentation through harmonisation which would reduce the difference between home and host country standards.
- In the case of contract law, it was noted that this is “deeply interwoven” with national civil laws making harmonisation almost impossible and mutual recognition the preferred approach.

It is possible that the publication of the report influenced the manner in which other measures were pursued; in particular whether harmonisation or mutual recognition was the preferred approach. In as far as this did arise, however, the economic impact of such effects would be seen through other measures.

Although the issues were mainly aimed at considering the implication in retail financial services, many of the comments made could also be seen to apply to other objectives. Thus in as far as this is an “enabler”, its influence could potentially go across all four objectives from the FSAP.

Creation of a Securities Committee

The European Securities Committee and the Committee of European Securities Regulators (CESR) were created as part of the FSAP. The Lamfalussy process more generally also led to the creation of CEBS and CEIOPS.

In and of itself, the creation of the Committees has no economic impact. Any impact arising from the Committees will only occur from actions that are taken in the Committees and lead to other forms of legislation, better (or different) legislation than would otherwise have arisen or enforcement of existing legislation.

It is likely that the Committees are an important part of ensuring that other components of the FSAP are appropriately implemented in a manner that is consistent across member states and have the intended effect. For example, the Committees may provide guidance on how an Article in a Directive should be interpreted. The impact of this would then be

seen through the implementation of the Directive where that particular Article would see a more harmonised interpretation than in the absence of the Committees.

However, in as far as this has an impact, this will be seen through the effect of the implementation of the Directive being greater than otherwise and as such the benefits of the Committees will be seen through the effectiveness of other measures. For this reason, we do not provide further details of the impact of the Committees that are separate from other measures. The market impact will be captured in looking at measures that directly affected the market. Given there are a number of Committees, these will “enable” measures in all three of the sectors considered.

Exchange of information with third countries

This Directive amended various insurance directives and the Investment Services Directive (ISD). The Directives enabled information to be exchanged between competent authorities and with certain other authorities or bodies within a member state or between member states as well as allowing for cooperation agreements providing for the exchange of information with the competent authorities of third countries.

The effect of this would be expected to lead to improved enforcement of other directives the information related to which is shared. As such the effect of this measure would be seen through these other measures. The impact of this would be expected to arise in the securities and insurance sectors.

Action Plan to prevent fraud and Corporate Governance Action Plan

COM(2001)11 on preventing fraud and counterfeiting of non-cash means of payment was aimed at improving the security and efficiency of these types of payment and thereby encouraging consumer confidence in using these methods. This was a particular concern for cross-border fraud which was believed to be much higher than domestic fraud.

The Communication contains a “Fraud Prevention Action Plan” which sets out action points for the Commission, as well as for the payment systems industry. This Action Plan was evaluated in 2004 which led to a new Fraud Prevention Action Plan 2004-2007 (outside the scope of the FSAP). It is understood that a significant portion of the work in fraud prevention would be done by card schemes anyway as they have the incentive to reduce fraud.¹⁰

The Corporate Governance Action Plan (CGAP) – COM(2003)284 - was a Communication which reviewed corporate governance practices. The aim of the plan was to foster efficiency and competitiveness of business by providing a flexible and

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A report on the completion of the 2004-2007 Action Plan was published by the Commission in April 2008 at: http://ec.europa.eu/internal_market/payments/fraud/index_en.htm.

dynamic corporate governance framework in the EU. In particular, it was aimed at enhancing shareholder rights and contained a number of different actions.¹¹

Among FSAP measures, the Action Plan to prevent fraud and the CGAP are unusual since they represent communications regarding actions for the future. Many of these actions have themselves resulted in (or enabled) Recommendations and Directives although these are outside the scope of the FSAP.¹² For this reason, we do not consider either the Action Plan to prevent fraud or CGAP in the remainder of the report.¹³

Methodological implications from enablers

There are a number of implications for the overall methodology of assessing the economic impact of the FSAP that flow from this section:

- In the case of enablers, the economic impact from particular measures will be seen through the measures which they “enable”. Thus it is not necessary to consider the enabling measures separately from the measures they enable.
- The methodology must be on the basis of the measures as actually implemented and not an “unobserved” alternative of what could have happened in the absence of an enabling measure. For example, in the absence of direction from CESR the interpretation of eligible assets under UCITS may have been different which may have weakened the impact of the UCITS Directive compared to that which did arise. However, this is not a circumstance that actually arose from the overall impact of the FSAP and, since the aim of the report is to evaluate the economic impact of the whole FSAP, it is not necessary to decompose the effect of the UCITS Directive on the one hand, and the CESR interpretation on the other hand.
- The evaluation is based only on the measures outlined in the FSAP Evolution Chart and does not take into account implications for future policy making that may have arisen, or may no longer arise, because of some of the measures in the FSAP. For example, the legal analysis of barriers to retail financial services indicates that mutual recognition is preferred over harmonisation in areas of contract law. It is therefore possible, that areas where harmonisation would bring benefits have not subsequently occurred because of the principles outlined in the legal analysis report.

11 The Commission services consulted in 2005/2006 about the medium/long term priorities for the action plan. The consultation document and the results of the consultation, including a hearing, are available at: http://ec.europa.eu/internal_market/company/consultation/index_en.htm. Following this consultation, the Commission altered its priorities.

12 For example, Directive 2006/68/EC on the formation of public limited liability companies and the maintenance and alteration of capital, and Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies

13 It is also possible that if measures which result from the CGAP subsequently lead to changes in market practice that this could lead to additional benefits arising from other measures contained in the FSAP such as those relating to the Transparency Directive since the ability to obtain information combined with the ability to influence corporate governance could lead enable investors to bring greater pressure on firm behaviour.

Similarly, it is possible that mutual recognition has been pursued in areas which have brought benefits. However, the methodology should not take into account either the impact of potential legislation that has not arisen; or the impact of measures compared to others which *could* have arisen. This is because appropriate counterfactual in both cases is the *absence* of measures under the FSAP rather than *different* measures.

2.4.3. Implemented measures are not the same as the proposed measures

Related to the issue of enablers and the principle that the appropriate counterfactual to be used is that of the absence of measures rather than different measures, is the treatment of “gold plating” where member states apply more stringent requirements than those set out in the FSAP measures.

The market impacts that have actually arisen will be a function of the measures that are implemented. This will include both those areas where member states have gold plated directives and also those areas where member states have implemented measures in a more “light touch” manner than was envisaged by the FSAP.

In terms of identifying indicators through which the FSAP measures can be assessed, therefore, there are two alternatives:

- The first is to examine the actual outcomes (which can usually be observed) and compare to the counterfactual of no FSAP (which is unobserved);
- The second alternative is to compare what would have happened if FSAP had been implemented with “no gold-plating” (which is unobserved) and to compare this to the counterfactual of no FSAP (which is unobserved).

The former case is preferred since it involves using actual market outcomes rather than attempting to establish a second counterfactual relating to “no gold plating”. Furthermore, it retains the principle of making comparisons on the basis of what did happen rather than an alternative of what *could* have happened. Arguably, where FSAP introduced measures that were minimum requirements, the way that the measure was implemented still arose due to the implementation of FSAP.

In addition, it is not possible to conclude that all member states would have been willing to implement FSAP measures in the absence of the ability to add additional constraints appropriate to their domestic market conditions and thus it is not apparent that the counterfactual of no gold plating could be considered to be a realistic alternative.

Finally, the aim of the report is to evaluate the impact of the FSAP and we need to be pragmatic. Thus the evaluation can only be conducted by assessing how member states chose to implement the FSAP (including the gold-plating or other interpretations that they made) even where this brings differences between member states. However, where the market impact of the FSAP varies significantly between seemingly similar countries the impact of gold-plating will be investigated. This in itself highlights the importance of qualitative interview evidence where interviewees can comment on where regulatory changes represent gold-plating rather simply reflecting the original FSAP measures.

2.4.4. Compliance costs

The introduction of measures associated to FSAP are likely to have imposed compliance costs on the financial services industry. Compliance costs will lead to market impacts. The costs may have taken different forms including:

- the cost of switching from meeting one type of regulation to another type of regulation;
- large fixed costs which need to be incurred in order to develop new systems or processes to meet the requirements of the new measures; and
- changes to the variable or ongoing costs of meeting regulatory requirements.

The EC has commissioned a separate report examining the compliance costs of the FSAP. We have not sought to gather compliance costs related to all of the different FSAP measures. However, the level of such costs may be an explanation for why theoretical impacts from FSAP measures may not have arisen in practice. In particular, there may be circumstances where the level of compliance costs have a significant impact on the behaviour of firms regarding issues such as entry to certain markets or making particular behavioural choices. Where this is the case we have sought to understand the market impact that such costs are having.

In each of these cases, the effect of compliance costs is to reduce the attractiveness of operating in the particular market. This could lead to a variety of different effects including:

- A reduction in the number of firms competing in the market – this could especially lead to a reduction in the number of small firms for whom the fixed costs of complying may be too great to continue in the market;
- Switching away from locations or regulatory models where compliance costs are incurred and towards those where they can be avoided; and
- A reduction in searching or switching by customers if the increase in ongoing costs for the supplier also increases the search cost for the customer.

Therefore evidence on compliance costs from impact assessments, CBAs or from information collected from the parallel project on compliance costs will be used to focus the examination of market impacts.

2.4.5. Sectoral assessment

Finally, from a methodological perspective we note that collecting information on the appropriate indicators and the impact of FSAP measures is more easily undertaken on a sectoral basis than by grouping the indicators according to the original operational measures of the FSAP namely:

- Establishing a single market in wholesale financial services;

- Making retail markets open and secure;
- Strengthening the rules on prudential supervision; and
- Improving wider conditions for an optimal single financial market.

This enables interviewees representing different sectors to assess the impact of the whole of the FSAP measures compared to the counterfactual whereas the operational objectives do not match as easily to the economic markets in which firms operate.¹⁴

¹⁴ It is also important to be mindful that some economic markets may cross sector boundaries. For example, lowering barriers to cross-border activity on investment funds could increase competition in the savings market as a whole and so impact the banking sector as well as the securities sector.

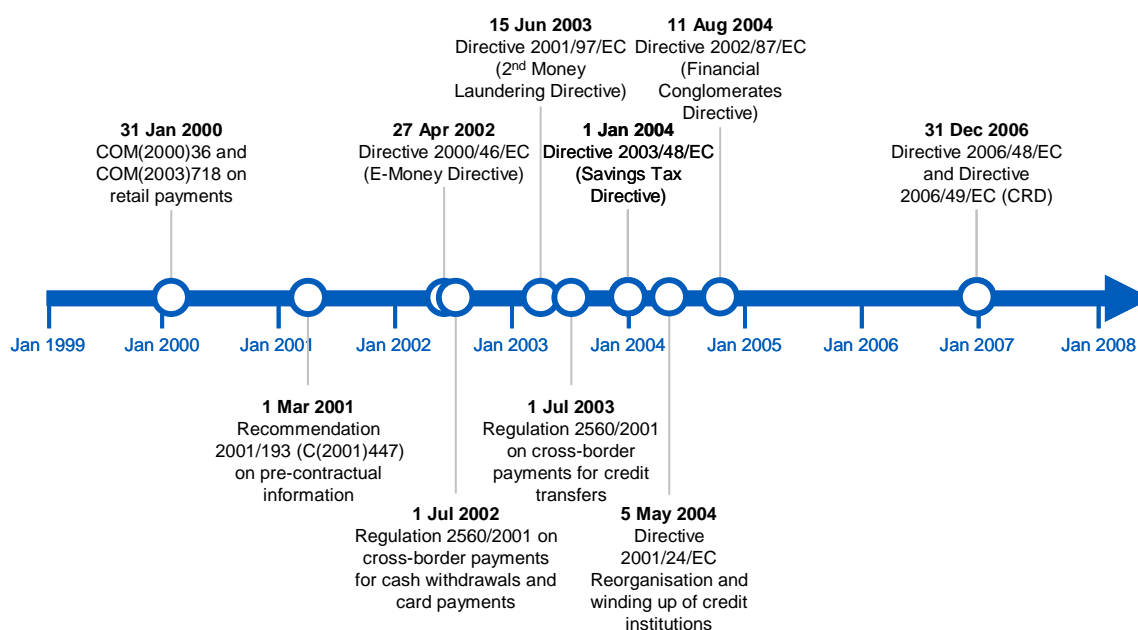
3. BANKING

There are several Directives, communications, recommendations and regulations related to the banking industry in the FSAP. These include:

- Recommendation 2001/193 (C(2001)447) on pre-contractual information to be given to consumers by lenders offering home loans;
- COM(2000)36 and COM(2003)718 on retail payments and a new legal framework for payments in the Internal Market;
- Regulation 2560/2001 on cross-border payments in euro;
- Directive 2001/24/EC on the reorganisation and winding up of credit institutions;
- Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions (E-Money Directive);
- Directive 2001/97/EC amending Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering – Commission Declaration (2nd Money Laundering Directive);
- Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast) (CRD);
- Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (Financial Conglomerates Directive); and
- Directive 2003/48/EC on taxation of savings income in the form of interest payments (Savings Tax Directive).

Figure 52 sets out the timeline for the publication of these measures. This refers to the publication date of communications, the date at which regulation comes into force and the deadline for transposition of directives. This clearly does not represent when particular countries transposed them which could be earlier than the deadline or in some cases after the deadline.

Figure 15: Banking



Source: CRA analysis.

Although many of the banking measures occurred prior to 2005 the most significant measure within the banking sector is CRD which had to be transposed by 31st December 2006, and came into force in January 2008. As such there has only been a short time in which impacts could emerge because of the CRD.

However, the timing of CRD coming into force coincided with the sub prime crisis and the credit crunch which developed during 2007 and 2008 and which is still causing severe stress in the banking sector at the time of writing. Indeed, this crisis reached a very critical point in September and October 2008, requiring radical government intervention in many countries to stabilise the situation. It is therefore especially difficult at this stage to attempt a full evaluation of CRD using quantitative measures. It should also be noted that the interviews for this research took place during the spring and early summer of 2008 and were therefore conducted before the difficulties of September and October 2008. Subsequent developments have demonstrated weaknesses and gaps in the CRD framework.

3.1. MARKET AND REGULATORY FAILURES

The various measures within the FSAP that applied within the banking sector were partly aimed at dealing with various market failures and regulatory failures that existed in this sector pre-FSAP. These are considered below.

3.1.1. Limitations of existing prudential regulation - Basel 1

Prior to FSAP, the Capital Accord (Basel I), a non-binding agreement adopted by the Basel Committee on Banking Supervision in 1988, introduced minimum capital

requirements for all internationally active banks for the first time. The framework had been built around two main concepts. The first is an agreed categorisation of bank capital between core capital and supplementary capital. The second is risk weights, which vary crudely to reflect the relative risk of lending to different classes of counterparties. The framework was initially directed towards assessing capital in relation to credit risk. Basel I introduced a minimum target ratio of capital to risk weighted assets of 8%. A later amendment in 1996 introduced specific additional capital requirements with respect to market risk.¹⁵ These standards were adapted to EU circumstances and applied through Directives, notably the Banking Coordination Directive and the Capital Adequacy Directive.

In recent times there has been widespread agreement that Basel 1 does not meet all the requirement of the market. Indeed, the main justification for CRD arises through the shortcomings of Basel I. One of the main shortcomings of Basel I is the lack of risk sensitivity, i.e. regulatory capital requirements do not very accurately reflect risk. It also failed to address changes in credit quality of counterparties over time. The EC noted the following shortcomings with the previous framework:

- Crude estimates of credit risks result in simplistic measurement of risk and the system was therefore in danger of falling into disrepute;
- Scope for capital arbitrage: innovations in markets have enabled financial institutions to effectively arbitrage the mismatch between institutions' own allocation of capital to risks and minimum capital requirements. In effect, the Basel 1 system was capable of being "gamed" by sophisticated banks;
- Lack of recognition of effective risk mitigation: the previous Directives did not provide appropriate levels of recognition for risk mitigation techniques;
- Incompleteness of the risks covered under the existing directives, including operational risk, which was not subject to any capital charges;
- Absence of a requirement for supervisors to evaluate the actual risk profile of credit institutions to satisfy themselves that adequate capital is held having regard to that risk profile;
- Absence of requirement for supervisory cooperation: in an increasingly cross-border market authorities must cooperate effectively with each other in the supervision of cross-border groups to reduce regulatory burdens; and
- Absence of proper market disclosures: the previous Directives do not facilitate effective market discipline through provision of reliable information for market participants to make well-founded assessments.¹⁶

¹⁵ HM Treasury, "The new Capital Adequacy Directive, CAD 3: The transposition of the new Basel Accord into EU legislation", December 2003.

¹⁶ European Commission, "COM(2004) 486", 14 July 2004.

The old EU system thus lacked the flexibility to keep pace with rapid developments in financial markets and risk management practices, and with improvements in regulatory and supervisory tools. Regulatory failure due to the increasingly obsolete nature of Basel 1 was increasingly possible.

3.1.2. Risk associated to money laundering

Money laundering is seen as a particular problem for the financial services industry. Regulation against money laundering is seen as an important part of the package of tools used to maintain market stability and the reputation of the financial sector by protecting the sector from the harmful effects of the proceeds of crime. To tackle these threats a number of regulatory approaches are adopted in terms of identifying the owner of the assets and monitoring transactions. The level of crime, although it imposes an economic cost, is largely a social and political problem rather than a market failure. However, the impact of money laundering can result in market and regulatory failures, for example:

- Confidence in the money laundering rules can affect confidence in the market place as a whole;
- Differential rules on money laundering can affect where financial activity takes place; and
- The regulation used to reduce the risk of money laundering imposes a compliance cost on the financial services industry, which may itself affect industry structure.

3.1.3. Fragmented home loans markets

Prior to the FSAP the home loans market in Europe was highly fragmented and was working primarily along national lines. This was seen to partially reflect significant differences in the types of product demanded in different countries but also reflected the different legal, regulatory and tax systems. One identified barrier to cross-border integration was the requirements regarding information given prior to sale which varied significantly between member states. The differences between home loans offered across member states are illustrated by:

- Significant differences in the price of mortgages (looking at the difference between the mortgage rate and the risk free rate in different member states); and
- The different types of loan offered in different markets.

In addition to national home loans markets varying significantly, there was very little cross-border lending or foreign entry into national mortgage markets.

3.1.4. Barriers to cross-border payments

Prior to the FSAP, the charges associated to cross-border transfers had to be transparent and disclosed to the consumer.¹⁷ However, studies demonstrated that the level of charges for cross-border transfers was significantly greater than that for domestic payments. It was estimated that in 2001 cross-border charges for a transfer of €100 were in the order of €24 whereas in 1999, domestic charges were estimated as being less than €1.¹⁸

3.2. MODEL OF THE IMPACT OF THE FSAP

It is possible to link the various measures both to operational objectives as well as the strategic objectives. The majority of directives applying to the banking sector relate to prudential supervision.

Table 2: Linking measures to operational objectives in the banking sector

Measure	Strategic objective	Operational Objective
Pre-contractual information on home loans	Creating open and secure retail markets	Harmonisation of information
New legal framework for Payments		Improve efficiency of retail payments
Cross-border payments		
Winding up	State-of-the-art prudential rules and supervision	Reduce regulatory requirements regarding bankruptcy; Consumer protection
E-Money		Appropriate prudential rules for e-money, encourage innovation and confidence for e-money
Money laundering		Reduce money laundering and ensure market confidence
CRD		Ensure soundness of financial institutions through better prudential regulation (risk reflective capital levels, improved risk management, harmonise cross-border and cross-sector supervision)
Financial conglomerates		
Savings Tax Directive	Wider conditions for an optimal single financial market	Eliminate tax distortions

Source: CRA analysis.

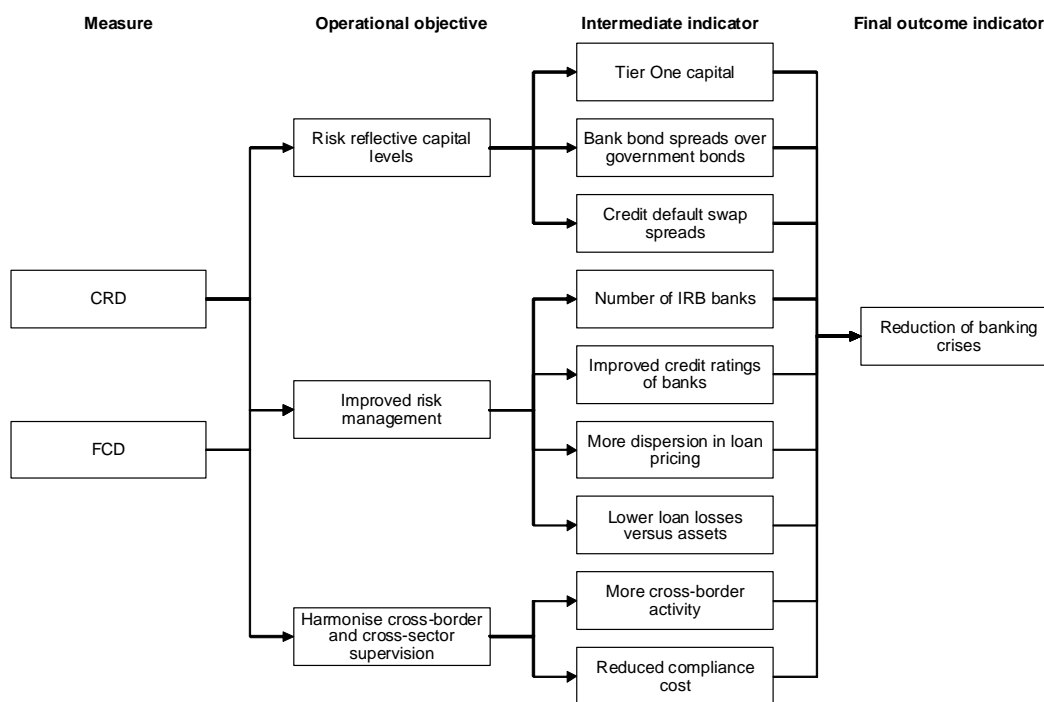
¹⁷ This was required under the Directive 97/5/EC on Cross-border Credit Transfers.

¹⁸ Figures for 1999 taken from COM(2000) 36, Communication on Retail Payments in the Internal Market. Figures for 2001 taken from SEC(2006) 1783, Commission Staff Working Document addressed to the European Parliament and to the Council on the impact of Regulation (EC) No. 2560/2001 on bank charges for national payments.

The overall impact of the various different measures affecting the banking sector can be summarised through a series of causality trees which are presented in Figure 16-Figure 20 below. These have been separated into figures for prudential regulation, payments, mortgages, savings and anti-money laundering.

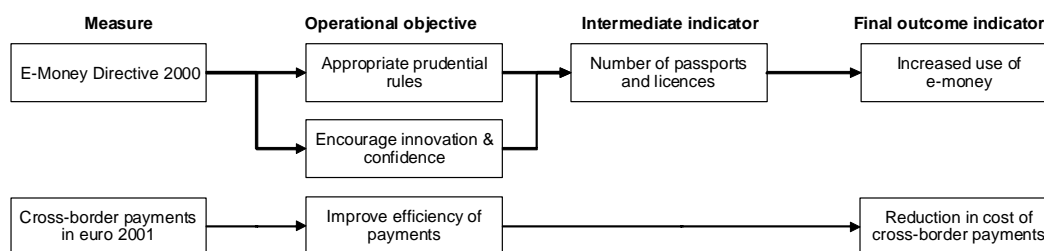
Each tree highlights the operational objective of the different FSAP measures and sets out the different indicators that would be expected to be impacted by the different measures. The causality trees are therefore a summary of the impacts of the FSAP measures and seek to consolidate the overall impact of the FSAP. Given the focus of the work on the FSAP as a whole, this is inevitably a simplification of all of the possible impacts of each of the different measures in different member states. Instead it focuses on the overall effect of the measures taken as a whole package.

Figure 16: Causality tree relating to prudential regulation measures in banking



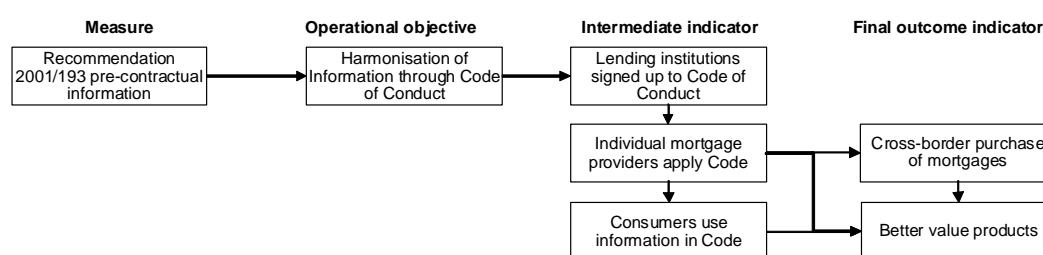
Source: CRA analysis.

Figure 17: Causality tree relating to payments in the banking sector



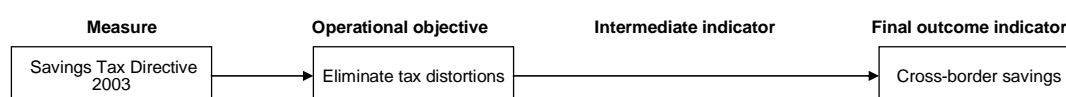
Source: CRA analysis.

Figure 18: Causality tree relating to mortgage market



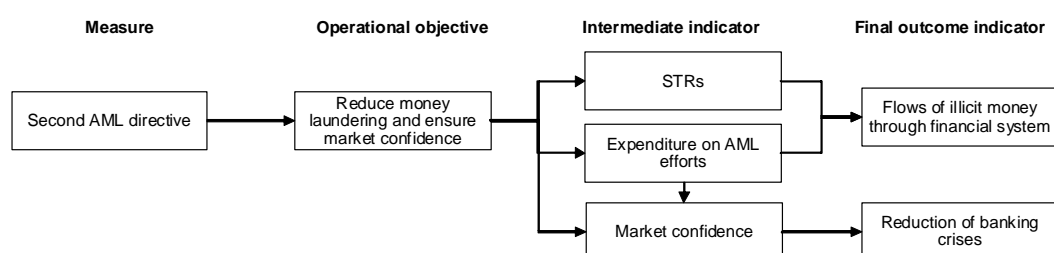
Source: CRA analysis.

Figure 19: Causality tree relating to saving in the banking sector



Source: CRA analysis.

Figure 20: Causality tree relating to anti-money laundering in the banking sector



Source: CRA analysis.

3.3. INDICATORS - PRUDENTIAL REGULATION

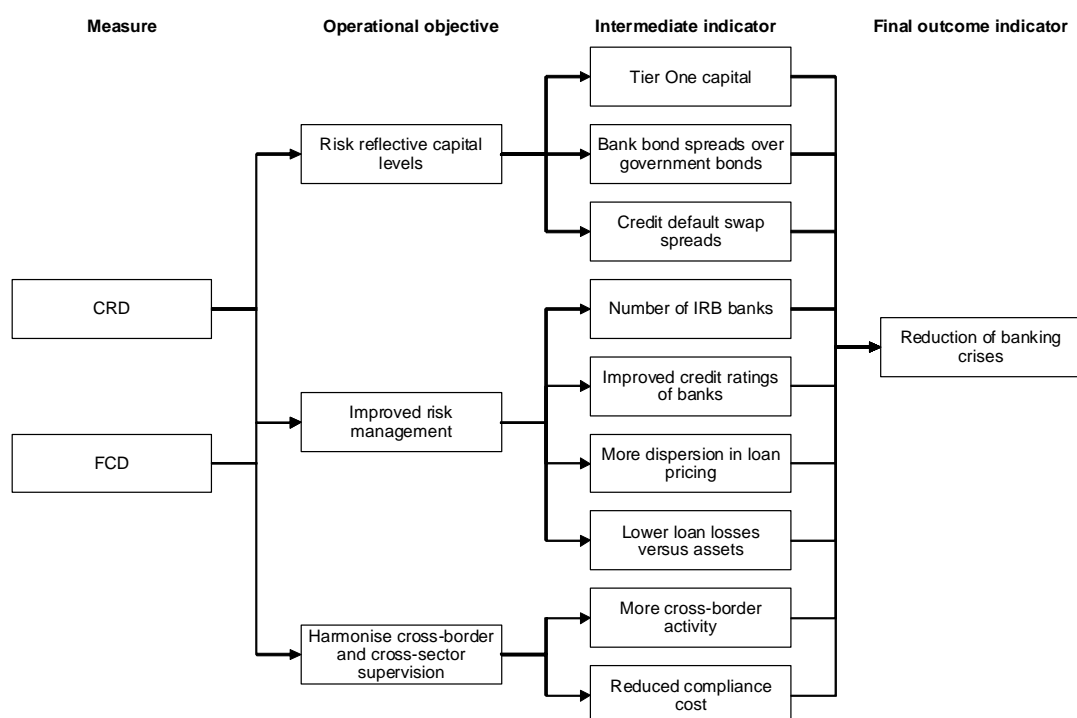
Basel 2 was introduced into European regulation through the Directive known as CRD. CRD seeks to address the inadequacies of Basel 1 by introducing more advanced risk management leading to risk reflective regulatory capital. It also introduces a degree of autonomy in setting capital levels for banks which satisfy their regulator as to the soundness of their risk measurement. Basel 2 has three pillars:

- Pillar 1 sets out rules for measuring risk and determining capital levels. There are three levels of proficiency: standardised; foundation; and advanced. The latter two levels are referred to as IRB (internal ratings based) because the bank uses its own internal ratings in the determination of regulatory capital levels;
- Pillar 2 is where the national regulator sets out the rules by which it will oversee its national banking system; and
- Pillar 3 is meant to enhance market discipline on banks by increasing transparency and disclosure of risk positions.

CRD also introduces for the first time a requirement that capital be explicitly held to protect against operational risk. The objective of CRD is to improve banks' risk management processes and ensure that capital is risk reflective. These improvements should increase the soundness of individual banks and enhance stability of the financial system.

In addition to CRD, the Financial Conglomerates Directive (FCD) introduces specific prudential legislation to ensure sound supervisory arrangements with regard to financial conglomerates. With regard to capital adequacy, FCD bans double gearing and excessive leveraging, and defines methods for calculating solvency ratios and capital adequacy at group level. Intra-group transactions are controlled to avoid risk concentration and other problems. Finally, the Directive provides for the establishment of a single supervisory authority to coordinate overall supervision of a financial conglomerate. For the purposes of our paper we group FCD with CRD in terms of the impact assessment.

Figure 21: Causality tree on prudential regulation in banking



Source: CRA analysis.

It is clear from the causality tree that the intermediate indicators are associated with different intermediate objectives:

- risk reflective regulatory capital levels;
- improved risk management; and
- harmonisation of cross border and cross sector prudential supervision.

We discuss each of these in turn.

3.3.1. Intermediate indicators – risk reflective capital levels

Banks hold capital in order to absorb unexpected financial loss. A basic tenet of CRD is that the amount of capital held by banks should be reflective of their risk profile, that is, banks which engage in riskier activities should be required to have more capital than those which conduct less risky business. The credit risk management techniques embedded in Pillar 1 of CRD are intended to enable risk levels to be quantified and translated into minimum capital requirements which will vary according to the amount of risk exposure. IRB banks should be able to calibrate this linkage more accurately than standardised banks, but in either case CRD aims to greatly strengthen the linkage between risk and capital relative to Basel 1.

Indicators of more risk reflective capital should measure whether bank capital is more responsive to risk under CRD than it was under the old regulatory regime. Indicators should show that bank capital goes up or down as risk goes up or down. CRD should therefore lead to increased correlation between indicators of bank capital levels and of risk levels.

The indicator we have chosen for bank capital is the Tier 1 capital ratio. Tier 1 capital is generally considered the core indicator of bank capital strength. This figure is publicly available for banks throughout Europe.

Indicators of risk are more difficult to identify. At the level of individual banks across Europe, elaborate processes are in place to identify risk but the resulting indicators are confidential. Fortunately, a number of market-based indicators have emerged in recent years which researchers increasingly cite as useful measures of risk levels in banks and the banking system. These measures, sometimes called macro-prudential indicators by central bankers, are carefully monitored by central banks as a means to identify threats to financial stability because they quickly show deteriorating conditions and heightened risk in the “system”.

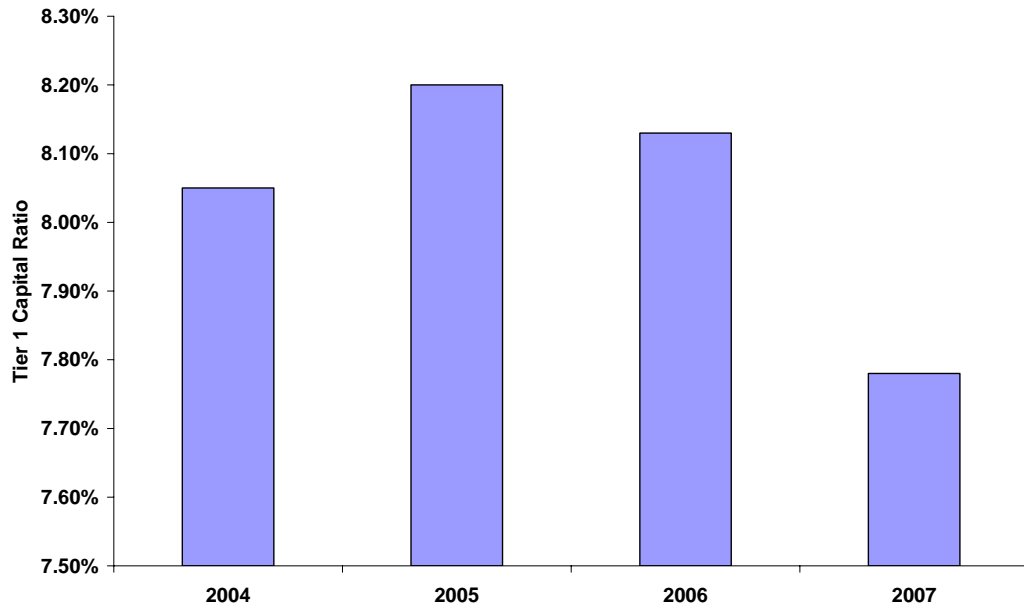
Tier 1 capital ratios

Figure 22 shows a weighted average Tier 1 capital ratio for approximately twenty large, complex, and systemically important banks in Europe, as compiled by the European Central Bank.¹⁹ This ratio declined from 8.13% in 2006 to 7.78% in 2007.

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Data shows that top 20 banks control about 42% of banking assets in Europe. Data from Gropp R and Moerman G (2004), “Measurement of contagion in banks’ equity prices”, *Journal of International Money and Finance* 23 (2004) 405 – 459, and CRA calculation.

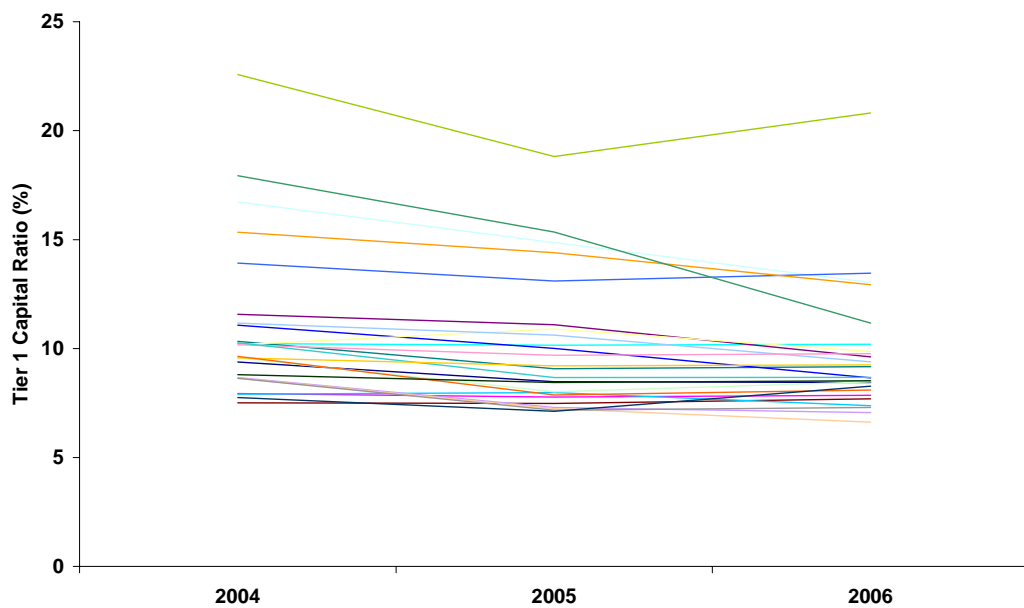
Figure 22: Weighted average Tier 1 capital ratio: large complex banking groups in the Euro area



Source: ECB, Financial Stability Review, June 2008 and CRA analysis.

Figure 23 shows Tier 1 capital for all banks in the EU up to the end of 2006. This chart shows Tier 1 ratios for European countries converging towards 8%.

Figure 23: Tier 1 ratio of European banks in EU



Source: ECB, EU banking sector stability, 2005 – 2007 and CRA analysis.

The average Tier 1 figure for all domestic banks in IFRS reporting member states was 8.81% in 2004, 8.16% in 2005, and 8.06% in 2006.²⁰ Both Figure 22 and Figure 23 show a slight reduction in Tier 1 capital ratios in the last few years.

For the purpose of our assessment there are a number of important caveats to be made about these Tier 1 ratios. In particular, it should be noted that Tier 1 ratios for 2008 are not yet publicly available. The data that is available is for 2007 and prior years and has therefore been prepared under Basel 1 rules.

However, even when examining later data on Tier 1 ratios it will need to be noted that Tier 1 is a ratio and therefore has a numerator and denominator, each of which has its own dynamic:

- The denominator is risk weighted assets, which, in 2008, will be calculated under the CRD regime. This is where the impact of CRD, in terms of the risk reflective Pillar 1 regulatory capital requirements, should be most directly observed (such risk weights change with the changing risk profile of assets). CRD applied different risk weightings to different types of assets which might be expected to have a one-off impact (e.g. lower weightings were applied to mortgages than previously). However, other things being equal (i.e. if there are no structural changes in the asset mix and size), risk weighted assets should go up in the economic downturn (as risk parameters, such as probability of default and loss given default used by AIRB banks, would go up). Trends in levels of risk weighted assets are therefore a good indicator of the impact of CRD on banks' capital as regards risk reflectivity. We will discuss this point in more detail below.
- The numerator is Tier 1 capital. Here the drivers include profitability (which is affected by write-downs), the speed with which banks are able to raise fresh capital; and behaviour of "capital buffers" (capital required to be held in addition to minimum regulatory capital). The numerator can also be impacted by Pillar 2 capital add-on requirements determined by supervisors.

The fact that the indicators are ratios means that even when the capital ratios are declining as in the charts above, one cannot necessarily conclude that capital requirements under the CRD are not risk reflective as Tier 1 ratios will not necessarily go up when there is increased levels of risk. For example, an increase in the denominator might not be immediately matched with a proportionate increase in the numerator.

This logic is reflected in the ECB's analysis of 2007 Tier 1 ratios (in the Financial Stability Review of June 2008), where the deterioration in the ratio is explained by reductions in retained income (numerator) and increases in risk-weighted assets (denominator) due to increased lending commitments, merger activity and reduced ability to distribute newly originated assets (as a result of diminished investor appetite for securitisations).

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ECB, EU Banking Sector Stability, November 2007, 2006.

It is therefore necessary to decompose the Tier 1 ratio to observe the separate movements of numerator and denominator where possible. In particular, it is necessary to examine trends in risk weighted assets as this will give the clearest indication of risk reflectivity under Basel 2. At present, data is not yet available for the post CRD period hence we provide the most recent data for future comparison.

Data on risk weighted assets

According to CRD, competent authorities are required to disclose aggregate statistical data on key aspects of the implementation of the prudential framework. This includes providing data on total risk weighted assets and solvency ratios (defined as Tier 1 plus Tier 2 capital) for national banking sectors. At present data is not yet available for all member states. Furthermore where data is available it is mainly only for year-end 2007 and thus prepared under Basel 1 rules and for a period which pre-dates the worst phase of the credit crisis. In future, however, it will be possible to examine how the risk weighted assets are changing over time. We nevertheless present below risk weighted capital for 2007 as reported by various countries on their national central bank web sites.

Table 3: Total risk weighted assets, 2007

Member state	Total risk weighted assets (€billion)
Austria	437
Belgium	143
Bulgaria	21
Cyprus	49
Czech Republic	1875 (CZK billion)
Germany	212
Denmark	3356 (DKR billion)
Estonia	14
Greece	239
Finland	63
France	318
Lithuania	57 (LTL billion)
Malta	17
Poland	342 (PLN billion)
Portugal	279
Romania	158 (RON billion)
Sweden	373 (SEK billion)

Slovakia

748 (Sk billion)

Source: CEBS, national regulator websites and CRA analysis.

Relationship between risk and capital

To examine the relationship between risk and capital we need an indicator of how risk changes over time. We have selected three such indicators which show changing levels of risk to banks. These are:

- Credit default swaps (CDS): these are financial instruments used to insure credit risk. Credit default swaps are designed to transfer the credit exposure of fixed-income products between parties. The buyer of a credit default swap receives credit protection, whereas the seller of the swap guarantees the creditworthiness of the instrument. By doing this, the risk of default is transferred from the holder of the fixed-income security to the seller of the swap.²¹ CDS spreads are the price of the protection offered by CDS. A spread of 100 basis points means it costs €100,000 a year to insure €10 million of debt against default. If the market perceives that risk levels in the debt instrument (and the underlying institution) are increasing then the spread of 100 basis points will increase. CDS are traded over the counter in considerable volumes and are therefore considered to be good market based indicators of credit risk. Pricing reacts very quickly indeed to credit-related events and perceptions. CDS therefore present the market's view of a bank's soundness crystallised in a single number which has all available information priced into it;
- Bond spreads: widening spreads between bank bond rates and the risk free rate are a classic indicator of increasing risk in the issuing institution, as perceived by the fixed income markets; and
- Distance to default: this third indicator is a measure of the excess of assets over liabilities in a bank or other institution, that is, the "distance" to the point where assets become less than liabilities (equals default). This distance to default figure is expressed as the number of standard deviations in asset value that would be required for asset value to fall below liability value. A decrease in this number indicates that fewer standard deviations are necessary to reach the point when assets might be less than liabilities. Lower numbers thus indicate a decrease in the soundness of the institution.

There is a large specialist literature on these three indicators and their strengths and weaknesses.²² However, these measures have the advantage of being market-based, that is, they are derived from trading in financial markets and reflect market sentiment towards banks, and they are forward looking. They change very rapidly as conditions change. Most importantly for our purposes, all three are available from published sources.

²¹ ECB, Financial Stability Review, June 2008.

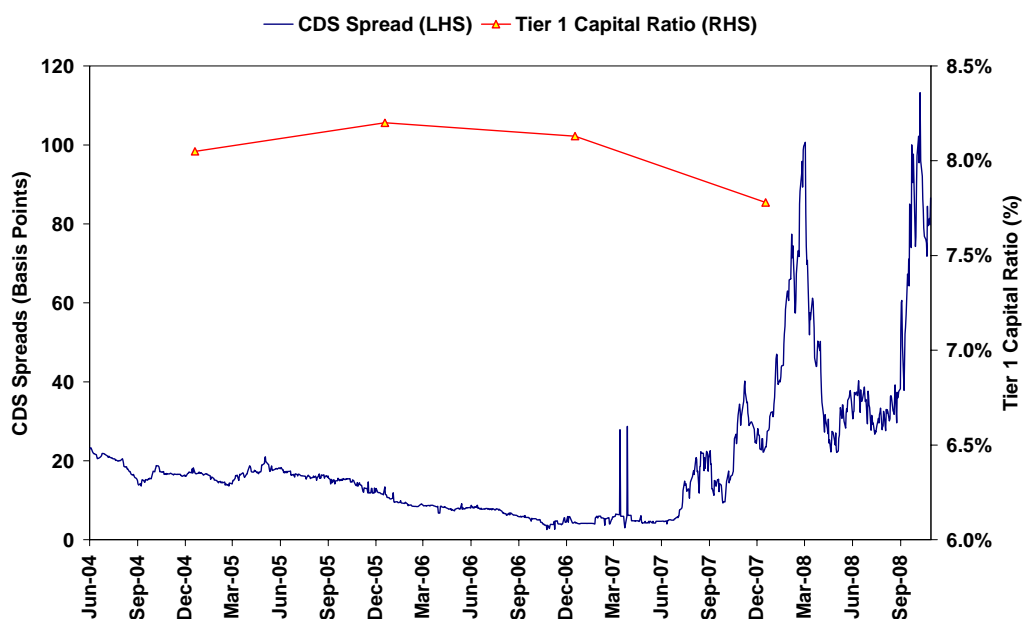
²² For example, ECB Occasional Paper Series, No. 26/April 2005, "Analysing Banking Sector Conditions – How to Use Macro-Prudential Indicators" by Leena Morttinen, Paolo Poloni, Patrick Sandars, and Jukka Vesala.

Our test of the effectiveness of CRD's enhanced linkages between risk levels and capital is based on examining whether movements in these three risk indicators for banks are in any way apparently a cause for movement in banks' capital levels. The expectation from CRD is that bank capital would be more responsive to increasing or decreasing levels of risk. We conduct this test using indices of capital ratios, CDS prices, bond spreads, and distance to default that represent calculated averages for a sample of banks. The following charts show indicators of risk over time.

Figure 24 shows (left hand scale) the CDS spreads of the iTraxx Europe Senior Financial Index Series 1. CDS spreads increased dramatically in early 2008 and again in September at about the time of the Lehman Brothers default and remain at an elevated level during the rest of 2008. This chart demonstrates sharply heightened perceptions of risk in the EU banking sector, especially for large banks.

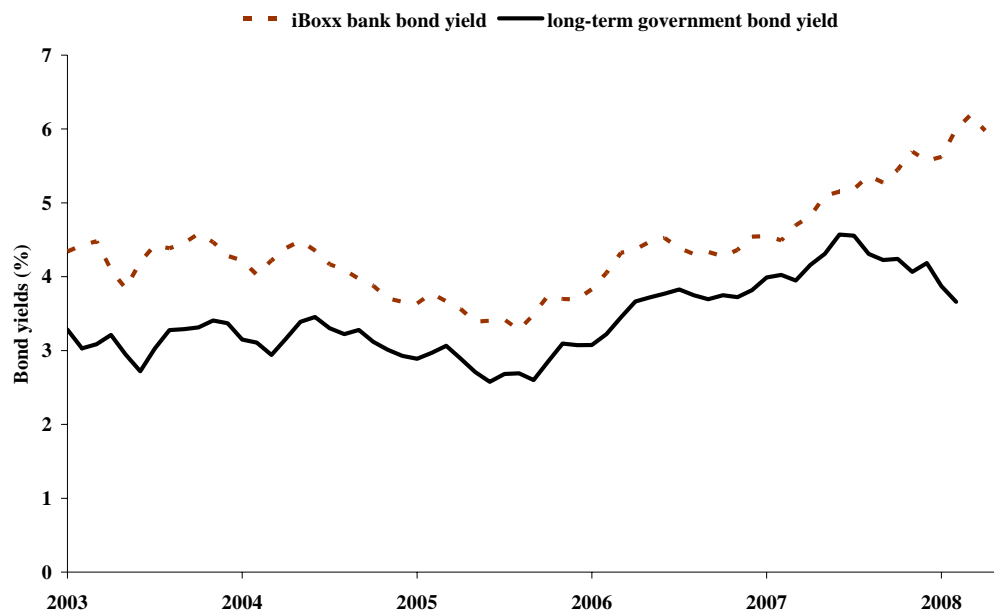
The right hand scale shows the Tier 1 capital ratio from for large, complex banks. Tier 1 ratios are slightly declining as risk increases sharply.

Figure 24: CDS spread and Tier 1 capital ratio



Source: Bloomberg and ECB, Financial Stability Review, June 2008 and CRA analysis.

Figure 25: Bank and Government bond yields

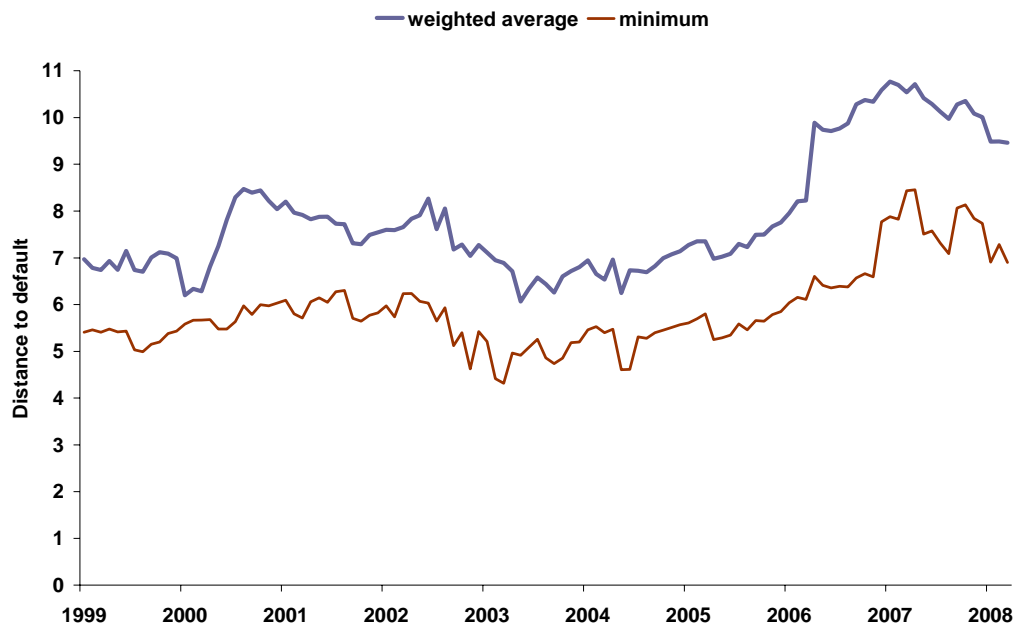


Source: ECB, Financial Stability Review, June 2008 and CRA analysis.

Figure 25 shows a sharply increasing spread between bank bond yields and government bond rates from mid-2007. This widening of spreads again illustrates a dramatic increase in perceived risk levels of banks during the sub prime crisis.

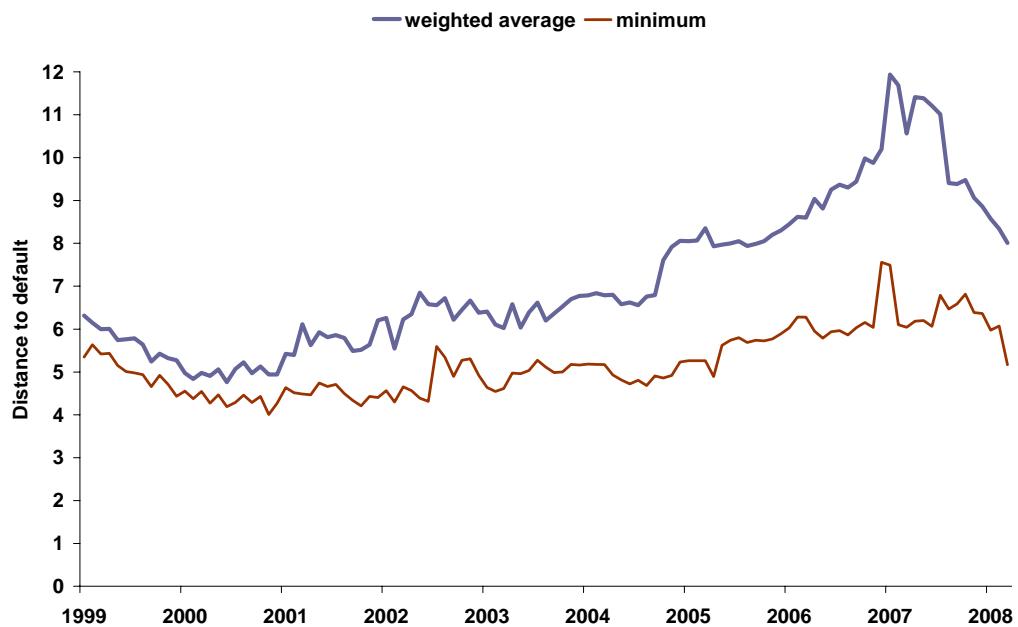
Figure 26 and Figure 27 shows distance to default for large and complex Euro area banking groups and large and complex global banks, respectively. Both sets of banks increased their distance to default in the period 2005 to 2007 but have experienced deterioration in 2008. This deterioration is especially marked for global large and complex banking groups in Figure 27.

Figure 26: Distance-to-default for large and complex banking groups in the Euro area



Source: ECB, Financial Stability Review, June 2008.

Figure 27: Distance-to-default for global large and complex banking groups



Source: ECB, Financial Stability Review, June 2008.

Although measures of risk increased in 2007 and 2008, capital ratios declined (as previously shown in Figure 22 and Figure 23). This is likely to reflect the combination of the decline in profitability which feeds into the numerator of the capital ratio and the

increase in the risk weighting on assets which feeds into the denominator, both of these effects would tend to reduce the capital ratio.

When data for 2008 becomes available the interpretation will be difficult in practice due to the fact that risk-weighted assets are expected to be lower for AIRB banks due to the incentives built into the CRD framework, but at the same time, the risk parameters used by AIRB banks will reflect the current economic context, which implies an increase in risk-weighted assets. If risk weighted assets increase this will reflect the impact of CRD through the increased measures of risk both in the current climate as well as increases in the general perception of the risk of certain assets in more steady state conditions.

As for the numerator of the Tier 1 ratio, bank profitability has declined sharply in 2008, particularly in view of large write-offs for bad debts. In some cases these write-offs will have exceeded profits and therefore caused losses leading to reductions in capital through write downs. This means the numerator of the Tier 1 ratio (bank capital) is likely to have declined. This effect, together with potential denominator increases explained above, will have fuelled the probable trend of declining overall Tier 1 ratios for many European banks in 2008. Declining Tier 1 ratios would explain the need for capital injections which many banks have sought from outside sources in 2008 to bolster their capital.

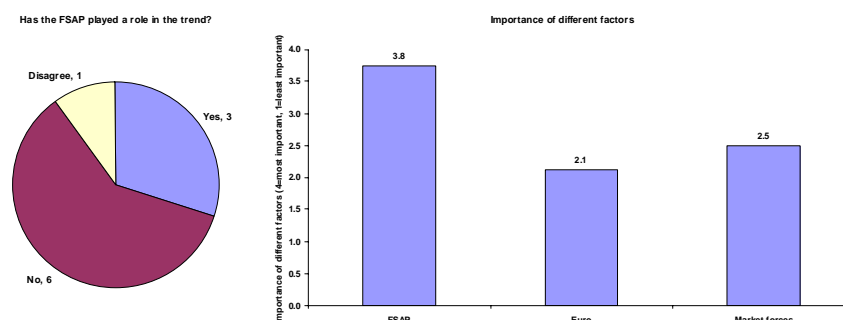
Drawing conclusions about whether CRD has increased bank capital risk reflectivity at the present moment of crisis is difficult. Changes to risk weighted assets of banks as credit managers alter inputs to their credit models to reflect rapidly deteriorating market conditions should represent a success for CRD. However, in practice, questions may now be asked as to whether these adjustments came too late in the cycle. It might have been expected that banks would have detected increasing risk levels in their portfolios well before the markets did in mid 2007 and that banks would have made adjustments to capital or decreased exposures long before the advent of this crisis.

It has been generally acknowledged that CRD did not lead banks to have sufficiently captured the risk of assets in advance of the credit crisis. In particular, they typically under-estimated the risk associated with certain financial instruments, in part due to inadequate disclosure of complex financial instruments. Whilst CRD was not officially in use during 2007, many banks claimed to have implemented the necessary improvements in risk management processes to meet the CRD requirements suggesting that even had CRD been in place it would have been insufficient to prevent the crisis developing (see next section).

During the course of our interviews in the spring and summer of 2008, market participants indicated that banks in multiple member states who had achieved IRB status would be able to reduce their minimum regulatory capital (and total capital) using Pillar 1 calculations often by 10 to 15% but in one or two cases by as much as 30 to 40%. This finding is not surprising: the various QIS Surveys have all demonstrated that Pillar 1 calculations were likely to lead to reduced minimum regulatory capital for IRB banks. However these views and calculations are likely to have changed considerably since June/July 2008 given the extraordinary negative events of September and October 2008.

Our interviewees stated that despite their Pillar 1 calculations, capital reductions would simply not occur for the foreseeable future. Figure 28 below relates to a question as to whether CRD may have driven some of the reduction in bank capital ratios observed in recent years. Two thirds of the respondents felt that CRD had not played a role. A minority disagreed and did ascribe the change to FSAP/CRD.

Figure 28: Decrease in capital ratio in recent years



Source: CRA analysis.

Few interviewees expected a change in capital ratios in the future even if Pillar 1 calculations permitted a reduction in capital for certain types of assets. There were a number of reasons given for this:

- in the current crisis regulators are using their powers under Pillar 2 to ensure banks maintain or increase capital levels;
- banks themselves are loath to reduce capital in the current crisis environment even if Pillar 1 calculations suggest they might do; and
- banks believe market expectations (which link to Pillar 3) are the real arbiter of capital levels, not Pillar 1 calculations.

In particular, the role of credit rating agencies and the market expectations which result were seen as important in leading banks to hold significantly more capital than Pillar 1 calculations would suggest is necessary. This is likely to reflect banks targeting or seeking to maintain a certain credit rating. However, the role of credit rating agencies and the willingness of investors to depend on their analysis rather than conduct their own due diligence has itself led to concerns being raised.²³

In any case, theoretical reductions in minimum regulatory capital as a result of Pillar 1 calculations did not seem highly relevant to our interviewees in light of the developing credit crisis. The possibility that Pillar 1 arrives at a “different answer” for capital ratios than Pillars 2 and 3 is a concern and may be an impediment to achieving risk reflective

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Report on the Sub Prime Crisis, OICU-IOSCO, Technical Committee of the International Organization of Securities Commissions, May 2008.

capital in banks (if Pillar 1 starts to be effectively ignored in the capital setting process). It is to be hoped that dialogue between banks, regulators, rating agencies, and other market participants will, over time, eliminate at least some of this apparent misalignment and cause the advanced risk management technology of Pillar 1 to play a more active role in the capital level setting process, bringing true risk reflective capital into being. The sub prime crisis has led the Basel Committee to review various aspects of Basel 2/CRD which will probably lead to significant changes.

Overall, there is a great deal of uncertainty regarding the impact of CRD on capital levels in banks both now and in the future. Our indicators clearly show an extraordinary increase in risk in 2007 and 2008, but the limited available data on capital does not yet provide a clear picture of how bank capital moved in response to this risk. More revealing data should start to emerge in 2009 at which point a better assessment will be possible.

3.3.2. Intermediate indicators – improved risk management in banks

The second operational objective of CRD is to improve bank risk management capabilities. CRD encourages banks to adopt advanced credit risk management techniques which should not only assist in capital level setting, as discussed above, but which should also generally improve the soundness of banks' internal risk management practices. We selected four intermediate indicators that could demonstrate improved bank risk management which are:

- Number of IRB banks;
- Improved credit ratings of banks;
- More dispersion of loan pricing; and
- Lower loan losses.

The following sections of the report show how these indicators have developed over past years to the present.

Number of IRB banks

Banks are granted IRB status by their home regulator only after an exhaustive process of proving the integrity of their risk models, data bases, processes and controls. The process of applying for IRB status may take several years and typically requires very significant capital expenditure and the deployment of large project teams to fundamentally re-engineer bank credit processes. There is therefore widespread belief that banks which are granted IRB status will have stronger risk management capabilities as a result of the investments in technology, people and processes that they have made in order to achieve this elevated status. We have therefore made the number of IRB banks in Europe an intermediate indicator of the effect of CRD. This indicator crystallises in a single measure

the very large and costly efforts made by banks to improve their risk management capability, as “certified” by regulators.²⁴

Table 4 shows the number of IRB banks and their share of banking activity in countries we visited during the research (figures were typically supplied by banking regulators in each country). The general pattern is that major banks accounting for 50-90% of banking assets in most member states have applied for and received IRB status. Clearly a very large part of the European banking sector has upgraded its risk management capability to IRB status as assessed by the competent regulators.

Table 5: Number and market share of IRB banks

Member state	Number	Approximate market share
Belgium	4	85%
France	10 (5 more applying)	80-90%
Germany	45 (50 in medium-term and 80 in long-term)	50-60%
Ireland	20	
Italy	3 (all major banks in future)	(70% in future)
Luxembourg	15% (20% in medium-term)	50% (60% in medium-term)
Netherlands	4	95%
Poland	0 (all use standard approach)	0%
Portugal	4 applications are being formalised	
Spain	7	60%
Sweden	4 (2 more in process)	80%
UK	14	>80%

Source: CRA survey and analysis.

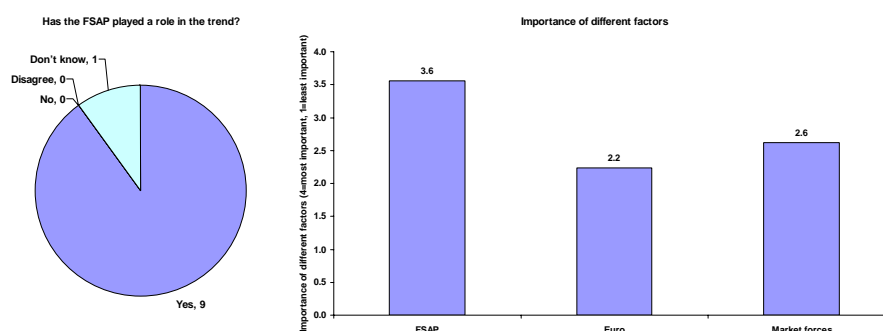
Interviewees stated that banks will have started the process of attaining IRB status as early as 2003 with the development of elaborate applications to regulators and very large investments in systems, software, processes and skills (well in excess of €100m invested for many banks). It is said that genuinely new capabilities, skills, and controls have been created in the process. Although some have said that the principles of advanced risk management would have developed independently of CRD, the great benefit of the

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In theory it is possible that for some banks, gaining IRB status was purely a “signalling” issue i.e. they gained IRB status to demonstrate or signal the high quality risk management system that they already had in place. As such it is possible that for some banks gaining IRB status does not reflect an improvement in their risk management systems. In practice, interviewees believed that even banks with very good risk management nonetheless saw improvements in order to gain IRB status.

Directive is said to be that it drives an integrated and organisation-wide implementation of advanced risk management techniques that might otherwise have been pursued in a piecemeal fashion in selected portfolios. Without this integrated approach, the benefits of advanced risk management would be much compromised.

Figure 29: More banks adopt IRB (expected)



Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

Almost all interviewees also agreed that CRD will lead to even more banks adopting IRB in the future (see Figure 29) with the FSAP seen as the primary driver of this compared to other factors.

The banks and regulators we interviewed were very positive about the risk management improvements associated with CRD and IRB status. It was felt that the technology and processes put in place as a result of CRD have increased banks’ soundness and the stability of the larger financial system. Interviewees said that while improved risk management derived from CRD does not provide a guarantee against surprises, it should improve control and understanding of risk, and transparency of risk up to board level.

The IRB indicator shows that a very large proportion of the European banking industry has upgraded its risk management capability as per CRD requirements. This is a very considerable accomplishment for CRD and the FSAP.

However, it is notable that a number of IRB banks have suffered considerable problems during the crisis. This suggests that despite the investments in risk management capabilities, which do appear to have been substantial, the credit crisis has nonetheless demonstrated that weaknesses remain in these areas and that further improvements are likely to be required.

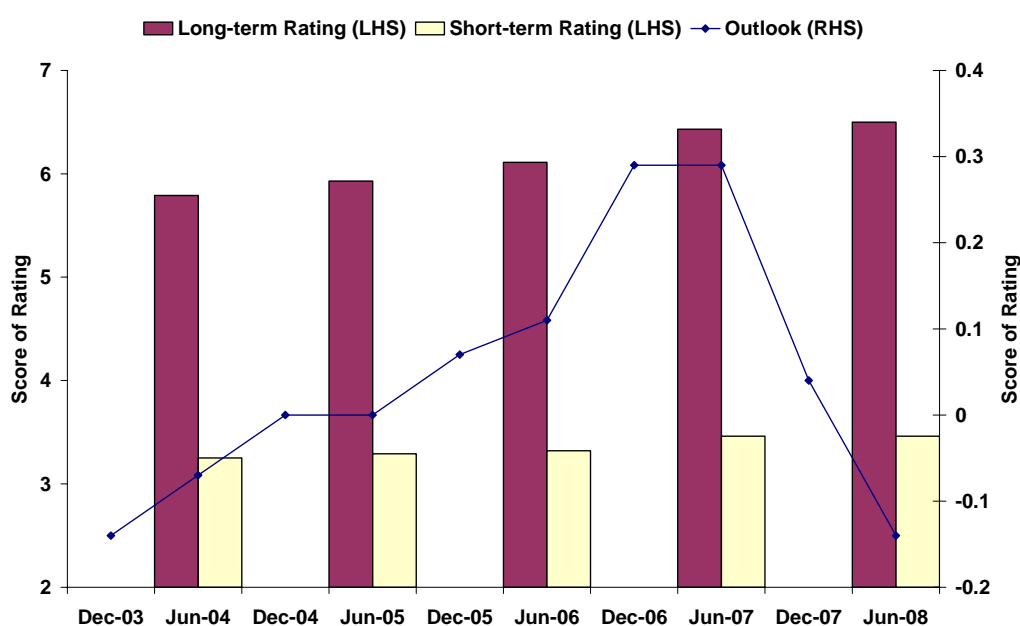
Improved credit ratings of banks

Credit rating agencies evaluate banks based on the level of their capital and on various other ratios and accounting measures. They also analyse the quality of banks’ risk management capabilities and controls. It is therefore possible to suppose that banks which improve the soundness of their risk management by applying CRD principles and techniques should improve their credit ratings. Furthermore, in times of stress, banks

with good risk management should be less prone to big write-offs and therefore to rating agency downgrades or negative changes in outlook. We have therefore chosen credit ratings of banks as a second intermediate indicator of banks' improved risk management. The quantitative indicator is a "banking sector indexed credit rating" we have constructed by blending the credit ratings of a large sample of leading European banks.

We have created an indicator for credit ratings of banks based on a scoring system which assigns points to S&P credit ratings for each of twenty-eight leading banks: the higher the points, the higher the credit rating. We have then calculated a simple average point score for the 28 banks for whom we have been able to obtain credit ratings over a five year period. There are short and long term ratings as well as an outlook which, without changing the official rating, suggests the tendency in the thinking of the rating agency towards a bank. Outlook ratings tend to change more frequently than actual credit ratings. Figure 30 shows the result of this analysis.

Figure 30: Long-term, short-term ratings and outlooks for major EU banks



Source: S&P and CRA analysis.

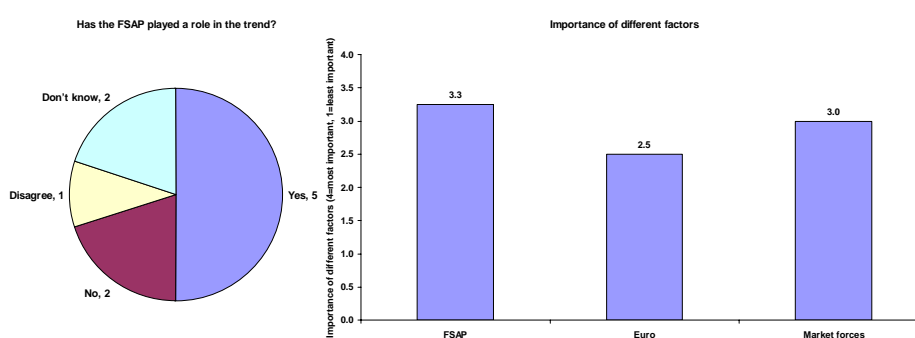
Average credit ratings, both short term and long term, show an increase over time right up to June 2008. Outlook rises sharply during the period of economic expansion from 2003 through 2006 but declines very sharply from June 2007 to the present as the sub prime crisis unfolds. CRD did not obviously prevent a sharp decline in Outlook in 2007 and 2008 although such a decline may have been expected purely because of the deteriorating economic conditions.

Our interviewees were mixed in their views of the impact of CRD on credit ratings over the longer term, although more interviewees agreed that CRD should increase ratings than disagreed with this (see Figure 31). It was generally acknowledged that rating agencies look carefully at banks' risk management processes and, if these were

systematically more effective as a result of CRD, the agencies could be inclined to give more favourable ratings. However, at the same time, Pillar 3 information should enable rating agencies to more accurately observe changes in capital and risk and therefore downgrade banks which have relatively poor risk management.

Once again, we suggest that this indicator be kept under review for signs of any clear trend arising from CRD. For the present all that can be said is that outlook rating index for leading banks have deteriorated during the sub prime crisis, and in general there was a failure to recognise the increased risk faced by banks in advance of the credit crisis.

Figure 31: Improved credit ratings of banks (expected)



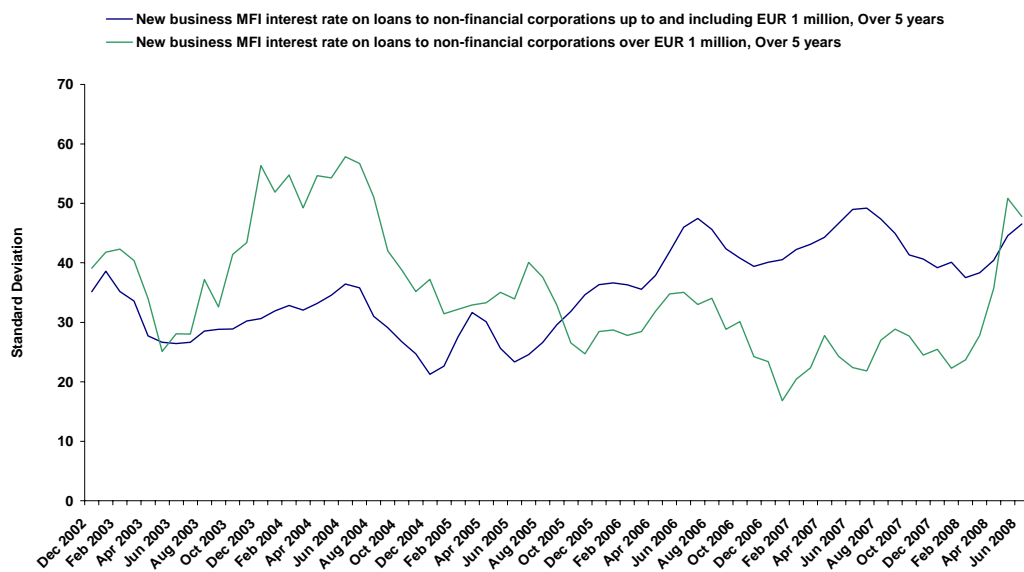
Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

More dispersion in loan pricing

IRB banks, particularly Advanced IRB banks, should be making individual risk assessments of every transaction with explicit expected losses. Ideally, pricing of a loan to a corporate client should be reflective of these calculations. This should mean that there is greater dispersion of loan pricing based on this differential assessment of risk, as opposed to “one size fits all” pricing. We have therefore chosen an indicator based on standard deviation of loan pricing. Greater standard deviation is indicative of more dispersion in pricing.

Figure 32 below shows the standard deviation of prices for business loans lasting more than 5 years and show that for small loans there has been an increasing level of standard deviation since 2005 while for larger loans there was a decreasing level of standard deviation over this period, although the standard deviation for both kinds of loans increases sharply in mid-2008. This may denote the beginning of a sharp increase in perceptions of risk. Figure 33 shows standard deviation of loan pricing for loans of less than 1 year and shows a decline in the standard deviation for smaller loans over time.

Figure 32: Standard deviation of MFI interest rate for new business (> 5 years)



Source: ECB, datawarehouse

Figure 33: Standard deviation of MFI interest rate for new business (< 1 years)

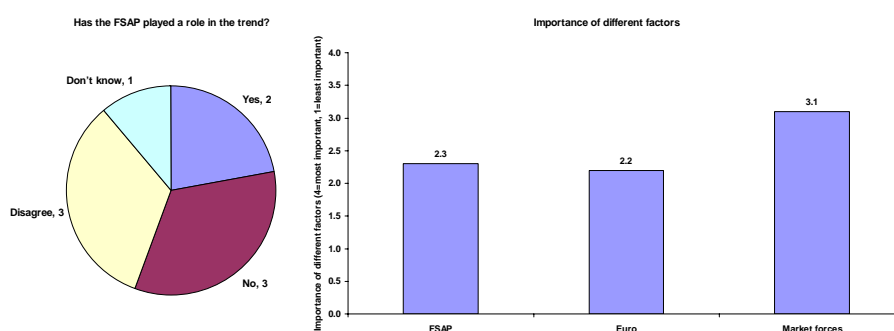


Source: ECB, datawarehouse

Interviewees in our country visits had a number of observations about this indicator. While there was agreement in theory that individual risk assessments should lead to a greater variation in loan pricing, in practice few interviewees believed banks were currently pricing on this individual risk adjusted basis.

Furthermore, numerous interviewees indicated that increases in competition meant that price dispersion between competitors had been falling over time and that the market price for loans was set by competitive rivalry amongst banks rather than by purely risk considerations. In Sweden it was thought that mortgage pricing had been affected by CRD in that mortgage spreads had steadily declined as banks started to apply reduced risk weightings in this market. Figure 34 illustrates the lack of clear agreement between interviewees regarding the expectation for the spread of loan pricing.

Figure 34: Increase in the standard deviation of MFI interest rates for SME new business in the Euro area



Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

The indicators in Figure 32 and Figure 33 will be useful to track over the coming years for any evidence of significant change arising from CRD, although interpretation will need to be done with care given the opposing trends driven by individual risk rating and increased competition.

Lower loan losses

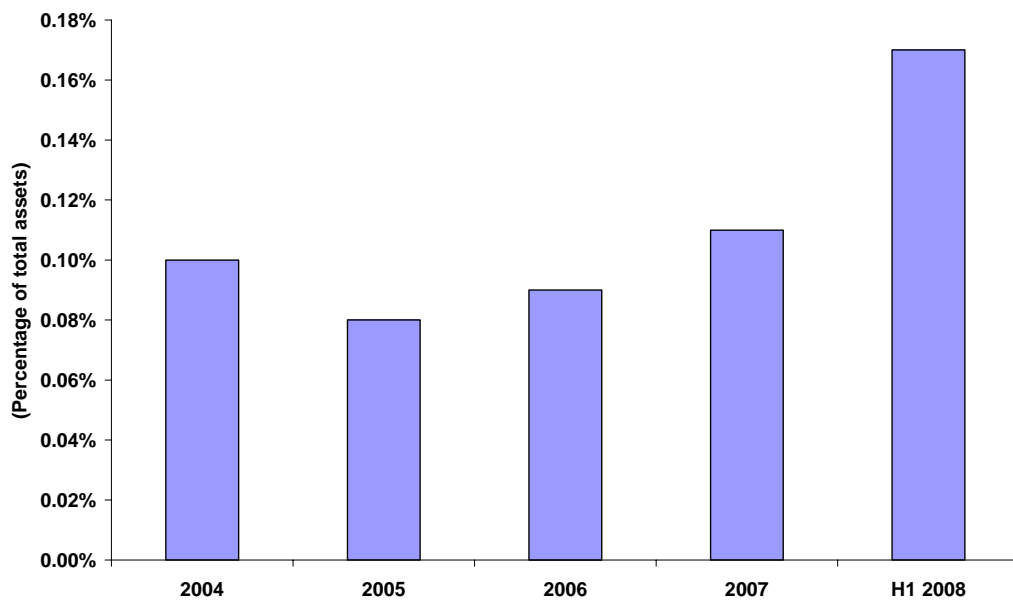
Various sources provide data on loan losses and loans in arrears in major banks. Better risk management resulting from CRD might lead to lower loan losses in banks although losses should be expected in any risk taking activity even when conducted using advanced risk management techniques. Thus it is also useful to examine the predictability of loan losses which should improve under CRD. Therefore there are two types of indicators regarding loan losses: one which measures loan losses relative to total loans in major banks, and one which measures the volatility in the level of these losses which is expected to be linked to predictability of losses.

This approach was supported by interviewees who believed that CRD should have a large impact on loan losses. However, there was disagreement on whether the effect of CRD would be observed through a general lowering of loan loss ratios or through an increased predictability and controllability of losses at a given level chosen by a bank given its risk appetite. In this regard it is possible that there is little change in the loan losses but that the capital held and the pricing to reward the risk would adapt. All agreed, however, that the sub prime crisis represented a period of extreme turbulence for banks

leading to a probability of large losses and hence it would not be possible to observe an effect of CRD during this period.

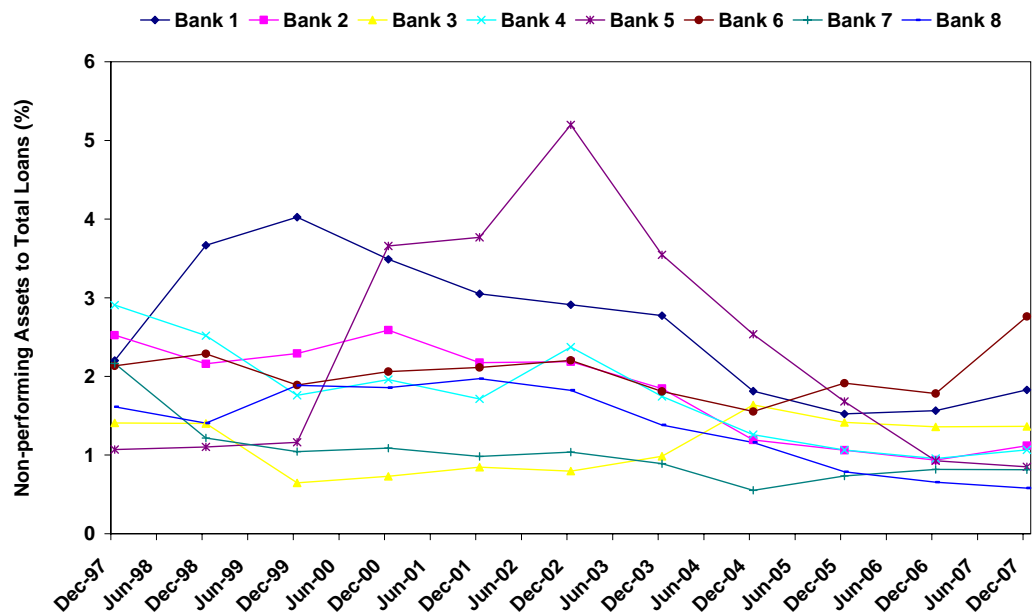
As can be seen in Figure 35, net loan impairment charges for Europe's twenty or so large complex international banks increased substantially in the first half of 2008 in line with the sub prime crisis. In Figure 36 we show loan impairment ratios for eight very large European banks for which data is available on Bloomberg over a ten year period. This data shows a great deal of variation in loan impairment with improvement and convergence in the ratio up to 2006. The data starts to trend upward in 2007 again reflecting the advent of the sub prime crisis.

Figure 35: Net loan impairment charges



Source: ECB, Financial Stability Review, December 2008

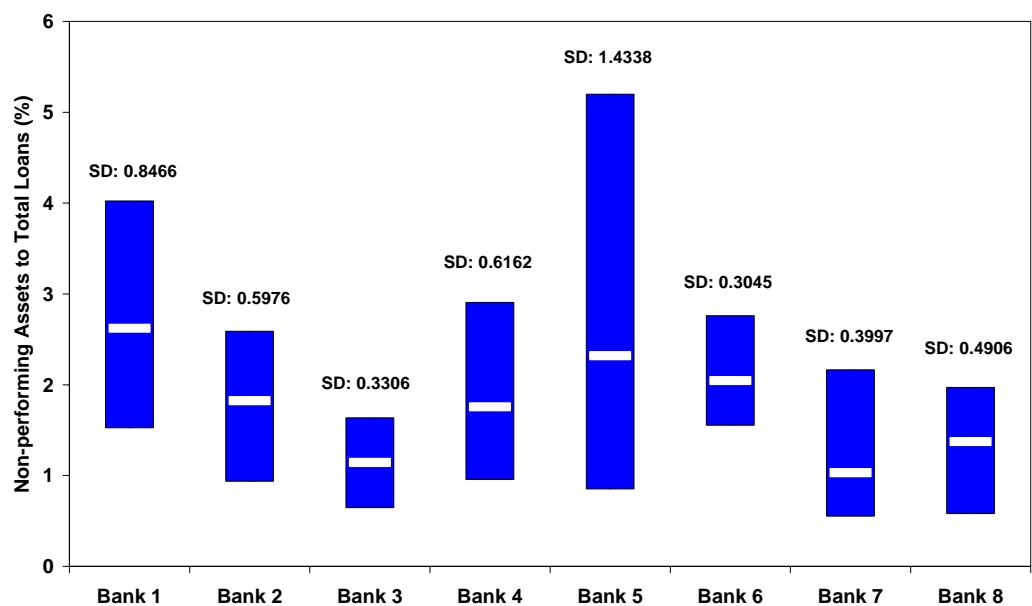
Figure 36: Non-performing assets to total loans



Source: Bloomberg and CRA analysis.

In order to test the notion that CRD should lead to increased predictability of losses, we have also analysed the volatility of the impairment ratios in Figure 37 which shows wide variance in the mean loss ratios.

Figure 37: Dispersion of non-performing assets to total loans of eight leading European banks: mean, minimum, maximum, and standard deviation



Source: Bloomberg and CRA analysis.

In future it might be expected that CRD would help to reduce the distribution of losses and lead to increased predictability of such losses.

Once again it should be noted that the sub prime crisis has led to substantial changes in 2007 in most of the indicators which would be used for assessing the impact of CRD. CRD was not officially in operation in 2007, although many banks will have been using much of its technology during this period. Nevertheless, the most that can be said is that CRD does not seem to have had much impact on these indicators up to the end of 2007 either in terms of reducing loan losses or volatility of loan losses.

The four indicators we have chosen present a mixed picture as regards the impact of CRD on bank risk management. Clearly, banks have made very significant efforts to upgrade their risk management capabilities. It is possible to measure this progress by observing the number of banks which have been granted IRB status by their regulator. The progress in this regard is very notable in a short time, as shown by the figures and as reflected in the comments of our interviewees throughout Europe. It is felt that the improvements driven by the CRD process are real and valuable and have enhanced financial stability in Europe. However, in practice even these risk management updates were insufficient to prevent the credit crisis.

With regard to the other indicators progress is less clear. Credit Outlook has been reduced sharply for major banks as sub prime unfolded, although actual credit ratings have held through 2007. Loan impairment has increased significantly in 2007 together with volatility of this ratio. The evidence that risk based pricing has established itself in the marketplace is unclear.

3.3.3. Intermediate indicators – harmonisation of cross border and cross sector prudential regulation

Regulatory compliance costs

A number of commentators have suggested that CRD and FCD should reduce compliance costs as a result of harmonisation of cross border prudential regulation. Lower compliance costs should result from facing the same regulatory requirements in member states and therefore having systems designed around a single set of requirements. In addition, lower costs would be expected from the clarified roles of home and host regulators, reducing burdens on banks and financial conglomerates wishing to operate in multiple jurisdictions. It is further argued that reduced compliance costs and regulatory harmonisation could lead to increased cross border activity.

Interviewees did not support the view that CRD and FCD are reducing banks' compliance costs or regulatory burdens, although since banks were still in the process of incurring the one off costs associated to changing systems for CRD this may not be surprising. The EC has commissioned a separate study on compliance costs of FSAP, which covers the compliance cost impact of CRD.²⁵ This study notes that the median one-off costs of

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Survey on the cost of compliance with selected FSAP measures, Europe Economics, forthcoming.

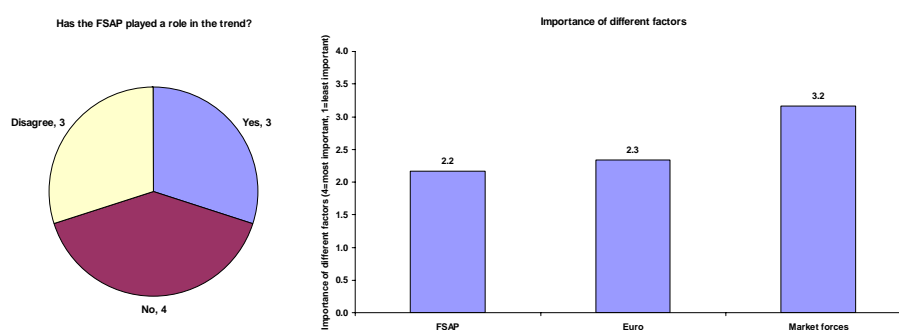
implementation as a proportion of operational costs were 1.56% for banks and 1.37% for investment banks. The median ongoing compliance costs were 0.19% for banks and 0.18% for investment banks. These numbers set a benchmark level that may be observed in coming years for the expected effects of simplified cross border reporting and management.

However, interviewees indicated that in practice, harmonisation of regulatory approaches had not yet been achieved through CRD. In part this was due to Pillar 2, which is at the discretion of national regulators and therefore allows national differences in approach to the implementation of CRD. Hence rather than facing a uniform regulatory environment across Europe that permits a single response, banks had to adopt multiple approaches to address multiple regulators. Furthermore, the home host regulator relationships were not fully worked out in a manner that could address these differences. Until this happens, there was little expectation that compliance costs would be reduced. The Committee of European Banking Supervisors (CEBS) is working to achieve more harmonisation but this will take time.

Cross-border merger and acquisition activity

As noted above, national differences remain between the regulation of banks in different member states. Hence it is not surprising that few interviewees believed that FSAP had significantly encouraged cross-border merger and acquisition activity. Instead interviews indicated that cross border trends are a function of banks seeking to enlarge the geographic scope of their activity in Europe for commercial reasons and as a result of market forces. This is also supported by the results shown in Figure 38 below.

Figure 38: Cross-border M&A in the banking industry



Source: CRA survey and analysis. Note that "Disagree" implies that multiple respondents in one member state gave different responses to the question.

3.3.4. Final indicators – prudential regulation

Reduction in bank failures

As shown in Figure 16, we have suggested the number of bank failures as the final indicator for the success of CRD. The Directive is intended to strengthen prudential

practices in individual banks so that banks are both more able to avoid credit mistakes which threaten their soundness, and also be more resistant to external shocks.

Bank failures in Europe have been few in the past, but banking failures are serious because of the impact on public confidence and because of possible contagion effects. In practice, institutions in Europe which are about to fail may be taken over by other banks or bailed out by governments. In terms of an indicator, we class these takeovers and bail outs as the equivalent of a bank failure.

Well known European bank failures from the past include Barings (1995), Credit Lyonnais (1992), BCCI (1991), Banesto and other Spanish banks (1993), Herstatt (1974), and the Scandinavian/Norwegian banking crisis of 1989-1991.

Over the past year a number of very significant government interventions have been required to save failing banks, or stabilise banks which have been very seriously weakened including for:

- Fortis (Belgium, 2008);
- HBOS (UK, 2008);
- Royal Bank of Scotland (UK, 2008);
- Northern Rock (UK, 2008);
- Roskilde (Denmark, 2008);
- Bradford and Bingley (UK, 2008);
- Sachsen LB (Germany, 2007); and
- IKB (Germany, 2007).

Once again we need to be careful about ascribing this poor market outcome to CRD. The seeds of the present crisis were sown many years ago, long before the advent of CRD. Nevertheless, in terms of future evaluation of the effectiveness of CRD and any changes made to the CRD framework, we believe that this final indicator is a good one and should be employed in future analyses.

3.3.5. Summary for prudential regulation

Although many of the banking measures occurred prior to 2005 the most significant measure within the banking sector is CRD which had to be transposed by 31st December 2006, and came into force in January 2008. As such there has only been a short time in which impacts could emerge because of the CRD.

However, the timing of CRD coming into force coincided with the sub prime crisis and the credit crunch which developed during 2007 and 2008 and which is still causing severe stress in the banking sector at the time of writing. Indeed, this crisis reached a very critical

point in September and October 2008, requiring radical government intervention in many countries to stabilise the situation. It is therefore especially difficult at this stage to attempt a full evaluation of CRD using quantitative measures. It should also be noted that the interviews for this research took place during the spring and early summer of 2008 and were therefore conducted before the difficulties of September and October 2008. Furthermore, data that is currently available mainly relates to the period before CRD was implemented.

Although a full assessment of CRD will need to be undertaken in the future, the credit crisis itself indicates that the current framework has proved to be insufficient. The crisis has revealed weaknesses with risk management approaches as inadequate disclosure of complex financial instruments and a failure of due diligence in understanding the risks such instruments imposed, especially during times of stressed markets, combined to lead to considerable write-downs of the value of assets. Capital requirements imposed on banks to mitigate against such risk also now appear to have been inadequate.

One of the aims of CRD was to make bank capital risk reflective i.e. banks which take on more risk should have more capital. A detailed understanding of the impacts of CRD will only emerge when it becomes possible to decompose the impact on Tier 1 capital ratios into the effects on the numerator (capital) and the denominator (risk weighted assets).

Tier 1 capital ratios declined during 2007 but evidence for 2008 is not yet systematically available. The numerator (capital) was impacted by profitability (affected by write-downs and retained income), the speed with which banks were able to raise fresh capital, and behaviour of "capital buffers" (capital held in addition to the minimum regulatory capital). Changes to the denominator arise from different risk weightings for different types of assets (e.g. lower weightings were applied to mortgages than previously), but also from changes in risk parameters such as the probability of default and loss given default which would both be expected to increase in a downturn. Data that will allow for a detailed examination of these issues will only be available in the coming years.

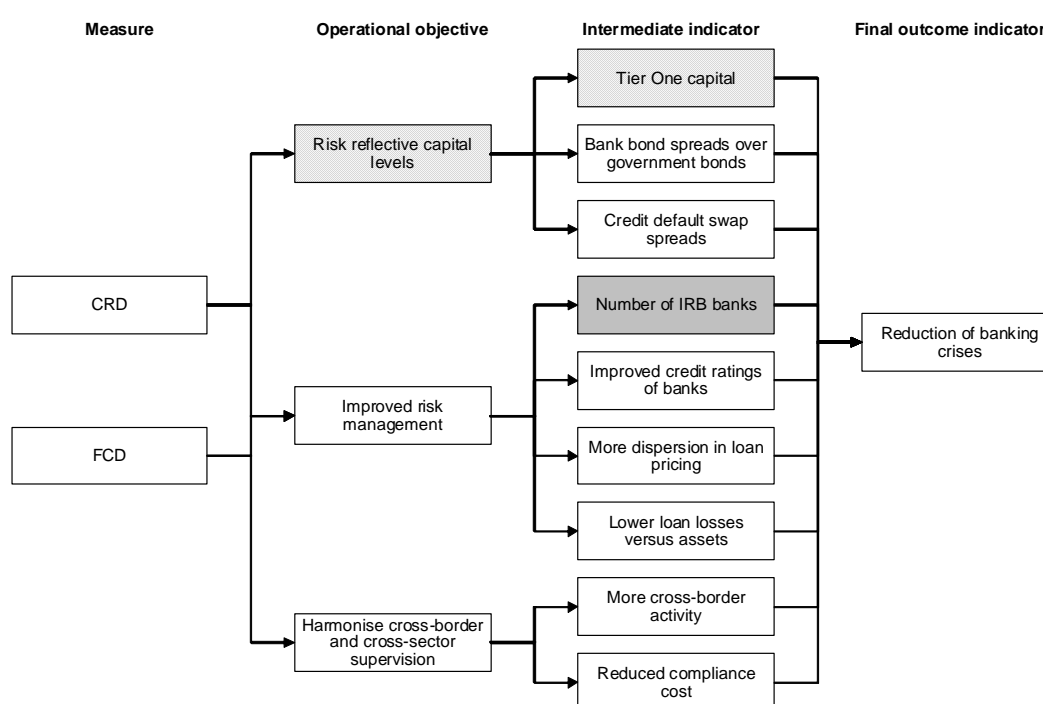
CRD has had a profound impact on the internal risk management capabilities of banks throughout Europe: leading banks accounting for a majority of assets in member states have gained IRB status following improvements to risk management procedures. Interviewees agreed that these improved capabilities were both important and beneficial to the financial system and that the systematic use of improved risk management systems across whole banks were primarily driven by the CRD. As noted above, however, even these improvements in risk management capabilities have not been sufficient to prevent the credit crisis from emerging as gaps in the framework have been exposed. It is likely that in the future further improvements will be needed in both risk management capabilities as well as in the overall prudential framework.

Loan pricing is not obviously changing, and loan losses and credit ratings both show bank vulnerability to the sub prime crisis despite all the efforts made in the implementation of CRD in recent years. The final indicator of the number of banking failures shows a number of very large government interventions to rescue failing banks in 2007 and 2008. All of these indicators will need to be reviewed over time in order to identify the overall impacts from CRD and any future refinements made to the prudential framework.

Limited gains have been made from cross-border harmonisation of regulatory regimes because CRD has not been implemented in a uniform manner between member states. Thus there have not been benefits as yet regarding reduced compliance costs or increased cross border activity resulting from harmonisation although CEBS is taking steps to improve harmonisation of requirements in this area.

Figure 39 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 39: Conclusion on prudential regulation measures in banking



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

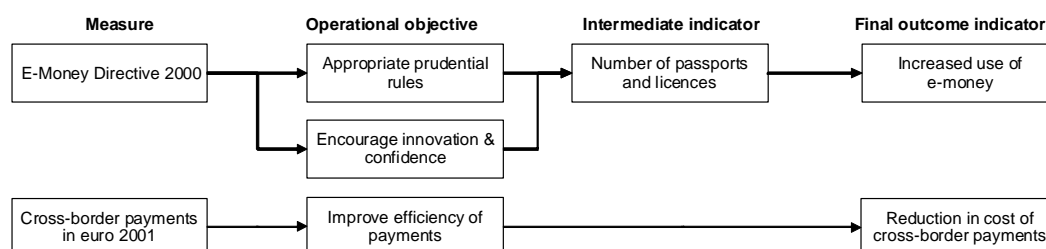
3.4. INDICATORS - PAYMENTS

The main measures affecting payments in the FSAP were the Regulation 2560/2001 on cross border payments in euro which was implemented in July 2003 and the E-Money Directive which took effect from April 2002.

The Commission issued two communications related to retail payments both of which were aimed at making retail payments more efficient across the EU. The first Communication – COM (2000)36 - as well as identifying inefficiencies in the payments market highlighted the fact that the cost of cross-border payments was much greater than domestic payments (subsequently addressed by the Regulation described below).

The second communication on a New Legal Framework for Payments (NLF) identified the need to eliminate existing technical and legal barriers to a truly integrated area for non-cash payments. It subsequently led to the Payment Services Directive (PSD) although the PSD is substantially different from the original proposals within the NLF and the PSD is outside of the scope of this report.

Figure 40: Causality tree relating to payments in the banking sector



Source: CRA analysis.

3.4.1. Intermediate indicators – payments

E-money licences

The E-Money Directive allows non-banks to issue electronic money throughout the European Union on a single passport basis. It was aimed at facilitating the EU-wide use of electronic money and the establishment of e-money institutions and also brought with it various supervisory requirements applying to administrative and accounting systems as well as minimum capital requirements.

In practice, there has been limited take up of e-money licences as is seen in Table 6 below. In 2005, there were only nine electronic money licenses of which only six were in use, although there were 72 companies operating under a waiver of which 33 were in the UK.²⁶ Such waivers have been granted, for instance, to mobile phone companies for pre-paid calls. By the end of 2007, these numbers had grown to 20 e-money institutions and 127 waivers.

Table 6: Number of electronic money issuers as of end 2005 and end 2007

Country	2005		2007	
	EMIs	Waivers	EMIs	Waivers
Austria	0	N/A	0	N/A
Belgium	0	0	0	5

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Source: Evaluation of the E-money Directive, Final report 2006, European Commission. Electronic money institutions operating under a waiver are not eligible for EU passporting. Several of these companies are public transport providers whose travel cards are accepted by other transport providers.

Bulgaria	N/A	N/A	0	0
Cyprus	0	0	1	0
Czech Republic	0	24	0	54
Denmark	1*	at least 3	0	7
Estonia	0	0	0	0
Finland	0	0	0	0
France	0	0	–	–
Germany	1	4	1	7
Greece	0	0	0	0
Hungary	0	0	–	–
Ireland	0	0	0	0
Italy	2**	0	3	0
Latvia	0	2	–	–
Lithuania	0	N/A	0	0
Luxembourg	0	0	0	0
Malta	0	0	–	–
Netherlands	1	at least 5	1	5
Poland	0	0	0	0
Portugal	0	N/A	0	N/A
Romania	N/A	N/A	0	0
Slovakia	0	N/A	0	N/A
Slovenia	0	N/A	0	N/A
Spain	0	0	0	0
Sweden	0	1	0	3
UK	4	33	14	46
Total EU	9	72	20	127

Source: Evaluation of the E-money Directive, Final report 2006, European Commission. Data for 2007 provided by the European Commission based on responses from member states in April 2008. Note: * The Danish ELM (PBS Danmønt) closed down at the end of 2005; ** Although licenses have been granted, the Italian ELMs were not active at the end of 2005; *** N/A denotes 'not applicable' because the country has no waiver regime; **** Romania and Bulgaria were not EU members at the end of 2005; ***** From France, Malta and Latvia, no data were received in 2008.

One of the reasons put forward for the limited number of E-money licences was that the prudential requirements of the Directive were relatively onerous compared to the size of the relevant market. For example, the initial capital requirement of €1 million represented an entry barrier for small entities. The small number of licences may also have arisen because in some cases the requirements for e-money institutions are more stringent than those for credit institutions and also because there are limits on the activities which these firms can undertake. In addition, some stakeholders including mobile operators have indicated that the legal framework is unclear which has also hampered market development.

One example cited regarding the high requirements of the E-Money Directive was that of Hong Kong's Octopus card, a pre-paid transit card which has expanded in use such that it can be used to purchase newspapers, coffee, and other small items useful to commuters in addition to paying for transport. It was stated that Transport for London (TfL) had similar objectives for its Oyster card which were abandoned because of the burdens imposed by the E-Money Directive. TfL has subsequently found a different way to attain this objective by partnering with existing banks and credit card schemes, combining Oyster, a credit card, and a contactless debit card for small values. It has not, however, become an ELMI. Nevertheless, the FSAP has enabled a number of "non-banking" service providers to enter the market.

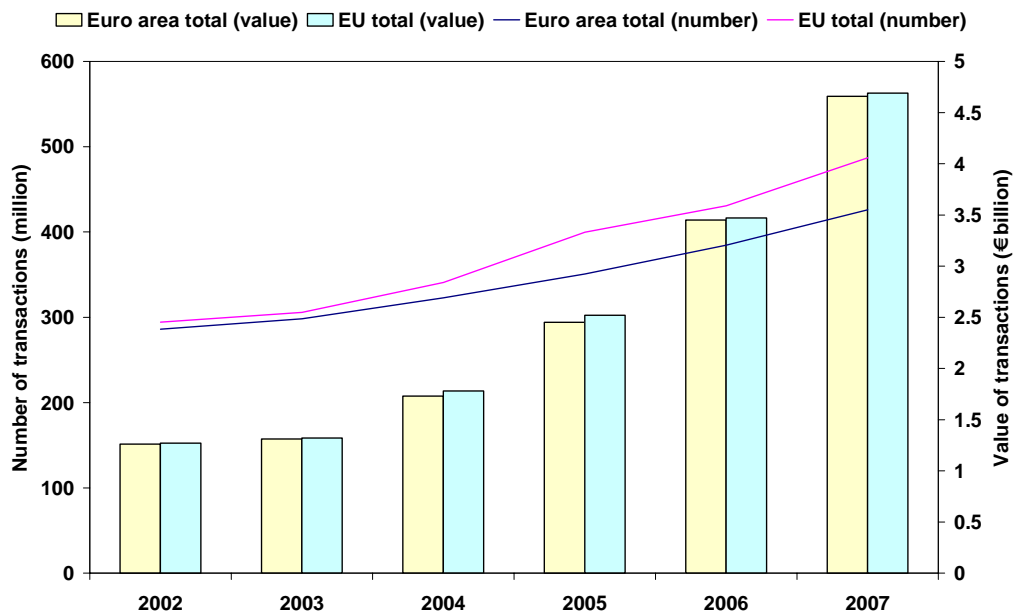
3.4.2. Final indicators – payments

E-money in circulation

Given the limited impact to date in terms of the number of E-money licences, we would not expect to find significant impacts in terms of the amount of E-money that is being used.

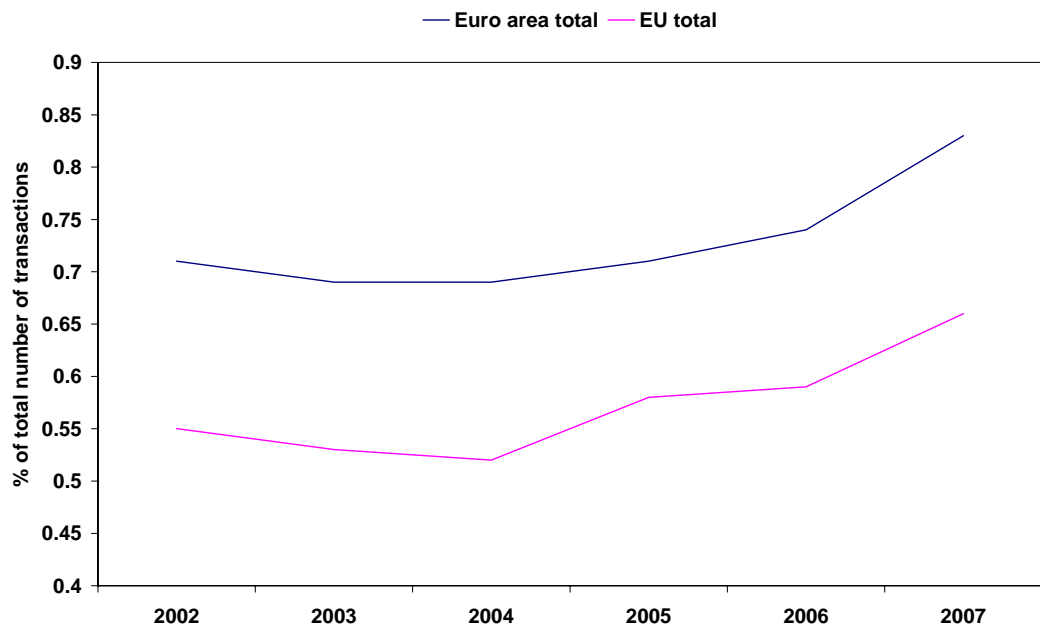
Figure 41 below shows that there has been a growth in the number and value of e-money transactions between 2002 and 2007 with relatively high growth rates of 65% and 269% respectively over this period although both of these are starting from a low base. However, as is seen in Figure 42, the importance of e-money in terms of percentage of total number of transactions is very small (less than 1%) and has remained limited.

Figure 41: E-money – number and value of transactions



Source: ECB, datawarehouse.

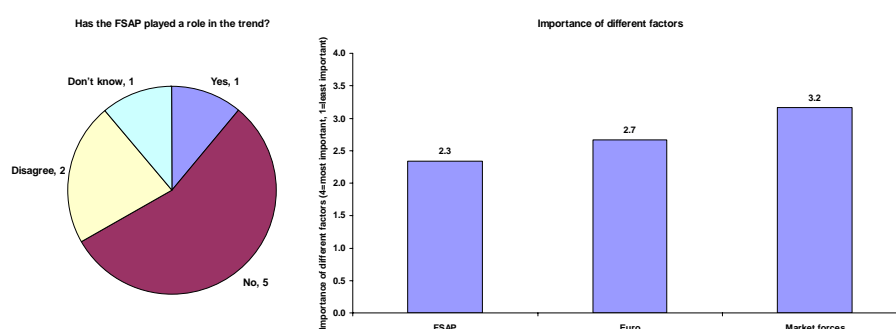
Figure 42: Importance of e-money



Source: ECB, data warehouse.

In addition, as seen in Figure 43, interviewees do not believe that the FSAP has played an important role in these limited impacts but rather that market forces and the Euro are more important factors in these changes.

Figure 43: Increase in the circulation and transactions of E-money



Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

Furthermore, as is clear from Table 7 around two-thirds of the e-money that is in circulation has been issued by credit institutions that are not operating under an e-money licence.

Table 7: Proportion of e-money by type of issuers

Type of issuing institution	Outstanding e-money in circulation end 2005	Outstanding e-money in circulation July 2007	% growth
ELMIs and waived institutions	€ 220 million	€395 million	79 %
Traditional credit institutions	€ 450 million	€658 million	46 %
Total	€670 million	€1,053 million	57 %

Source: Evaluation of the E-Money Directive (2000/46/EC) for DG Internal Market, The European Commission, by The Evaluation Partnership Limited, 17 February 2006, page 40. Data for 2007 provided by the European Commission.

The evidence in Table 7 shows that the electronic money market has been growing very rapidly (especially for ELMI's) in recent years after a slow take-up in the first few years. However, relatively it remains a small market niche and its future is difficult to predict.

Table 7 also highlights the role of existing credit institutions in the e-money arena and a number of interviewees indicated that since existing banks could already offer such services, there was limited business opportunity for those seeking e-money licences which may have limited the impact of the e-money directive thus far. Existing banks have the advantage of already having a strong prudential structure in place. In this context, the E-money Directive may be construed as regulation for a type of non-bank competitor that has been hindered in its market entry by relatively high prudential requirements.

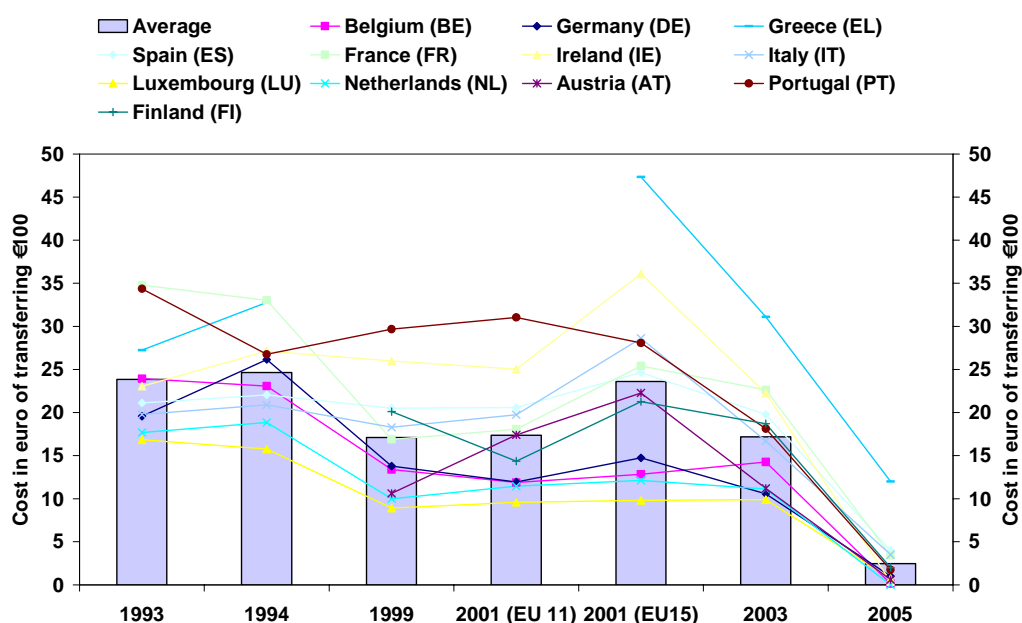
In addition, interviewees also noted that the main success story in the e-money arena, Pay Pal, had recently sought and obtained a banking licence in Luxembourg, which is believed to be due to the relatively heavy prudential requirements.²⁷

Reduction in the cost of cross-border payments

Regulation 2560/2001 on cross border payments in euro stipulated that charges for cross-border payments in euro in all member states must be set at the same level as charges for corresponding domestic payments in euro. The Regulation was brought in because of concerns that previous differentials between these prices were not compatible with a single market and could not be justified. In countries where the national currency is not the euro, application of the Regulation to the national currency is an option but not obligatory. Sweden, for instance, has opted to apply the Regulation to the Krona, and has observed a decline in the price of cross border transfers of Krona.²⁸

Figure 44 below shows the trend in prices of cross border credit transfers in euro for various countries.

Figure 44: Cross-border credit transfers



Source: SEC(2006) 1783, Commission Staff Working Document addressed to the European Parliament and to the Council on the impact of Regulation (EC) No. 2560/2001 on bank charges for national payments.

²⁷ In some cases the requirements for electronic money institutions are more stringent than for credit institutions.

²⁸ In addition an agreement between the Swedish government and the banks has led to the prices for cross-border payments in euro being set at the same level as cross-border payments for Krona (and therefore national payments for Krona).

As is clear from Figure 44, there was a substantial reduction in charges for cross-border euro transfers after the introduction of the Regulation in 2003. The average charge for a cross-border euro payment of €100 fell from €24 in 2001 to €2.50 in 2005. Countries that did not opt into the Regulation for their national currency (where this is not the euro), such as the UK, did not experience a similar decline in the price of cross border payments in their national currency, representing a strong indication that the Regulation is the real driver of the observed effect on the euro payments. Furthermore, there was no evidence that market forces would have led to this rather sudden reduction in the price of cross border euro payments. Interviewees also agreed that the reduction in price was driven by the FSAP.

It is thus recognised that the Regulation had a one-off effect in reducing cross-border prices to the level of domestic prices when it was brought in. If the review of the FSAP is repeated there should be no expectation of further reductions in the future resulting from the Regulation.

It was not expected that the Regulation would affect cross border payment volumes, and it has not. This reflects the derived nature of demand for such payments. That is, cross-border payments are made because of a specific purpose relating to what the payment is for. There was therefore no expectation that the reduction in cost would lead to a change in the underlying transaction.²⁹

3.4.3. Summary for payments

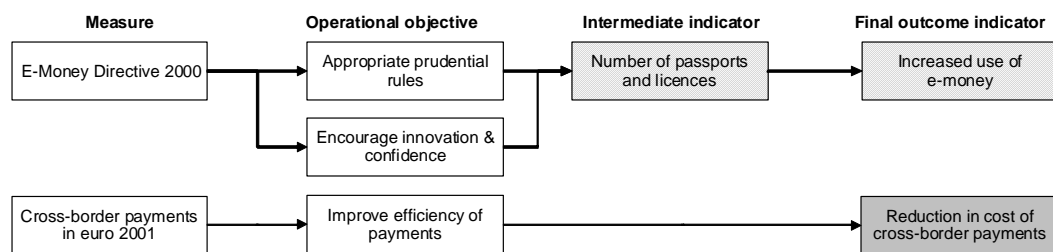
There are two important payments measures in the FSAP: the Regulation on cross border payments in euro and the E-Money Directive. The impact of the E-Money Directive has been limited although it has enabled some non-banking providers to enter the market. There have been 20 e-money licences granted and 127 companies are operating under a "waiver." The amount of e-money issued by these institutions remains small relative to mainstream transaction volumes, but is growing rapidly from a small base. The relatively limited impact is due to the relatively high prudential requirements for e-money institutions (initial capital requirement of €1 million and limits on the activities that can be undertaken) and a lack of clarity regarding the legal framework which have hampered market developments. The EC is currently reviewing the legal framework.

By way of contrast, it is very clear that the Regulation on cross-border payments has had a substantial impact. When it came into force there were sharp reductions in the price of cross border credit transfers, as intended, and there is good evidence to attribute this change to the Regulation.

Figure 45 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

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It is recognised that there might be a marginal effect if consumers have a choice of a domestic or a cross-border provider for the underlying transaction as then the reduction in the cost of the cross-border payment might alter the balance between whether the total transaction would be cheaper domestically or cross-border.

Figure 45: Conclusion on causality tree related to payments

Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

3.5. INDICATORS - MORTGAGES

Pre-contractual information on terms and conditions of home loans in the EU was judged to be not fully transparent and comparable prior to the FSAP. Negotiations between lenders' representatives and consumers' representatives resulted in a Voluntary Code of Conduct on pre-contractual information for home loans. The aim of the code is to provide consumers with the most suitable information in a standardised form, enabling them to compare the offers of different product providers not only in their own countries but also across borders. The Commission Recommendation 2001/193 (C (2001)447) encouraged adoption of the Code.

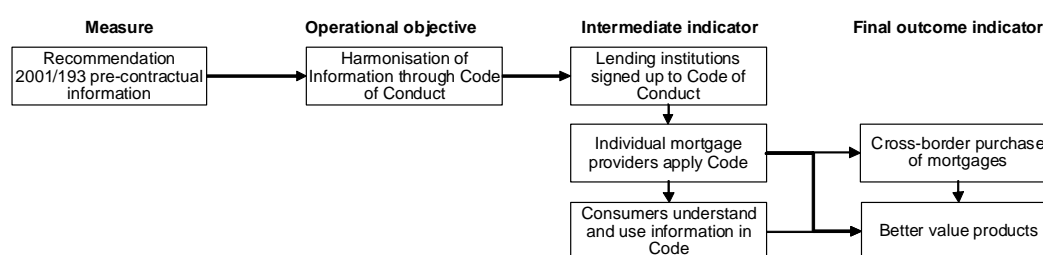
This measure may have had effects in two ways: consumer benefits arising from greater transparency compared to what was previously in place in domestic markets; and increased cross border take up of mortgages as a result of comparability between lenders' offers in different member states. This potential cross border take up would lead to increased financial integration and enhanced competition.

There are five indicators of possible effects of pre-contractual information on mortgages:

- number of lending institutions that have signed up to the Code of Conduct;
- number of lending institutions that apply the Code of Conduct in practice;
- consumers understand and use the information contained in the Code;
- volume of cross border mortgages; and
- better value mortgages.

The first three of these indicators represent intermediate indicators which in part measure the effectiveness of implementation.

Figure 46: Causality tree relating to information on mortgages



Source: CRA analysis.

3.5.1. Intermediate indicators - mortgages

Number of lending institutions that have signed up to the Code

The Voluntary Code of Conduct on pre-contractual information for home loans was adopted in most markets. For example, early assessments found that 90% of mortgage providers have signed the code, as Table 8 shows.

Table 8: Number of banks signed up to the Code

Country	Number of banks signed up to the Code	Coverage of national market
Austria	Almost all members of the national associations	
Belgium	27	90%
Cyprus	9	
Czech Republic	6	
Denmark	6	94%
Estonia	6	99%
Finland	334	99%
France	42	40%
Germany	A very large number of members of the National Associations	
Greece	21	95%
Hungary	No information yet	
Ireland	12	99%
Italy	512	96%
Luxembourg	15	90%
Malta	No information yet	
The Netherlands	124	99%

Portugal	21	95%
Spain	No Spanish lender has so far adhered to the Code	
Sweden	85	90%
UK	142	98%

Source: EBIC, European Agreement on a Voluntary Code of Conduct on Pre-contractual information for Home Loans - Second Progress Report on Implementation in the European Union, December 2005, page 5 – 6

Number of lending institutions that applied the Code

However, of those who have signed the Code, not all have fully followed through on the implementation, particularly with regards to the introduction of the European Standardised Information Sheet (ESIS). Indeed, a study conducted on behalf of the European Commission investigated the degree to which implementation actually occurs and found that in only 50% of cases were individuals given the ESIS, although this varies with some member states being considerably worse than this.³⁰ Furthermore, in only 5% of the cases was the personalised information that is required under the code of conduct both complete and correct.

In December 2007, the Commission published its White Paper on the Integration of EU Mortgage Credit Markets which includes an annex giving an updated assessment of the Code of Conduct. This annex notes that:

“The European Banking Industry Committee’s second progress report published at the end of 2005 confirmed that not all European mortgage lenders had yet adhered to the Code. Although adherence and implementation of the Code in some markets was close to 100%, in other markets the situation was less satisfactory. At the end of June 2005, institutions representing only 40% of the French mortgage market had subscribed to the Code with even fewer (institutions representing 30% of the market) having actually implemented it. Furthermore, no Spanish mortgage lender has so far adhered to the Code due to incompatibility between the Code and the national legislation. In addition, although progressing, subscriptions in many of the new Member States remain limited.”³¹

It is further noted that in the UK mortgage lenders are required to provide a “Key Facts Illustration” which covers the requirements of the ESIS, but in a different format. This means the UK has not applied the Code.

The White Paper also notes that intermediaries are often involved in selling mortgages but that their level of adherence to the Code is unknown.

³⁰ Monitoring the uptake and effectiveness of the Voluntary Code of Conduct on Pre-contractual Information for Home Loans, Institute for financial services e.V., for the European Commission.

³¹ EC, White Paper on the Integration of EU Mortgage Credit Markets COM(2007) 807, Annex 3: Impact assessment on specific issues, SEC(2007)1683/4, 18 December 2007. Available at: http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm

Consumers understand and use information in the Code

The next intermediate indicator regarding the Code relates to consumers. The EC notes that there are two problems at present:

*"...the information currently provided to European consumers is insufficient in two ways: consumers do not necessarily have all the information that they require in order to make a decision and even if consumers do have the relevant information, they do not necessarily understand it."*³²

As noted in the section above, not all lending institutions have actually applied the Code such that consumers receive the ESIS. As such it is not possible for them to use the information contained within it. However, even if consumers did receive this information, they do not always use it because they do not always understand it. Indeed, according to a Eurobarometer survey in 2005, 59% of European consumers found it difficult to understand the information given to them by financial institutions about the way their mortgages work.³³

3.5.2. Final indicators - mortgages

Cross border mortgage volume

It is evident that cross-border mortgages are rare. Table 9 shows that only 1% of customers have had cross-border mortgage borrowing experience in 2002 and 2003 in the EU 15.

Table 9: Experience in cross-border mortgage borrowing

Country	Yes (as % of all responses)	
	2002	2003
Austria	1	1
Belgium	1	1
Denmark	1	1
Finland	1	0
France	1	0
Germany	1	1

³² EC, White Paper on the Integration of EU Mortgage Credit Markets COM(2007) 807, Annex 3: Impact assessment on specific issues, SEC(2007)1683/4, 18 December 2007. Available at: http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm

³³ As quoted in EC, White Paper on the Integration of EU Mortgage Credit Markets COM(2007) 807, Annex 3: Impact assessment on specific issues, SEC(2007)1683/4, 18 December 2007. Available at: http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm

Greece	0	0
Ireland	1	2
Italy	0	0
Luxembourg	2	4
Netherlands	1	1
Portugal	0	0
Spain	0	1
Sweden	1	1
UK	1	1
EU15	1	1

Source: Standard Eurobarometer 2005/Wave 60.2. Later data is also consistent with only a small proportion of customers having cross-border mergers.

The EC's White Paper notes problems with the ESIS which may reduce its effectiveness in encouraging cross-border mortgages including that the basis of calculation of the Annual Percentage Rate of Charge (APRC) appears to vary widely amongst member states, thus undermining comparability of this essential element of the ESIS.³⁴

However, a lack of growth in the volume of cross-border mortgages can not be attributed simply to issues to do with the ESIS and Code of Conduct. Although the Code of Conduct has attempted to overcome barriers related to harmonisation of information other barriers remain which limit the volume of cross-border mortgages.

Regulators and industry representatives surveyed for this study stated that the main barriers to integration of the European mortgage market were not primarily associated with comparable information disclosure by lenders from different countries. Rather, they argued that cross border lending was seen to be hampered from the supply side because of factors such as: national differences in property registers; differences in laws regarding property repossessions in the event of default; access for foreign lenders to national credit history databases; and differences in national product characteristics. In addition, regulators and industry representatives surveyed noted that language differences remain an issue from the consumer perspective.

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EC, White Paper on the Integration of EU Mortgage Credit Markets COM(2007) 807, Annex 3: Impact assessment on specific issues, SEC(2007)1683/4, 18 December 2007. Available at: http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm

Better value mortgages

As noted earlier (section 2.1.3) information asymmetries between providers and consumers may mean that consumers are unable to make the best decision regarding their purchase.

One of the aims of the ESIS is therefore to address this information asymmetry such that consumers are better able to choose between providers as to the best value mortgage for them. In addition, if the ESIS encourages cross-border mortgages, additional competitive pressure would result. Hence the impact of the ESIS would be expected to be seen through lower prices and better quality products which meet the needs of consumers.

However, in practice, given that lending institutions have not fully implemented the Code, and consumers are therefore not able to use the ESIS, we would not expect to observe increased competition at present. Furthermore, the EC's White Paper on the Integration of EU Mortgage Credit Markets also notes that the point in the sales process at which the ESIS is given to the customer varies between countries, and in some countries this occurs only after the transaction is irrevocable. If the ESIS is meant to be used by consumers to influence their decision making and to encourage shopping around, it cannot do so if it is given to the customer after the transaction has already been agreed.³⁵ Regulators and industry representatives surveyed stated that there was no evidence that consumers were actively searching around on the basis of the ESIS.

3.5.3. Summary for mortgages

The only measure primarily affecting mortgages is the recommendation which encouraged the adoption of the Voluntary Code of Conduct on pre contractual information on home loans. In the Code of Conduct, lenders agreed to provide consumers with harmonised information.

Overall, while many banks have signed up to the Code of Conduct, the actual adherence to it has been much weaker. Not all lending institutions actually provide the European Standardised Information Sheet (ESIS) to their customers and as such there is limited evidence that customers are able to use the information contained in the ESIS or that they search around on the basis of it to obtain the best value mortgages. In addition, national legislation in some member states (e.g. Spain) requires different information to be provided to consumers and thus the ESIS is not used in those countries.

The extent of cross-border mortgages remains small but the regulators and industry representatives surveyed for this study did not ascribe this primarily to issues to do with comparable information disclosure. Instead, they argued that barriers to cross-border mortgages on the supply side arise from national differences in: property registers; laws regarding property repossessions; national product characteristics; and access for foreign

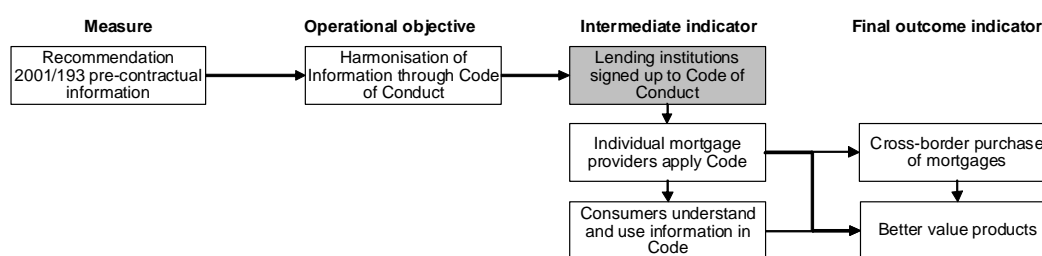
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EC, White Paper on the Integration of EU Mortgage Credit Markets COM(2007) 807, Annex 3: Impact assessment on specific issues, SEC(2007)1683/4, 18 December 2007. Available at: http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm

lenders to national credit history databases. In addition, the regulators and industry representatives surveyed stated that from the consumer perspective language differences remain an issue.

Figure 47 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 47: Conclusion on causality tree related to information on mortgages

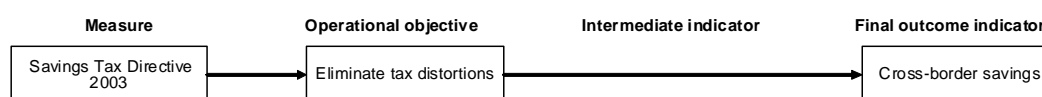


Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

3.6. INDICATORS - SAVINGS TAX DIRECTIVE

The aim of the Savings Tax Directive is to eliminate distortions in tax payments that might arise when citizens of one member state place their savings in another member state with the objective of tax evasion. The Directive sets out withholding measures or information sharing measures to be applied by all member states and some notable other participants such as Switzerland. The withholding measures apply to several jurisdictions which levy a withholding tax on the savings of EC foreigners and pay over 75% of this amount to the home country of the foreigner. This approach preserves the banking privacy laws of those jurisdictions where it is illegal for banks to reveal customer information. The affected member states are Luxembourg, Austria, and Belgium, although certain other jurisdictions such as the Channel Islands and Switzerland also participate in the withholding regime.

Figure 48: Causality tree relating to Savings Tax Directive



Source: CRA analysis

3.6.1. Final indicators – Savings Tax Directive

Indicators of interest would be, for instance, the monetary value of EU citizens' savings held in member states other than their home country, and savings flows associated to

these individuals over time, particularly as the Directive came into force. It might be anticipated that the Directive would lead to movement of these savings, perhaps back to the home country. However, such data is not readily available.

One indicator that has emerged in limited form is the amount of withholding tax collected by the jurisdictions which operate under this regime. The amount of tax collected could be considered an indicator of the effectiveness of the Directive as it provides a crude indication of the amount of savings held by EC citizens in other member states. While there does not seem to be any central data base, we have found the data below as announced by certain of the jurisdictions.

- Jersey withholding: £34.98 million in 2007; £28.9 million in 2006;
- Switzerland withholding: €400.3 million in 2007; €331 million in 2006; and
- Luxembourg withholding: €48.9 million in the first 9 months after the Savings Tax Directive was implemented.

It is generally felt that these sums are small relative to expectations. A typical comment is:

“Tens of thousands of investor with money tied up in offshore financial centres have been successfully exploiting loopholes in the new EU Savings Tax Directive, allowing them to escape the scrutiny of tax authorities and bypass withholding taxes introduced last year under the new law.

“Tax accountants said the surprisingly low figures were the latest signs that many offshore savers had channelled their money to centres such as Singapore which are not covered by the EU savings directive or had re-organised their offshore savings so they escaped the scrutiny of tax authorities.”

Financial Times, July 7, 2006

3.6.2. Summary for Savings Tax Directive

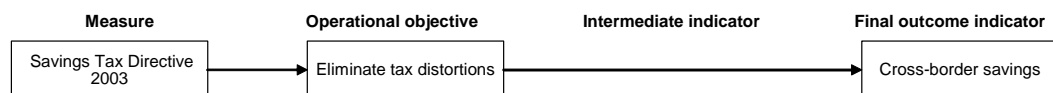
The Savings Tax Directive seeks to eliminate the possibility of citizens in member states evading tax by placing their savings in another state with lower or no taxes on such accounts. Countries participating in the Directive agree either to share information with home states or to withhold tax on savings of foreign citizens which is then remitted to the home state. Information on the amount of withholding tax applied is limited but the sums involved are considered to be small

The Commission is currently conducting a review of the Savings Tax Directive which has identified a number of “loopholes” in the Directive including the narrow definition of the savings products which it covers, the application of the Directive to individuals and not to legal entities such as foundations and trusts, and the movement of money to centres outside Europe and therefore outside the Directive’s territorial scope. All of these issues have sharply reduced the effectiveness of the Directive. The EC is moving to close these loopholes but the issues are technically complex and difficult to resolve easily. The

current conclusion is that this Directive has not so far proved as effective as originally hoped.

Figure 49 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 49: Conclusion on causality tree relating to Savings Tax Directive



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

3.7. INDICATORS - ANTI-MONEY LAUNDERING

The 2001 second money laundering Directive (2001/97/EC) amends the 1991 Directive on anti-money laundering in two main respects. First, it widens the definition of criminal activity giving rise to money laundering to include all serious crimes, including offences related to terrorism. Second, it applies to activities and professions beyond credit and financial institutions (which were covered by the 1991 Directive) such as accountants, lawyers, notaries, real estate agents, casinos and dealers in high value goods. They are now subject to the same obligations as regards customer identification, record keeping and reporting of suspicious transactions.

The 2001 Directive was reviewed and criticised for leaving open the precise definition of serious offences. In June 2003, the international body Financial Action Task Force on Money Laundering (FATF) revised its recommendations to cover terrorist financing. This led to the development of the 3rd anti-money laundering Directive which came into force in December 2007. Although the 3rd anti-money laundering Directive is outside the FSAP and therefore outside of the scope of this report, it is difficult to disentangle the impacts of the 2nd and 3rd Directives in some cases.

Directive 2005/60/EC notes that,

“(1) Massive flows of dirty money can damage the stability and reputation of the financial sector and threaten the single market, and terrorism shakes the very foundations of our society. In addition to the criminal law approach, a preventive effort via the financial system can produce results.

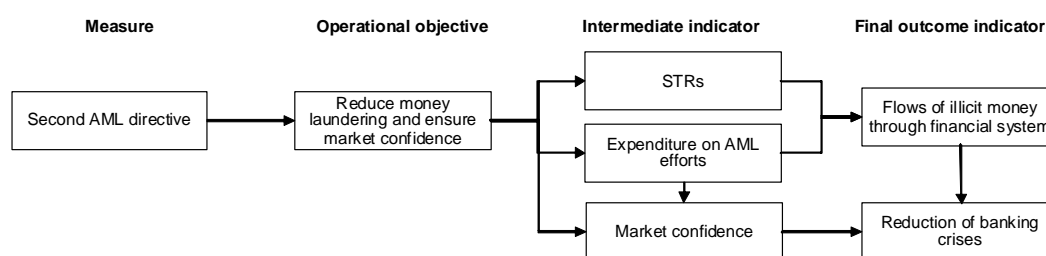
(2) The soundness, integrity and stability of credit and financial institutions and confidence in the financial system as a whole could be seriously jeopardized by the efforts of criminals and their associates either to disguise the origin of criminal proceeds or to channel lawful or unlawful money for terrorist purposes. In order to avoid Member States' adopting measures to protect their financial systems which could be inconsistent with the

*functioning of the internal market and with the prescriptions of the rule of law and Community public policy, Community action in this area is necessary.*³⁶

The Directive updates and enhances the content of the First and Second Directives on the prevention of money laundering in the EC. It brings into effect a risk-based approach to anti-money laundering, and it introduces a regime requiring due diligence in dealings with PEPs (Politically Exposed Persons) because of the sensitivity of their roles. It also requires the identification of beneficial owners of assets and how this may be defined.

The causality tree for anti-money laundering has two operational objectives: a reduction in the amount of money laundering but also, importantly, the need to ensure market confidence and the stability of the financial system.

Figure 50: Causality tree relating to anti-money laundering



Source: CRA analysis.

3.7.1. Intermediate indicators – anti-money laundering

There are three intermediate indicators for anti-money laundering: AML expenditure, STRs, and the degree of confidence which market participants have in financial institutions, although we consider the latter along with the final indicator of reduction in banking crises.

Anti-money laundering expenditure

Information is available on the efforts which reporting entities have incurred in implementing anti-money laundering (AML) measures from a recent survey of banks.³⁷ The survey finds that banks have sharply increased their spending on AML in the past few years and that management is much more directly involved in AML efforts than before. Some of the key findings are as follows:

- AML spending had grown by 58% over the three years prior to 2007;

³⁶ Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, Available from http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2005/l_309/l_30920051125en00150036.pdf

³⁷ Global Anti-Money Laundering Survey 2007, KPMG, 2007.

- Special due diligence on PEPs was up from 35% in 2004 to 75% in 2007; and
- 65% of banks reported that they had implemented sophisticated IT-based transaction monitoring systems.

Globally, 93% of banks felt the burden of AML regulation was acceptable or should be increased. Given the recent nature of the survey it is likely that these changes are mainly due to the 3rd rather than the 2nd anti-money laundering directive although they give an indication of greater effort being incurred by banks in meeting the AML requirements.

Suspicious Transaction Reports

An aspect of the AML regime is that countries are required to have a Financial Intelligence Unit (FIU) capable of investigating and bringing action against potential AML offenders. Financial institutions and other groups such as accountants and lawyers are required to submit Suspicious Transaction Reports (STRs) to their FIUs, who may then decide to open investigations which may result in court cases leading to judgements (or not) against those alleged to be involved in money laundering. Data on STRs is not available in a uniform and consistent manner for different member states although FATF assessments provide some data in this regard which we provide below:

- Finland: 2,716 in 2003; 4,315 in 2004; 3,661 in 2005; 9,975 in 2006;
- France: 8,719 in 2002; 9,019 in 2003; 10,842 in 2004; 11,653 in 2005; 12,047 in 2006;
- Ireland: 5,491 in 2004; 10,735 in 2005; 11,100 in 2006;
- Netherlands: 27 in 2007;
- Portugal: 166 in 2002; 330 in 2005;
- Spain: 1,000 in 2001; 2,500 in 2004; and
- Sweden: 8,000 in 2006; 6,000 in 2007.

FATF country reports also revealed that Belgium sent 5,000 cases to the courts between 2000 and 2003 and Italy reported 600 anti-money laundering convictions per annum.

One of the difficulties of using the data on STRs is that changes in the level of STRs could be due to increased detection of money laundering, increased money laundering activities or simply changes in reporting procedures by banks. Most interviewees indicated that they did not believe that numbers of STRs were a reliable indicator of levels of money laundering activity but were more likely to represent changes in banks' internal procedures. Indeed, in one member state, a 25% reduction in STRs from one year to the next was understood to have been the result of a change in reporting procedures in a single bank.

It was also noted by some interviewees that most STRs came from financial institutions and not from accountants and lawyers and others required to report under the new

Directive. There was a suspicion, although no evidence, that this was because of less effective implementation of anti-money laundering rules by these other parties. This may indicate that it would be worth capturing some data according to the type of entity to ensure that all firms which are covered by the directives have taken measures to implement their requirements.

In addition, there are difficulties in relying simply on the number of STRs as a guide to the number of prosecutions related to money laundering since information is not gathered on the number of STRs which subsequently lead to investigations. Indeed even gathering information on the number of detailed investigations, prosecutions and convictions may be difficult to interpret since authorities may decide to prosecute individuals for the related offence rather than for money laundering per se even if the money laundering requirements assist with the investigation.

There are a number of additional indicators which the EC could choose to capture to assess the intermediate impact of the anti-money laundering directives. These include:

- transactions refused by financial institutions and relationships terminated with clients because of money laundering;
- the number of staff in financial institutions convicted for money laundering offences;
- the number of investigations conducted and sanctions applied by financial services regulators on money laundering issues as well as information regarding money laundering scandals affecting financial institutions;
- the number of staff who are tasked with implementing money laundering requirements such as the number employed by the FIUs in member states; and
- the value of frozen assets.

At present information on these various indicators is not available in a systematic manner although the EC could seek to gather some of this in the future.

3.7.2. Final indicators – anti-money laundering

Market confidence and reduction in banking crises

Money laundering has the potential to undermine confidence in a country's banking system. For example, it is possible that a money laundering problem becomes so endemic as to damage the reputation of the banking system. Ultimately this could become a prudential problem in which the stability of the banking system as a whole is in jeopardy.

Quantitative indicators do not exist in the public domain linked to the impact of money laundering measures on consumer and market confidence. During the course of interviews with banking associations and regulators in different member states, interviewees did not highlight any concerns regarding a lack of confidence in the market because of concerns about money laundering. Neither did these interviewees highlight

concerns about any particular banking scandals in Europe which were associated with money laundering. Indeed the lack of scandal itself helps to build confidence in the system and could be seen as an indicator of the success of the regime. However, as with other prudential measures it is difficult to conclude that the lack of scandal is an impact of the FSAP since there may well have been a lack of scandals in the absence of the 2nd Money Laundering Directive.

Flows of illicit money through the financial system

The remaining final indicator of anti-money laundering activity focuses on trends in the volume of “laundered” funds. However, illicit activity is, by its nature, covert. This means that little information is available in quantitative terms on overall flows of money laundering. Regarding the magnitude of proceeds of crime, the FATF states:

“However, it must be said that overall it is absolutely impossible to produce a reliable estimate of the amount of money laundered and therefore the FATF does not publish any figures in this regard.”³⁸

Interviewees in different member states indicated that there was no reliable data available on the amounts of money laundered. A number of academic articles have attempted to estimate the size of money laundering which vary as following:

- In 1996, the IMF estimated money laundering represented 2-5% of world GDP;³⁹
- In 2001, the IMF estimated money laundering represented 2% in Italy and less than 1% for the Netherlands (estimates for Australia and Canada were 0.075% and 2-3% respectively);⁴⁰ and
- In 2002, it was estimated that “Gross Criminal Product” may be of the order of US\$1-1.5 trillion dollars globally, of which 10 to 30% is laundered.⁴¹

However, the IMF notes that various estimates of money laundering have a very large range including: Australia, 4-12%; Germany, 2-11%; Italy, 10-33%, Japan, 4-15%, the United Kingdom, 1-15%; and the United States, 4-33%.⁴² These very large ranges indicate the methodological difficulties associated with estimating the value of illegal

38 Money Laundering Q&A from FATF website.

39 Vito Tanzi (1996): “Money Laundering and the International Finance System,” IMF Working Paper. No. 96/55.

40 Monetary and Exchange Affairs and Policy Development and Review Departments, IMF (2001): “Financial System Abuse, Financial Crime and Money Laundering – Background Paper”, 12 February 2001.

41 Jean-François Thony (2002): “Money Laundering and Financing of Terrorism: An Overview”. Available from <http://imf.org/external/np/leg/sem/2002/cdmfl/eng/thony.pdf>.

42 Quirk, P. J. (1997): “Money Laundering: Muddying the Macroeconomy”, Finance & Development, March 1997, Volume 34, Number 1.

activities and hence indicate considerable caution should be applied before relying on any particular estimate of the size of money laundering.

Given this wide range in estimates for money laundering it is not possible to assess over time whether or not anti-money laundering activities are having a final market impact in reducing money laundering through the financial system. Instead it may be more appropriate to assess the intermediate indicators for anti-money laundering including some of the additional indicators which we have suggested.

3.7.3. Summary for anti-money laundering

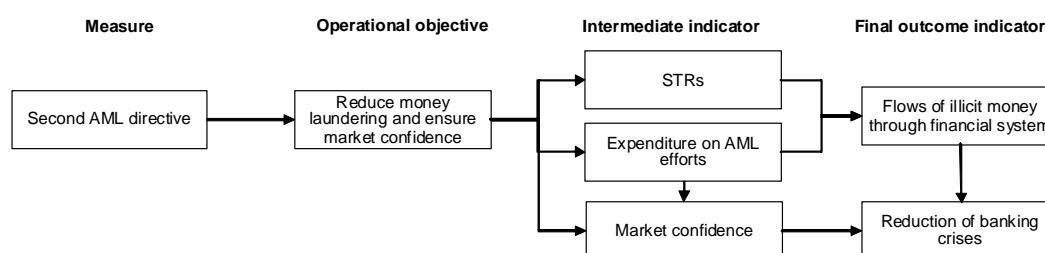
The majority of interviewees viewed the Anti-Money Laundering (AML) Directives as useful and effective in deterring money laundering from crime and terrorism as well as maintaining market confidence although it was difficult to identify specific impacts from these directives. There is evidence that expenditure on AML activities by banks has increased in recent years and that senior management in banks are more directly involved in AML activities than previously, although this appears to be due to the 3rd Directive rather than the 2nd Directive.

Banking associations and regulators in different member states did not highlight any concerns arising from a lack of confidence in the market or banking scandals because of money laundering. The lack of scandal is seen to be positive, although it is not possible to conclude that this represents an impact of the FSAP.

Changes in the numbers of Suspicious Transaction Reports (STRs) were believed to have resulted from changes in procedures within banks rather than being interpreted as linked to underlying trends in money laundering. Systematic data was not available on the number of convictions or the value of frozen assets which would be useful data to gather in the future. Evidence on the underlying flows of illicit funds is not available and therefore it may be more appropriate to focus on a wider range of intermediate indicators for any future reviews.

Figure 51 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 51: Conclusion on causality tree relating to anti money laundering



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable

economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

4. INSURANCE

There are four key measures affecting the insurance sector and three affecting the pension industry which fall under the different strategic objectives of the FSAP.

- COM(1999)134 Towards a single market for supplementary pensions: the aim of this communication was to allow pension firms (personal and occupational pensions) to invest efficiently by relaxing constraints on investment rules and the use of asset managers and service providers across the EU;
- 2000/C 43/03 Commission Interpretive Communication on the freedom to provide services and general good in the insurance sector (2000): the aim was to provide a contribution to the debate and clarification on earlier provisions of insurance directives;
- Directive 2002/92/EC Insurance mediation directive: This was aimed at removing barriers to insurance intermediaries acting across member states, enhancing the single market in insurance, setting professional standards for intermediaries, and improving consumer protection;
- Directive 2001/17/EC Reorganisation and winding up of insurance undertakings (2001): This set out a framework for a single winding up process (alongside a similar directive on credit institutions);
- Directive 2002/83/EC and Directive 2002/13/EC Solvency 1: The aim was to bring together the previous requirements on solvency as a pre-cursor to a more fundamental review of prudential requirements leading up to Solvency II;
- COM(2001)214 The elimination of tax obstacles to the cross-border provision of occupational pensions. This called for a co-ordinated approach to remove unduly restrictive or discriminatory tax rules; and
- Directive 2003/41/EC Directive on the activities and supervision of Institutions for Occupational Retirement Provision (IORP Directive). The aim was to optimise prudential supervision, including an authorisation and registration regime and thereby encourage cross-border provision of IORPs.

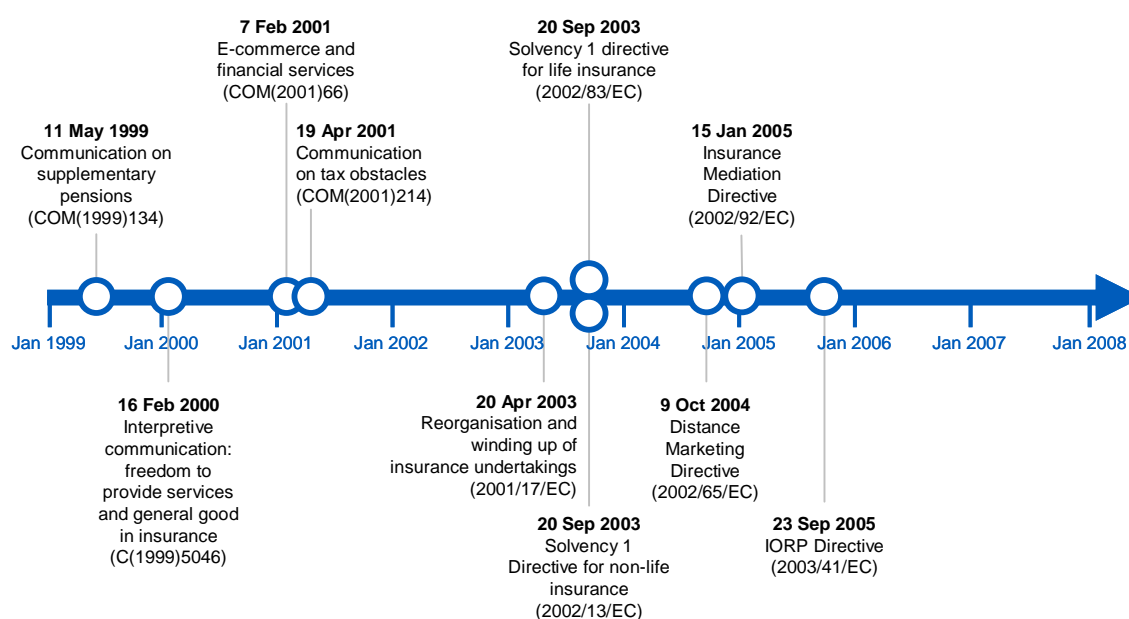
There are two further measures which affect the retail financial sector more widely, but that have particularly impacted retail insurance markets and hence we include the details of them in this chapter of the report:

- Directive 2002/65/EC concerning the distance marketing of consumer financial services (Distance Marketing Directive or DMD). The aim of the DMD was to set out common rules for financial contracts carried out remotely, to create a regulatory environment that encourages the development of e-commerce in financial services; and
- COM(2001) 66 on E-Commerce and Financial Services. This Communication builds on the E-Commerce Directive and provides member states with information on how

the E-Commerce Directive interacts with existing financial services legislation, enabling the member states to comply with the Directive with respect to financial services.⁴³ This led to the creation of FIN-NET.

Figure 52 sets out the timeline for the publication of these measures.⁴⁴ This refers to the publication of date of communications, the date at which regulation comes into force and the deadline for transposition of directives. This clearly does not represent when particular countries transposed them which could be earlier than the deadline or in some cases after the deadline.

Figure 52: Insurance and pension timelines



Source: CRA analysis.

As can be seen from Figure 52 the early measures relating to insurance and pensions sectors were primarily communications. The only very recent directive is that of IORPs, where the deadline for transposition was only late 2005. Given its relatively recent implementation and the nature of the pensions market, observing a significant impact on the market from this directive is unlikely at this time.

43 The E-Commerce Directive 2000/31/EC itself does not fall within the scope of the FSAP. It should also be noted that the FSAP measure to have a green paper on e-commerce policy was combined as part of the Communication on e-commerce.

44 Although Solvency I has separate directives for the life and non-life insurance sector, we generally use Solvency I to refer to both directives.

4.1. MARKET AND REGULATORY FAILURES

To understand the impact of the FSAP on the insurance industry we need to distinguish between different segments of the insurance market. In particular, the level of financial integration prior to the FSAP varied significantly between:

- Non-life insurance; and
- Life insurance.

In practice the industry uses a range of other classifications. We have also found it useful to distinguish between the insurance market and the pensions market. An important distinction also exists between insurance purchased by individuals and that purchased by businesses. Business insurance has been the focus of a recent Commission investigation.⁴⁵ Prior to the introduction of FSAP, the insurance market was seen to be suffering from three market failures:

- Barriers to entry preventing benefits from European integration and causing fragmentation;
- Asymmetric information resulting in concerns regarding consumer protection; and
- Concerns regarding prudential supervision.

4.1.1. Fragmentation

Looking at the life and non-life insurance markets, the EU insurance market was extremely fragmented prior to the FSAP. In general, the level of integration seen for life insurance was considerably lower than that for non-life insurance, based on analysis of the foreign presence of life and non-life insurance markets in EU member states.⁴⁶ On the whole, there was a consensus that “[t]he reality of European insurance [was] still far away from representing a highly integrated market.”⁴⁷

However, in looking at the level of fragmentation, we need to take into account the types of cross-border activity, whether we are expecting integration in the final product or in the services that go into providing that product, and differences between retail and wholesale markets.

45 Business insurance sector inquiry: Inquiry into the European business insurance sector pursuant to Article 17 of Regulation 1/2003

46 Rainer Beckmann, Carsten Eppendorfer and Markus Neimke. *Financial Integration within the European Union: Towards a Single Market for Insurance*. In ZEW Economic Studies 19, “The Incomplete European Market for Financial Services”, 2002.

47 Rainer Beckmann, Carsten Eppendorfer and Markus Neimke. *Financial Integration within the European Union: Towards a Single Market for Insurance*. In ZEW Economic Studies 19, “The Incomplete European Market for Financial Services”, 2002.

For example, the level of integration in retail insurance was very low. Cases of consumers shopping around for the best insurance contracts on a pan-European basis were still extremely rare. In addition, volumes of direct cross-border business were still extremely low, despite the prevalence of the internet, which one might expect to facilitate such transactions.⁴⁸

The highly fragmented nature of the market was seen as being caused by a number of barriers:

- Consumer preferences: The average consumer was seen as very risk averse and biased towards local structures and established channels of distribution;
- Information asymmetries: “Problems that are relevant for every single insurance contract ... are reinforcing with a growing spatial and cultural distance between the insurer and the customer”;⁴⁹
- Legal and tax system in general: This was seen to hinder the creation of a level playing field for the insurance industry; and
- Conventions regarding the terms of insurance contracts: This affects the readiness of policy holders to switch to rival products.

However, the potential for the FSAP to increase integration was also seen as limited due to:

- Taxation: The responsibility of tax treatment with respect to insurance lies with individual member states. Direct taxation is not harmonised on an EU basis, tax discrimination is prevalent, and diversity exists in terms of tax rates as well as tax systems – therefore, taxation issues were seen as important strategic factors when an insurance company takes on cross-border activity.⁵⁰
- Regulation and supervision: Regulation and supervision issues in the EU were subject to minimal harmonisation standards. So, issues related to solvency and technical provisions were left to member states’ discretion and therefore varied widely.
- Consumer protection: Extensive consumer protection with respect to the “general good” principle was seen as a basic problem for retail markets. This principle

48 Rainer Beckmann, Carsten Eppendorfer and Markus Neimke. *Financial Integration within the European Union: Towards a Single Market for Insurance*. In ZEW Economic Studies 19, “The Incomplete European Market for Financial Services”, 2002.

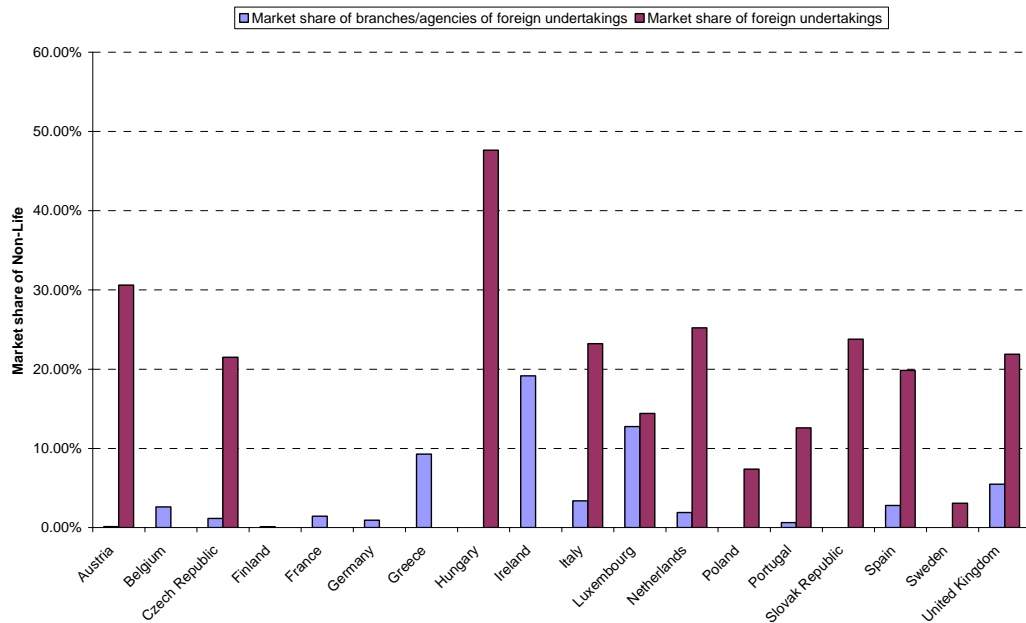
49 Rainer Beckmann, Carsten Eppendorfer and Markus Neimke. *Financial Integration within the European Union: Towards a Single Market for Insurance*. In ZEW Economic Studies 19, “The Incomplete European Market for Financial Services”, 2002.

50 Anecdotal evidence is the creation of the International Financial Services Centre in Dublin.

enabled national authorities to set individual national rules that possibly denied market access to foreign companies if certain public interests were violated.

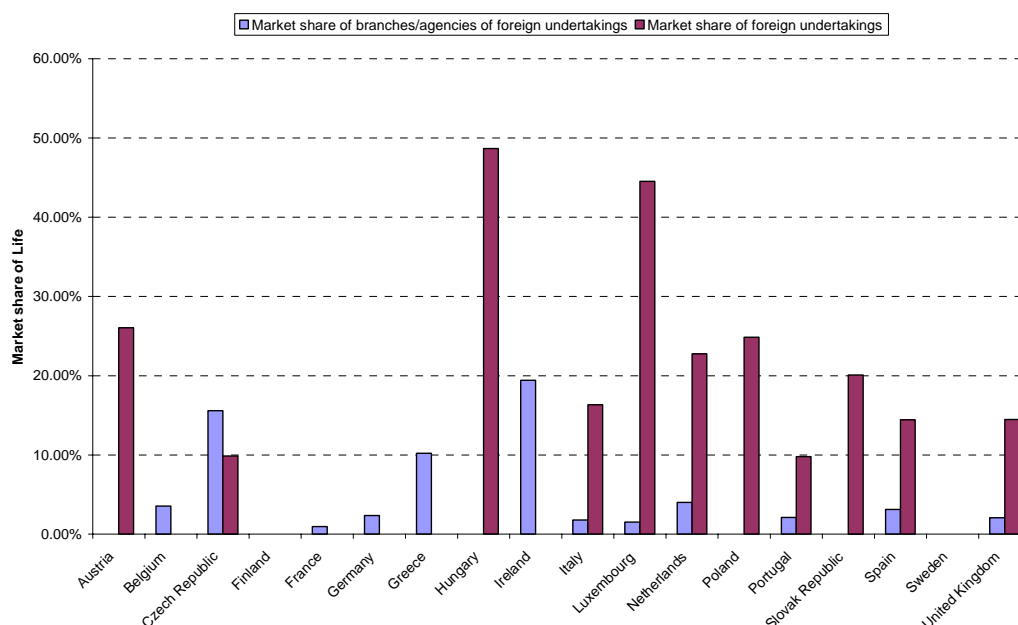
The integration that had occurred pre-FSAP was through use of branches and cross border M&A activity. This however, varied considerably between member states.

Figure 53: Market share of Non-Life (1997)



Source: OECD Insurance statistics.

Figure 54: Market share of Life (1997)



Source: OECD Insurance statistics.

The lack of integration of insurance markets was seen as diminishing competition and preventing efficiency improvements and economies of scale.

However, in other parts of the market, the level of financial integration was seen as relatively high. According to Beckmann et al (ZEW), integration in the re-insurance market was seen as “undoubtedly high” prior to the FSAP directives on insurance, and the re-insurance business is generally seen as a “widely internationalized business.”⁵¹ Brokers commented on the fact that re-insurance had never been tightly regulated “because it was felt that everyone within the wholesale market knew what they were doing.”⁵² As the re-insurance market is seen as highly integrated and it was therefore largely unaffected by measures with FSAP we do not focus on this segment.⁵³

51 Rainer Beckmann, Carsten Eppendorfer and Markus Neimke. *Financial Integration within the European Union: Towards a Single Market for Insurance*. In ZEW Economic Studies 19, “The Incomplete European Market for Financial Services”, 2002.

52 Eddie McLaughlin of Marsh insurance reported in Open Europe, Selling the City Short.

53 Pure reinsurance companies were not covered in the Third Generation directives, but were covered, post-FSAP, by the Reinsurance Directive and in the Solvency II Directive. See European Commission Press Release, 2004, at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/04/90&format=HTML&aged=0&language=EN&guiLanguage=en>. In the EU, reinsurance is now regulated in the Reinsurance Directive although this only applies to companies doing reinsurance business and which are not already authorised in accordance with the life or non-life insurance Directives.

4.1.2. Asymmetric information

Quantitative evidence on the extent of problems associated to asymmetric information is notoriously difficult. Where consumers suffer from asymmetric information we might expect them to pay too high a price or receive too low a quality product, with the result that consumers are more likely to be mis-sold to or receive lower than expected returns. However, other than clear cases of mis-selling identifying the extent of consumer detriment arising from asymmetric information is difficult.

In a 1997 Communication, the Commission throws light on problems with existing Single Market legislation, particularly concerning the lack of focus on consumer protection, and acknowledges that “the Single Market is based on confidence”.⁵⁴ The Commission addresses the following specific problems, which apply to the insurance industry:

- Lack of consumer information and means of redress: Although existing rules provided for consumer information, the Commission’s consultation showed that there is still sometimes a lack of information, or the information provided is not comprehensive or clear.⁵⁵
- Regulation of intermediaries: For insurance intermediaries, the Commission adopted a Recommendation in 1992 on the status and professionalism of the insurance intermediary. The provisions of this Recommendation were largely adopted by the member states (by 1997, only Germany and Denmark had no rules in this area).⁵⁶ However, rules (where implemented) still varied considerably across member states, and “The Commission believes that only measures adopted at Community level will remove the existing differences and establish an internal market for insurance intermediaries.”⁵⁷
- Insurance contracts: The Commission received feedback that further measures were necessary to set minimum requirements for insurance contracts to consumers, in order to allow consumers to compare insurance contracts across borders.

4.1.3. Concerns regarding prudential supervision

Prior to the introduction of the FSAP there were concerns regarding the prudential requirements of the insurance industry. These took a number of forms:

- Inappropriate requirements for regulatory capital unrelated to the associated risk;

54 COM (97) 309, Financial Services: Enhancing Consumer Confidence, 26.06.1997.

55 COM (97) 309, Financial Services: Enhancing Consumer Confidence, 26.06.1997.

56 COM (97) 309, Financial Services: Enhancing Consumer Confidence, 26.06.1997.

57 COM (2000) 511; Proposal for a Directive of the European Parliament and of the Council on insurance mediation, 20.09.2000.

- Different levels of capital across countries impacting cross-border activity; and
- Inefficiency because benefits from pooling, diversification and reinsurance were not being taken into account.

There was in fact no minimum level of prudential supervision between countries, thus diminishing consumer protection and preventing integration. However, the requirements under the FSAP were largely not seen as addressing these market or regulatory failures. Instead there was a concern that the rules on solvency requirements had been unchanged since the 1970's.⁵⁸ The regulation of insurance undertakings (on this issue of their financial soundness and the protection of their policyholders in the case of adverse events) had not kept up with the developments of the financial markets since then. This clearly needed to be addressed and a significant directive was seen as necessary.

4.2. MODEL OF THE IMPACT OF THE FSAP

It is possible to link the various measures both to operational objectives as well as the strategic objectives. In the insurance and pension sector the measures fall under all four of the strategic objectives.

Table 10: Linking measures and operational objectives in insurance and pensions

Measure	Strategic objective	Operational objective
Supplementary pensions	A single EU wholesale market	Remove investment restrictions
IORP		Remove barriers to cross-border occupational pensions; remove investment restrictions; increase consumer protection
Communication on general good	Creating open and secure retail markets	Clarify definition regarding cross-border activity facilitating entry
IMD		Increase minimum standards for intermediaries; Consumer protection; remove barriers to cross-border provision
DMD		Increase minimum standards for intermediaries; Consumer protection; remove barriers to cross-border provision
E-commerce and financial services		Increase minimum standards for intermediaries; Consumer protection; remove barriers to cross-border provision

⁵⁸ European Commission Internal Market website, http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm.

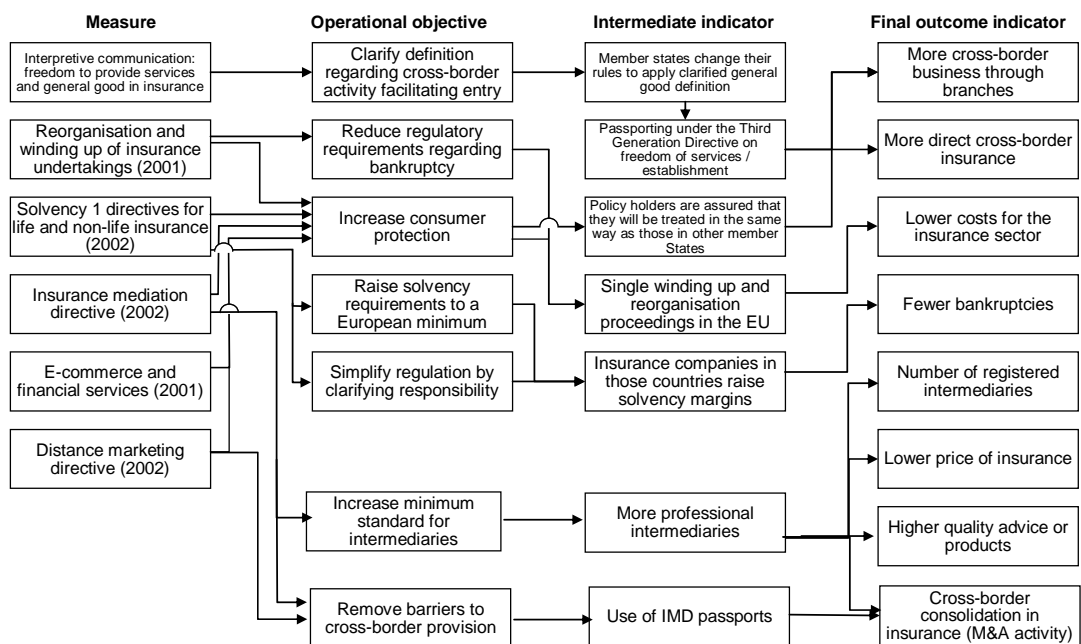
Winding up	State of the art prudential rules and supervision	Reduce regulatory requirements regarding bankruptcy; Consumer protection
Solvency I		Raise solvency requirements to a European minimum; simplify regulation by clarifying responsibility; increase consumer protection
Tax obstacles	Wider conditions for an optimal single financial market	Remove barriers to cross-border occupational pensions

Source: CRA analysis.

The overall impact of the various different measures affecting the insurance sector can be summarised through two causality trees set out in Figure 55 and Figure 56 below. These have been separated into a figure for the insurance market and a figure focusing on pensions for ease of review.

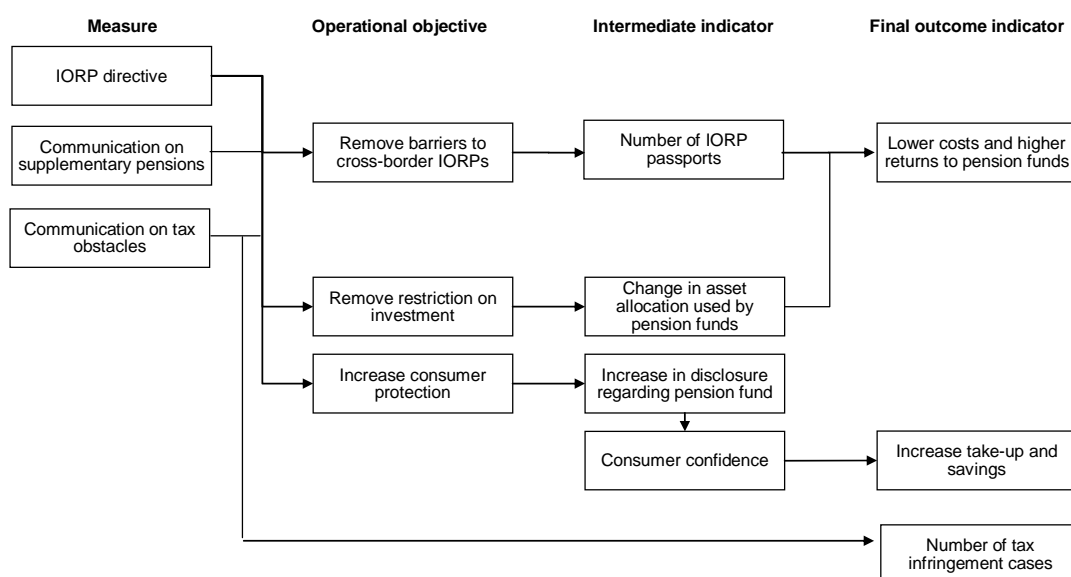
Each tree highlights the operational objective of the different FSAP measures and sets out the different indicators that would be expected to be impacted by the different measures. The causality trees are therefore a summary of the impacts of the FSAP measures and seek to consolidate the overall impact of the FSAP. Given the focus of the work on the FSAP as a whole, this is inevitably a simplification of all of the possible impacts of each of the different measures in different member states. Instead it focuses on the overall effect of the measures taken as a whole package.

Figure 55: Causality tree relating to insurance



Source: CRA analysis.

Figure 56: Causality tree relating to pensions



Source: CRA analysis.

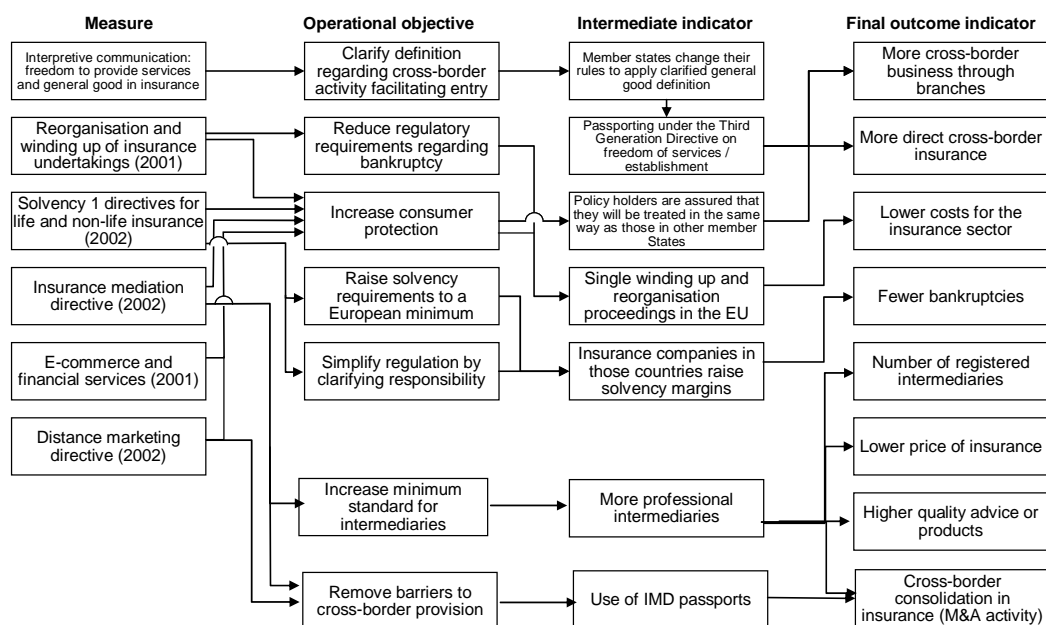
As is clear from Figure 55 and Figure 56 above, there are a number of different indicators that need to be considered in order to establish the impact of the FSAP in the insurance sector. We consider each of these in turn seeking to understand the extent to which any changes in these indicators have been driven by the FSAP as opposed to factors such as ongoing trends or other market developments.

This section first considers the indicators related to insurance, Section 4.4 examines the indicators relating to the pension sector.

4.3. INDICATORS - INSURANCE

Using the structure set out in Figure 57 we look first at the intermediate indicators and then at the evidence regarding final indicators as to the market impacts of the FSAP in the insurance sector. In each case, we consider the evidence that the FSAP affected the indicator in question, whether this would have happened without the FSAP and whether this diminishes the market failures discussed above.

Figure 57: Causality tree relating to insurance



Source: CRA analysis.

There are a number of different measures which all aim at improving prudential regulation or creating an open and secure retail market. These include various measures which were implemented over a long period of time: Interpretative communication on the freedom to provide services from February 2000; E-commerce directive February 2001; Winding up directive from April 2003; the Solvency I Directives from September 2003 2005; the Distance marketing Directive from January 2005; and the Insurance Mediation Directive (IMD) from January 2005.⁵⁹

4.3.1. Intermediate indicators – insurance

Changing the general good rules

One of the first FSAP measures to directly impact the insurance sector was the interpretative communication on the freedom to provide services and general good. The general good allows countries to apply national rules:

59

However, it should be noted that there were problems in the transposition of the IMD in the member states - with Germany particularly late in this regard. Germany only implemented the IMD directive in 2007, therefore it is too early to assess IMD in this case. The EC is undertaking an implementation check that was launched in August 2008.

“A Member State may have recourse to the concept of the general good in order to enforce compliance with its own laws by an insurer wishing to carry on its business within its territory under either the right of establishment or the freedom to provide services.”⁶⁰

The general good was not defined but determined by case law. The communication clarified how the general principles would be applied to the insurance sector (for example, that they should be based on non-discrimination and proportionate to the objective pursued). By clarifying the general good it was hoped that this would reduce unnecessary barriers to cross-border insurance provision and encourage greater integration. The problem was largely seen as resulting from different countries interpreting the general good in different ways.⁶¹ We consider evidence on the amount of cross-border activity below but changes in the way different countries applied the general good rule is a useful intermediate indicator. As a communication it had no legal binding effect, so the result depended largely on how member states decided to react to the communication.

Based on interviews, insurance companies regularly complain about the application of general goods by host member states, however, to identify market impacts we are looking for cases where decisions have been made on the basis of the clarification. Since the communication, the application of the general good in different member states has changed in a number of ways:

- There has been an increase in the clarity regarding the provisions resulting from the general good in particular member states. For example, in Belgium the general good rules are now published and in Spain the insurance regulator has recently published clarification on its rules resulting from the general good. These changes have occurred recently however and the large majority of countries reported that the communication did not lead directly to changes in the application of the general good provision in their country.
- Even without changes in domestic rules, the clarity introduced by the communication may have made it easier to challenge the use of general good which may have previously been used to justify protectionist policies. There have been a number of Commission actions that have focused on the interpretation of the general good provision. This includes:
 - Belgium: the European Commission objected to the Belgian Government regulating no claims bonuses and deductibles for motor insurance. Belgium subsequently changed the rules to allow market forces to determine the application of no claims bonuses.

⁶⁰ Interpretative communication of the Commission concerning the freedom to provide services and the general good of the insurance sector [Official Journal C 43 of 16.02.2000]

⁶¹ “European Insurance Law: A single insurance market?” EUI Working paper Law No. 2001/4. Available at <http://cadmus.iue.it/dspace/bitstream/1814/168/1/law01-04.pdf>

- France and Luxembourg: In both France and Luxembourg the general good was used to justify a compulsory bonus-malus system for third party motor insurance.⁶² The position of France and Luxembourg was eventually up-held by the Courts.⁶³

Recently, the ECJ referred to the freedom to provide services and general good principles in insurance (of this Communication, and as restated in Directive 2002/83/EC) in C-522/04 to show that Belgium had failed to fulfil its obligations by requiring foreign insurers operating under the freedom to provide services to obtain prior authorisation of a resident tax representative (who is personally responsible to the State for the payment of the annual tax on insurance contracts and interest and fines which may be payable under contracts relating to risks situated in Belgium).

Overall, a minority of interview respondents saw that the communication could be useful in complaints against protectionist rules faced by companies. However, even in these cases it would only be referred to in passing and its overall effect was thought to be very small. Unsurprisingly, those countries that primarily export insurance products saw the communication as more useful than those countries that primarily import insurance products.

Based on the interviews undertaken, the impact of the communication was helpful but did not materially reduce the barriers to cross-border insurance provision. We did not identify particular cases, where this reduced or removed barriers that would not have occurred without the communication.

It was recognised that the communication provided greater clarity on the use of the general good provision and may have prevented additional barriers being imposed. However, the definition of the general good is still seen as problematic today. Indeed it was commonly recognised that much of this is still not harmonised, and many rules are imposed on a national basis due to custom. For example, in Spain there is a requirement to have a register of death insurance which is public which means that when someone dies, their beneficiaries can find out whether there was any insurance in place. Indeed, CEIOPS reports that there remains a wide divergence in the interpretation and use of general good across member states.⁶⁴

62 The communication was used in the judgement of Advocate-General Stix-Hackl delivered on 30 March 2004. "Joined opinion of Advocate-General Stix-Hackl" delivered on 30 March 2004(1) Cases C-346/02 and C-347/02 Commission of the European Communities v Grand Duchy of Luxembourg (C-346/02) and French Republic (C-347/02).

63 Judgment of the Court of Justice in Cases C-346/02 and C-347/02, Press release No 60/04, 7 September 2004. Available at <http://curia.europa.eu/en/actu/communiqués/cp04/aff/cp040060en.pdf>.

64 CEIOPS response to EU commission green paper on retail financial services in the Single market. Available at http://www.ceiops.eu/media/docman/public_files/publications/submissionstotheec/FeedbackEUCommissionPaper.pdf

However, it was widely agreed that interpretation of the general good was a minor problem compared to issue to do with differences in contract law.⁶⁵

The number of winding up proceedings and improved consumer protection

As in banking, the directive on reorganisation and winding up procedures of insurance undertakings was intended to ensure that all European consumers were treated fairly, reducing the cost of trading in multiple member states by requiring only a single winding up procedure.⁶⁶ The impact of this could be measured through a reduction in the cost of winding up proceedings and theoretically an increased consumer confidence in purchasing insurance from insurers based in other member states.

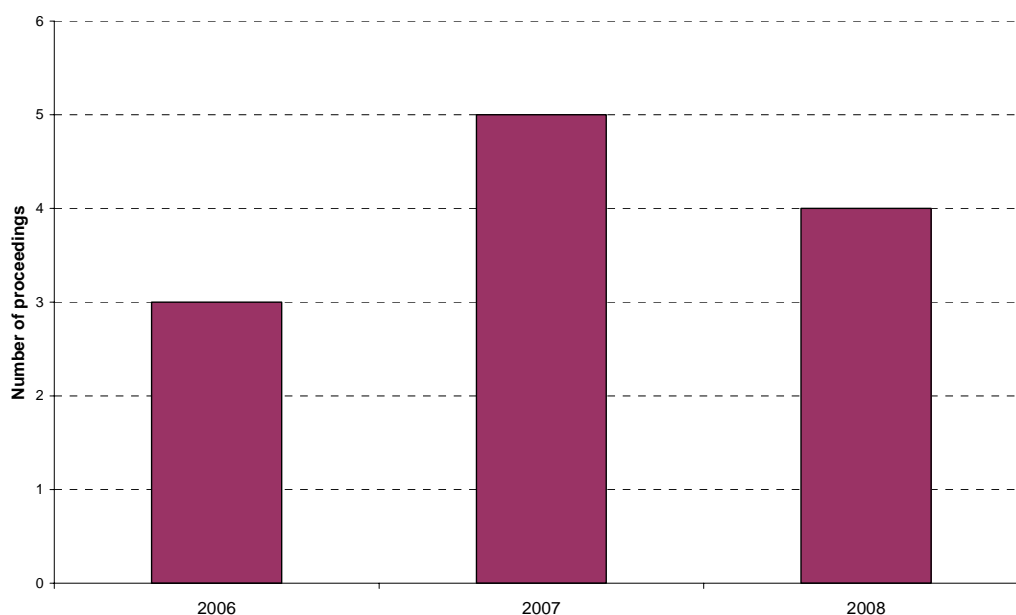
There is no time-series data on consumer confidence but from our interviews it is clear that the impact of common rules on winding-up procedures on consumer confidence was thought to be negligible in all member states. Interviewees state that consumers were often not even aware where the insurer was located and certainly would not be aware of the winding up procedure should the insurer become insolvent. However, this illustrates the difficulty in assessing the market impact of prudential rules. It was recognised that if a large pan-European insurer had become insolvent and had treated consumers differentially in different member states, this could have significantly reduced consumer confidence in any subsequent purchasing of insurance from insurers beyond their member state. As we cannot observe this state of the world it is difficult to fairly assess the impact of this directive. However, it should be noted that we have not been able to identify examples of this kind prior to the introduction of the directive.

Given that the objective of the directive was to establish a procedure that was equally valid for all policyholders in the event of insurance undertakings winding up, it is instructive to look at the number of insurance insolvencies to understand the magnitude of the market impacts. On a country by country basis the number of insurance insolvencies was very low. In only two countries of the 12 member states where interviews were conducted were there any insurance insolvencies reported in the interviews over this period. This is consistent with the very low number of winding up and reorganisation procedures published in the Official Journal (which only shows the number after the impact of the directive). Figure 58 shows the number of insurance winding-up and reorganisation proceedings in the EC Official Journal.

65 Another possible intermediate indicator is the level of passporting using the third generation insurance directives. Data on the number of insurance companies passporting products into different member states is not publicly available.

66 The directive sets standards for the protection of policyholders rights when reorganisation measures are taken. These are defined as measures to preserve or restore the financial situation of an insurance undertaking, which affect pre-existing rights of the parties.

Figure 58: Number of insurance winding up and re-organisation proceedings published in the Official Journal



Source: Official Journal. Available at http://ec.europa.eu/internal_market/insurance/windingup_en.htm.

In total, only 12 proceedings have occurred in the last three years. For each of these the number of countries where the insurer is operating may also be relatively small, as it is most likely to be smaller insurers, operating across fewer countries, are likely to go insolvent. For example, at least two of the companies in the data above operated in only one country.⁶⁷

Few countries were aware of this directive having an impact on participants in their markets. Given the long term liabilities of insurance companies, insolvency is rare and instead companies typically close to new contributions and go into run-off. In this case, it is common for other insurance companies to take-over the insurance liabilities. For this reason, the rules on winding-up proceedings were not seen as having a dramatic market impact in the majority of countries.

The impact of the directive varied from country to country but in many countries the directive was seen to support existing legislation. For example:

- In many countries, domestic rules already required creditors to be treated equitably wherever they were located;⁶⁸ and

⁶⁷ Centro Asegurador, Compañía de seguros y reaseguros (Spain) and Eurolife Assurance (United Kingdom) whose winding-up proceedings were carried out in 2007 and 2008 respectively, each carried out business in a single country. (Source: Capital IQ).

⁶⁸ For example, this was noted in the UK regulatory impact assessment. Available at [http://www.hm-treasury.gov.uk/media/6/B/RIA\(17.9kb\).pdf](http://www.hm-treasury.gov.uk/media/6/B/RIA(17.9kb).pdf)

- Industry vehicles exist in some countries that take over failing insurance companies in countries such as Spain so there is not a problem associated to insurance company failures.

It is also unlikely that the cost of the directive changed company behaviour since it only imposes a cost on any insurance undertaking when it goes into insolvency. Given the low number of insolvencies this will have had relatively little impact on the market place.⁶⁹

Overall, there is limited observable effect but this is unsurprising and does not imply that the directive did not bring the benefits anticipated from the directive. Given both the small number of insolvencies and the unobservable counterfactual of what would have happened in the absence of this measure it is inherently difficult to conclude that there has been a market impact however.

Solvency margins

Since the 1970s there have been solvency margin requirements on insurance companies. Solvency I represented a limited reform to these previous directives and was generally seen as quite simplistic.⁷⁰ It uses multipliers of liabilities and the sum at risk (or the amount payable on death minus the provision held) for life insurance and multipliers using premium and reserves for non-life insurance. Unlike Solvency II, it does not reflect the risk of the insurance undertaking.

In all member states, Solvency I was not seen to have had a significant impact on the solvency margins of most insurance companies. It was generally agreed that the national requirements for a minimum guarantee fund and a minimum solvency margin were already in excess of the rules under Solvency I.

However, even though Solvency I was not seen to have a big impact for the market as a whole, this did not mean it did not affect segments of the market in some member states. For example in Spain and Poland (which chose to apply Solvency I requirements even prior to accession to the European Union), the impact of Solvency I was to raise solvency requirements (in particular the increase in the absolute minimum amounts of capital required was seen as a significant change - the minimum guarantee fund increased substantially from €800,000 to several million⁷¹). In both Spain and Poland there was a large number of small insurance companies and the increased solvency requirements resulted in a small number of insurers merging or being taken over. The market impact of

69 However, we again need to be cautious about assuming this has no market impact. This does not imply that the market impact in terms of confidence and consumer protection is small, only that given the level of insolvencies this is inherently difficult to observe.

70 The solvency margin is the amount of regulatory capital an insurance undertaking is obliged to hold against unforeseen events.

71 The minimum guarantee fund was €800,000 for both life and non-life prior to Solvency 1 (as laid out in Directives 79/267/EEC and 73/239/EEC). Solvency 1 raised this to €2 million (for non-life) and €3 million (for life insurance).

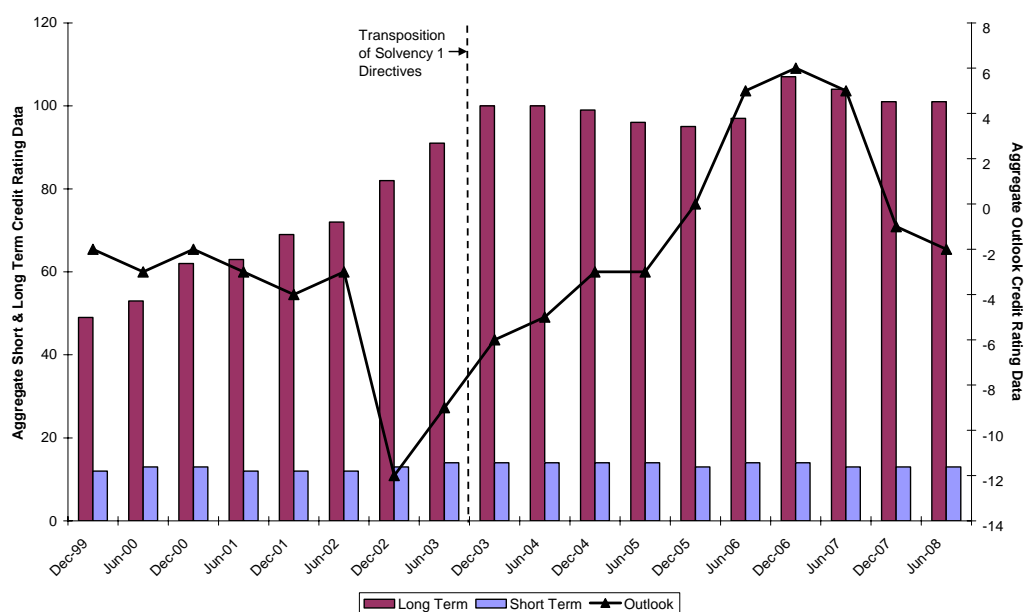
Solvency I in these cases was more significant as it led to consolidation in the industry (even if it only affected very small market participants with a small market share).

However, this is not generally the case. There were a number of other reasons why Solvency I is seen as having little impact on the market in most member states:

- Even when Solvency I was being transposed, member states were discussing the potential for Solvency II – that is Solvency I was not intended to change the solvency of insurers; and
- There was a long transitional period for insurance undertakings allowed under the Solvency 1 directives (5 years from entry into force in 2002) and as of August 2007, some member states still had not implemented the provisions in this Directive.⁷²

Given the qualitative responses from interviews it would be surprising to see a significant change in the amount of regulatory capital or the financial strength of insurers due to Solvency I. In Figure 59 we illustrate the credit rating of leading insurance groups. If Solvency I had increased their solvency margin we would expect their credit rating to rise, other things being equal.

Figure 59: Credit ratings for leading European insurance groups (Top 20)

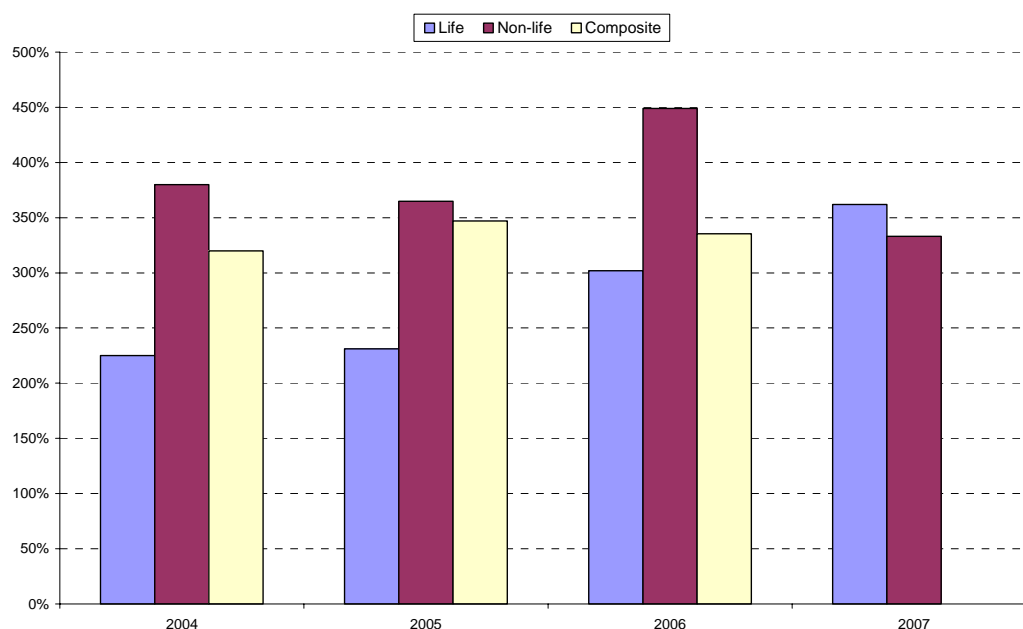


Source: S&P data and CRA analysis. Note that aggregate scores have been generated by S&P using its 'Issuer Credit Ratings' data. Short-term ratings data is available for only 9 of the 20 insurance groups in the Top 20 sample. Indicators in the chart are created by giving points to an insurer for different credit ratings.

⁷² CEIOPS - P1-14/07, Report on the implementation of the current insurance Directives with regard to the eligible elements to meet the solvency margin, August 2007.

On average, Figure 59 shows flat credit worthiness of the largest European insurers over the last four years at the time as overall solvency margins have been increasing (which can be seen in Figure 60). The Outlook data indicates S&P's view of potential change and the likely direction of the rating of the issuer in the future, over the intermediate term (up to 2 years). This "outlook" rating incorporates trends or risks in the market, and tends to change more often than actual (short-term and long-term) credit ratings. As explained in the banking chapter, although actual credit ratings are quite stable, the outlook rises sharply during the period of economic expansion (2003-2006) and then declines very sharply with the sub prime crisis (from June 2007 to the present). The slump in outlook ratings towards the end of 2002 reflect stock market sentiments, however actual long-term ratings were increasing.

Figure 60: Average European solvency margins



Source: CEIOPS Financial Conditions and Financial Stability Report. Note: 2007 data for composite insurance companies is not available.

The slight increase in solvency margin, in Figure 60, cannot be attributed to Solvency 1, since the increase in the minimum guarantee fund as laid out in Solvency 1 did not affect these large insurance groups. These groups would have already had in place guarantee funds higher than the Solvency 1 minimum. Nevertheless, credit ratings are more likely to be driven by general economic conditions rather than Solvency legislation, as seen by the recent downward trend in credit ratings outlook data in Figure 59.

The indicators above will be useful in assessing the impact of Solvency II but it seems clear that Solvency I did not have a significant impact on large insurers and any change we observe in these indicators is due to other factors. In markets where there was a high level of fragmentation this resulted in some consolidation.

In addition to changing solvency margins, harmonisation of solvency margins could bring other benefits, for example, reducing the cost of entering other member states or mergers

and acquisitions. However, in Solvency I member states were free to establish more stringent rules than those laid down in the Directives, to take account of specific local risks. It is therefore unsurprising that in practice there are significant differences between member states.

In preparation for Solvency II, the CEA conducted a survey of pan-European insurers as to differences in the application of Solvency I.⁷³ They found differences in the following areas:

- The methodology for calculating technical provisions, e.g. the UK has a market-consistent approach, and in some countries there is an interaction of technical provisions with local accounting rules (e.g. France, Germany);
- The extent of prudent margins;
- The treatment and recognition of unrealised gains which is different in virtually every country;
- Spain has a unique cashflow / duration matching requirement;
- ALM stress requirements differ in some countries e.g. UK and Germany;
- Treatment of equalisation reserves;
- Sub-group consolidation, which is required in many states (e.g. Belgium and Germany);
- Provision for financial hazard, which is required in France and Belgium, but generally not elsewhere;
- Asset admissibility and eligibility rules, especially for new asset classes not covered in the existing Directive, e.g. derivatives, asset backed securities, hedge funds, private equity; and
- Additional actuarial reports, e.g. in Luxembourg special actuarial reports were required from 2006 onwards.

The CEA concludes that these large differences in regulatory requirements are effective barriers to cross border competition. This is consistent with the behaviour of insurance groups who have found it necessary to acquire operations or enter into joint ventures rather than develop their own businesses in new territories. Similarly, groups have typically found it necessary to design different products for different states because of the different regulatory environment, which greatly reduces possible economies of scale. Therefore we do not believe that Solvency I contributed to the increase in merger and acquisition activity seen in the insurance sector below.

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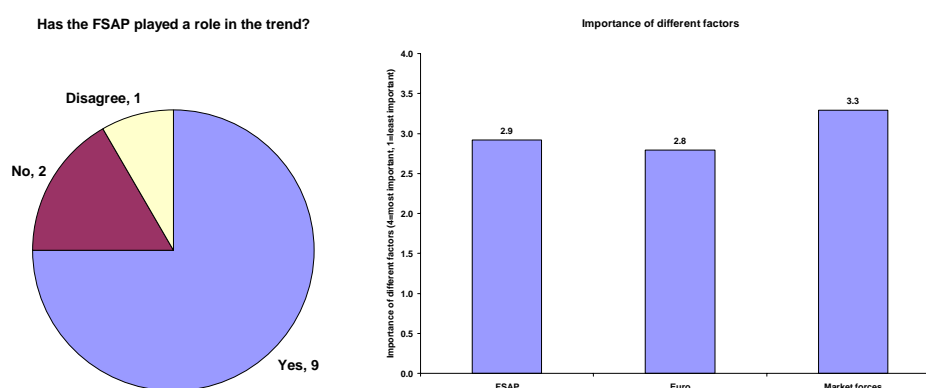
Impact on insurers of the lack of harmonisation in Solvency I 5 June 2007. Available at http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/annex-c08e_en.pdf

Increase quality of intermediaries

Under the IMD rules, insurance intermediaries in all member states are required to be registered with a specifically designated competent authority in their respective jurisdictions. Registration of intermediaries is subject to the fulfilment of strict professional requirements and enables them to operate across the entire EU, after previous notification to the home competent authority of the decision to carry out insurance mediation abroad. According to article 4.1 of the IMD, insurance intermediaries must possess “appropriate knowledge and ability, as determined by the home member state of the intermediary.”

A direct effect of IMD could therefore be to raise professional standards of intermediaries. In the interviews, we found consistently that IMD had increased the rules regarding application for intermediary status, the exams required and ongoing training. This is shown in Figure 62 below.

Figure 61: Impact of FSAP on quality of insurance intermediaries



Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

However, although there is a clear impact of IMD in increasing the quality of intermediaries, this should not be overstated since in some member states

- Market forces were already encouraging higher standards; and
- Domestic regulation was already requiring a registration procedure and training requirements.

The results from our interviews are set out in Table 11 below.

Table 11: Increased professionalism of insurance intermediaries

Member state	Previous regulation	Change in professional standards
Belgium	Statutory regulation	Similar to existing standards

France	Statutory regulation	Already contained in Livre V of the Code des Assurances but modest increase in standards
Germany	No previous regulation	None
Ireland	Statutory regulation	Marginal increase building on domestic regulation
Italy	Statutory regulation	Ongoing training in addition to an exam
Luxembourg	Statutory regulation	Similar to existing rules
Netherlands	Statutory regulation	Pre-existing but increase in standards required
Poland	Statutory regulation	Increase by type of intermediary
Portugal	Statutory regulation	Introduced exams and training
Spain	Statutory regulation	Significant increasing in training
Sweden	Statutory regulation	Increase focus on intermediary professionals
UK	Voluntary regulation	Increase in training

Source: CRA survey and analysis.

Overall, this provides evidence of an increase in the professionalism and quality of intermediaries.

4.3.2. Final indicators – insurance

The direct impact of the insurance directives should be to:

- Increase cross-border insurance provision;
- Reduce the number of insurance bankruptcies;
- Raise the quality of advice provided to consumers;
- Impact the number of registered intermediaries (although theoretically it could increase or decrease the number); and
- Increase cross-border consolidation.

Cross-border insurance provision

Even before the FSAP the insurance market had seen a number of European directives (including three generations of Life and Non-life insurance directives) and we need understand whether changes in the market after the FSAP were resulting from its introduction or were due to earlier interventions.⁷⁴ The First, Second and Third

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For Non-life: Directives 73/239/EEC, 88/357/EEC and 92/49/EEC. The corresponding Life Assurance directives have been consolidated in Directive 2002/83/EC.

Generation Insurance Directives were seen as including important changes to insurance regulation. These directives addressed issues related to freedom of establishment and freedom of services for life insurance, non-life insurance and reinsurance undertakings in the EU.

The Life and Non-Life Third Generation Directives were implemented on 1 July 1994, and these entailed:

- The single licence, permitting insurance companies registered in their home country to transact insurance business anywhere in the EU;
- The principle of home country control, whereby insurance companies are under the control of their home country; and
- The abolition of substantive insurance supervision, so that prices and conditions can be governed by the market, and so there are minimum standards for financial supervision.⁷⁵

Although certain obstacles and loopholes in legislation are recognised, these were expected to increase market integration within Europe potentially allowing the insurance companies to build up an insurance portfolio that is better diversified internationally. Deregulation was intended to change the structure of insurance markets, with more foreign companies being encouraged to enter the markets. In addition to the insurance measures pre-FSAP discussed above, a number of other directives have affected the insurance market: five directives concerning third party motor liability insurance; the recently adopted Reinsurance Directive; and a number of directives dealing with specific insurance-related matters.⁷⁶ To measure the impact of the FSAP it is important to examine the amount of insurance that is provided on a cross-border basis, either through branches and agencies or through the freedom to provide services.

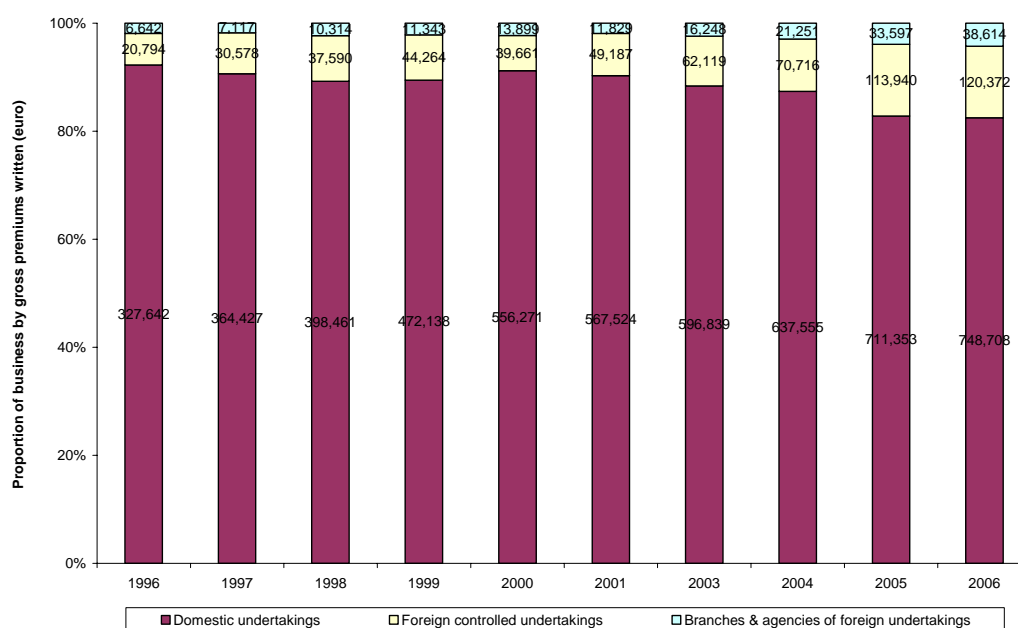
Branches and agencies

Figure 62 and Figure 63 show the breakdown of gross premiums written for life and non-life insurance respectively and suggest that for life insurance, the proportion of business written through foreign branches and agencies has remained relatively constant over time, while that written through foreign controlled undertakings has increased slightly. For non-life insurance, the proportion of business written through both foreign branches and agencies and foreign controlled undertakings has increased slightly over time. It is important to note, however, that the “foreign” shares in this data include countries within *and* outside the EU-15; so while these foreign shares might be partly from cross-border activity within the EU-15, and EU-27, they might also be partly from non-EU countries.

75 Hess & Trauth (1998)

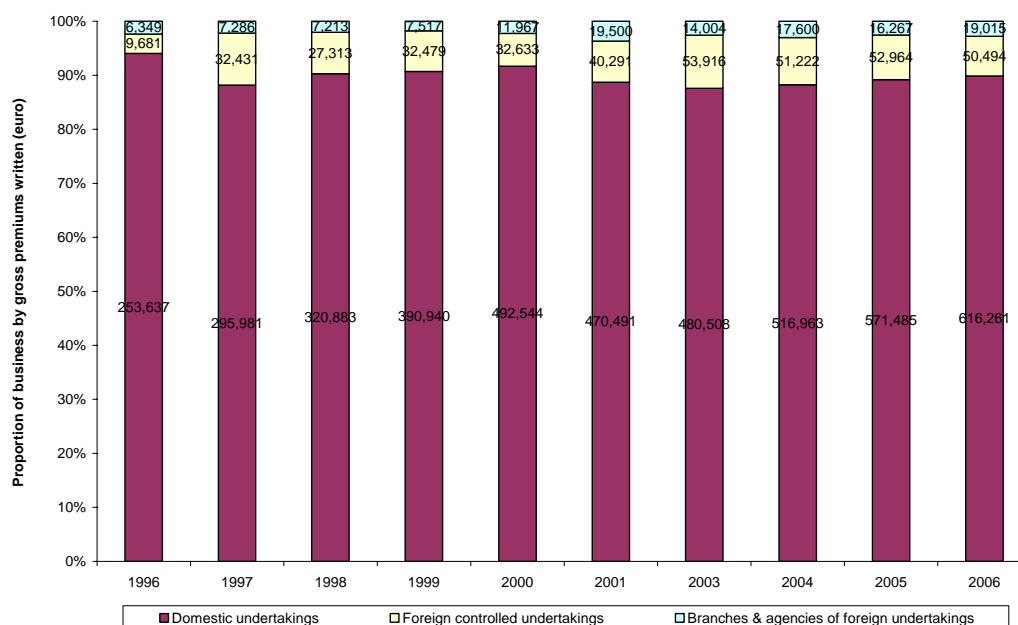
76 Directives covering motor insurance were 72/166/EEC, 84/5/EEC, 90/232/EEC, 2004/26/EC, 2005/14/EC. Reinsurance directive 2005/68/EC. Directives on Coinsurance (1978), Tourist Assistance (1984), Credit and Suretyship (1987) Legal Expenses (1987), Insurance Company Accounts (1991), Supplementary supervision of insurance groups (1998).

Figure 62: Proportion of business by gross premiums written in the EU-15 – Life insurance



Source: OECD Insurance Statistics. Note: 2002 has been excluded due to missing data.

Figure 63: Proportion of business by gross premiums written in the EU-15 – Non-Life insurance



Source: OECD Insurance Statistics. Note: 2002 has been excluded due to missing data.

The trend towards increased use of foreign branches and agencies has been slight and reflects a trend that was already occurring prior to the FSAP and market participants did not believe that this was due to the FSAP measures. However, the trend does vary to some extent from country to country.

- In Spain, the trend to foreign branches and agencies has been more dramatic and there has been a growth of around six times for premiums from insurance companies from various countries coming into Spain. There has also been a growth of around 3 times for Spanish companies going out to other countries. Both of these changes are to do with market forces and are little to do with the FSAP.
- For Belgium, on the other hand, the harmonisation of insurance standards from FSAP legislation did facilitate cross-border activity. For example, KBC (a Belgium bancassurance company) decided to invest in a number of Central European countries including Poland, Czech Republic and Hungary. In this case KBC's decision stemmed from commercial opportunities (including those resulting from privatisations), but it was facilitated by the FSAP.

Overall, where there has been an increase in cross-border insurance, most member states suggest that this was made possible due to freedom to provide services and the increasing importance of bank assurance, which was in place well before the FSAP legislation. Ireland and Luxembourg have always experienced a great deal of cross-border insurance activity, but this happens mostly in the form of foreign EU companies setting up in Ireland and Luxembourg and passporting back to their own countries through the freedom to provide services. This has been happening for a long time, and pre-dates the FSAP.

Cross-border purchases

When considering cross-border purchases of insurance it is important to note other ongoing changes. Particularly at the retail level, the rising significance of e-business was thought likely to drive financial integration. In particular, technological changes through the internet were seen as offering a big chance to offset certain obstacles to market entry. There was an expectation of entry into the market by "potential competitors with a lower financial size."⁷⁷

Insurance selling via the internet has been growing in Europe, but is still quite limited. The reason for this is not only that internet connectivity varies greatly across Europe (80% of the people in the Netherlands are connected to the internet, while this figure is only 40% in Italy), but also that advice is important to the consumer, and remains central to the insurance selling in many European countries. Consumers do use the internet for product research, but actual online sales are still low. In motor insurance, however, online sales in

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Rainer Beckmann, Carsten Eppendorfer and Markus Neimke. *Financial Integration within the European Union: Towards a Single Market for Insurance*. In ZEW Economic Studies 19, "The Incomplete European Market for Financial Services", 2002.

countries like the UK are quite high. In the UK, where 60% of the population is connected to the internet, about 40% of motor insurance is sold online.⁷⁸

In practice, there has not been an increase in the direct selling of insurance across borders of member states. Distance selling has not been significant across borders – a physical local presence is usually necessary for the selling of a product like insurance. Insurance integration, particularly at the retail level, still faces several obstacles, which are the causes for the sector falling short of market expectations despite the liberalised, deregulated framework provided by the Third Generation Directives. In particular, contract law and differences in tax regimes remain significant issues meaning that general insurance remains a national market.

Number of insolvencies

Given that Solvency I did not have a big impact on the solvency margins held by insurance companies we would not expect it to have a significant impact of the number of insurance failures. The number of insurance failures in the period 2001 to 2004 and in the period 1996 to 2001 is shown in Table 12.

The evidence presented suggests that the number of failures on an annual basis has stayed broadly the same. In annual terms the number of failing companies went from 14 per year, to 12 per year. This is consistent with Solvency I having little impact on the overall level of capital held by insurance companies.

Table 12: Number of insurance failures

	1996-2001	2001-2004
Number of failing companies	85	48
- in which policyholders' rights were safeguarded	65	37
- resulting in winding-up (life)	3	11
- resulting in winding-up (non-life)	17	0
Near misses	155	152

Source: Oxera report, Insurance guarantee schemes in the EU, November 2007. The numbers in the report apply to different period lengths (6 years and 4 years respectively).

Solvency 1 was introduced in 2003 so it is difficult to draw strong conclusions on the basis of this data, however, based on interviews this has not changed since the FSAP so we conclude that Solvency I did not have a significant impact on the number of insolvencies. In most markets insurance companies are seen as having very high levels of reserves.

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PA Consulting, Extract article from PA Perspective on European insurance, *Unleashing the internet: follow the customer*, First Edition 2008. Available from http://www.paconsulting.com/publications/pb_open/pb_european_insurance_extract_unleashing_internet.htm

Solvency II is being anticipated as bringing more a more appropriate relationship to the risk and is likely to have a much more significant impact than Solvency I.

Number of insurance intermediaries

The impact of IMD was to raise the professionalism of insurance intermediaries as discussed above. In addition to the need for intermediaries to register with their regulator, and comply with the training and qualification regime, they needed to change their disclosure documentation and ensure they had professional indemnity insurance. It is possible that increased consumer confidence resulting from higher professionalism could lead to a larger market and more intermediaries. On the other hand, the increased regulatory requirements and the associated cost of regulation could have reduced the number of intermediaries that were serving the market. This could, in theory, reduce competition in the market and could even mean that consumers are not able to access advice whereas they had previously been able to do so. To try to measure this impact we have collected data on the number of registered intermediaries and how this has changed over time. This is reported in Table 13 below.

Table 13: Number of registered intermediaries

Member state	2003	2004	2005	2006	2007
Belgium	28,048	26,921	26,307	24,798	23,373
France					40,000
Germany					108,070
Ireland	~10,000				<10,000
Italy		36,219	35,540		180,000
Luxembourg		7,000			7,000
Netherlands			25,000	12,000	9,500
Poland					40,000
Portugal	39,680	38,814	37,916	37,466	25,000
Spain	3,304	3,362	3,346	3,116	90,276
Sweden					6,000
UK					15,984

Source: CRA analysis.

All member states must now keep a register of intermediaries (and make this available for consumers to interrogate). This means that the availability of statistics after IMD are much more comprehensive than those before. However, it is very clear from examining the evidence on the number of intermediaries that in some markets there have been significant changes in the number of registered intermediaries. In some cases these changes have been significant increases, in other significant reductions. Looking purely at

the quantitative evidence that is reported on the number of intermediaries would be extremely misleading. When countries transposed IMD they took different positions regarding the need for different types of intermediaries to register. In particular:

- Whether tied agents need to register individually or only through a central function;
- Whether administrative staff registered; and
- Whether intermediaries with very low levels of insurance premiums needed to register.

The significant changes in the number of intermediaries often seems to reflect the change in the definition of intermediaries that needed to register rather than a real change in the number of advisers. For example, in Italy, pre-IMD, it was not necessary to register all people involved in the sale of insurance products. So for example collaborators of insurance agents and commission based salesman were not listed on the register before IMD but they are now. On the other hand, the introduction of the register may have had a big impact on certain categories of operators whose principal professional activity is other than insurance mediation (for instance: stores of electronics goods, renting cars, leasing firms). In order to consider this phenomenon, there has been an effort on the regulatory side to allow these categories, under certain circumstances, to have at least one reference registered per sale point, instead of all employees.

Instead of relying purely on the quantitative data alone, evidence from interviews is especially important in interpreting this data. Indeed most weight should be put on the qualitative assessment of the impact of IMD on insurance intermediaries derived from the interviews which reports what interviewees within the market thought had really happened to the underlying number of intermediaries (rather than the number of reported intermediaries that may reflect definitional changes). This is set out in Table 14 below.

Table 14: Impact of FSAP in the number of intermediaries

Member state	Change in number of intermediaries following IMD	Whether IMD main driver
Belgium	Decrease	Not due to IMD
France	Possible increase	
Germany	Too early to tell	Only transposed in May 2007 and distributors have until the end of the year to take an exam and register
Ireland	Small decrease	Yes, some contribution
Italy	No change	Regulation allowed small intermediaries to continue.
Luxembourg	No change	
Netherlands	Decrease	Yes
Poland	No change	
Portugal	Decrease	
Spain	Difficult to tell (although numbers show dramatic increase)	The scope of the register changed in Spain after the IMD – more types of companies included in register.
Sweden	Decrease	
UK	Small decrease	Yes

Source: CRA survey and analysis.

Even where the number of intermediaries have changed, we need to allow for the fact that the number of intermediaries may also change for other reasons. In particular, market forces were thought to be the most important driver in most markets. This could take a number of forms:

- Insurers could be choosing to focus their activity on a smaller number of intermediaries;
- Consolidation between insurers and banks could result in consolidation in the main intermediary channels being used by a company; and
- Consumers may be changing their purchasing decisions. There has been a general trend away from the use of intermediaries in the non-life sector and towards direct writing. This has partly been driven by the internet and the ability to easily find out information about the policy terms and the availability of comparison sites.

Domestic regulation was also thought to be a very significant factor. For example, in the UK the number of intermediaries changed significantly following the mis-selling crisis associated with personal pensions and the regulatory changes that followed.

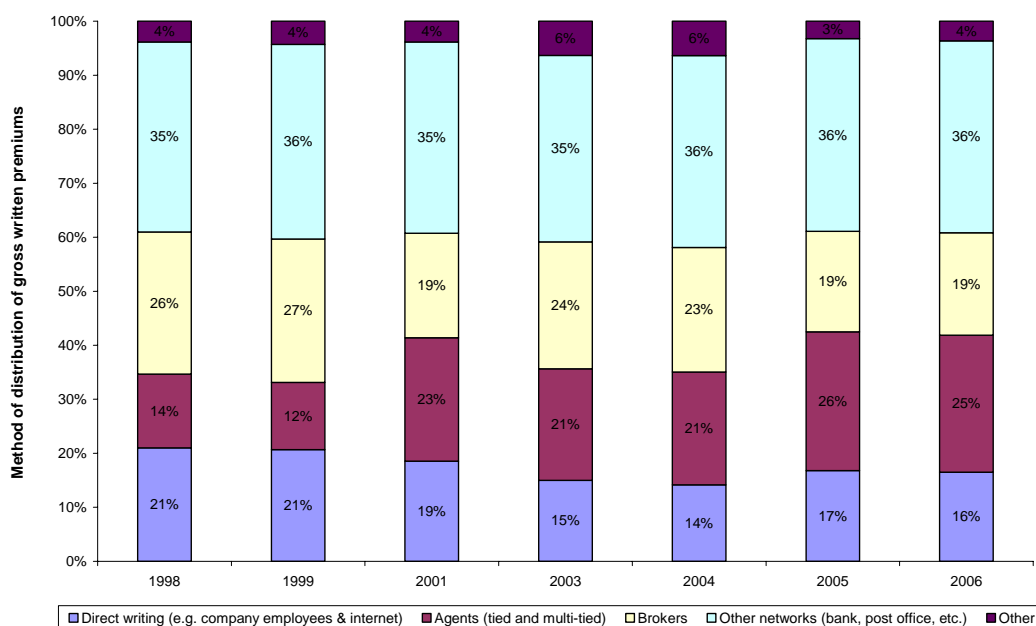
However, in summary in a small number of member states, the introduction of IMD did result in a reduction in the intermediaries operating in the market with very low levels of premiums. IMD clearly impacted the reported number of intermediaries and in some markets it did significantly reduce the number of intermediaries conducting services (the impact depends on the way regulation was introduced and the pre-existing regulation).⁷⁹ IMD was perceived to be a big clean up in terms of the intermediaries who were active in the market and represented the first time that the intermediaries were really regulated. This was not generally seen to have reduced the amount of insurance purchased or the availability of insurance. For example some companies involved in retailing (that had previously offered insurance) were now introducers rather than advisers. We do not therefore find evidence that IMD significantly reduced access to insurance or that it reduced competition.

Indeed, another way to look for this effect is to examine how insurance products were distributed before and after the introduction of IMD in January 2005. Prior to the introduction of the IMD directive, there was a significant decrease in the role of insurance company employees (direct writing) in distribution. Indeed, between 1998 and 2004 this fell from 21% to 14% for life insurance, and from 34% to 20% for non-life insurance. Over the same period, the role of brokers and agents has increased for both life and non-life insurance, and the role of banks and post-offices has stayed roughly the same. Since the introduction of IMD at the beginning of 2005, there has been a slight increase in the role of direct writing and a slight decrease in the role of brokers, for both life and non-life insurance. It is important to note that in many countries, companies have launched a multi-channel strategy that might explain the erosion of the leading distribution channel to the benefit of other channels. Furthermore, large changes that can be seen in the data may be due to changes in the classification of channels over time for some countries.

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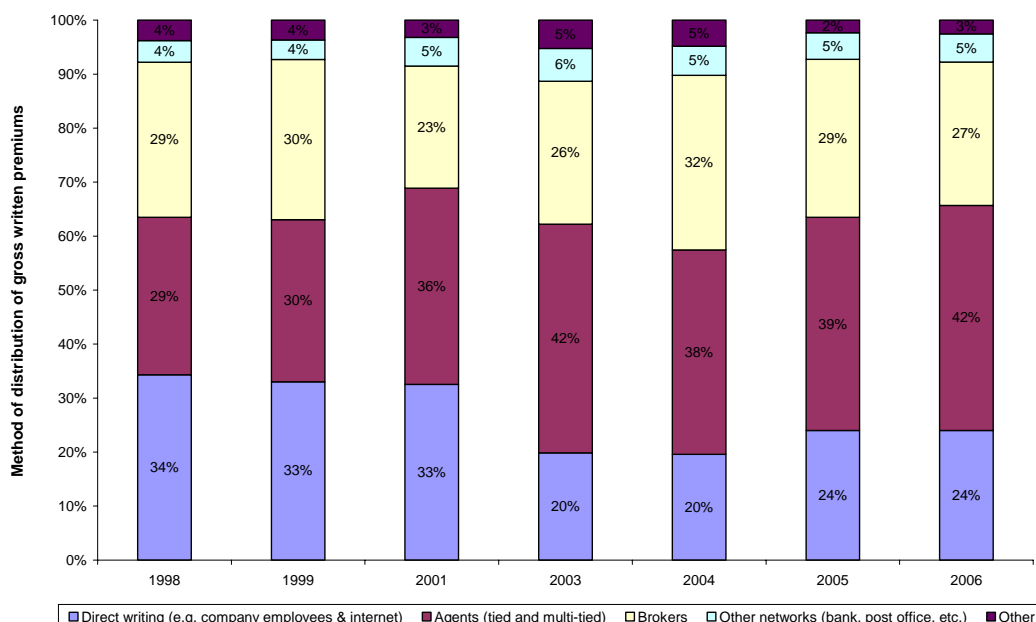
In particular, some countries significantly gold-plated the implementation of IMD, in the UK IMD was applied to insurance companies selling direct. This has subsequently been removed. Equally, in Italy, IMD has been applied to a very wide definition of intermediaries.

Figure 64: Insurance distribution channels in Europe – Life insurance



Source: CRA calculations based on CEA Statistics. Note that 13 countries have been included: Austria, Belgium, Spain, France, United Kingdom, Ireland, Italy, The Netherlands, Poland, Portugal, Sweden, Slovenia and Slovakia.

Figure 65: Insurance distribution channels in Europe – Non-life insurance



Source: CRA calculations based on CEA Statistics. Note that 13 countries have been included: Austria, Belgium, Spain, France, United Kingdom, Ireland, Italy, The Netherlands, Poland, Portugal, Sweden, Slovenia and Slovakia.

The above picture shows aggregate data for 13 EU countries. In order to understand the data better, we need to look at the data on a country by country basis. In many markets,

retail non-life insurance has increasingly been distributed by direct channels, in particular, the sale of motor insurance over the internet has become very common. We can see this in Figure 65, over the 2004- 2006 period. In life insurance markets there are different trends in different member states, in some countries banks have become more important and insurance employees have increased due to the importance of bancassurers (this is captured in the “Other networks (bank, post office, etc)” category in the data). However, based on the interviews, the primary driver behind changes in distribution is market forces rather than the FSAP, we therefore conclude that changes in the pattern of distribution of insurance products has little to do with the FSAP.

High quality advice

One of the objectives of IMD was to raise the quality of financial advice provided by insurance intermediaries. Through a better qualification and training regime, ensuring intermediaries collected information on consumer circumstances and provided more documentation on why the customer was advised, IMD should have encouraged a higher quality of advice and better recourse if things went wrong.

It is notoriously difficult to measure the quality of advice. Advice by its nature often depends on the characteristics of the individual customers and advice is based on the information available at the time – good advice at the time, may subsequently lead to the consumer suffering a financial loss (due to unexpected circumstances).

There are a number of possible indicators to try to measure the quality of advice. In particular, the number of complaints can be used a possible metric – if quality of advice increases we would expect the number of complaints to fall.

Table 15: Impact of FSAP on the number of complaints

Member state	Change in number of complaints following IMD
Belgium	Increasing. From 2003 to 2006, it has grown from 3000 to 3,400 complaints in 2007
Germany	The number of queries had increased from 8,408 in 2002 to 18,451 in 2006
Ireland	Recent complaints data for life and non-life shows an increase in number of complaints (1,632 in 2005; 1,886 in 2006; 2,046 in 2007 and 2,773 in 2008)
Italy	Increasing, in 2007 there were 29,523 complaints
Spain	There has been an increase in number of complaints
Sweden	Sweden has a similar level of complaints to before FSAP
UK	Increase

Source: CRA survey and analysis.

The problem with data on the number of complaints is how to interpret them. In some countries IMD resulted in the creation of an ombudsman and increased the amount of

information provided to consumers on the availability of an ombudsman. This introduces a number of problems:

- The number of complaints might rise because consumers are now aware of complaints procedures – this may be beneficial but not as a measure of the quality of advice;
- Complaints at the ombudsman might displace those that were going to companies directly (and may be resolved to the consumer benefit);
- A complaint does not mean that the consumer suffered, we would need evidence on the number of complaints found favour of the consumer; and
- Consumer complaints can involve product issues or intermediary issues. For example, many complaints are regarding the ability of the consumer to claim from the insurer rather than the sales process or advice the consumer is given.

On the basis of the interviews undertaken, it seems clear that IMD raised the profile of the complaints procedure and may have made a small contribution to more complaints being made. This may bring benefits to consumers but is not a useful indicator of the quality of advice.

In order to measure the quality of advice some member states have experimented with mystery shopping exercises and using the experience of real consumers. Given the differences in the experiments tried in different member states it is not possible to compare these across countries and draw overall conclusions.

Evidence from interviews explained above indicated that IMD had increased the professionalism of intermediaries and interviewees stated that the quality of advice had risen as a result of IMD. It is not possible to find a quantitative indicator to measure this directly and hence we rely on the interview evidence that quality has increased.

Cross-border consolidation in insurance

Ultimately increased cross-border provision of insurance products and intermediaries is intended to increase competition.⁸⁰ Ideally this could be measured by looking at the insurance offering to consumers and seeing if they were being offered better value products or products of higher value. In practice it is not possible to do this. There are a number of ways we can measure this effect by looking at changes in market structure, in terms of entry and consolidation and the impact on concentration.

Mergers and takeover activity

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This could result from consumers purchasing across borders, or through cross border activities such as freedom to provide services or the freedom of establishment. In practice very little insurance is purchased by consumers directly from other member states today, although if the market develops in the future this could bring substantial benefits. For this reason we have not focused on the impact of the distance marketing directive at this point in time.

M&A has been the dominant strategy for insurance market integration for some time because “a merger with a foreign insurance company has the crucial advantage of acquiring the necessary know-how about national conditions.”⁸¹ Also, foreign companies tend to use acquisitions to gain access to distribution channels to avoid high investment costs needed to set up their own distribution networks.

Even prior to the FSAP, most of the integration in the EU insurance sector took place through cross-border mergers and acquisitions.

- Information available on the M&A activity in the non-life insurance sector shows that the value of M&A transactions in Europe’s six biggest non-life markets rose from \$1.5 billion in 1992 to more than \$35 billion in 1997, although it had dropped back down to \$20 billion in 1999. These figures include national, as well as cross-border deals. However, cross-border M&A was becoming increasingly significant – 30% of deals announced in 1992 were cross-border deals, while 50% were cross-border in 1999.⁸²
- Swiss Re’s analysis of the 6 largest non-life national markets also indicates the significance of mergers and acquisitions: Over the period of 1990-1998 the combined share of European multinational insurers in the 6 markets rose from 18% to 39%, which can be attributed almost exclusively to M&A. European market shares of the biggest European non-life insurers also doubled (16% to 31%) over the same time period.⁸³

The focus on M&A activity has not been even across member states. From 1990 to 2002 there were 2,595 M&A transactions involving European insurers as an acquirer and/or as a target. Activity peaked in the year 2000, and 1,669 of the deals resulted in a change of control. These transactions occurred both cross-border and within-border as well as cross industry (e.g. “bancassurance” deals). However, M&A activity often focused on UK targets. Evidence from the Sector inquiry shows that during this period transactions in which the target was a UK company ran at approximately four times the level, both in terms of number and value, of transactions involving targets in any other large insurance market and they exceeded the total for such deals involving targets in France, Germany and Italy combined.⁸⁴

81 Hess & Trauth (1998)

82 Swiss Re (2000) – Europe in focus: Non-life markets undergoing structural change. This number includes intra-State M&A, but also includes several cross-border deals as well. A list of ‘megadeals’ in Europe non-life in the 1990s is available in the Swiss Re report.

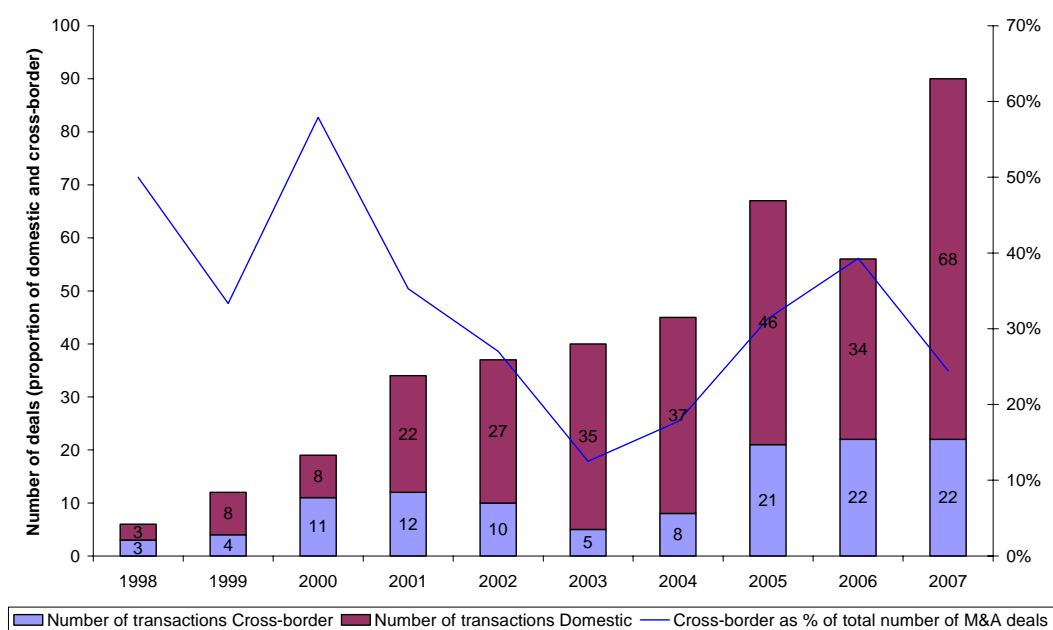
83 Allianz, AXA, Generali, Zurich, RSA, CGU and Winterthur. Swiss Re (2000).

84 See Cummins, D.J. & Weiss, M.S. ‘Consolidation in the European insurance industry: do mergers and acquisitions create value for shareholders?’ Brookings- Wharton Papers on Financial Services (2004) pp. 217-257.

The recent EU investigation in insurance provision for commercial organisations, identified deregulation of EU insurance markets as causing a sharp rise in M&A activity in the 1990s leading in turn to more concentrated European markets. While the 1980s saw a large volume of national mergers and acquisitions, cross-border deals became more prominent in the 1990s, rising to 50% of the total in 1999.

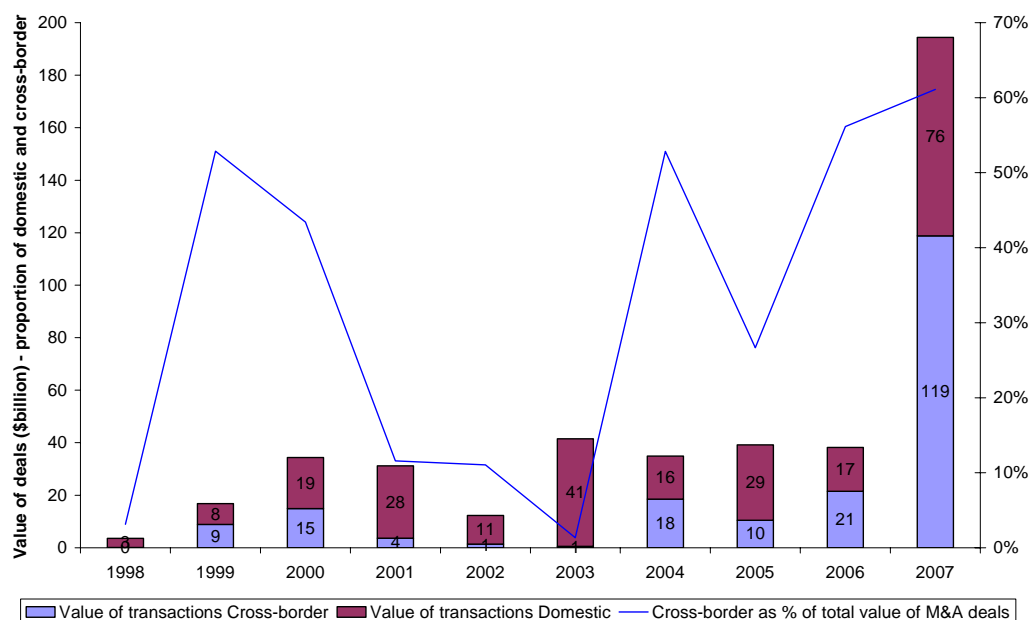
Turning to the post-FSAP period, there has been considerable M&A activity in insurance, with consolidation both within and across member states. Figure 66 and Figure 67 below show the increasing trend of M&A activity in Europe. The proportion of cross-border transactions (in terms of both number of deals and value) shows a mixed trend. Overall, however, though cross-border transactions make up a relatively small proportion of M&A activity in terms of the number of deals, they make up a fairly large proportion of M&A activity in terms of the value of deals.

Figure 66: M&A activity in the EU in the insurance sector – number of deals, cross-border vs. domestic.



Source: Capital IQ and CRA analysis.

Figure 67: M&A activity in the EU in the insurance sector – value of deals, cross-border vs. domestic.



Source: Capital IQ and CRA analysis.

Overall, there is continued growth in number of M&A deals but this reflects an ongoing trends. The value of M&A activity is clearly closely related to overall stock market performance. There has been a significant increase in the last year, but is difficult to associate any change in the level of M&A activity with the changes resulting from the FSAP.

Concentration

The result of M&A activity has been increasing concentration of EU member states' insurance markets. In 1999, the CEA noted that the life insurance market was generally concentrated, and that a few large operators dominated the market in most European countries. Only in Germany, Spain and Italy do the 10 largest life insurance companies have 50% or less of the market whereas, in Cyprus, Estonia, Finland, Lithuania and Poland, the 5 largest have a market share of 90% or more. The existence of highly concentrated markets could be attributed to the developing markets in Eastern European countries, or to the fact that small populations in some European countries do not create the need for as many companies as large populations.⁸⁵

In the same period, there has also been a substantial change for non-life insurance market shares. Over the 1992-2006 period, in most countries, the market share of the 10 largest companies had grown between 5 and 15%. In 1999, in Germany and Spain, the 10 largest companies held less than or equal to 50% of the non-life insurance market

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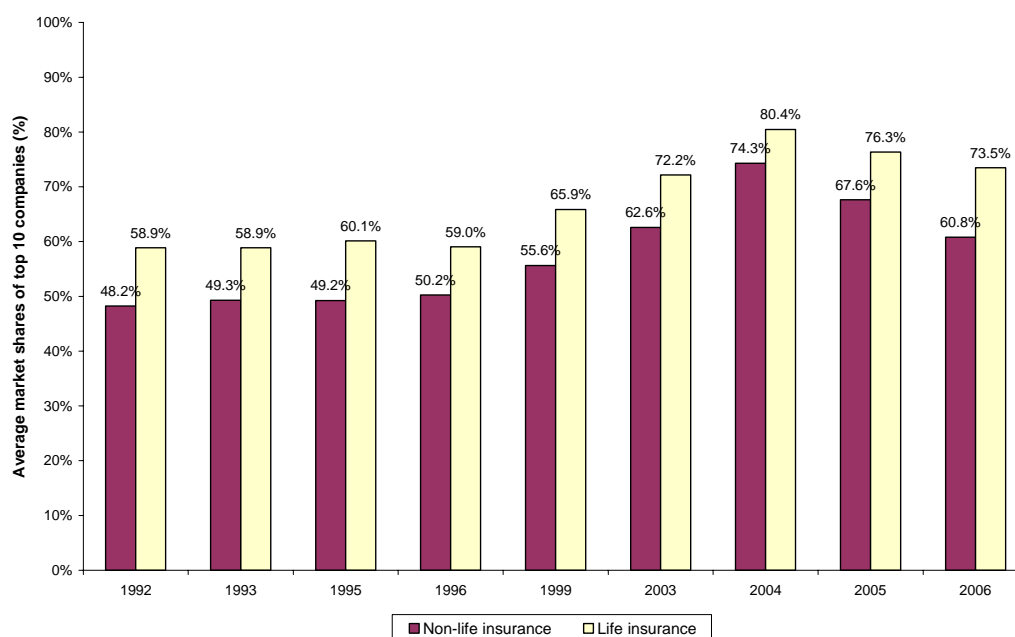
CEA, European Insurance in Figures: Basic Data 2000, Complete 1999 Data.

share and only in 3 countries (Finland, Ireland and Sweden) did the 10 largest companies have more than 90% of the market.

Data on the average market share of the 10 largest companies in the EU-15 suggests that both life and non-life insurance markets became increasingly concentrated in the years leading up to the FSAP, as well as after the FSAP came into effect, even though concentration in life insurance was greater than in non-life insurance overall.⁸⁶ CEA data indicates (see the figure below) that for non-life insurance, the average market share for the 10 largest companies increased from 48% in 1992 to 61% in 2006; and for life insurance the increase was from 59% in 1992 to 74% in 2006. Market shares for the 10 largest companies for both types of insurance peaked in 2004 (74% for non-life and 80% for life insurance).

The increase in market concentration is mainly driven by domestic consolidation within the sector, which in turn is due to existing market forces. In some markets an additional driver of market concentration is Solvency 1 requirements which drove some small insurance companies out of the market but this is a second-order effect.

86 Looking at the size of insurance companies can be misleading. European banks' involvement in life insurance is far greater than their involvement in non-life insurance, especially as regards insurance underwriting (as opposed to insurance distribution). While nearly all the major European banks have set up or acquired life insurance subsidiaries, far fewer have established non-life insurance subsidiaries. Non-life insurance underwriting companies owned by banks focus almost exclusively on simple non-life insurance products, such as home insurance, accident and health insurance.

Figure 68: Average market shares for the top 10 insurance companies in the EU

Source: CRA calculations based on CEA statistics. Note that data shows weighted average of market shares in EU-15 countries, weighted by the national premiums for the year. Data for newer member states are not included in the figure above due to missing and inconsistent data.

As a consequence, the EU insurance market has become more concentrated. In 1980 there were approximately 7,000 insurers, both life and non-life, in the countries that now make up the EU, and this number has now reduced to fewer than 5,000, amongst which there may be fewer than 2,000 economically independent entities writing non-life insurance.

Although increasing concentration is a prevailing trend, there are differences between member states. Concentration has increased markedly in virtually all the large EU markets and also in most of the small ones. However, concentration has decreased in some markets, most notably in a number of the new member states.

Nevertheless, despite this strong consolidation trend in both the life and non-life markets, the market remains rather fragmented when considered from a European perspective, as noted earlier in this chapter. It is possible that efforts to establish a European insurance market prompted companies to develop pan-European groups, equally, this could reflect a maturing European insurance industry. It is difficult to directly associate changes due to the FSAP to increasing consolidation but it is possible that the FSAP has played a role in the changing structure of the European insurance industry although its impact is small compared to market forces.

Cross-border intermediation

Competition may also have increased due to IMD. This could occur through two mechanisms:

- intermediaries can passport in from other member states increasing competition; and
- regulation of intermediaries may assist insurance providers in selecting high quality intermediaries.

The use of IMD to encourage cross-border provision of intermediary services is unconvincing. Indeed, although passports have clearly been used (there is no firm data on this however), the intermediary markets largely remain national.

It is possible that the regulation of insurance intermediaries reduces the cost for insurance providers entering new markets as they no longer need to undertake monitoring or due diligence. However, based on interview evidence, the benefits in terms of lowering the cost of provision of insurance on a freedom of services basis seem small. For the most part, insurance providers were already using the large bancassurers (who dominate most markets) and continue to undertake due diligence on their intermediary partners.

However, this does not mean that IMD will not increase competition in the future. Intermediaries may be able to take advantage of this passport to provide other services. In order to measure this, data on the number of passports, whether they are actually used, and the activities that are involved, needs to be collected.

4.3.3. Summary on the insurance sector

Out of the three sectors considered in this report, the FSAP has had the smallest impact on the insurance sector. This partly reflects the progress that had already been made in the third generation insurance directives but also reflects the fact that the barriers in other parts of the insurance market (such as contract law and tax differences) which vary significantly between member states are national issues that are difficult to change.

The FSAP measures were important as they consolidated some of the changes from the earlier directives. For example, the interpretative communication on the general good and Solvency I are seen as beneficial in that they added greater clarity, but they did not in themselves result in changes in the market. It is clear that Solvency II is expected to be much more significant than Solvency I.

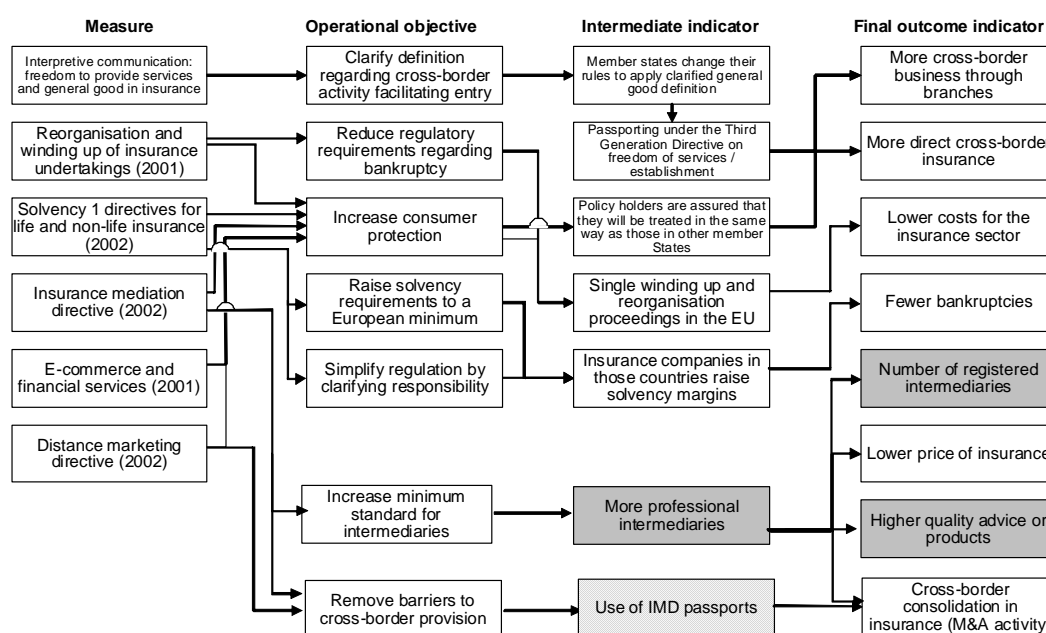
The most significant insurance directive was IMD. The degree to which this had an impact on national intermediary markets depended on the pre-existing regulation of intermediaries. For some countries, IMD involved little change. However, in the majority of member states this raised professional standards, and increased both disclosure and consumer protection. Although it is difficult to measure with any precision, it is likely that this did reduce the number of insurance intermediaries, however, there is a surprising degree of consensus that this had a positive impact on the quality of advice and will raise consumer confidence in the longer term.

The use of IMD to encourage cross-border provision of intermediary services is much less certain. Indeed, although passports have clearly been used (there is no firm data on this however), the intermediary markets largely remain national. The benefit in terms of lowering the cost of provision on insurance on an FOS basis seems small. Intermediaries may be able to take advantage of this passport but this is an issue for the future (where

we might expect changes in the next 3-5 years). In order to measure this, data on the number of passports, whether they are actually used, and the activities that are involved needs to be collected.

Figure 69 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 69: Conclusion on causality tree related to insurance



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

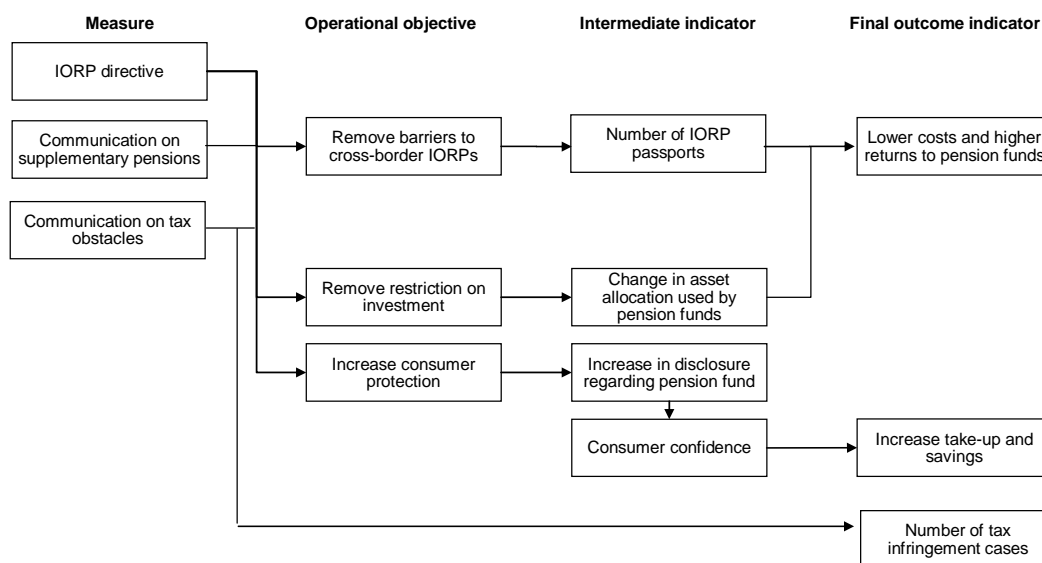
4.4. INDICATORS - PENSIONS

There are three FSAP measures that directly affect pensions. The first two are communications that happened shortly after the start of the FSAP in 1999 and 2001. The IORP directive, the only FSAP directive specifically aimed at pensions, was scheduled to be implemented by 2005.⁸⁷ Although including some elements that target the four strategic objectives, these FSAP measures were primarily focused on developing the single European wholesale market and improving the wider conditions for an optimal single financial market through removing tax obstacles.

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CEIOPS-OP-03-08, Initial review of key aspects of the implementation of the IORP directive, 31 March 2008 has reviewed how different member states have implemented IORPs. The Commission is going to provide a report on certain aspects of this implementation later this year.

Figure 70: Causality tree relating to pensions



Source: CRA analysis.

The communications and IORPs directive were targeted at slightly different parts of the pension landscape. In most member states there will be a state provided pension (known as Pillar I), employer based or occupational pension schemes (known as Pillar II) and an pension policies (known as Pillar III). IORPs and the tax communication focus solely on occupational pensions (Pillar II), whilst the communications on investment restriction included occupational and personal pensions (Pillar II and III).

4.4.1. Intermediate indicators – pensions

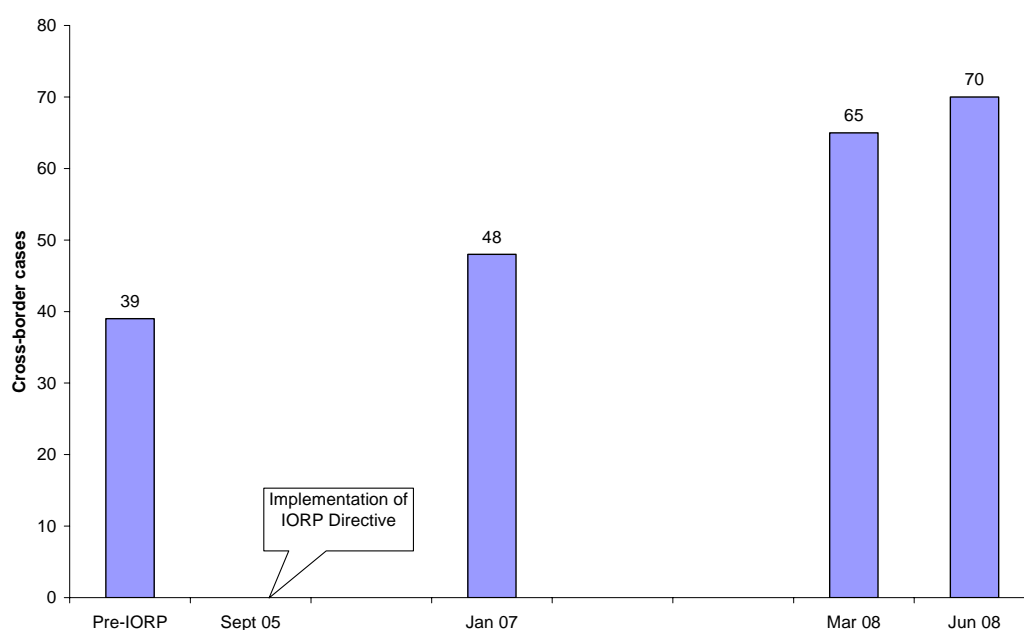
IORP passports

To determine whether IORPs affected the market for occupational pensions we can first look at whether passports have been used. As noted throughout this report, the use of passports represents a necessary but not sufficient condition that IORPs had a market impact. CEIOPS data indicates that the number of cross-border cases for pensions has increased since the IORP Directive but the number remains very low.

As of January 2007, there were 48 cross-border cases. To put this in context there were tens of thousands of UCITS passports and thousands of passported prospectuses. In addition, the vast majority of the IORPs passports (39 of 48) were cross-border pension vehicles that had already existed before the IORP Directive. The number of cross-border pensions cases has increased to 70 since then, across 9 home states and some 18 host states. Two member states have between 20-30 cases between them and a further seven member states have between 1 and 5 cases.⁸⁸

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CEIOPS-OP-03-08, Initial review of key aspects of the implementation of the IORP directive, 31 March 2008.

Figure 71: Number of reported cross-border pensions cases

Source: CEIOPS (CEIOPS-OP-03/07, Report on Market Development, 7 March 2007; CEIOPS-OP-03-08, Initial review of key aspects of the implementation of the IORP directive, 31 March 2008; CEIOPS-OP-19/08, 2008 Report on Market Development, 11 November 2008).

It is clear that the number of IORPs passports is small and focused on a small number of countries:

- A large number of these pre-existing cases were between the UK and Ireland. The size of the existing market also determines the direction in which passports have been used. In the Netherlands, where there is a significant occupational pension market, there have been no passports going out, but there have been 8 passports coming in from Luxembourg and the UK.
- A number of member states had little or no passporting or cross-border provision of pensions from the IORP directive. This was largely attributed to large differences in the social and labour laws of member states and the relative immaturity of the occupational pension market. For example, in Poland, the regulator (Polish FSA) did receive notification from a number of companies based in the UK and the Netherlands of their intention to enter into the Polish market, however these companies did not follow through by actually doing so. In Poland, the occupational pensions sector is not very developed, and there is believed to be a lack of sufficient tax incentives for occupational pensions.

However, we should be cautious about reported differences between countries. As set out in the CEIOPS report, different member states have a different understanding of the concept of cross-border activity, so the reporting of cross-border activity will reflect this. Consequently, this also leads to different notification practices, different legal requirements for IORPs and potential regulatory and/or supervisory gaps or overlaps.

Countries also differed in terms of their expectations of how IORPs might develop in the future. A number of member states have positioned themselves as providing the best environment for pan-European IORPs. Belgium has marketed itself with the intention of becoming the headquarters of pension companies by adopting a favourable regulatory regime.⁸⁹ Luxembourg also saw the IORP directive as an opportunity to become a pension fund hub, but to date this has not yet been successful.

Respondents in several markets noted that passporting may turn out to be a second-order goal for IORP. They argued that the only real advantage of passporting pension funds seems to be for those firms that employ people from different member states. In this case, they would still have different schemes for different countries but locate these in one member state.

The great majority of respondents stated that it was too early to assess IORPs (indeed, in some countries such as Belgium it was only transposed in late 2006) and hence we should not place too much weight on the number of passports observed today. Indeed, it was argued that:

- The potential for pan-European pensions is large but this will only be developed over time. A Towers Perrin survey of 323 large European companies, typically multinationals, in 5 member states indicates that 26% of the companies were considering setting up pan-European pension funds in the next 10 years;
- IORPs has resulted in a cultural change and companies and insurance providers were now thinking about the development of pan-European pensions; and
- IORP has increased the profile of European pensions and stimulated interest in occupational pensions in new member states.

All of these may be true but the impact of IORPs in terms of passports has been relatively minor and hence the prospect for observable impacts of cross-border activity on the pensions market, at this stage, is extremely unlikely. The tangible impact today is probably only on a small number of companies offering pensions to ex-pat employees, however, the effect in the longer term could clearly grow.

Tax obstacles

The April 2001 Communication on the elimination of tax obstacles to the cross-border provision of occupational pensions was intended to encourage member states to remove restrictions caused by tax. There has been some change in the tax regimes of member states related to pensions partly reflecting infringement cases brought by the EC. Denial of tax deductibility on cross border contributions to occupational schemes has been identified as being in breach of the EU law. Consequently from 2003 onwards the Commission launched infringement procedures against a number of member states

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"Belgium Prime Location for Pan-European Pensions Funds" available at http://www.cbfa.be/fr/bpv/crossborder/pdf/informationbrochure_en.pdf

(Belgium, Germany, Denmark, France, Spain, Ireland, Italy, Portugal, Sweden and the UK).⁹⁰ In Belgium, restrictions on transfers were also criticised by the ECJ. Following infringement proceedings by the EC several countries have changed their tax regimes:⁹¹

- Belgium: decided not to wait for a decision from the ECJ and with the Act of 27 December 2006, the restrictions were abolished. From 1 January 2007 Belgian companies have been able to finance occupational pensions in the EEA without suffering unfavourable tax consequences. The transfer of accrued reserves to a pension vehicle established in the EEA is now also a tax neutral operation;
- Denmark: The Ministry of Taxation has responded to the ECJ finding by introducing a Bill in Parliament to amend the Danish legislation to make it compatible with the EC Treaty;
- Portugal: abolished the tax discrimination between contributions to national and foreign pension funds in 2003; and
- UK: also took legislative action. Infringement proceedings by the EU have been dropped following the enactment of the Finance Act 2004 as amended in April 2006.

Other countries noted that barriers to pensions in the form of tax obstacles were being lowered from time to time due to efforts of the European Commission, but it is unclear the degree to which this is a result of measures included within the FSAP in particular or would have occurred without the communication. Nevertheless, this has not at this point impacted cross-border activity.

Change in asset allocation

Prior to the FSAP, in some member states there were restrictions on the underlying investments of the pension schemes preventing integration occurring in the provision of these products. The position of the European supplementary pension market is described in the Commission Green Paper published in 1997 and summarised in Table 16 below.⁹²

90 See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/04/1283&format=HTML&aged=0&language=en&guiLanguage=en>

91 Pan European Pension Funds. Has the final barrier been removed? Available at http://www.sackers.com/whats_new/documents/Article_0607.pdf

92 Supplementary Pensions in a Single Market, European Commission COM(97)283.

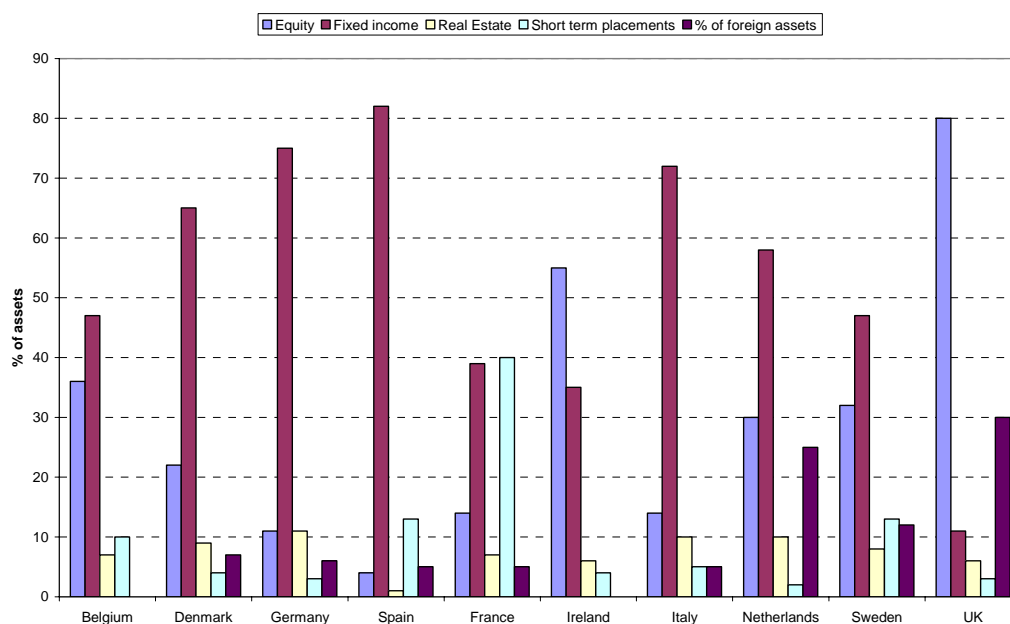
Table 16: Investment restrictions (Pillar II) pre FSAP

Member state	Restriction
Denmark	A maximum of 40% may be invested in "high risk assets" - these include domestic equities, foreign equities and unlisted securities. Also 80% currency matching requirement. In case of EU currency, up to 50% of liabilities can be covered by assets denominated in ECU. No self-investment.
France	At least 50% to be invested in EU government bonds, less than 33% in loans to sponsors
Germany	Maximum 30% EU equity, 25% EU property, 6% non-EU shares, 6% non-EU bonds, 20% overall foreign assets, 10% self-investment limit
Ireland	Prudent man rule
Italy	No pension law for self-administered schemes but investment policy determined by the board of directors and usually restricted to government bonds, bank deposits, insurance policies and property.
Luxembourg	Prudent man rule
Netherlands	5% self-investment limit; prudent man rule
Spain	5% limit in securities issued by any one enterprises. 90% of assets must be invested in quoted securities, bank deposits, property or mortgages. 1% must be in current accounts or money market.
Sweden	Majority to be held in bonds, debentures and loans
UK	5% self-investment limit; prudent man rule

Source: EC Green Paper on Supplementary Pensions (1997).

At least in part as a result of these restrictions, the asset allocation of different second pillar pension vehicles in Europe was seen to vary dramatically (as shown in Figure 72) and to create artificial barriers in investment policy. This was thought to reduce efficiency of pension investments, lowering efficiency of the capital market but also leading to lower returns to European savers than would otherwise be the case.

Figure 72: Distribution of assets in Pillar II pensions pre FSAP in 1997



Source: EC Green Paper on Supplementary Pensions (1997).

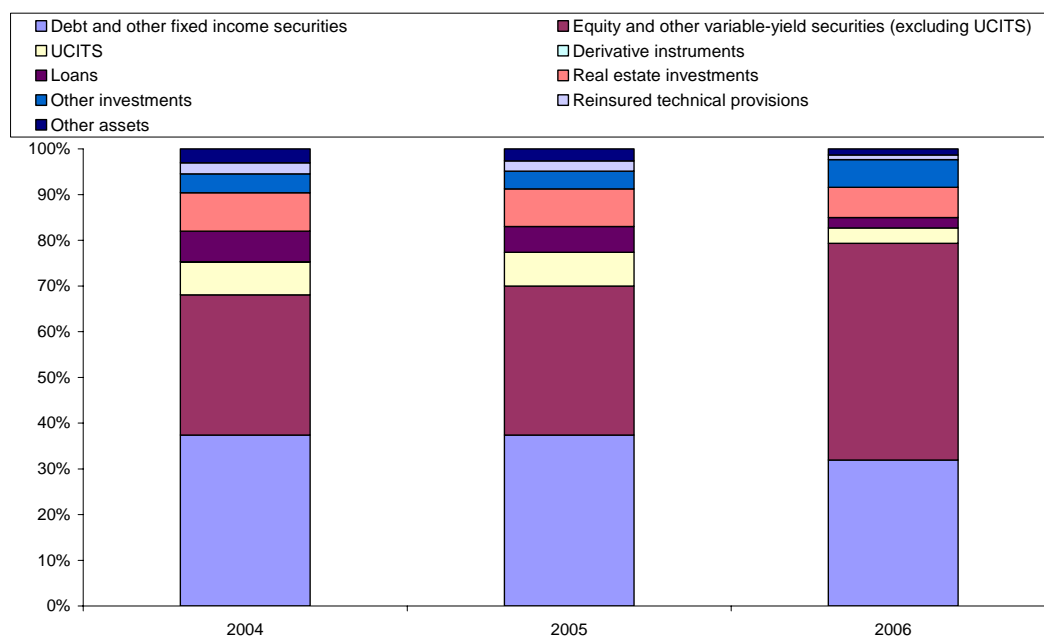
To investigate whether IORPs effectively removed investment restrictions we first identified countries that had changed their investment restrictions. Countries fall into three groups:

- Regimes that already incorporated the “Prudent man” principle: Countries like Ireland, the UK, the Netherlands and Luxembourg already had some form of the prudent man principle in place, and so for these, the IORP directive did not lead to much change in investment of pension funds. In Belgium, too, the existing rules were not seen as restrictive, and so there was not much of an impact on pension funds investment.
- Existing restrictions were removed to allow “Prudent man” principle: Some member states, like Spain and Italy, have recently made the investment rules for pension funds less restrictive. Italy used to have a limitation on asset classes and an exclusion of hedge funds – IORP eliminated fixed limitations, following a value at risk principle, increasing pension funds’ investment freedom. Although this was a change that was already anticipated in Italy, the IORP directive definitely facilitated and accelerated the implementation of this change. Spain used to have a restriction of 10% investment in non-quoted companies, which was subsequently relaxed. However, this change happened in 2004, prior to the IORP directive.
- More liberal regime existed prior to IORP requirements: In Sweden on the other hand, the IORP directive was more restrictive than what was already in place, since Sweden did not have any investment restrictions prior to IORP. However, applying IORPs to insurance companies rather than pension schemes in Sweden, which was not required under IORP, has meant more flexibility for these.

This is consistent with the findings of the CEIOPS report that only 4 member states opted for the pure prudent person rule, enforcing no other quantitative limits than the self-investment limit imposed by the Directive itself. They identified that quantitative investment limits can still be observed reflecting the fact that IORPs only required minimum standards rather than harmonisation.⁹³

Even if the regime introduces flexibility, this does not necessarily result in changes to the market. It may be the case the existing restriction were not binding, for example, pension funds may be cautious and risk averse even without limitations on the amount of equity that could be held. To examine this we have looked at how asset allocation of occupational pension funds has changed over the last three years. CEIOPS publishes aggregate data on the asset allocation of occupational pension funds. The impact on asset allocation can be seen in Figure 73 below.

Figure 73: Asset allocation of EU occupational pension funds



Source: CEIOPS statistics. Note that 2007 asset allocation data for pensions is not yet available.

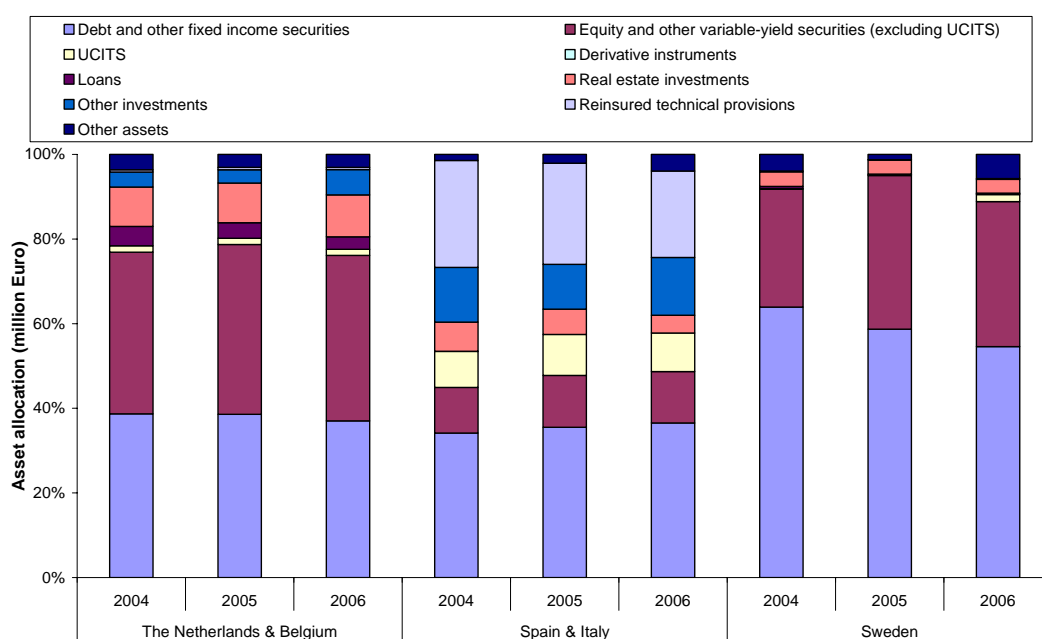
The picture above indicates that, on the whole in the EU, the proportion of investment held in equity vehicles has increased. This appears to be consistent with a relaxation in rules that generally restricted investment in equity in favour of less risky assets. However, this conflates regimes that saw a significant change from IORPs with ones that did not and does not allow for trends over time (such as increased value of equity markets). It is of course also the case that the deadline for transposing IORPs was only in 2005, so we should not expect to see too significant a change in a single year.

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This was also the finding of the survey conducted European Federation of Retirement Provision "IORP Directive - a catalyst for change" November 2007. Available at http://www.efrp.org/downloads/efrp_publications/EFRP%20leaflet%20-%20IORP%20Directive%20implementation%20survey%20-%202007-11-21.pdf

We can use our three groups of countries to provide us with a counterfactual to examine the impact of IORPs. Figure 74 shows asset allocation for the same time period, for different groups of countries. The first band shows asset allocation in the Netherlands and Belgium, which had a prudent man rule in place even before the transposition of the IORP directive.⁹⁴ Spain and Italy in the second band lessened asset allocation restrictions with the IORP directive. Sweden, in the last band, had no asset allocation restrictions in place prior to the IORP directive, and therefore asset allocation was more restrictive after the directive was transposed.

Figure 74: Asset allocation of occupational pension funds – specific EU countries



Source: CEIOPS Statistics. Note that 2007 asset allocation data for pensions is not yet available.

The biggest increase in the use of equity was seen in Sweden where IORPs did not liberalise investment freedom (indeed had the opposite effect). For countries which already had prudent man principle, there is a small increase, and there has been a very small increase for markets which previously had investment restrictions. Interviewees, however, indicated that asset allocation decisions in some member states had become more flexible following the IORP Directive and thus we would expect to see further changes to this over the next few years.

Increased disclosure

The IORP Directive requires that occupational pension schemes provide a minimum level of information. This includes annual reports and accounts, information on changes to pension scheme rules, a statement of investment policy principles, detailed information in

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The UK and Ireland also had prudent man rules prior to IORP, however asset allocation data for these two countries is not available prior to 2006.

relation to the target level of retirement benefits; benefits on cessation of employment; the range of investment options (where the member bears the risk if applicable) in the portfolio, risk exposure and costs; and arrangements on transfer of pension rights.

Even prior to IORPs most countries had rules on the information that must be given to members and each country has its own solution on providing information on benefits that reflects the differences in the legislation on benefits in general.⁹⁵

For most member states, the amount of information required to be disclosed as a result of the IORP directive was more than existing requirements. However, many member states note that transparency for pensions was already quite high, and that key information was already being disclosed prior to the directive. Therefore, although the IORP directive resulted in more information, it is not clear that this additional information was beneficial or that it increased consumer confidence.

In Portugal, the amount of information disclosed did increase, and it was believed that this additional information would be beneficial in principle, but it was doubtful that this additional information was actually being read. The Portuguese came up with a solution to overcome the problems of how the information was perceived but this was due to Portuguese actions, and not due to the FSAP.

In Sweden, it was noted that the additional information might be too much for the consumer, and might actually confuse and harm consumer confidence.

We have not identified any comparative data sources that allow us to compare the information disclosure regime pre and post IORPs. The differences between the member states were to some extent identified as work that could usefully be undertaken by CEIOPS. Therefore, we cannot draw conclusions on this element or provide a benchmark for future studies. A bespoke survey would need to be undertaken to establish impacts in this area in the future.

4.4.2. Final indicators – pensions

The overall objective of FSAP pension regulation is to facilitate a more efficient pension market that will help Europe meet the challenges of an ageing population. Final indicators to assess whether the FSAP has achieved this goal include examining:

- Increase returns to occupational pension schemes; and
- Increase take-up of pensions.

Realistically given the short period of time since IORPs was transposed and the other changes in the market, it is impossible to associate any changes in final indicators to FSAP, however, the analysis below might provide a useful benchmark for the future.

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CEIOPS-OP-03-08, Initial review of key aspects of the implementation of the IORP directive, 31 March 2008.

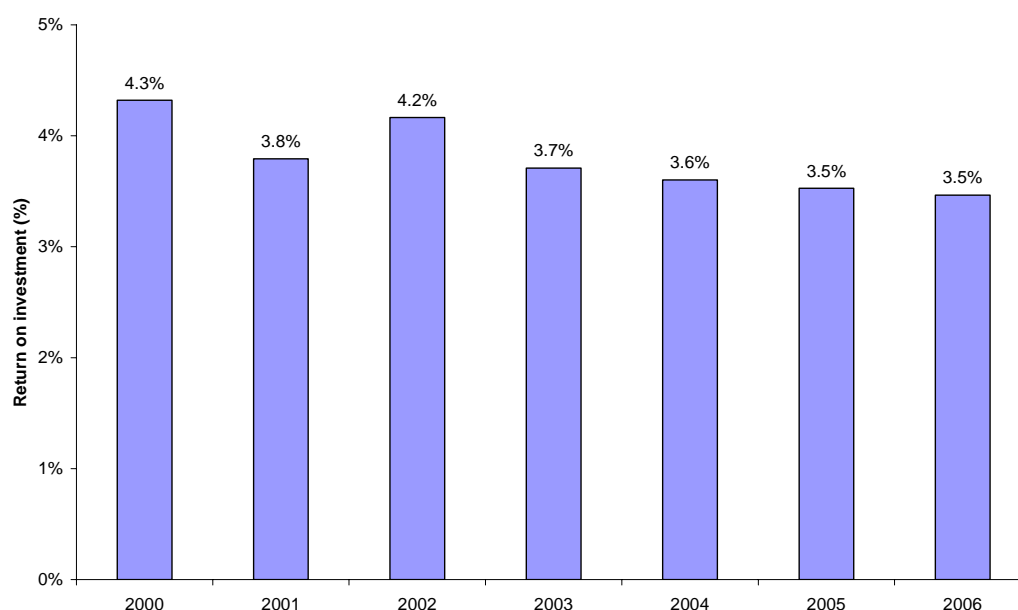
Increased returns to pensions

Ultimately allowing pension funds greater flexibility to optimise asset allocation such that they reflect their liabilities should allow them to achieve greater investment returns and provide higher income in retirement for European pensioners.

Figure 75 shows the return on investments of occupational pension funds in the EU. Although the quality of data is somewhat variable, the return on investment since 2001 has been roughly constant. This does not show any change following the introduction of IORP but realistically we should not expect one given the short period of time this it was introduced.

It is important to note that those countries that did relax invest rules only make up a very small proportion of the pensions market. For example, the Eurostat data indicates that Spain makes up only 1-3% of total investments by occupational pension funds.⁹⁶ Examining data on returns at an individual country basis shows considerable volatility such that it is not possible to draw any conclusions about changes to returns.

Figure 75: Returns on occupational pension funds' investments in the EU



Source: Eurostat pensions statistics, and CRA analysis. Note that Eurostat data is missing for 2007.

Note: Countries included in the above data include: Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Latvia, Lithuania, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, United Kingdom. Data for the UK, which makes up about 60% of total investments in the EU, is missing for the years 2004-2006. Return investments is calculated using the formula: $(\text{Investment income} - \text{Capital gains and losses}) / \text{Total investments}$.

Even if we observed a change in investment returns there are other more significant changes that would be the more likely cause. The most important of these is the introduction of the Euro, and the formation of a large Euro capital market from a number of nationally fragmented capital markets. This has also contributed to structural change in the European insurance industry. Looking back to the literature prior to its introduction the Euro was predicted to have a number of effects:

- A single currency will lead to keener competition for equity capital between European insurance companies. Hess and Trauth (1998) explain that currency risks were previously an important obstacle to investment in foreign countries, which resulted in “hardly any competition between European insurance companies when procuring equity capital.” The European Monetary Union was expected to lead to a uniform capital market “in which French Axa-UAP and German Allianz will have to compete for investors willing to buy their equities.”
- A common financial market will lead to a higher degree of diversification of investors’ portfolios (due to a broader and deeper European capital market without currency risks).
- Share of equities is likely to rise, especially in countries where insurers hold only a small portion of equities, due to higher competition which forces higher investment returns by insurance companies.⁹⁷
- With currency risks no longer a factor, underperforming insurers will find the cost of capital more expensive, since investors will be able to compare insurers’ performance more effectively and measure it against European benchmarks.⁹⁸

Following the introduction of the euro, individual insurance companies owned a smaller share of the larger overall market with the result that their investments could be liquidated more easily while, at the same time, the range of investment products increased. Indeed the Sector inquiry found *“Monetary Union thus forces companies to have a wider geographical spread in their investment portfolios and to gear their portfolio performance to a European benchmark. The shares of insurance companies themselves will increasingly be measured against a European benchmark and companies that do not match up to their rivals will be identified more easily and will find it increasingly difficult and expensive to attract capital funds.”*

Therefore, even without the FSAP, we would expect to see insurance companies and pension schemes to change their investment strategy to use a higher proportion of equities and invest across European countries. So when looking at changes in the asset allocation of insurers it will be important to compare countries directly affected by the euro, with countries that did not join the euro.

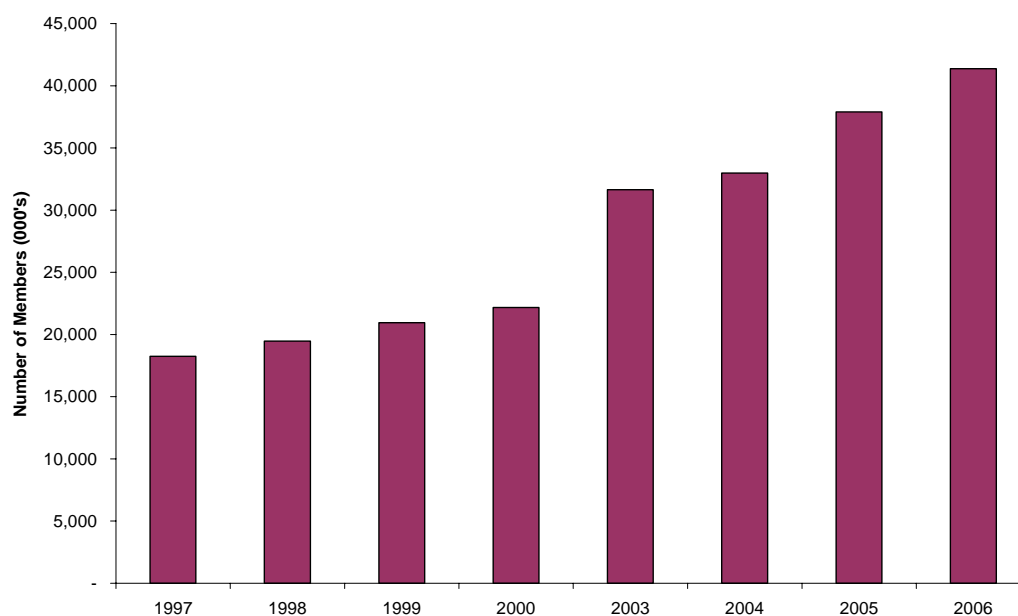
97 Hess & Trauth (1998)

98 Swiss Re (2000).

Increased take-up and savings

The pension market has seen dramatic change over the last ten years. This has resulted from the significant pressure to increase the relative importance of private pension savings. The result of this has been significant changes in the tax incentives to use pillar II and pillar III pension vehicles.

Figure 76: Number of members in occupation pensions in the EU



Source: Eurostat pensions statistics. Note that Eurostat data is missing for 2007. Note: Missing data for 2001, 2002. EU countries included in the above data: Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, Hungary, Ireland, Italy, Latvia, Lithuania, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, United Kingdom.

Figure 76 shows the increase in membership of occupational pensions over time. Although the IORP directive is aimed at improving information disclosure and increasing consumer confidence, based on the interviews there is considerable scepticism that this has yet had an impact on take-up. It seems very likely that the increase seen in the picture above is due to things like a recognition of the need to have pension provision given increased life expectancy, domestic regulation and market forces, rather than the IORP directive. We do not believe that we can attribute any of the current increase in pension membership to measures within the FSAP.

4.4.3. Summary on the pensions sector

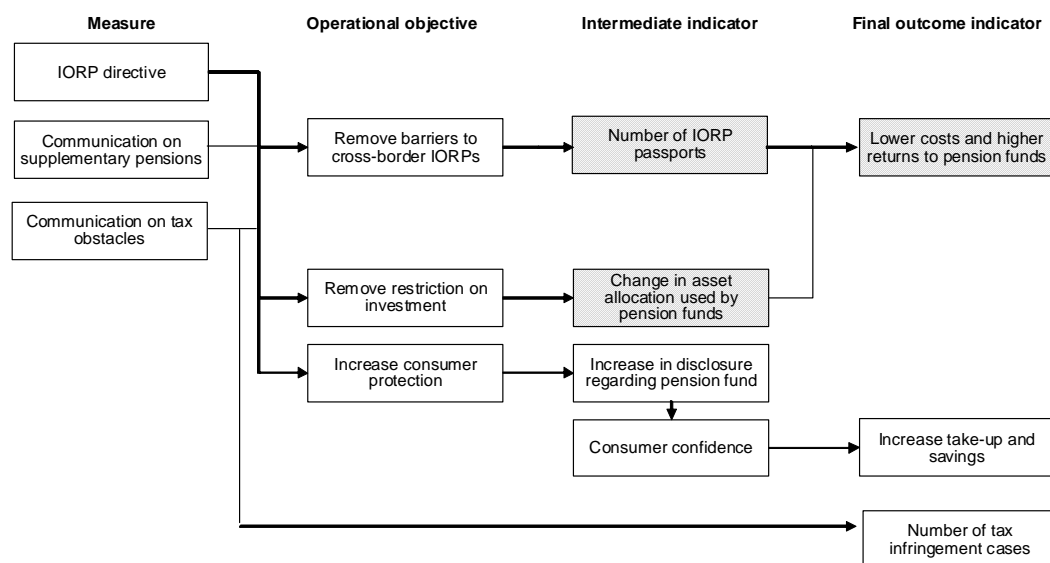
Pensions measures

It is too early to assess the impact of IORPs. In terms of the number of cross-border pensions the impact on the market is undoubtedly small (but is likely to increase in the next 3-5 years). However, it is clear that different member states have seen this as an

opportunity to compete internationally to provide pension services and this may prove successful in the future. It is also the case that IORPs removed restrictions on asset allocation in a number of member states with the result that pension funds can manage the assets appropriately given their liabilities. Interview evidence supports the case that over the longer term this should raise pension returns, and give European pensioners higher incomes.

Figure 77 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 77: Conclusions on causality tree related to pensions



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

5. SECURITIES

There are a large number of measures within the FSAP that impact the securities sector. These include measures relating to information to be disclosed to the market such as:

- Prospectus Directive - Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC;
- Transparency Directive - Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC;
- Fair value accounting Directive - Directive 2001/65/EC amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions;
- IAS Regulation - COM(2000)359 "EU Financial Reporting Strategy: the way forward" and Regulation (EC)1606/2002 on the application of international accounting standards;
- Modernisation Directive - Directive 2003/51/EC amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings;
- Statutory audit - Recommendation 2001/6942 (C(2002)1873) Statutory Auditors' Independence in the EU: A Set of Fundamental Principles and COM(2003)286 Reinforcing the statutory audit in the EU, following Recommendation 2001/256 on quality assurance for the statutory audit in the European Union: minimum requirements of 15.11.2000 (C(2000)3304).
- Disclosure of financial instruments - Recommendation 2000/408 concerning disclosure of information on financial instruments and other items complementing the disclosure required according to Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions.

The securities sector is also impacted by measures relating to trading issues including:

- Market Abuse Directive (MAD) – Directive 2003/6/EC on insider dealing and market manipulation (market abuse);
- Communication on distinguishing between investors – COM (2000)722 on the application of conduct of business rules under Article 11 of the investment services Directive (93/22/EEC); and

- Markets in Financial Instruments Directive (MiFID) – Directive 2004/39/EC on markets in financial instruments amending Directives 85/611/EEC, 93/6/EEC and 2001/12/EC and repealing Directive 92/22/EEC.

In addition, FSAP includes measures relating to post-trading or the events that arise after a securities trade has occurred:

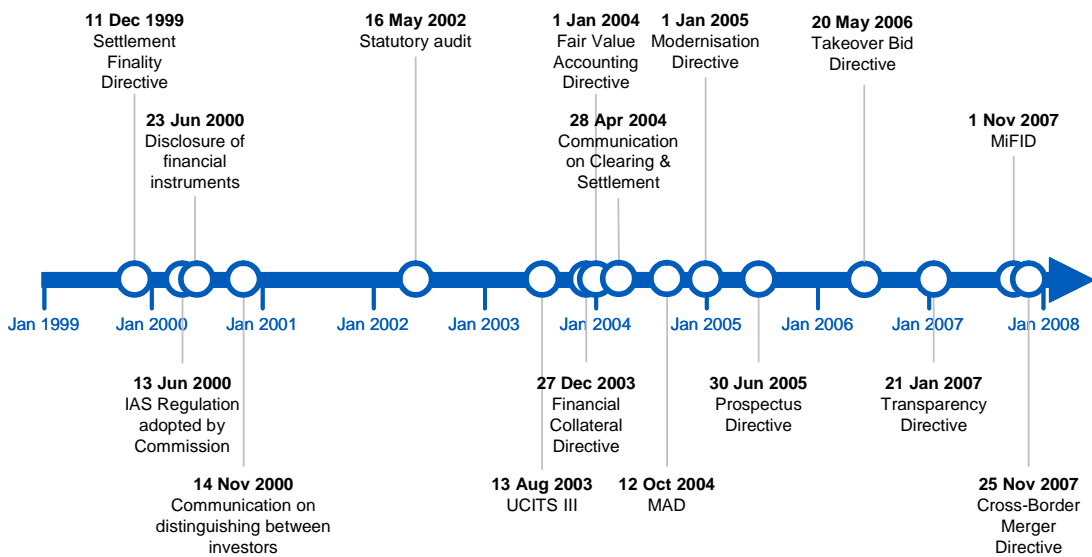
- Settlement Finality Directive - Directive 98/26/EC on settlement finality in payment and securities settlement systems;
- Communication on Clearing & Settlement - COM(2004)312 Clearing and Settlement in the European Union – The way forward; and
- Financial Collateral Directive - Directive 2002/47/EC on financial collateral arrangements.

Finally, this sector is also impacted by measures relating to UCITS and M&A activity:

- UCITS III - Directive 2001/107/EC (amending Directive 85/611/EEC) on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses; and Directive 2001/108/EC (amending Directive 85/611/EEC) on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS;
- Takeover Bid Directive – Directive 2004/25/EC on takeover bids; and
- Cross-Border Merger Directive – Directive 2005/56/EC on cross-border mergers of limited liability companies.

Figure 78 sets out the timeline for the publication of these measures. This refers to the publication date of communications, the date at which regulation comes into force and the deadline for transposition of directives. This clearly does not represent when particular countries transposed them which could be earlier than the deadline or in some cases after the deadline.

Figure 78: Timeline of transposition date for measures in the securities sector



Source: CRA analysis.

5.1. MARKET AND REGULATORY FAILURES

The various measures within the FSAP that applied within the securities sector were partly aimed at dealing with various market failures and regulatory failures that existed in this sector pre-FSAP. These are considered below.

5.1.1. Differential application of existing directives

Article 11 of the Investment Services Directive (ISD), which relates to conduct of business rules, was found to have been implemented in different ways by different member states. In particular, member states were found to use different criteria to distinguish professional investors from retail investors and applied different tests to determine *where* the service was provided (which determines the competent authority with responsibility for enforcing and implementing conduct of business rules).⁹⁹ It was noted by the EC that these differences created uncertainty regarding the cross-border provision of investment services and therefore resulted in cross-border trade being more costly than it would otherwise have been, both because of legal uncertainty and also because of overlapping regulatory requirements.

Some member states, notably France, Italy and Spain imposed the so-called “concentration rule” whereby national firms were required to make client trades on a regulated market. As such this represented a barrier to entry and reduced competition for trading activities.

99

Communication from the Commission, The application of Conduct of Business Rules under Article 11 of the Investment Services Directive (93/22/EEC), European Commission, 2000.

5.1.2. Significant differences remained across member states causing fragmentation

The use of the single passport through the ISD was found to have had limited success and thus not as much cross-border trade in investment services was arising as had been anticipated through the previous directive. However, during the late 1990s, many large investment banks started to concentrate their trading desks in a single location (mainly London) and operated on several markets as remote trading members.

In addition, different member states had different rules regarding market manipulation arrangements (which were not covered under the Insider Dealing Directive that was in place). This may have led to less cross-border trade arising because of a lack of confidence in trading on other markets.

There was also considerable variation in the way in which information related to listed companies was revealed to the market with different member states having different requirements regarding what should be included in statutory accounts and how frequently information should be provided to the market.

The fragmentation of markets was believed to be preventing companies from accessing liquid capital markets and from preventing competition from driving down the cost of this capital. Indeed, it was understood that the cost of raising capital in the EU was higher than in the US including for large companies because of the complexity of cross-border capital raising.¹⁰⁰

Furthermore, differences in legal systems and taxation arrangements were also highlighted as causing barriers to both cross-border trading and also to cross-border mergers and acquisitions.

5.1.3. Regulation had not kept up with market developments

In the area of UCITS funds, there had been considerable progress made regarding common standards for what was categorised as a UCITS fund and hence cross-border trading in these products had grown over many years. However, barriers remained in respect of cross-border trading related to funds being registered in other member states, and differing requirements regarding marketing literature in different member states.

In addition, given the specific criteria that funds had to meet in order to be categorised as a UCITS fund, developments in financial instruments had not been taken into account and hence new types of investment funds could not be categorised as UCITS products. For this reason these new funds could not be as easily traded across borders as other products that could be categorised as UCITS funds.

100 Final Report of The Committee of Wise Men on the Regulation of European Securities Markets, (The Lamfalussy Report), 15th February 2001.

In other areas, it was noted that financial instruments had also developed beyond the scope of existing legislation including in areas such as the treatment of alternative trading systems. Over The Counter (OTC) trades were mainly outside of the scope of existing legislation and differences arose between member states regarding whether such trades needed to be disclosed.

5.1.4. Knock-on consequences for clearing and settlement

Increasing cross-border trading of securities has knock-on consequences on the need for cross-border clearing and settlement services. As such, the latter services are not services that are demanded in and of themselves, but rather the demand for these services depends on the extent of cross-border trading. Thus the trends in cross-border trading drive trends in cross-border clearing and settlement. However, difficulties with executing post-trade arrangements can reduce the amount of trading that would otherwise occur – either because of the difficulty in executing the arrangements per se, or because these difficulties impose costs which therefore reduce the demand for cross-border trading.

One of the key potential market failures in this area is that of systemic risk and the danger that damage to one party within the post trading arena could have knock-on consequences for other participants.

In addition, other forms of operational risk existed. For example, it is important to identify which member states had insolvency provisions in place regarding settlement finality and which did not, since the latter may have suffered from a market failure relating to unwillingness to participate in the system due to risk concerns. Similarly it would be important to identify which member states made use of financial collateral arrangements.

One of the key issues facing the post-trading environment was the difference in rules followed by member states in these parts of the securities value chain. While each member state may have rules that operate effectively, the difference between these rules causes difficulties in terms of cross-border trading. In addition to the inherent differences in market practices, tax rules, regulation and legislation, there may also have been a lack of linkages between post-trading institutions significantly hindering cross-border trading.

In 2001, the “Giovannini Group” was appointed to assess the clearing and settlement arrangements and concluded that there were market failures in relation to cross-border transactions,

“Relative to domestic transactions, transactions within the European economy that occur across Member States are far more complex, are hindered by a number of significant barriers and...are much more costly than domestic transactions.”¹⁰¹

101 Cross-Border Clearing and Settlement Arrangements in the European Union, The Giovannini Group, November 2001. (The first Giovannini Report.)

In total, the Group identified 15 barriers to efficient cross-border clearing and settlement including:

- Technical or market-practice barriers such as national differences in IT platforms and interfaces, settlement periods, operating hours, availability or timing of intra-day timing, rules governing corporate actions;
- Legal barriers such as national differences in the treatment of securities, bilateral netting and the application of conflict-of-law rules; and
- Tax barriers such as withholding tax procedures disadvantaging foreign intermediaries and tax collection functionality that was integrated into the settlement system.

The resulting effect was that the cost of clearing and settlement varied substantially between member states and also that the cost of cross-border clearing and settlement was considerably above the cost of domestic clearing and settlement.

Cross-border market failures were identified in both the treatment of settlement finality in the case of insolvency and also in the arrangements regarding financial collateral. For example, in the latter case, the EC notes that there had been complaints regarding the costs and complexity of the cross-border use of collateral.¹⁰² In 1999, collateral in use within the Euro zone was approximately €650 billion and around 12% was used on a cross-border basis.¹⁰³

5.2. MODEL OF THE IMPACT OF THE FSAP

It is possible to link the various measures both to operational objectives as well as strategic objectives. With the exception of the Recommendation on disclosure of financial instruments (which had the strategic objective of state of the art prudential rules and supervision), all of the directives considered in this chapter fall under the strategic objective of a single EU wholesale market. For this reason, in Table 17 we capture the intermediate level of the strategic objective within the single wholesale market set out by the EC in the original FSAP.

Table 17: Linking measures and operational objectives in the securities market

Measures	Strategic objective	Operational objective
MAD	Establishing a common legal	Increased market confidence

¹⁰² "Evaluation report on the Financial Collateral Arrangements Directive (2002/47/EC)", Annex 1, European Commission, 20th December 2006.

¹⁰³ "Evaluation report on the Financial Collateral Arrangements Directive (2002/47/EC)", European commission, 20th December 2006.

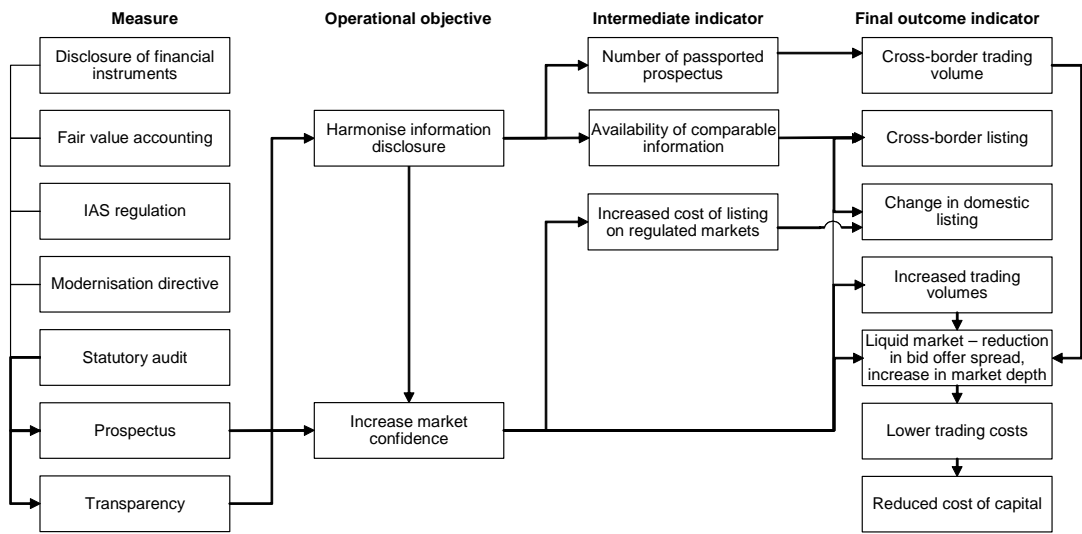
Communication on distinguishing between investors	framework for integrated securities and derivatives markets	Appropriate investor protection
MiFID		Appropriate investor protection; create single passport; best execution; remove barriers to entry for exchanges; increase competition between trading venues
UCITS III	A single market which works for investors	Remove barriers to entry for management companies; harmonise information to investors; expand investment options
Takeover Bid Directive	Towards a secure and transparent environment for cross-border restructuring	Ensure efficient market for M&A activity
Cross-Border Mergers		
Prospectus Directive	Raising capital on an EU-wide basis	Increase market confidence; harmonise information disclosure
Transparency Directive		
Fair value accounting Directive	Towards a single set of financial statements for listed companies	
IAS Regulation		
Modernisation Directive		
Statutory Audit Recommendation		
Recommendation on disclosure of financial instruments	State of the art prudential rules and supervision	
Settlement Finality Directive	Containing systemic risk in securities settlement	Harmonise legal treatment of financial collateral; protect transfer orders entered into a designated system; greater competition between clearing and settlement providers; removing barriers to post-trading through increased choice.
Communication on Clearing and Settlement		
Financial Collateral Directive		

Source: CRA analysis. Note that the post trading measures are also impacted by MiFID.

The overall impact of the various different measures affecting the securities sector can be summarised through a series of causality trees which can be found in Figure 79-Figure 83 below. These have been separated into five figures for ease of review, although an examination of the figures shows that many of the indicators are similar across the figures and as such there would be interaction between the different causality trees.

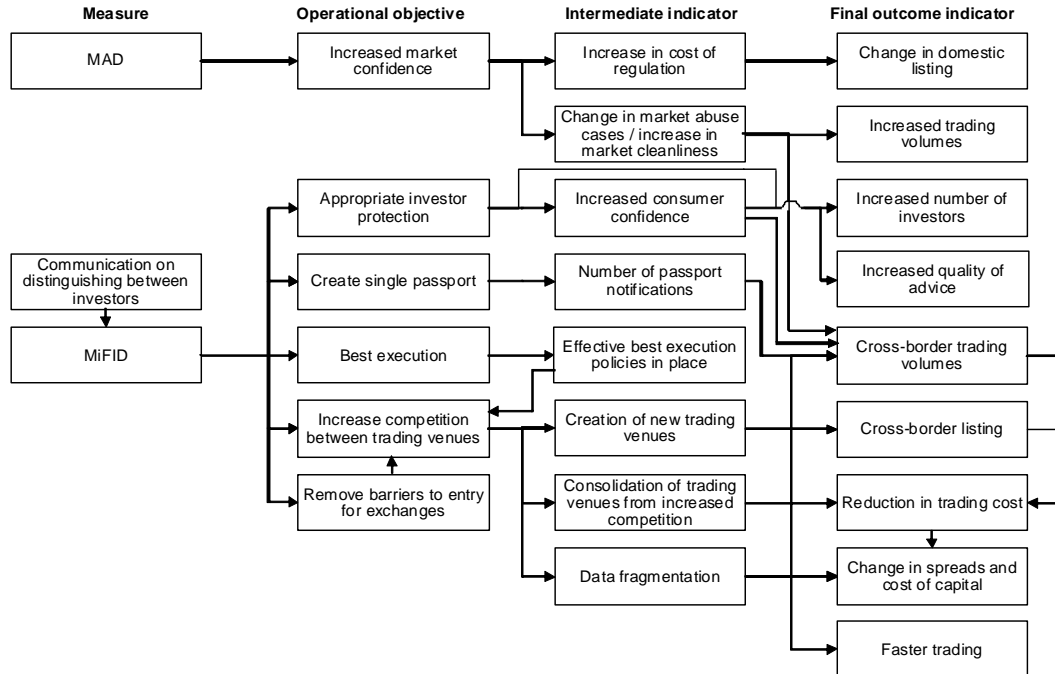
Each tree highlights the operational objective of the different FSAP measures and sets out the different indicators that would be expected to be impacted by the different measures. The causality trees are therefore a summary of the impacts of the FSAP measures and seek to consolidate the overall impact of the FSAP. Given the focus of the work on the FSAP as a whole, this is inevitably a simplification of all of the possible impacts of each of the different measures in different member states. Instead it focuses on the overall effect of the measures taken as a whole package.

Figure 79: Causality tree relating to information disclosure measures in securities



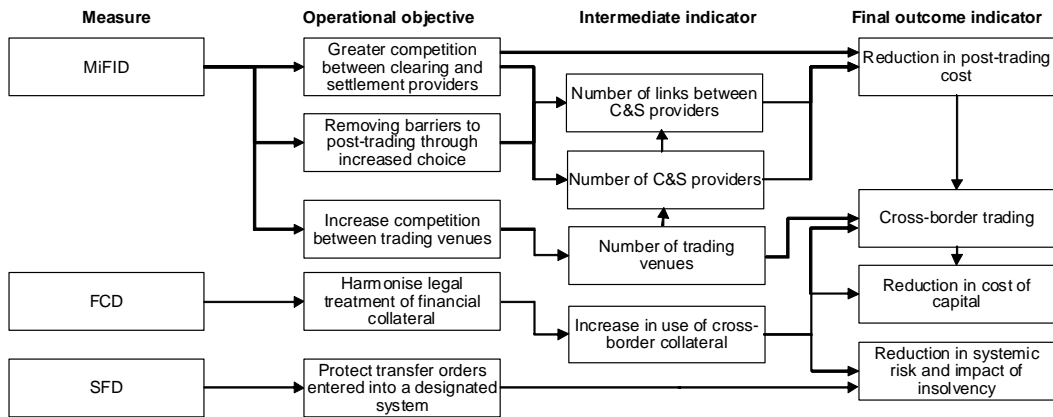
Source: CRA analysis.

Figure 80: Causality tree relating to trading related securities measures



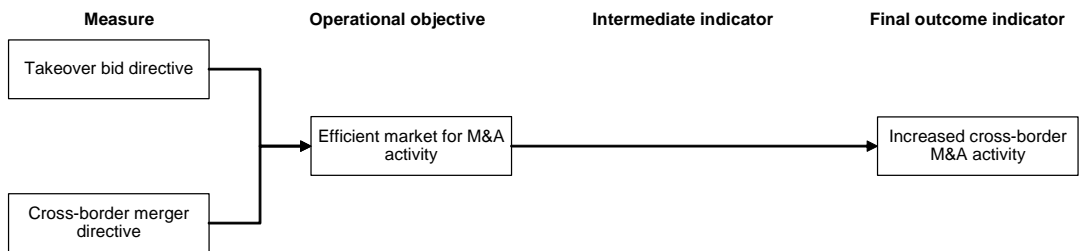
Source: CRA analysis.

Figure 81: Causality tree relating to post-trading aspects of the securities market



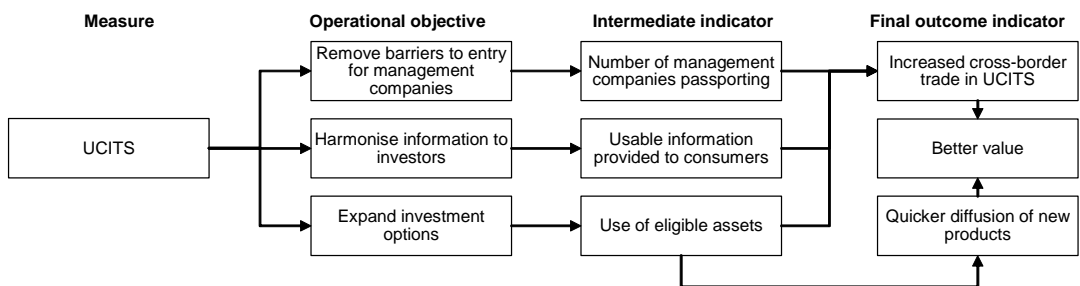
Source: CRA analysis.

Figure 82: Causality tree related to M&A aspects of the securities markets



Source: CRA analysis.

Figure 83: Causality tree related to UCITS



Source: CRA analysis.

As is clear from Figure 79-Figure 83 above, there are a number of different indicators that need to be considered in order to establish the impact of the FSAP in the securities sector. We consider each of these in turn seeking to understand the extent to which any changes in these indicators have been driven by the FSAP as opposed to factors such as ongoing trends or other market developments.

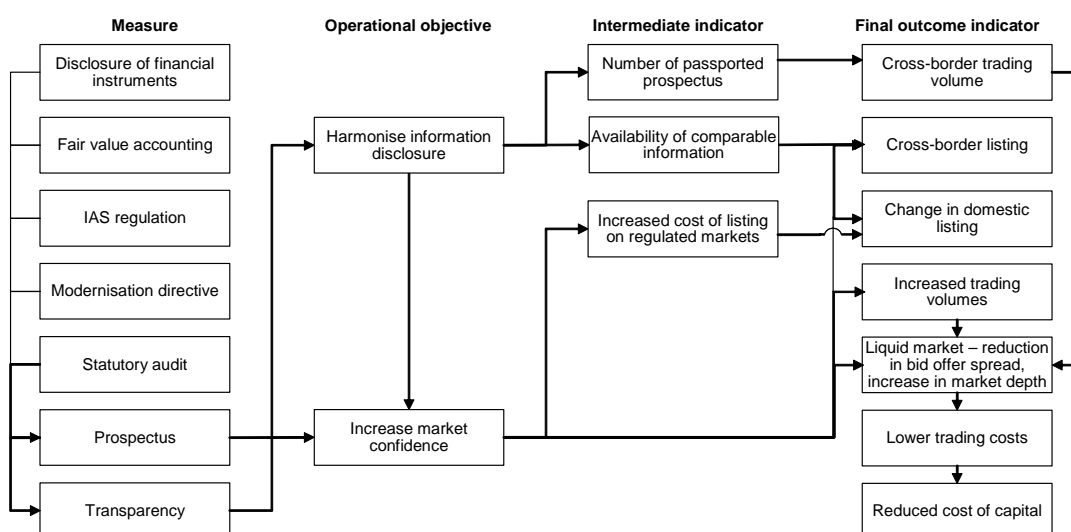
Section 5.3 examines the indicators relating to information measures shown in Figure 79. Section 5.4 considers indicators relating to trading as shown in Figure 80 and section 5.5

examines issues to do with post-trading measures shown in Figure 81. Section 5.6 examines the implications of the M&A related directives shown in Figure 82 and then section 5.7 consider the implications for UCITS funds shown in Figure 83. All of the sections start by examining the intermediate indicators and then the final indicators.

5.3. INDICATORS - INFORMATION MEASURES

There are a number of different measures which all aim at harmonising information disclosure and increasing market confidence. These include various measures which were implemented over a long period of time: Disclosure of financial instruments and the IAS regulation were applied from June 2000; Statutory audit from May 2002; Fair value accounting from January 2004; the Modernisation Directive from January 2005; the Prospectus Directive from June 2005; and the Transparency Directive from January 2007. The causality tree relating to these measures is set out in Figure 79 below.

Figure 84: Causality tree relating to information disclosure measures in securities



Source: CRA analysis.

Due to the overlap of final indicators between the information measures and those relating to trading (see section 5.4), this section contains details on the intermediate indicators for the information measures but only the final indicators related to listing are examined in this section. Other final indicators are combined with those relating to trading and examined in that section.

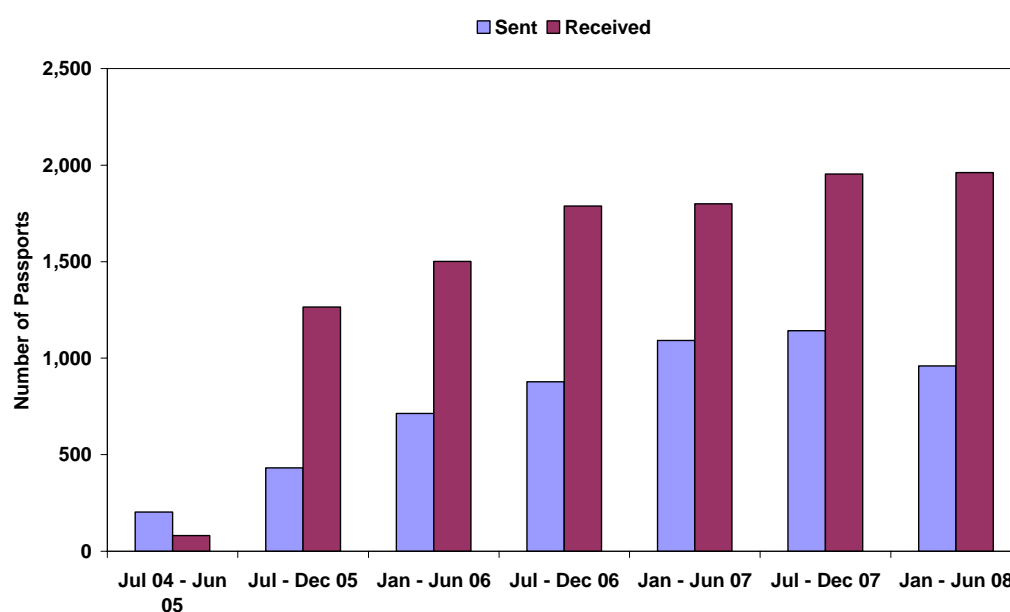
A number of these measures impact the quality or type of information disclosed by companies in the EU which are aimed at providing a harmonised set of standards of what financial accounts contain. By contrast the Prospectus and Transparency Directives could be seen as measures impacting the process by which such information is transmitted to the marketplace (i.e. to shareholders and consumers). For this reason we have found it useful to see the impact of the measures focused on the content of information as being linked to the measures focused on the process of revealing this information to the market.

5.3.1. Intermediate indicators – information measures

Number of passported prospectuses

The Prospectus Directive harmonises the information disclosure requirements of the prospectus across EU member states such that the information disclosed in one member state can be used in another member state. Previously, although there was a mutual recognition regime, member states could have requested additional information to be provided by issuers which increased the costs of accessing other markets. If the directive is effective, we should expect to see an increase in the use of the prospectus over time.

Figure 85: Prospectus passports in EU



Source: CESR's Report on the supervisory functioning of the Prospectus Directive and Regulation, CSER/07-225, CESR, June 2007; CESR data on Prospectuses approved and passported for various other dates. Note that the first observation is for a year (as six monthly data is not available) whereas the remaining observations represent six month periods.

Figure 85 above shows the total number of prospectuses which have been sent by 23 member states and also that have been received by these member states.¹⁰⁴ It is clear that in both cases the total number has increased substantially since June 2005 when the directive was transposed, although part of the increase may reflect changes to capturing the data after the directive was implemented.¹⁰⁵ The number of prospectuses sent

¹⁰⁴ Note that data is not available for the remaining members of the EU-27.

¹⁰⁵ For example, the FMA in Austria and the AFM in the Netherlands were not the competent authorities for approving prospectuses for the period July 2004-June 2005 and hence were unable to provide data from this period, similarly data from the UK is unavailable for this period.

increased from 432 in the second half of 2005 to 960 in the first half of 2008 and the number received increased from 1,265 to 1,962 over the same period. The increases were particularly dramatic in Germany, Luxembourg and the UK which together make up 766 of the 960 prospectuses that were sent out from member states in the first half of 2008. These countries are also among the countries who received the largest number of prospectuses although the Netherlands, Belgium and Ireland also saw substantial increases.

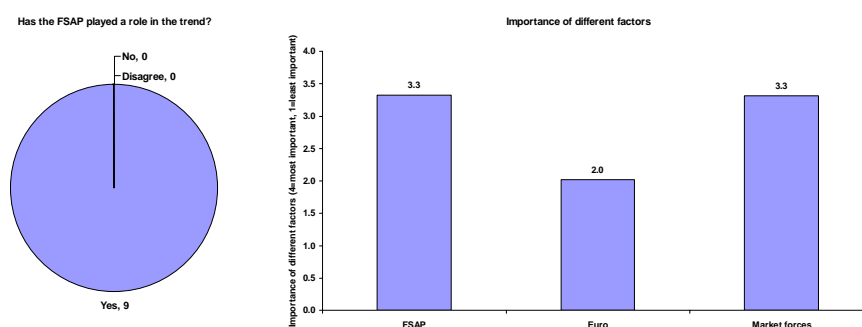
While the increase in the sending and receiving of prospectuses is in line with the expectation of the impacts of the FSAP, this does not necessarily mean that this changes where capital is raised. For example:

- CESR noted that passporting the prospectus does not necessarily imply that this has led to an increase in the number of pan-European offers as, in some cases, issuers have passported a prospectus into a member state where no public offer has subsequently occurred.¹⁰⁶
- Some of the uses of the Prospectus passport are due to tax reasons where companies may be incorporated in one member state for tax reasons even though they conduct most of their business in another member state. These companies would then use the passport out of the country in which they are incorporated to use in the country in which they conduct business and this may mean that they do not actually make an offer in the country of incorporation. This issue was mentioned by market participants in Netherlands where companies may chose to incorporate even though they do not conduct business there.
- It was also suggested that some member states may be faster at approving the prospectus than others and hence some issuers were choosing to have a (debt based) prospectus approved in a different member state to that in which they intended to sell the securities. As such some of the uses of the passport may not represent true cross-border trade but rather “round-tripping”.¹⁰⁷ For example it was highlighted in Italy that some issues would be approved in Luxembourg but passported back to be sold only in Italy.

Nonetheless, market participants in each member state, including those where there had been significant changes in the number of passports sent or received stated that this was directly linked to the Prospectus Directive. This was also supported by qualitative evidence from the interviews as shown in Figure 86 below where there was unanimous support that the FSAP had led to an increase in the cross-border use of the prospectus.

106 CESR's Report on the supervisory functioning of the Prospectus Directive and Regulation, CSER/07-225, CESR, June 2007.

107 Such an approach has been seen for some time with UCITS funds where funds are frequently authorised in Luxembourg and Ireland even though they may be intended for sale in a (single) different member state.

Figure 86: Impact of FSAP on cross-border use of the prospectus

Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

It is notable that the Prospectus passport has mainly been used for the passporting of debt securities rather than equity. For example, market participants in Germany drew attention to the use of the passport for bonds and options, those in Luxembourg and Spain highlighted covered warrants and certificates, and Portugal highlighted warrants. The focus on debt securities rather than equity may have been because the ability to choose a different competent authority to that where the issuer is located is more difficult for equity than debt. In addition, it may be the case that issuers do not wish to reach cross-border retail investors for the purpose of equity investments and can reach institutional investors from a domestic prospectus anyway. It is not possible to determine from the available data which of the passports have been used for debt securities and which for equities.

Cost associated with listing on a regulated market

The various measures relating to information disclosure, as well as requirements under MAD may have increased the costs associated with listing on a regulated exchange. Part of the increase in costs may have arisen from the way the Prospectus Directive has been viewed. Market participants indicated that many issuers saw the document as a tool by which the risk of future litigation could be avoided and hence large quantities of information are contained within the documents.

Various interviewees stated that the Prospectus Directive required more detailed information compared to previous requirements and that this additional detail was costly to provide. In this regard, a survey by ESME of 31 IPOs carried out in the first half of 2007 found that the average length of a prospectus was more than 300 pages in two member states and over 200 in a third.¹⁰⁸ They also noted that some base prospectuses were over 750 pages. The increased detail and cost was also noted by representatives of

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Report on Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading, European Securities Markets Expert Group, 5th September 2007.

issuers who indicated that costs associated with preparing a prospectus could be around €0.6 million; others suggested an increase in direct regulatory costs of around 25%.

The use of a base prospectus with supplementary information was noted in Portugal as something which was prompted by the Prospectus Directive and because of the observation of similar approaches being taken in other member states. As such, for issuers regularly offering very similar securities this could have reduced costs.

One particular concern which appeared to be specific to the UK was related to rights issues. It was argued by market participants that the need to provide a prospectus to existing shareholders when offering a rights issue was an unnecessary cost since these shareholders would be expected to be monitoring their investments already. No other member state highlighted this as a concern although this may be because of the relatively small number of rights issues that happen in other member states.

Most market participants agreed that the formal listing costs applied by regulated exchanges were small in comparison to the costs associated with the advisory services that are used. In particular, legal advice was cited in many member states as the area where costs had increased the most and these had often been substantial increases in costs. In addition, costs associated to meeting the various accounting requirements were noted as being a high burden for small companies to meet. This is supported by evidence from CSES which found that legal and accounting costs represented approximately €748,000 out of the total costs of €912,000 for the development of an equity prospectus.¹⁰⁹

In some cases, market participants indicated that some of the increase in costs faced following the Prospectus Directive represented transitional costs reflecting the need to understand the new requirements and learn new processes – which was the case for both issuers and their advisers.¹¹⁰ As such future ongoing costs may not be as high as immediately after the implementation of the Prospectus Directive although market participants argued that costs were higher than the previous position. In Italy it was noted that exceptions in the Prospectus Directive led to the possibility of a lighter touch option in some areas compared to the mandatory approach to the prospectus previously taken.

Similar comments were raised in France and Ireland with respect to the Transparency Directive where increased costs were believed to have been particularly associated to the transition period as firms had to implement and get used to a new process although in future years it was expected that costs would fall back again. In the Netherlands especially high transition costs resulted because of the delayed transposition of the directive which has led to duplication of costs. Conversely, in Italy it was noted that the

109 Study on the Impact of the Prospectus Regime on EU Financial Markets, Final Report, June 2008, Centre for Strategy & Evaluation Services.

110 There was some discussion in a small number of countries regarding the temporary position in Ireland where prospectuses continued to be approved by the Irish Stock Exchange rather than moving to the regulator, IFSRA. Some (non-Irish) interviewees suggested that Ireland had gained from this position although other (non-Irish) interviewees disagreed citing the benefits of regulatory approval.

Transparency Directive meant that mandatory quarterly reports could be replaced by an interim management statement (IMS) which could be cheaper for firms to produce. However, it was noted in many countries that there was a need to wait and see whether the information being provided by firms through the IMS was considered to be sufficient by regulators. Ongoing costs in many member states were thought to especially arise from the maintenance of the list of insiders.

Overall, therefore the costs associated with listing on a regulated market have increased. As with other measures, it was noted that for those smaller issuers who did not wish to access international capital markets, the overall cost had increased considerably, which may impact which market they choose to list on (see section 5.3.2). However for those issuers that did wish to access such markets the cost of reaching multiple markets may have fallen because even though the cost of preparing a single prospectus had increased, the ability to passport this meant that there have been lower costs associated with gaining access to additional markets.

Harmonisation of information requirements

The Transparency Directive and the Prospectus Directive both have the aim of harmonising information and therefore the aim to make comparable information available to the market. Part of this includes the information relating to accounting measures where the detail of measures determines the content of the information which is then revealed to the market through the processes prescribed in the Transparency Directive.

Participants representing institutional investors indicated the importance of the availability of comparative information as investors are then able to systematically compare information between companies. This includes the ability to take information that is available in comparable electronic form and apply internal models to assess whether the companies meet investment objectives. In particular, interviewees made reference to the ability to more easily monitor investments that are made - both because accounting information is comparable and also because it is more freely available than in the past. Interviewees also drew attention to the benefits to risk management from the additional information available since this enables them to understand the risks involved with the investments they were making.

This finding was also supported by evidence from the ICAEW based on survey evidence of over 350 respondents.¹¹¹ The majority of respondents agreed that the IFRS standards had made accounts easier to compare across countries, competitors and sectors, with 50-60% of investors agreeing. Many of our interviewees also thought that comparable information may make pan-European "sectoral" strategies easier to pursue and therefore more common although this may take some time to occur.

111 The survey respondents included investors (51), those who prepare accounts (162) or those who audit accounts (141). EU implementation of IFRS and the Fair Value Directive, A report for the European Commission, ICAEW, October 2007.

However, while there is general support for the view that the various accounting measures have led to harmonised information being available for the market, the Transparency Directive more generally was seen as not yet bringing harmonisation to the market. The two main areas where market participants raised concerns were:

- Significant holdings – where thresholds for revealing holdings vary between member states ranging from 2% to 5%;¹¹² and
- Notification process – both in terms of the timing of this and also the methodology of revealing information to the market.

In both cases, market participants were largely indifferent to which threshold was applied or which notification process was used, but were mainly concerned that there should be a harmonised approach taken between member states. In the case of the threshold, this suggests that market participants believe there is minimal additional useful information gained from a lower threshold of 2% compared to 5%. Indeed ESME has raised concerns about possible excessive information if the threshold were to universally fall to 2% although some interviewees indicated that market participants would be able to distinguish the important information from the “noise”.¹¹³

Some interviewees indicated that information on significant holdings was important to investors and hence preferred to have non-harmonised information available quickly rather than to wait for perfectly harmonised information to become available over a longer period of time had the Transparency Directive been delayed until such an agreement had been made. Nonetheless, many interviewees raised concerns that the implementation of the Transparency Directive had brought considerable systems costs. These findings are consistent with the views of ESME regarding the issues raised by the Transparency Directive.¹¹⁴ Some interviewees noted that revising these requirements to make them more harmonised would have a similar systems cost, although others indicated that there were not-insignificant ongoing monitoring costs that were incurred because of these differences. This means that companies need to continually monitor the local rules in each member state that they invest in. Despite this, interviewees did not believe that investment decisions were being distorted by this monitoring cost, but rather this was seen as increasing the fixed cost of doing business.

In conclusion, the Prospectus Directive was seen much more positively than the Transparency Directive, regarding harmonisation. Although this was not perfect for the Prospectus Directive, there was considered to be greater consistency because of the

112 Some member states have a 2% threshold (including Italy and Portugal), some 3% (including Germany, Ireland, Spain and the UK) and some 5%. Often the lower thresholds reflect pre-existing thresholds before the directive was implemented.

113 First report of ESME on the Transparency Directive (“TD”), ESME, 5th December 2007.

114 First report of ESME on the Transparency Directive (“TD”), ESME, 5th December 2007.

maximum harmonisation approach that was taken.¹¹⁵ In the case of the Transparency Directive, a lack of harmonisation, means gains from this source are limited compared to those which could potentially be achieved.

5.3.2. Final indicators – information measures

Listing and issuing

As noted above, various measures may have increased the cost of meeting regulatory requirements related to listing on a regulated market. It is possible that this reduces listings and issuing as the costs of these activities increase. There are a number of different factors that need to be taken into account when considering this issue including: the types of exchange on which listing occurs; the investors offered issues; and competition between different products.

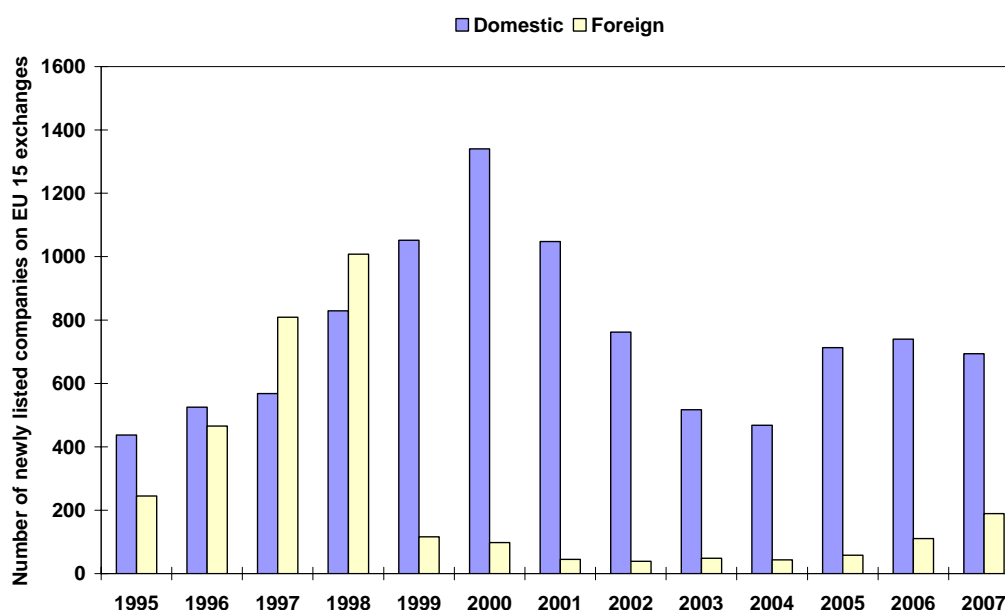
Listing on an EU-regulated market

The total number of listings that arise in any given year is likely to be somewhat cyclical since companies will take account of the likely ability to raise capital when deciding whether or not to list at any particular time. In addition, it will be influenced by the relative costs between raising equity and borrowing through debt.¹¹⁶ The number of newly listed companies on EU-15 exchanges is shown in Figure 87 below.

115 It should be noted that concerns have been expressed that the Prospectus Directive is not fully harmonised even though it was a “maximum harmonisation” directive. For example, competent authorities may request additional information or translation of the prospectus.

116 In addition some companies may also seek private equity deals rather than listing on exchanges.

Figure 87: Newly listed companies on EU-15 exchanges



Source: WFE statistics. Note that the fall in newly listed companies between 1998 and 1999 is almost entirely due to changes on Deutsche Börse. Before 1999 the Deutsche Börse statistics contained a large number of companies which were admitted to trading but not listed (known as "Freiverkehr"), while in 1999 the numbers were adjusted to include "listed" companies only. It should also be noted that methodological changes mean that data before 2000 may not be comparable to later data.

Given the strongly cyclical nature of listings, it is not possible to disentangle the impact of increased costs associated with listing on a regulated market from the overall listings that would have happened anyway. However, interviewees indicated that rather than not listing, issuers may have decided to list on alternative markets, particularly Exchange Regulated markets.

Listing on Exchange Regulated markets

One of the outcomes of the higher costs of meeting the requirements for listing on EU Regulated markets could be that issuers have listed on Exchange Regulated markets where they can avoid many of these requirements. This suggests that the overall listing may not change, but that there might be a substitution between these markets. As such, issuers would effectively be able to choose the level of regulation appropriate for them. Indeed many interviewees indicated that there was a spectrum of choices regarding capital raising and listing and that different choices would be appropriate for different companies or for the same company at different stages of the lifecycle of the company.¹¹⁷ Similarly investors could choose to invest on an EU-Regulated market with greater

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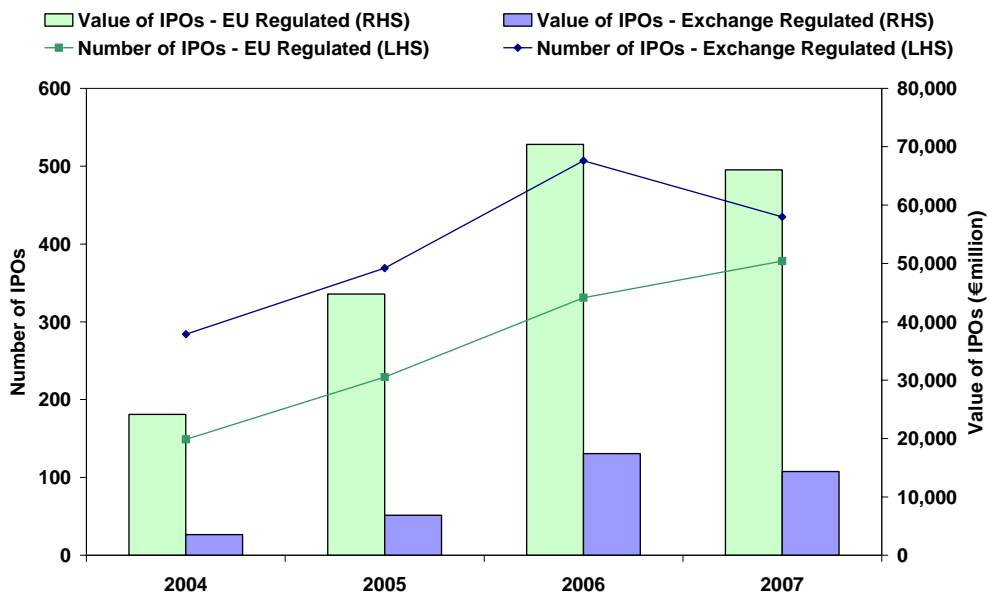
These choices included listing on EU Regulated markets, listing on Exchange Regulated markets (often aimed at smaller companies and from where some companies may then move to an EU Regulated market), venture capital and private equity, and bank based funding.

confidence regarding information and disclosure or to invest in Exchange Regulated markets in order to access different companies.

In addition, this may have impacted the markets themselves which can choose to be EU Regulated Markets or Exchange Regulated markets. It is believed that some of the costs and changes associated with FSAP measures (including the Transparency Directive, Prospectus Directive, accounting measures and MAD) were at least partly influential on the decision for the AIM in the UK to move from a Regulated Market under the ISD to an Exchange Regulated market.

Figure 88 below provides details on IPOs for both EU Regulated and Exchange Regulated markets.

Figure 88: IPOs for EU Regulated and Exchange Regulated markets



Source: IPO Watch Europe – Review of the year for various years, PWC.

There is mixed evidence regarding switching between EU Regulated and Exchange Regulated markets.¹¹⁸ The number of IPOs on EU Regulated markets has grown faster than those on Exchange Regulated markets between 2004 and 2007 with the proportion of IPOs by number on EU Regulated markets compared to Exchange Regulated markets increasing from 34% to 46% over this period. However, when the value of IPOs is considered the trend moves in the other direction with EU Regulated exchanges falling from 87% to 82% over the period.

Examining the data at the overall level of the EU, however, disguises some important developments that have arisen for certain exchanges. In particular, there have been a

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Much of the data in this section is based on IPO Watch Europe – Review of the year for various years, PWC.

number of new Exchange Regulated markets which have developed over this period including three which were launched in 2005:

- Alternext (NYSE Euronext)
- Entry Standard (Deutsche Börse);¹¹⁹ and
- EuroMTF (Luxembourg).

In addition to these, AIM in London is the largest Exchange Regulated market in the EU both by number and by value of IPOs, the Irish Stock Exchange operates the Irish Enterprise Exchange. First North (OMX) was launched in 2006 and the NewConnect market in Warsaw was launched in August 2007.

Both Alternext and Entry Standard saw very strong growth between 2005 and 2006 but had fewer IPOs in 2007. EuroMTF in Luxembourg has had a dramatic impact since launch as in both 2006 and 2007 all IPOs launched in Luxembourg listed on EuroMTF with none arising on the EU Regulated market. It is also worth noting that all of these IPOs were international IPOs with a strong influence from India which represented 22 of the 25 IPOs in 2006 and 7 of the 13 IPOs in 2007. Interviewees in Luxembourg attributed this directly to the impact of the Prospectus Directive.

Thus there is evidence in different member states that the presence of Exchange Regulated markets allows issuers to choose the level of regulation and some evidence of the information measures leading to switching to such markets. This is supported by evidence by CSES which found 26% of survey respondents agreed that the Prospectus regime had led to an increased use of exchange regulated markets whereas only 9% believe it had led to an increased use of EU regulated markets.¹²⁰

Restricting offers to qualified investors

An alternative method of avoiding some of the requirements of the Prospectus Directive is by restricting the offer to qualified investors by issuing debt with a minimum investment of €50,000. A number of market participants highlighted this as a concern, and ESME reports that on the Stuttgart stock exchange, 42% of bonds listed had a denomination of €50,000 in 2006 whereas in 2005 this figure was only 8%.¹²¹ Similarly in other countries, interviewees argued that smaller denominations had all but disappeared. However it was thought that there was already a general trend for the denomination to increase and some suggestion that the Prospectus Directive forced the reassessment of the business value

119 The Entry Standard is a segment of Deutsche Börse's Exchange Regulated market (Freiverkehr).

120 Study on the Impact of the Prospectus Regime on EU Financial Markets, Final Report, June 2008, Centre for Strategy & Evaluation Services.

121 Report on Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading, European Securities Markets Expert Group, 5th September 2007.

chain which was overdue and simply accelerated this trend. Nonetheless, one of the concerns of this is that information that was aimed at protecting the retail investor is actually having the effect of preventing access to that same investor.¹²²

Distortion of competition between different products

Some concerns were expressed during interviews, especially by representatives of the fund management sector, that the disclosure requirements under the Prospectus Directive (PD) is less stringent than that under UCITS. For example, under UCITS, the Total Expense Ratio (TER), entry and exit charges, and the Portfolio Turnover Rate must be disclosed. One concern is that structured products, which disclose under the PD may therefore have cheaper disclosure requirements than UCITS products which may distort competition between these products.¹²³ In addition to issues to do with disclosure, differences regarding approval times and eligible assets may also be affecting competition between UCITS funds and products using the PD. The EC is reviewing these issues through the discussions regarding substitutable products.

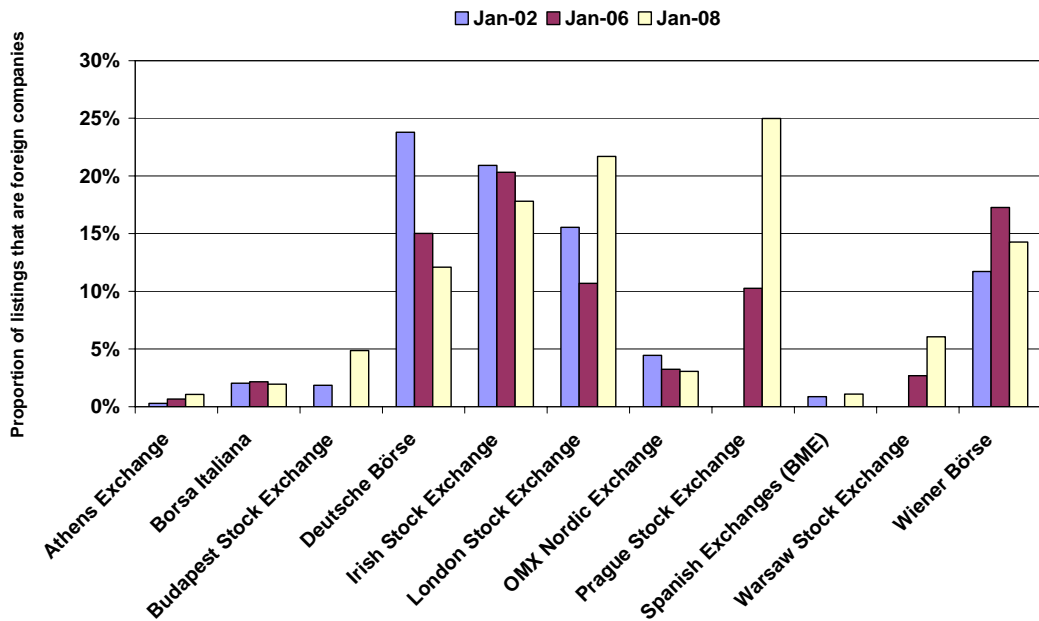
Cross-border listing and issuing

As noted above, although FSAP measures may have increased the cost of access to a single exchange, for those firms seeking international access, the harmonisation of requirements may have led to lower overall costs when listing on multiple exchanges. Figure 89 below shows the proportion of listed companies which are foreign compared to domestic and how this has changed over time.

122 A further restriction that was highlighted in a small number of interviewees was the negative impact of the Prospectus Directive on employee schemes.

123 These concerns were also noted in CESR's Report on the supervisory functioning of the Prospectus Directive and Regulation, CSER/07-225, CESR, June 2007.

Figure 89: Percentage of Foreign Listed Companies on EU exchanges



Source: FESE Monthly Statistics, January 2002, January 2006 and January 2008.

There is no clear trend across the various exchanges regarding foreign listings. The decline in the proportion of foreign listings in Germany reflects a long term trend since 1999.

A lack of clear impact from the FSAP was supported by evidence in interviews. Interviewees argued that foreign listings were linked to factors other than FSAP measures including issues such as the quality and reliability of the exchange, speed of access to the market, quality of service from the exchange and any marketing support, and the availability of associated services such as lawyers and advisers.

A number of market participants noted that home-biases remain and most believed that they would inevitably remain as companies would first seek to list on their domestic market, partly as a commitment to their customers in their home market. This is also supported by evidence of large companies undertaking IPOs. In 2005, each of the 10 largest IPOs involving western European companies took place on the issuer’s home market.¹²⁴

In terms of secondary listings, it was noted that with harmonisation requirements and easier cross-border trade, the need for cross-border listings was actually falling. This was argued to be particularly the case in the light of exchange consolidation where access to multiple markets has arisen or is expected over time. Competition between exchanges following MiFID is believed to have increased significantly although interviewees

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Dealogic as quoted in Sustaining New York’s and the US’ Global Financial Services Leadership, McKinsey.

suggested this had focused so far on trading rather than listing. Given that MiFID has only recently been implemented, this may change over time, but as yet no strong trend on cross-border listing (as opposed to cross-border trading) has been observed.

In general it was noted that the Prospectus Directive helps if there is a secondary listing but higher or lower costs associated to the Directive would not determine whether or not such a listing arose. Instead, when cross-border listings do arise, most interviewees argued that this was due to historical reasons or because of cross-border M&A activity in order to demonstrate continued commitment to the country of the acquired company. For example, it was noted that there was cross-listing between Spain and Latin American companies, and between the UK and Ireland reflecting the fact that the stock exchanges used to be part of the same company.

Impact of non-EU regulation

Changes to listing may also be impacted by regulation that arises outside the EU. This is highlighted by the experience of the US in which the burdens of regulation are considered to be partly responsible for a shift in IPOs away from the US and towards both Europe and Asia. For example, the global share of IPO volume on European exchanges has expanded by more than 30% from 2001-2006. One of the key drivers of this was the worsening performance of the US which saw its global share fall to around a third of what it was in 2001.¹²⁵

When considering IPOs, the proportion of foreign listings seen on the LSE increased from a very low base of around 2% in 2002 to reach around 60% in 2006. Furthermore, 6 of the 10 largest IPOs in 2005 were by foreign issuers compared to only one on the NASDAQ and none on the NYSE. Moreover the NYSE saw foreign IPOs remain at less than 20% throughout the period from 2002-2006. However, the growth in foreign listings on the LSE is much less than that seen in Hong Kong (where listings from mainland China count as "foreign") and similar to that seen in Singapore, suggesting that other exchanges are able to gain from cross-border listings.

Regulatory burdens were seen as being one of the main reasons for the poor performance of the US. Particular areas of concern in this regard were:

- Sarbanes Oxley;
- the extra-territorial reach of some US requirements;
- differential applications of Basel II (implemented though CRD in Europe); and
- the requirements for reconciliation between IFRS and US GAAP (although changes have subsequently been suggested in this regard).

¹²⁵ Details in this section are based on Sustaining New York's and the US' Global Financial Services Leadership, McKinsey.

All of these factors were commonly cited concerns that were pushing companies away from listing in the US and towards listing in Europe especially in London. Hence increases in listings and cross-border listings in Europe that have been observed during the period in which the FSAP measures have been implemented are also linked to the regulatory environment in the US. The case of Sarbanes Oxley is especially relevant since it indicates the impact which one piece of legislation can have on the securities market and therefore provides a salutary lesson for policymakers in the EU. This also serves to highlight the nature of the securities markets which must be increasingly viewed as global rather than national or even EU-wide as companies face choices across the globe of where to list when seeking to raise capital.

5.3.3. Summary for information measures

Overall, information disclosure measures within the FSAP have had a mixed impact on the market. There has been an increase in the number of prospectuses that have been passported into other countries which is directly linked to the Prospectus Directive. There is evidence that some of these passports are being used for tax reasons or represent round-tripping, but nonetheless the passport has made access to foreign markets easier.

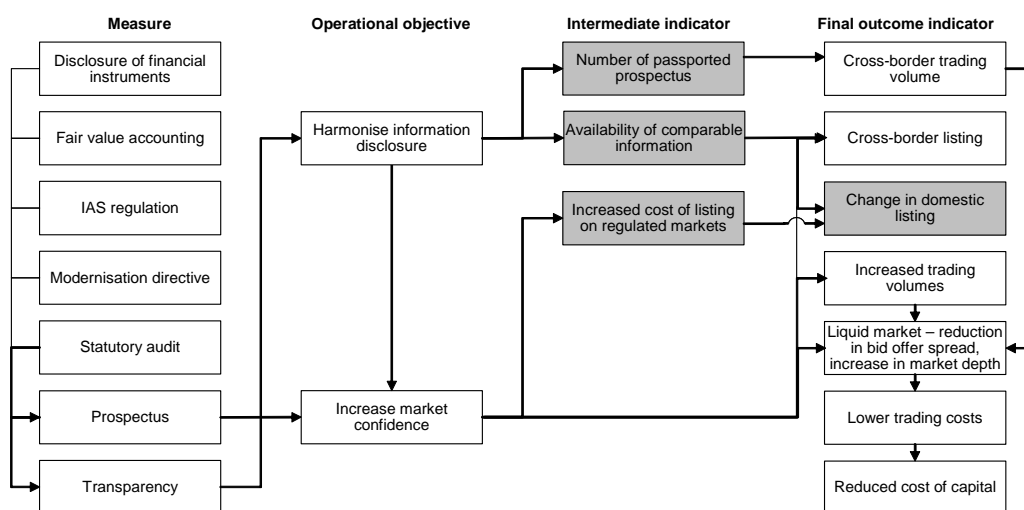
The Prospectus Directive is also viewed as having resulted in harmonised information being available since it was a maximum harmonisation directive. Although the Transparency Directive has made progress towards harmonisation there remain numerous differences between member states which would need to be overcome in order to see impacts through this channel and hence no harmonisation impact has yet been achieved.

When considering the impact of the cost of regulation, the most significant effect appears to have been a switch in some countries from listings arising on the EU Regulated market to Exchange Regulated markets. This includes the markets themselves choosing to switch to, or set up as, Exchange Regulated markets. It is possible to interpret this trend in two ways. Firstly it could be seen as an important mechanism for avoiding the impact of regulation. Secondly, given that an alternative mechanism for listing exists (i.e. Exchange Regulated markets) issuers are effectively able to choose the level of regulation appropriate for them - those that wish to be on EU Regulated markets gain from the higher level of regulation and quality mark from harmonisation but must also incur the higher costs. Even though the total listings may be unaffected, the markets on which listing is occurring have therefore changed.

Regulatory burdens in the US may have pushed some foreign listings to EU markets. However, less impact has been observed or is expected from the FSAP measures regarding cross-border listings with interviewees arguing that the home bias remains and that the need for cross-border listings is reduced when cross-border trade is possible.

Figure 90 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 90: Conclusion on causality tree related to information disclosure measures in securities

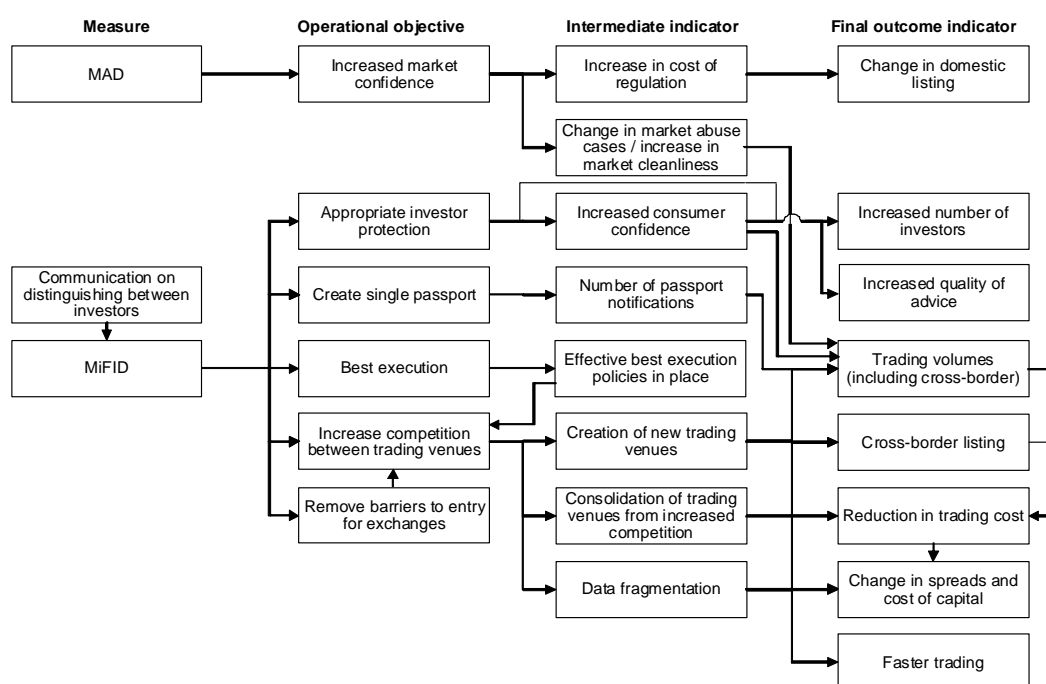


Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen. Note that at this stage only final indicators related to listing have been assessed. The remaining final indicators will be considered in the next section.

5.4. INDICATORS - TRADING

There are three main measures which impact the trading environment. The communication on client categorisation was applied from November 2000, the Market Abuse Directive (MAD) applied from October 2004, and MiFID took effect from November 2007. Given the far reaching nature of MiFID and its recent implementation, it is not yet possible to assess the impact of elements of this directive and many parts of the market are still in a transitional period where considerable change is expected in the future but where the final outcomes are not yet clear. The observation that it was too early to assess the impact of MiFID was made by almost all interviewees. For this reason, many of the MiFID related impacts can only be explained qualitatively rather than through quantitative data. The causality tree relating to these measures is set out in Figure 91 below.

Figure 91: Causality tree relating to trading related securities measures



Source: CRA analysis. Note that for convenience the intermediate indicator "Effective best execution policies in place" has been shown as leading to the operational objective of "increase competition between trading venues" – this is for simplification in order that best execution could be linked to the three intermediate measures below it in the figure.

As was noted in section 5.3 above, some of the information measures also impact the same final indicators as measures considered in this section and therefore account is taken in this section of their impacts as well. Conversely, issues to do with listing have already been considered in section 5.3 above.

5.4.1. Intermediate indicators – trading measures

Number of market abuse cases and increased market cleanliness

One of the key aims of MAD is to reduce the amount of market abuse that occurs or, conversely, to increase market cleanliness. Indicators that could be useful include:

- the number of Suspicious Transaction Reports (STRs); and
- the number of market abuse investigations and prosecutions.

During the course of the project, we have sought to identify this information, but were not able to gather this information in a systematic manner from regulators. We would therefore recommend that such information is collected in the future in order that these issues can be monitored over time.

Even once this data is available, however, there are significant difficulties with the interpretation of market abuse figures which means that qualitative interviews are also needed in order to draw conclusions from the information. In particular, our interviews show that understanding the local context in which the cases are found is very important. The number of market abuse investigations is a function both of the amount of market abuse that arises and also of the ability to detect such abuse. Thus an increase in the number of cases could reflect either an increase in market abuse or an increase in detecting such abuse; and similarly a decrease in the number of market abuse cases could reflect a decrease in market abuse or a decrease in detecting such abuse. Given these difficulties, the qualitative assessment of market participants is especially important in this area and future assessments would need to take these qualitative factors into account as well as quantitative factors.

Generally, most market participants viewed MAD positively believing that it had enhanced supervision, with some market participants noting the benefits from increased international co-operation (although others were concerned about the potential for regulatory arbitrage). For example, in Poland it was believed that MAD brought clarity to existing rules and meant that it is now easier to legally identify market abuse – this would be expected to lead to a greater number of market abuse cases being prosecuted than previously.

In addition, while it was not always explicitly linked to MAD the general view during the course of conducting interviews across member states was that supervisors were taking the issue much more seriously at present than had been the case in the past. Many supervisors gained additional tools for examining market abuse and market participants indicated in many member states that there had been an increase in the resources given to this activity. However, most market participants indicated that this was a relatively recent change in attitudes during 2007/2008 and therefore arose somewhat after the implementation of MAD in 2004. Some market participants believed that these changes were due to MAD while others indicated they were due to more “political” domestic factors although often relying on new powers and tools due to MAD. The credit crisis in 2008 may also lead to changes in attitudes regarding enforcement.

Furthermore, requirements on listed companies to disclose information to the market as soon as possible was believed to have increased the amount of information that was being disclosed and most market participants believed that this had positive effects on market transparency.

In addition to this qualitative evidence, two member states have conducted detailed econometric research in order to attempt to understand the state of market cleanliness and the impact of MAD.

The Dutch regulator, the AFM, has undertaken an initial examination of the impact of MAD by examining “abnormal” returns before company announcements as a method of

understanding whether there is evidence of insider trading.¹²⁶ Although the results should be considered as indicative as the AFM acknowledges a number of factors relating to the methodology that require further analysis, the research concludes that there has been a statistically significant reduction in the abnormal returns for small companies and for announcements regarding alliances or mergers and acquisitions. The impact on small companies is consistent with some previous research which suggests that since smaller firms are not followed as closely by analysts as larger firms, there may be more opportunities for gains from insider trading. Overall, therefore the AFM research suggests an increase in market cleanliness following the implementation of MAD.

The Financial Services Authority in the UK has conducted similar research linked to the Financial Services and Markets Act (FSMA) implemented in 2001 and finds that there was a reduction in insider trading following this, but notably finds that there is a more significant reduction following the first enforcement of the FSMA.¹²⁷ While this work does not relate directly to MAD, it demonstrates that legislation alone is not necessarily sufficient to lead to changes in market abuse.¹²⁸ The importance of enforcement in improving market cleanliness is also identified in other academic research.¹²⁹

This role of enforcement is also noted by ESME,

“There is a concern that without the Market Abuse directives being seen to be implemented, abusive practices are continuing. There is little incentive for compliance among general market users where there appears to be a low risk of being caught, which is partly a result of settlements that are not published, and where sanctions are light.”¹³⁰

This issue was also supported by interviewees in many member states who indicated that it was helpful to have high-profile investigations in order to have a dissuasion effect on others who might be tempted to engage in market abuse, or that market abuse cases would be expected to increase to show the effect of the directive (indicating a view that increased detection was the key driver on the number of market abuse cases).

Member states where market participants indicated that high profile market abuse investigations cases could be useful as they are seen as evidence of enforcement

126 Report: The effects of a change in market abuse regulation on stock prices and volumes: Evidence from the Amsterdam stock market, Autoriteit Financiële Markten, September 2007.

127 Updated Measurement of Market Cleanliness, Financial Services Authority, 2007.

128 The research does not examine whether the Market Abuse Directive had an impact on market cleanliness.

129 See for example, The World Price of Insider Trading, Journal of Finance, 57(1), 75-108, Bhattacharya and Daouk, 2002.

130 Market abuse EU legal framework and its implementation by Member States: a first evaluation, ESME, 6th July 2007.

included: Ireland, Poland, and the UK.¹³¹ In Sweden there had been high profile cases which were taken to court but where individuals were found not guilty and hence the desired deterrent effect was not achieved. By contrast in Portugal, it was thought that recent high profile cases were already acting as deterrents. In Spain, there had been an increase in the number of STRs since MAD which was viewed positively as it enabled the supervisor to investigate more potential cases. In Germany, it was noted that there had been a steady decline in the number of cases in which fines were imposed which have fallen from a peak of 33 in 2004 to 14 in 2007, although it was also noted that this does not imply that there is less abuse occurring. In addition, some interviewees believed that MAD enabled supervisors to identify cases of abuse earlier than they would previously have done.

Table 18: Market abuse cases

Member state	Trend in market abuse cases following MAD
Belgium	No significant change
France	No significant change
Germany	Reduction from peak of 33 in 2004 to 14 in 2007, but not possible to establish this implies a reduction in market abuse.
Ireland	No significant change
Italy	Increase in number of cases
Luxembourg	No significant change
Netherlands	No change, but indicative evidence of an increase in market cleanliness
Poland	No significant change
Portugal	No significant change
Spain	Increase in number of STRs
Sweden	Substantial increase in STRs but no change in number of cases
UK	No significant change. Around 700 STRs between 1 st July 2005 and 31 st March 2008.

Source: CRA analysis and various regulators.

Overall, it appears that an increase in market abuse cases is likely to be viewed as evidence of enforcement. Qualitative evidence will be essential to understand whether this is correct and to assess whether MAD is having an impact in terms of cases and prosecutions and also in terms of the deterrent effect that is seen as desirable by many

131

It should be noted that in the UK these comments were made before the FSA launched its second criminal investigation of market abuse and before a series of high profile arrests in a further case. It is thus unclear whether these cases (which were well publicised in the media) would have this deterrent effect. The FSA also launched criminal proceedings against two individuals in January 2008.

interviewees. Given the speed of some court systems it is likely that this will take some time to observe. While there is some evidence of an impact of MAD in the Netherlands, as yet it appears as though more time is required before impacts are observed more generally.

Increased consumer confidence and numbers of investors

Increased market and consumer confidence are aims from both MAD and MiFID as well as the measures relating to information disclosure.¹³² In turn these measures, by harmonising regulations and information disclosure and increasing consumer confidence could bring additional investors into the market.

By its very nature, consumer confidence in markets is difficult to measure and market participants were not able to provide evidence of any national surveys focused on this issue or on the numbers of consumers investing in securities markets. Furthermore, interviewees did not subscribe to the view that the FSAP measures would have a significant impact on confidence levels or on the number of investors. It was noted by many interviewees that the impact of market wide events such as the recent credit crunch were likely to have a much more significant impact on consumers than the FSAP measures and hence it was highly unlikely that the impact of the FSAP on consumer confidence was measurable. In addition, numbers of market participants indicated that national market issues would also dominate the FSAP measures in their impact on consumer confidence. For example, a number of market participants from different member states mentioned domestic concerns regarding mis-selling of investments as having a much more substantial impact on confidence.

The impact of MiFID on the retail sector is unclear at present given the short period of time since the directive was implemented. In terms of the impacts so far, numerous interviewees made reference to MiFID as leading to written processes being put in place but will little other change thus far. The main impact observed by existing retail investors was to receive considerable volumes of paper from different firms. It was not thought that retail investors had used this information or changed their behaviour because of it.

In addition, many interviewees indicated that the ability of consumers to understand financial information was a necessary development before such information could be expected to change behaviour. Hence the possibility remains that over the longer term consumers who gain greater financial capability would have greater confidence in using securities markets because of the availability of information and the increased investor protection. This is likely to arise only over the long-term.

Quality of advice

In some countries where suitability and know your customer requirements were not previously in place or not at the same standards as in MiFID, interviewees expressed the

¹³² Note that the number of investors is a final indicator, but it has been included here for ease of review and because many of the issues relating to increased consumer confidence are relevant to the number of investors.

views that some consumers were reluctant to divulge personal information to advisers.¹³³ Consumers in these countries potentially saw confidence levels fall as they became suspicious as to the reason for gathering personal information that was not previously required.

However, it is also clear that in member states where financial advice was not previously a regulated activity, there is an expectation that the quality of advice should increase. Given that advisers need to meet the new regulatory standards some advisers would need to increase the quality of their advice and others might exit the market if they do not meet these standards. Overall therefore there would be an expectation of the quality of advice increasing. At present, given the short period of time since MiFID was implemented, it is not possible to observe whether the quality of advice has increased and this represents an indicator that is difficult to measure in a quantitative manner. However, as with the regulation of insurance intermediaries through the IMD examined in section 4.3, it may be possible to obtain qualitative evidence regarding changes to the quality of advice in the future.

Number of MiFID passport notifications

One of the aims of MiFID was to enable investment firms in one member state to easily access another member state without needing to go through an authorisation procedure in the second member state. The Investment Services Directive (ISD) already allowed for a passport and there was automatic mapping between the ISD passport and the MiFID passport but MiFID widened the scope of this and sought further harmonisation between member states.

Evidence from interviews suggests that as yet there is relatively limited use of such a passport with firms preferring alternative methods to access other member states rather than by passporting in services from a different member state. Some member states reported an increase in the number of passport notifications although few interviewees were aware whether the passports were actually being used in practice:

- Market participants in France indicated that many passport notifications had been made;
- The FSA in the UK reports an increase in the number of passport notifications from 1,759 in 2006/2007 to 3,330 in 2007/2008;¹³⁴ and
- Interviewees in Ireland indicated that there had been an increase in passport notifications due to the new services and instruments covered by MiFID, but noted that it was not yet possible to observe whether the passports are actually being used.

133 Note that the quality of advice is a final outcome indicator but has been addressed here because it relates to the retail sector which is also discussed in this section.

134 Annual Report 2007/08, Financial Services Authority.

Given the recent implementation of MiFID it is not yet possible to identify quantitative evidence on the number of passports across the EU – it is likely that the involvement of CESR would be appropriate in order to obtain this information on a consistent basis over time.

However, while interview evidence suggests there is a small effect from the MiFID passport at present, this does not preclude the possibility that in years to come this passport could be of importance in enabling more cross-border trade. Indeed, it appears to be the case that whereas other measures within the FSAP have removed barriers to cross-border activity that were previously binding on providers, the MiFID passport may represent the removal of a barrier that was not currently binding but that could otherwise have become a constraint in the future as markets develop.

Application of best execution

The application of MiFID has brought requirements regarding the best execution of trading decisions. In practice, the role of best execution in which traders go in search of the best location at which to execute trades is not perceived to have changed in the light of MiFID. Most interviewees indicated that in terms of trades for retail investors, there had been little practical changes to the best execution policies and that most trades continued to be executed on the major domestic exchange.

In some cases, countries already had requirements that were similar to the best execution aspects of MiFID although in many cases there has been an additional need to have written policies. At the time of interviewing, the majority of both regulators and representatives of the industry indicated that the focus thus far had been on ensuring that there were written policies on best execution that would meet the regulatory requirements rather than having policies that would actually lead to a change in behaviour. The only exception to this was in the UK where market participants indicated that greater enforcement of best execution policies was being observed – this is likely to reflect the greater availability of alternative trading venues in the UK than has yet arisen in many other member states (see next section). There was also some suggestion that firms were reducing the number of brokers that they used for trading in the UK because of the desire to use brokers which are connected to multiple venues.

Best execution does not mean that for any single trade the best venue needs to be chosen for that individual trade, but rather that this occurs over time. Particularly in those countries that had previously had a concentration rule, the lack of viable alternatives for trading in the immediate aftermath to MiFID implementation meant that a policy of continuing to trade on the main regulated market was unlikely to be problematic. A small number of interviewees highlighted the cost of investing in links to these new venues which some firms may be unwilling to make until the venue had proved it was likely to remain in the market for longer than just the short term.

More generally, however the impact of the best execution rules are linked to changes in trading venues and if new trading venues grow and become successful, best execution rules may lead to the location of trades changing and this impact would be expected to

develop overtime, and it would become possible to identify which of these venues best meet the needs of investors.

Linked to this, it was noted that many best execution policies were rather imprecise at present and therefore may not be having a dramatic impact on behaviour. For example, some interviewees have indicated that: a list of venues was not always included in the execution policy; the factors used in the choice between the venues in the policy were sometimes presented in vague terms, or not at all; and there was an insufficient distinction between products or investor categories. Over time, firms will need to develop their best execution policies both to take account of the greater choices that they have and also in order to provide more precise information for investors. Given the speed at which new trading venues are being developed (see below), it is likely that some changes to best execution will arise within around 3 years.

Number of trading venues

Historically, many stock exchanges have been national monopolies although even before the beginning of the FSAP process these were beginning to face competition as technology reduced the cost of trading and created the ability to compete across borders. By removing barriers to entry for exchanges through MiFID, the FSAP would be expected to lead to a change in the number of trading venues, with new competitive forces operating in two different ways:

- The removal of the concentration rule (requiring trading on particular exchanges) would be expected to lead to new trading venues to be developed in member states; and
- At the same time, increased competition might be expected to lead to consolidation of trading venues in order to exploit economies of scale.

There is strong evidence of both of these effects arising, although it is less clear whether the latter is due to the FSAP. Nonetheless, the FSAP, and MiFID in particular, were cited as key reasons for the development of new trading venues.

Concentration rule

Table 19 below provides details of whether or not member states had a concentration rule before MiFID was applied.

Table 19: Presence of concentration rule pre-MiFID

Member state	Was there a concentration rule pre-MiFID?
Belgium	No
France	Yes
Germany	No

Ireland	No
Italy	Yes
Luxembourg	No
Netherlands	Rule where members of exchange had to trade on the exchange was abolished in 2001
Poland	Concentration rule was removed in 2005
Portugal	Default rule where if no other exchange is specified, trades are executed on Euronext
Spain	Yes
Sweden	No
UK	No

Source: CRA analysis.

Given that some member states previously had a concentration rule, it would be expected that the development of new trading venues might arise in these member states – since the freedom to have alternative trading platforms already existed in other member states. However, in practice the removal of the concentration rule appears to have had impacts which are wider than simply the countries which previously had the concentration rule (France, Italy and Spain). In particular there has been an expansion of trading venues set up in the UK despite the fact that this was possible before MiFID. Nonetheless, there are a number of reasons that appear to link these developments to MiFID:

- Some market participants suggested that the desire to set up a new trading venue had been in place before MiFID but the practice of setting up new venues had not succeeded. MiFID was understood to make it easier for new trading venues to succeed.
- A small number of interviewees indicated that while trading venues could have been set up, MiFID created a reason to change and make investments. In particular, it was thought that MiFID was being developed during a critical moment of strategic thinking regarding trading venues. This was also thought to have impacted the willingness of senior management's to make investment decisions.
- Even though some countries such as the UK did not previously have a restriction in the form of the concentration rule, new trading venues may have depended on attracting trades from other countries whose trading may have been restricted by concentration rules and hence they would only be viable under the circumstances in which it was known that these rules would be removed. Hence commercial opportunities were increased by MiFID even for trading venues located in countries which could have been set up (or indeed were set up) before MiFID. In particular, MiFID provided certainty regarding the creation of a pan-European regime and so greater confidence that a new trading venue would be able to gain access to multiple markets.

Furthermore, a number of market participants have suggested that MiFID brought more certainty and more information about the ability to trade through non-regulated exchanges in other countries and hence had an impact even in those (non-London) locations which did not have any restrictions. The expectation of a number of these participants was that more of the trading would flow to London following MiFID and as some of the London based MTFs (especially Chi-X and Turquoise) developed. While some market participants indicated that the development of new trading venues would have arisen in the absence of MiFID, the vast majority stated that MiFID played an important role.

New trading venues

Some of the trading venues that have recently started or are planned to commence trading shortly and where market participants most linked their development to MiFID included:

- Chi-X which claimed to have captured an average 13 per cent of all trading in FTSE 100 stocks in July 2008.¹³⁵ In addition, interviewees indicated that Chi-X had gained around 5-10% of trading in both Amsterdam and Stockholm. It should be noted that Chi-X launched in the summer of 2007 before MiFID came into effect, but nonetheless most market participants linked much of its success to MiFID;
- Turquoise – while this only commenced trading in the summer of 2008, the great majority of market participants (interviewed before it was open to trading) highlighted this venue as one which was likely to have an important impact on the market. In some discussions the view was expressed that the market was waiting for Turquoise before the real effects of MiFID could be observed;
- Euronext's Pan-European MTF; and
- NASDAQ OMX's MTF.

In addition, media coverage highlighted the expected entry of BATS Trading (which has gained considerable market share in the US at the expense of NYSE and is therefore seen as a credible entrant in the EU) as well as Equiduct, majority owned by Börse Berlin.¹³⁶ NYSE Euronext announced a planned January 2009 launch for its own European MTFs, Smartpool and NYSE Arca Europe across a full range of markets involving an 400-500 shares initially including UK and German securities. Thus there are considerable structural changes still expected to arise regarding new trading venues.

In terms of the new trading venues that are being set up there are differences regarding whether or not these represent additional competitive threats to existing exchanges according to what is traded on the new venues. For example, a substantial amount of the trading in bonds has typically arisen off-exchange in the past and hence the existing exchanges that focus on bond trading do not perceive the changes brought in through

135 LSE suffers huge outage, Financial Times, 8th September 2008.

136 Chi-X claims trade lead over rival platforms, Financial Times, 13th August 2008.

MiFID to be likely to have a significant impact. By contrast, many of the new MTFs have focused on equities trading that would historically have arisen on-exchange and hence these are thought more likely to have a significant impact in equity trading.

Consolidation of trading venues

In addition to new trading venues being developed, it is also possible that various FSAP measures lead to consolidation of exchanges due to increased competitive pressure. Such consolidation has also been seen for example with the development of Euronext and OMX being examples where considerable cross-border consolidation has been seen over a number of years. For example:

- OMX merged with the Stockholm Stock Exchange in 1998 and also developed a joint trading platform on all the Nordic exchanges. In 2003 it merged to include the Helsinki Stock Exchange (HEX), Tallinn and Riga exchanges and in 2004 acquired the Vilnius exchange and implemented a joint trading platform on all Nordic exchanges. 2005 saw the merger with the Copenhagen Stock Exchange, 2006 that with the Iceland Stock Exchange as well as the launch of the OMX Nordic Exchange. In 2008 OMX merged with NASDAQ.¹³⁷
- Euronext was formed from the merger of the exchanges in Amsterdam, Brussels and Paris in 2000. In 2002 BVL in Lisbon merged with Euronext and LIFFE was also acquired by Euronext. In 2007, NYSE Group and Euronext merged.¹³⁸

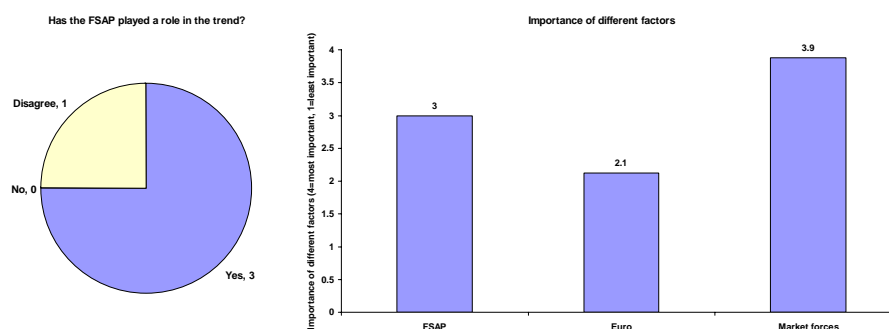
In addition to these mergers, various regional exchanges in Spain merged to form BME and the London Stock Exchange merged with Borsa Italiana.

While the consolidation of these various exchanges is clear, only a few market participants believed that this was due to the FSAP. Instead the various mergers were seen to be driven by commercial reasons as increased competition over time and technological progress forced a greater need to exploit economies of scale. However, it should be noted that in as far as the FSAP fosters conditions which enable increased competition then it may, in part, play a role in this trend. Indeed a small number of market participants noted that the ethos behind the FSAP made it clear that the direction of market trends would be towards competition between different trading venues rather than having a direction focused on protecting the incumbent stock exchanges. As such, this was then taken into account when firms consider the likely development of the market and when they consider how best to compete in future. Amongst those who did believe that consolidation was partly driven by the FSAP respondents nonetheless stated that the role of market forces was more important.

137 Based on information from NASDAQ OMX website: <http://nasdaqomx.com/whoware/milestones/milestonesomx/>

138 Based on information from NYSE Corporate Timeline.

Figure 92: Impact of FSAP on consolidation of exchanges



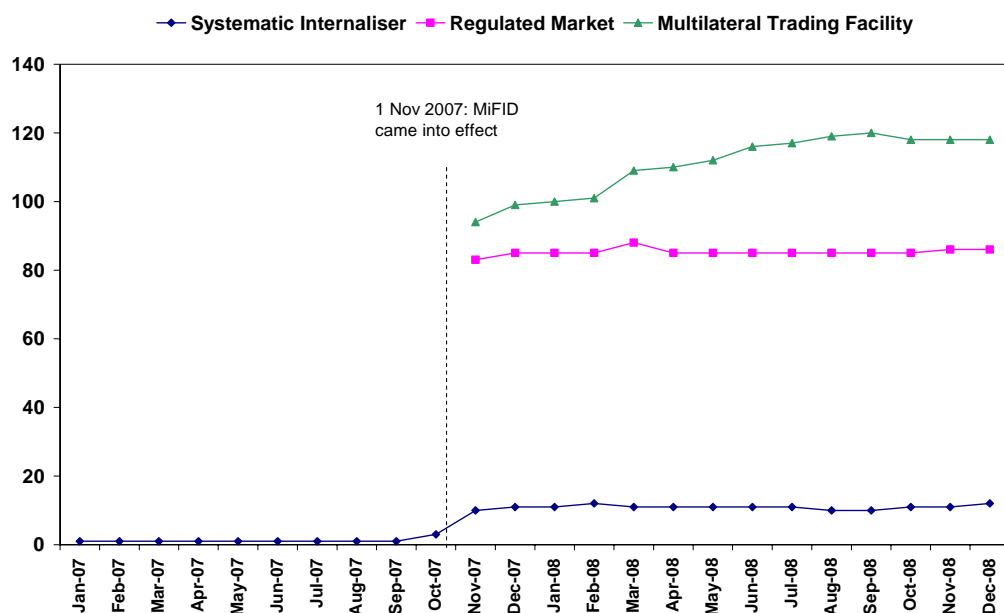
Source: CRA survey and analysis. It should be noted that there were only a small number of responses on this question and it is not possible to draw strong conclusions as to whether the FSAP impacted the consolidation of exchanges although there is more robustness regarding the role of market forces being more significant. Note that "Disagree" implies that multiple respondents in one member state gave different responses to the question.

As noted above, in 2007-2008 both OMX and Euronext were involved in transatlantic mergers. This development was noted by some interviewees as indicating the growing international nature of trading platforms and that exchanges were competing more and more in a global rather than European market.

Number of trading venues

Figure 93 below provides details of the number of trading venues according to the different regulatory types although data has only been available since MiFID was implemented. It is clear that even in the short period of time since MiFID was implemented there has been an increase in the number of MTFs from 94 in November 2007 to 118 in December 2008. By contrast the number of EU Regulated Markets and the number of Systematic Internalisers has remained fairly constant since November 2007. Systematic Internalisers are investment firms which on an organised, frequent and systematic basis, deal on their own account by executing client orders outside a regulated market or an MTF.

Figure 93: Number of trading venues



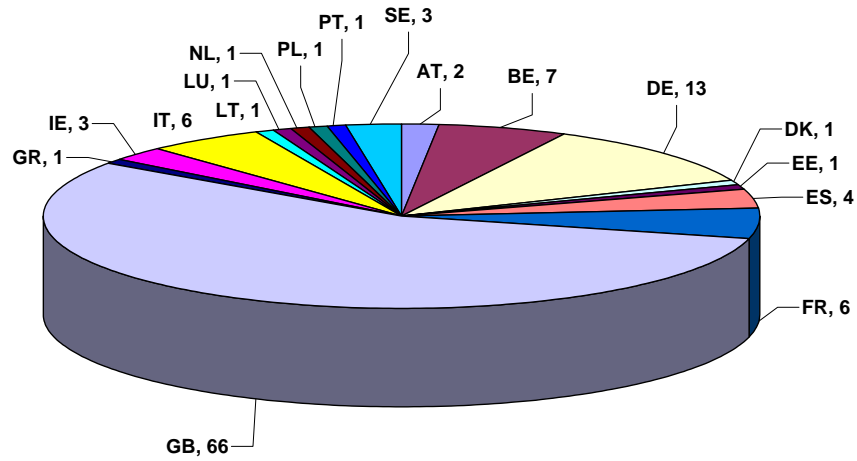
Source: CESR MiFID database for EU countries only.

Data does not allow for an easy comparison of Alternative Trading Systems (ATS) that were in place before MiFID. Evidence from interviews makes it clear that a number of the MTFs that are now in place have simply converted from ATS following MiFID. Nonetheless, there has been growth in MTFs and most interviewees noted that there had been development of new MTFs following MiFID and more are still expected.

There are different types of MTFs which are currently seen in the market including those which trade only shares admitted to trading on a Regulated Market (such as Turquoise, Chi-X and Nasdaq OMX) and those which the MTFs themselves admit to trading (such as AIM and Alternext). In addition, some trading venues avoid the pre-trade transparency rules of MiFID (often referred to as “dark”). Some MTFs have been set up by market operators, whereas others have been set up by intermediaries. Finally, some MTFs have a particular focus such as SMEs, whereas others are seeking to compete in large, pan-European trading.

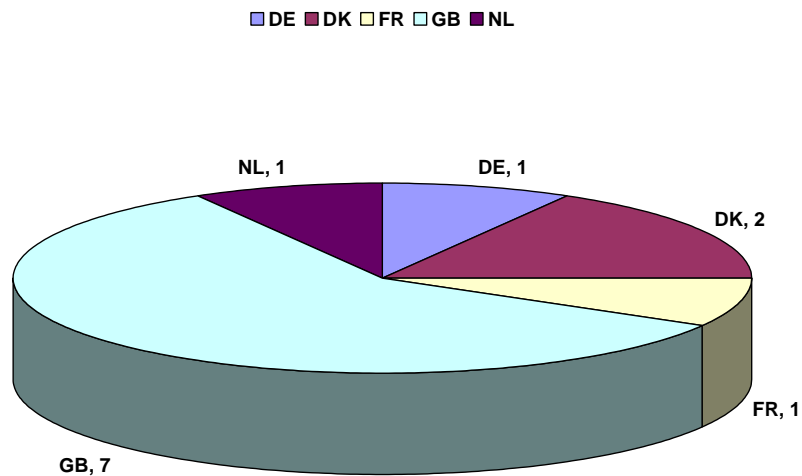
The strength of the UK in terms of its position as a key location for the securities trading sector is clear when the number of trading venues is examined by different member states as shown in Figure 94 and Figure 95 below. Of the 118 MTFs in December 2008, 66 of these were based in the UK, with Germany the second most popular location for MTFs some considerable distance behind with 13.

Figure 94: Number of MTFs by member state, December 2008



Source: CESR MiIFD database for EU countries only.

Figure 95: Number of Systematic Internalisers by member state, December 2008



Source: CESR MiIFD database for EU countries only.

While MiFID clearly prompted a number of investment banks to become systematic internalisers, the numbers have remained fairly small over time with only 12 in place at the end of December 2008. Before MiFID was in place, BNP Paribas was categorised as a systematic internaliser but stopped being one after MiFID was applied until late in 2008;

and Merrill Lynch was only one for three months between December 2007 and February 2008.¹³⁹ It is also clear from Figure 95 above that the UK has a strong position with 7 of the 12 SIs located in the UK.

Many market participants have been surprised by the relatively small numbers in this regards although it is noted that it remains too early to know whether these numbers have reached an equilibrium position or whether more systematic internalisers will be observed over time. The small number of systematic internalisers may reflect the choices of investment banks to focus on the development of MTFs (such as Turquoise which is backed by a number of investment banks). In addition the small numbers may have remained because banks have launched trading platforms which are classified as Over the Counter (OTC) platforms as they fall outside of both MTF and SI definitions. OTC trading platforms are not subject to pre-trade transparency rules which a small number of interviewees described as raising concerns regarding having a level playing field in competition between different trading venues.

Trading on new venues

As well as changes in the number of trading venues it is also useful to assess the actual amount of trading that is arising in order to understand the impacts that the new venues are having on trading conditions. At present it is not possible to gather this information in a systematic manner because of the short time for which some of the trading venues have been in existence and because there is a transitional period in which data may not be available for new venues. However, some of the information that would be useful to examine in a few years time includes:

- Number of financial instruments traded on particular venues;
- How these financial instruments break down according to categorisations such as blue-chip versus small companies, equities versus bonds etc; and
- Total volumes of trading for the different instruments and different venues.

Conclusions regarding trading venues

In conclusion, it is clear that the FSAP, and MiFID in particular, has been linked to the development of new trading venues, although less clear whether the consolidation of stock exchanges that has been observed throughout the last decade is linked to the FSAP. A small number of market participants believed that FSAP was partly responsible for this trend because it set out a clear trend towards increased cross-border competition between trading venues.

However, given that MiFID has only recently been implemented, there is currently considerable speculation as to how markets will continue to change over the next few years. There is a general expectation among many of those interviewed that Europe will

139 Source: CESR MiFID database for EU countries only.

follow a similar pattern to that observed in the US when similar freedom regarding trading venues was observed. In particular, many market participants believe that the number of MTFs and other trading venues will increase in the short to medium term as the freedoms of MiFID are exploited. In the medium to long term, it is anticipated that the competitive process will mean that the less successful platforms will be forced out of the market and thus over time there will be a reduction or consolidation of trading platforms. Some market participants believe that this will be linked to increased specialisation among trading venues with different venues focusing on either different types of securities or on different companies. It will only be possible to assess this in a number of years' time although the number of changes that have already occurred in this area indicate that an assessment in around 3 years might be appropriate.

Data fragmentation

One of the concerns expressed regarding changes arising due to MiFID was that the ability to trade on many different trading platforms would lead to data fragmentation and traders losing the ability to understand what is happening across all of the platforms. As such this could lead traders to be less willing to trade or lead to a lack of liquidity. This issue was seen to be a particular concern in countries that previously had a concentration rule i.e. France, Italy and Spain, although a small number of participants indicated it was also a concern in the UK because of the increase in the number of trading venues from which data now needed to be gathered.

All interviewees who expressed concern about this issue noted that it was too early to assess whether data fragmentation would be a concern in practice. The great majority of market participants believed that data providers would have every incentive to provide consolidated data to clients who would find this useful. In addition, it was noted that investment banks had invested in proprietary systems which would take in data from multiple trading venues and present a consolidated picture for their own traders; as such representatives of investment banks in different countries believed that their members had been able to considerably reduce (although not eliminate) concerns about fragmentation. It was also noted that users of data would probably take some time to learn how to best use the data and how to consolidate it in the most effective manner. Overall, most market participants believed that, even were there to be a temporary concern about data fragmentation, it was most likely that market forces would solve these concerns over the medium term.

According to Reuters data, there have been considerable changes in trade reporting since MiFID took effect with Markit Boat (a trade reporting venue only) estimated as having a share of around 15% of trade reporting for European equities. However, one of the complexities of multiple trading venues has been a concern that information on trade reporting suffers from potential double-counting and Reuters are understood to combine data from both trading and reporting venues which may have this effect. Thus the data provided below in Table 20 should be treated cautiously and is mainly provided in order to demonstrate the changes over time.

Table 20: Market shares of trade reporting for European equities

	Nov-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08
LSE Group	43.5%	47.4%	45.8%	45.5%	43.5%	37.0%
Markit BOAT	15.3%	15.1%	16.7%	18.9%	15.0%	15.1%
Deutsche Börse	4.6%	5.0%	4.6%	3.8%	5.0%	9.0%
Euronext	7.1%	7.3%	6.0%	6.2%	6.8%	6.6%
Nasdaq/OMX	5.0%	5.6%	3.9%	2.8%	4.3%	4.9%
CHI-X/Instinet	0.4%	0.4%	2.1%	3.6%	5.6%	4.0%
Spanish Markets	4.0%	5.0%	3.9%	4.5%	3.9%	4.0%
Euronext - OTC	0.6%	1.7%	1.4%	2.6%	2.0%	3.4%
Oslo	2.8%	3.4%	2.8%	2.2%	2.1%	2.8%
Plus Markets	9.8%	0.4%	1.0%	0.9%	1.2%	1.9%
SWX Europe	1.5%	1.5%	1.3%	2.1%	1.5%	1.2%
Warsaw	1.1%	2.2%	0.9%	0.6%	0.8%	1.2%
Xetra OTC	0.6%	1.1%	0.7%	1.0%	0.7%	1.2%
Others	7.4%	8.3%	9.7%	6.3%	8.1%	8.8%

Source: Reuters - MiFID Market Share Reports – various months and CRA analysis.

As is clear from the data in Table 20 above, even in a year there have been considerable changes in the shares according to trade reporting. As with other parts of MiFID, it is likely that this will take some time to reach an equilibrium position in which the impact can be assessed.

In addition to issues of data fragmentation, a small number of interviewees highlighted the concern that in the UK there had been a decline in the timeliness of trade reporting since market practice had previously been to report off-exchange trades within a day. MiFID requires such trades to be reported within three days and the implementation of this has typically been done in an automated manner leading to all such trades being reported precisely three days later rather than any earlier. Market participants indicated that it was not yet possible to observe whether this would have a significant impact on trading conditions. More generally, however, representatives of investment banks indicated that, notwithstanding concerns about data fragmentation in some locations, across Europe there had been an increase in the quality of information that was being reported and that this was now done in a more structured manner than before MiFID.

Overall, however, it remains to be seen whether some of the difficulties regarding data fragmentation that have been observed will be solved by the market as is expected by the majority of interviewees or whether some concerns will nonetheless remain.

5.4.2. Final indicators – trading measures

Having considered the intermediate indicators regarding whether or not the measures in the trading sector had an impact, it is then important to consider the final market impacts. Indicators relating to listing have already been considered in section 5.3.2, leaving indicators relating to trading volumes, trading costs and other factors to do with the trading environment such as speed, spreads and the cost of capital.

Trading volumes

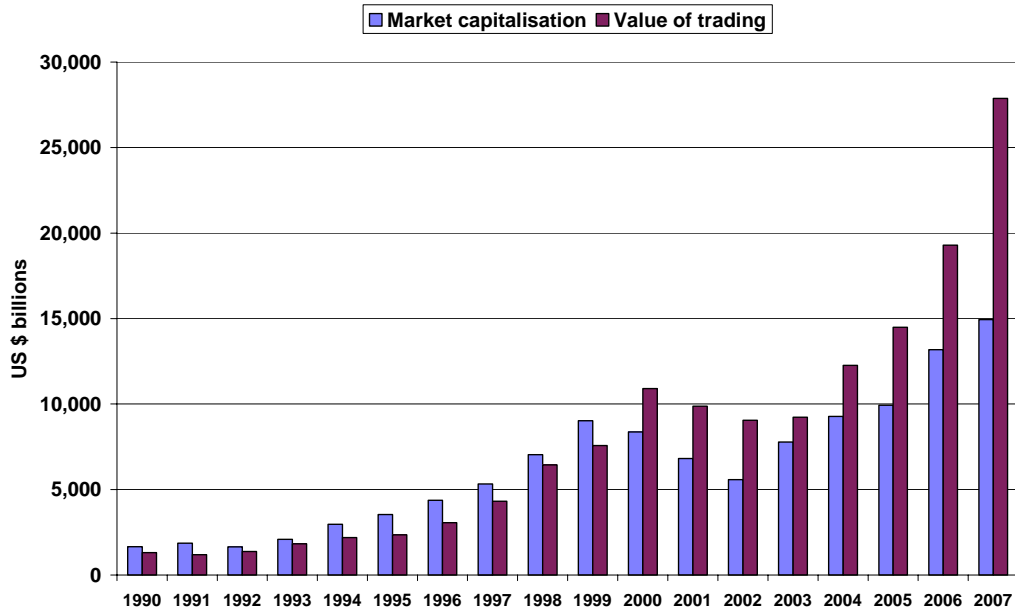
There are a number of elements of the FSAP that might be expected to lead to greater trading volumes within member states including:

- Information flows related to the Transparency and Prospectus Directives;
- Improved market confidence in countries which previously did not have robust regulation in relation to market abuse as well as from appropriate investor protection through conduct of business rules; and
- Reductions in trading costs from increased competition between trading venues.

As noted above, one of the impacts of MiFID has been to lead to additional trading venues. It has been suggested from market commentators that the presence of additional trading venues itself increases the total amount of trading as arbitrage opportunities become possible between the platforms. The notion that trading venues are not purely substitutes is supported by evidence on trading behaviour during the very small number of occasions in which trading is prevented on one trading venue. For example, during interviews in Sweden it was noted that on one occasion when trading was not possible on NASDAQ OMX for part of the day in early June 2008, relatively little trading occurred on Chi X. Similarly, when the LSE was closed for much of the day in early September 2008, Chi X did not make significant gains in the volume of shares traded. This is likely to link to whether or not MTFs trade shares admitted to trading on a Regulated Market. In addition, in March 2008, the closure of the Athens Exchange (due to strikes impacting the Bank of Greece's payments system) led to very limited OTC trading arising.

Data is available for the value of share trading and stock market capitalisation is presented in Figure 96 below. As is clear both of these measures move in a similar line and reflect the general economic cycle.

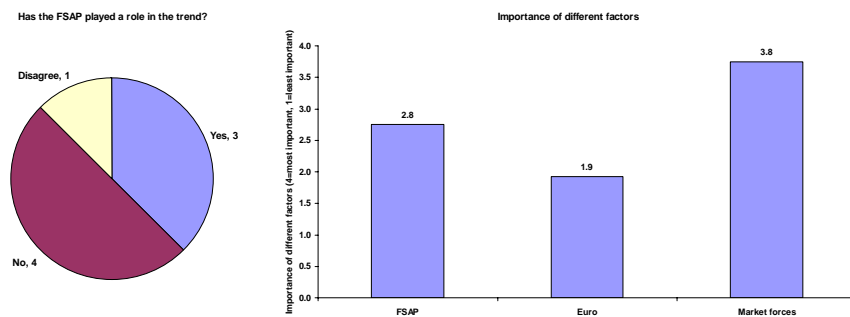
Figure 96: Stock market capitalisation and value of trading for EU-15 stock markets



Source: World Federation of Exchanges. Note that not all exchanges in the EU-15 are captured throughout the period.

While many market participants acknowledged the theoretical reasons why various FSAP measures would be expected to lead to increased trading, relatively few believed that any of the increase in the value of trading or in the value of the stock market could be associated to the FSAP as is seen in Figure 97 below.

Figure 97: Impact of FSAP on value of trading and stock market significance



Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

Furthermore, the great majority of market participants did not believe that it would be possible to disentangle the impact of the FSAP from market developments that would have happened anyway. As is clear from Figure 96, there is considerable volatility in the value of trading and the value of the stock market reflecting general economic conditions. With such high volatility it is not possible to separately identify the impact of FSAP measures in a quantitative manner.

It is also possible that the new trading venues caused by MiFID lead to trades that would previously have arisen off-exchange being brought onto these new trading venues. This may lead to some trades being captured in data where they would not previously have been captured, but when considering the total trading volume may give misleading results regarding the impact. Data for off-exchange trading is not easily available nor is consistent data from the various new trading venues.

Finally, while MiFID may be the most significant of the FSAP measures to impact the securities markets, it has coincided with market turmoil due to the credit crunch and hence when data becomes available for later dates, disentangling these effects is likely to be very complex. Furthermore, the increased market turmoil may itself have driven additional trading as algorithmic traders increase their trading when securities are highly volatile and hence there are further difficulties in assessing the impact of MiFID even once data becomes available.

Cross-border trading volumes

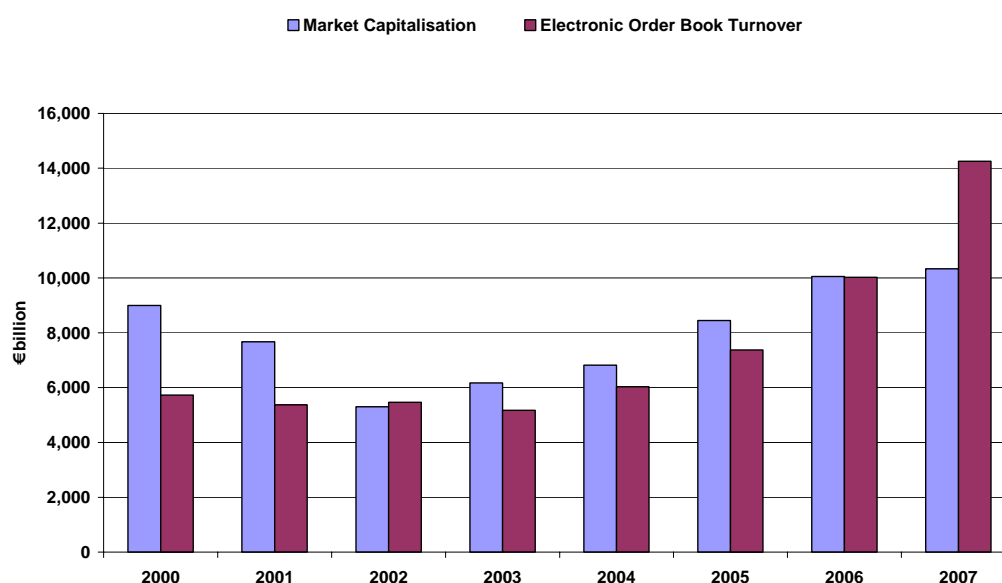
The factors highlighted above regarding the ways in which various FSAP measures might lead to increased trading are also relevant to increased cross-border trading. For example, increased cross-border trade might be expected to arise from better information being disclosed through the Prospectus and Transparency Directives giving investors more confidence on the information revealed in all member states and thus increasing the willingness to invest in other member states. At the same time, however, these measures also imply that EU Regulated Markets all meet the same standards and hence firms listing on any of these markets should be meeting the same quality. As such, it is possible that harmonisation of standards implies that issuers are less concerned about listing on non-domestic exchanges. In turn, this may imply that cross-border trading is less necessary if trading on the domestic exchange can offer the same results.

However, despite agreement that accounting information made comparisons easier, according to the ICAEW survey, 53% of investors stated that their behaviour had not changed the way that they make investment decisions.¹⁴⁰ Only around 6% of investors stated that they had invested in countries that they had not invested in before, and while 4% stated that they invested in sectors that they had not previously invested in before, the same proportion stated that they had withdrawn funds from sectors. The last observation indicates that the availability of information should not always be assumed to have a positive impact on cross-border trading since information could reveal that such investment would not meet the objectives of the investor.

Data is available for the value trading and stock market capitalisation is presented in Figure 98 below. As is clear both of these measures move in a similar line and reflect the general economic cycle. It is also apparent that the growth in trading has been greater (150%) compared to that of market capitalisation (15%) between 2000 and 2007.

140 See section 5.3.1 for further details.

Figure 98: Market capitalisation and trading turnover for EU-15 Regulated Markets



Source: FESE

As well as additional information, the removal of the concentration rule and the development of new trading venues as well as the application of the best execution rules is particularly pertinent to cross-border trading since investors will not be prevented from trading in other countries, but rather will be actively encouraged to seek the best trading venue even if that is not a domestic venue. As noted in section 5.4.1, the best execution rules are not yet considered to be effective and thus we would not yet expect to observe an impact on cross-border trading although this would be expected to arise over time.

Euro

Numerous market participants highlighted the effect that the Euro had on cross-border trade since currency risks were removed within the Euro-zone. In particular, it was noted that institutional investors such as pension funds were able to diversify investments across Europe where they might previously have been focused on their domestic member state in order that their assets were matched to the same currency of their liabilities or because of restrictions in their investment policies which may have prevented investments from being made in a different currency. The conversion of domestic currencies to the Euro was stated as having a very significant impact on cross-border trading and was considered to be much more significant than the FSAP measures in driving this. A similar effect was also noted when considering the pensions sector where more diversification across member states arose in the light of the use of the Euro – see section 4.4.

Commercial developments

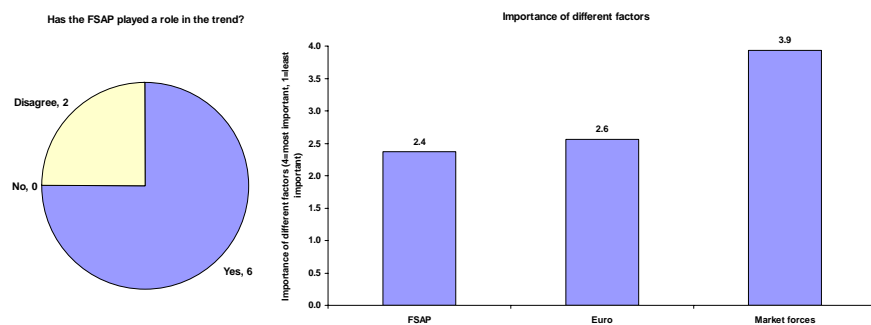
An additional factor which was thought to be likely to lead to increased cross-border trade was the development of a single order book by Euronext where securities from the

different Euronext exchanges can more easily be traded. As noted in section 5.4.1, the wider aims of the FSAP are believed to have focused attention on increased competition between trading venues and hence steps taken by trading venues to increase the competitiveness of their platform may, in part, be due to the FSAP measures.

Overall

Overall, market participants in all member states believed that the FSAP had played a role in the increase in cross-border trading, although market forces were seen as the primary driver of this in all cases.

Figure 99: Impact of FSAP on cross-border trading



Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

However, as with measuring trading volumes, interviewees stated that it was not possible to quantitatively disentangle the impact of the FSAP from these other factors.

Trading costs

Increased competition in any sector would be expected to lead to pressure on costs as well as an increase in quality. Given that MiFID removes barriers to entry and, as noted above, has led to the development of new trading venues, it would therefore be expected to lead to lower trading costs and faster trading speeds which were seen by many market participants as an important dimension of competition.

As noted above, the best execution requirements will bring competitive pressure to ensure that trades occur in the best value location and the impact of this would be expected to grow over time and hence lead to increasing pressure on trading costs.

In line with the expectations from the impact of the FSAP measures, there have been a number of reductions in trading costs which have arisen both in the run up to MiFID and also after the implementation of MiFID. Many of these fee reductions have been particularly focused on attracting algorithmic traders in order to bring liquidity to the relevant trading platform. These include reductions in fees by:

- Deutsche Börse – which replaced the minimum fee of €0.60 for executed orders in the “Automated Trading Program” (ATP) by a transaction fee directly based on value

of the executed order. Deutsche Börse estimates that the change will reduce the transaction fee, for example, for an executed ATP order with a value of €6,250 by 50%. An additional discount levels was introduced taken the total to eight, with discount rates per level increasing from 7% to 7.5%. Accordingly, the maximum discount rate on Xetra transaction fees will increase from 49% to 60%. With the new model, Deutsche Börse estimates that ATP customers would benefit from a fee reduction of €10 million per year on the basis of the volume figures of the first half of 2008.¹⁴¹

- Irish Stock Exchange – the ISE reduced prices and changed its pricing structure in December 2007 including the average cost per ISE Xetra execution being reduced by over 50% to €0.99. The ISE attributed the changes in prices directly to MiFID, “The new pricing structure is a key element of our strategic response to the Markets in Financial Instruments Directive (MiFID)...”¹⁴²
- LSE – In September 2008, LSE extended its free tariff for "passive executions" of up to £2.5bn in value to be traded and introduced a rebate of up to 0.4 basis points for larger values of trading.¹⁴³ In addition the LSE abolished a 7.5p execution charge and a 1p order management charge.
- NYSE Euronext - announced in June 2008 a reduction of fees of up to 30% for high frequency trading on its European cash equity markets. The changes also enabled eligible clients to significantly increase their order flow capacity without incurring a transaction fee.¹⁴⁴

Comparing information on trading costs is complex as there are a range of different elements to pricing structures on different trading platforms including:

- Different prices according to whether trades are on-exchange or off-exchange where exchanges offer both services;
- Volume incentives or discounts;
- Differential fees for algorithmic traders;

141 Deutsche Börse, “Deutsche Borse Introduces New Pricing and Discount Model for Algorithmic Trading”, 26 August 2008. http://deutsche-boerse.com/dbag/dispatch/en/notescontent/gdb_navigation/press/10_Latest_Press_Releases/10_All/INTEGRATE/mr_pressreleases?notesDoc=8B8E9031EFAAFFEFC12574B1003105B4&newstitle=deutscheboerseintroducesnewpri&location=press

142 ISE introduces a radical new pricing structure for trading in equities on the Exchange, Irish Stock Exchange, 4th December 2007.

143 Passive executions are where traders effectively advertise a trade they are prepared to execute and wait for a buyer to appear. Source: LSE cuts fees while rivals test systems, Financial Times, 1st September 2008 and Trading Services Price List with effect from 1 November 2008, London Stock Exchange.

144 NYSE Euronext, “Dedicated fee package for high frequency trading on Euronext cash markets”, 5 June 2008. Available from: http://www.euronext.com/news/press_release/press_release-1731-EN.html?docid=541253.

- Differential fees for market makers;
- Differential fees according to which method of placing orders is used;
- Membership fees; and
- Admission fees for new members.

Given the complexity of the structure of trading costs, and the fact that trading platforms have altered these structures it is very difficult to easily compare information on the cost of trading over time.¹⁴⁵

Most of the fee reductions that have been seen recently are understood to be part of a long term trend for fees to fall. This partly reflects improvements in technology leading costs to fall and these reductions in costs being passed on to traders because of the increasing competitive nature of trading markets. Nonetheless, the majority of market participants stated that many of the very recent fee reductions were directly attributed to the increased competition from new trading venues which most in turn believed had been due to MiFID. Some market participants also believed that earlier reductions in fees were also attributable to the knowledge that MiFID was coming. Indeed, some market participants indicated that one of the important factors driving investment banks to set up or support the development of MTFs was that these alternative trading venues would place the existing exchanges under competitive pressure and drive reductions in costs. These participants agreed that, because of the FSAP, trading costs had fallen faster than they otherwise would have done.

Faster trading speeds

Most market participants noted that trading speeds were an important component of competition between trading platforms and therefore that in as far as the FSAP measures led to increased competition between trading platforms that there would be an expectation of faster trading. Indeed some trading venues use trading speeds as something which they advertise in order to highlight the benefit of trading on their venue rather than on an alternative.¹⁴⁶ However, market participants believed that the more significant impact regarding trading speeds was the availability of technology rather than the FSAP measures and therefore that any FSAP effect would not be distinguishable.

Although we attempted to gather data on trading speeds from many trading venues across Europe, nearly all of these were unwilling to provide this information and hence it has not been possible to provide any quantitative data on changes to trading speeds over time. This would, however, be a useful indicator to gather information on over time in order to monitor the developments of this aspect of competition.

145 The EC has commissioned work on the evolution of prices, costs and volumes of post-trading activities.

146 For example, Chi-X had a press release stating that its roundtrip latency was 10 milliseconds which they stated was 10 times faster than many of the incumbent exchanges. Instinet-Chi-X press release, "Chi-X latency measured to be 10 milliseconds by TransactTools", 24th January 2007.

Impact on spreads and cost of capital

Many of the FSAP measures end with an objective of increasing liquidity and reducing the cost of capital. This effect may arise from:

- The presence of information which may help to reduce spreads in as far as spreads partly reflect asymmetry of information where investors do not know as much information as insiders and hence require a spread in order to reduce their risk.¹⁴⁷
- Increased competition between trading venues leading to lower costs of capital raising; and
- Increased volumes of trade leading to lower spreads as is clear from more frequently traded securities having lower spreads than other securities.

In general, interviewees supported the notion that the FSAP facilitated reductions in spreads and a reduction in the cost of capital. However, they did not believe that it was possible to identify this because these were both affected by more significant impacts.

One of the difficulties of examining information on spreads is that these are partly affected by cultural norms regarding the pricing of securities. For example, when considering the impact of competition through the bid-offer spread it is important to note that the tick sizes are fixed, but the level of the share price will vary for cultural reasons (i.e. some countries will tend to have higher nominal share prices than others). As a result, the proportionate size of the spread may vary as the denominator varies. This makes comparison across countries difficult; it also makes comparison over time difficult if the minimum tick size is changed since a reduction in spreads would then arise because of a technical change to specifications.

Changes to tick sizes have been observed over time and one of the most recent examples was that in 2008, NYSE Euronext introduced in a pilot phase a tick size of either €0.005 or €0.001 to 29 blue-chip stocks across its European markets and subsequently extended the tick size of 3 decimals to an additional tranche of 71 European stocks in September 2008. NYSE Euronext stated that the decimalisation in the pilot phase has on average reduced spreads by 60% which represents a cost saving of 8 basis points for the end-investor.¹⁴⁸ A small number of interviewees indicated that changes to

147 For example, it may be the case that insiders can take advantage off outsiders because of opacity. This means that insiders face relatively more of the firm-specific risk than outsiders who therefore face more market based risk. Hence provision of information reduces the extent to which outsiders face market based risk and increase the extent to which they face firm-specific risk. There is a relatively recent area of finance developing to assess these sorts of issues and hence more robust methods of testing for this hypothesis would be expected to become available over time. Thus the EC could examine this issue in a number of years time when they review the later impact of the FSAP.

148 NYSE Euronext further improves market efficiency of its European cash equity markets with increased decimalisation, NYSE Euronext, 1st September 2008 available from http://www.euronext.com/news/press_release/press_release-1731-EN.html?docid=576607.

tick sizes reflected increased competition between trading venues and in particular reflected competition to attract arbitrage or algorithmic traders.

More generally, however, a number of market participants indicated that over time liquidity had increased and spreads had fallen but that this was a function of technology and in particular of the development of arbitrage traders who use algorithms to undertake automated trading. As such the impact of this effect would substantially dominate any effect of regulatory change. It was therefore noted by interviewees that in this area it would not be possible to quantitatively disentangle the impact of FSAP measures from much more significant market trends and developments.

Respondents to a survey by CSES were relatively negative regarding the impact of the Prospectus Directive on access to capital with 38% of respondents stating that the Prospectus regime had not facilitated access to a broader pool of capital compared with 30% stating that it had done so.

Finally, it was noted that because these indicators are impacted by a multitude of measures which took effect over a long period of time, it was even less likely that the FSAP measures could be disentangled from market trends. That is, there was no single "event" or moment that could be tested to observe the overall impact of the FSAP. However, given that many market participants view MiIFD as the most significant of the FSAP measures impacting the securities sector, in the future it may be possible to attempt to assess the effect of MiFID on these indicators.

5.4.3. Summary for trading measures

The most significant FSAP measure affecting trading in the securities sector was MiFID which has far reaching consequences in the sector. Since MiFID was only recently implemented, the full implications are not yet clear. Nonetheless, already there are substantial changes being observed in the securities sector where MiFID, along with other FSAP measures, is credited as playing an important role.

In particular, the removal of the concentration rule and the clear focus towards increasing competition between trading venues has led to a number of new trading venues being set up in recent times. Many of these venues have been established in London which would have been possible before MiFID, but where market participants nonetheless provided the following reasons for crediting MiFID with being partly responsible for these developments:

- While new trading venues could have been set up in theory, the practice of doing so had not always succeeded and MiFID was understood to make it easier for new trading venues to succeed;
- MiFID created a reason to change and make investments and was developed during a critical moment of strategic thinking regarding trading venues; and

- Trading venues set up in London may have depended on attracting trades from other countries whose trading may have been restricted by concentration rules and hence they would only be viable under the circumstances in which it was known that these rules would be removed.

One of the consequences of the increased competition has been a reduction in trading costs, with MiFID one of the reasons for this.

The best execution requirements are currently perceived to have led to written policies being developed but little practical changes to trading decisions. However, it is clear that the impact of the best execution rules is linked to the availability of realistic alternative trading venues in some member states. Hence as new trading venues grow and become successful, best execution rules would be expected to have a greater impact over time in ensuring venues are chosen for trading which best meet the needs of investors. With rapid changes to the trading venues already being seen, practical changes linked to best execution are likely to arise within around 3 years.

One of the concerns expressed regarding changes arising due to MiFID was that the ability to trade on many different trading platforms would lead to data fragmentation and traders losing the ability to understand what is happening across all of the platforms. This issue was seen to be a particular concern in countries that previously had a concentration rule i.e. France, Italy and Spain, although it was also a concern in the UK because of the increase in the number of trading venues from which data needed to be gathered. Data providers and proprietary systems by investment banks are expected to solve these concerns over the medium term although all interviewees noted that it was too early to assess whether data fragmentation would be a concern in practice, and this would need to be reviewed in around 3 years.

On the retail side there have been limited impacts thus far with MiFID mainly seen as leading to written processes being put in place but with few other changes thus far. However, there is an expectation that the quality of advice would increase in those member states where advice was not previously a regulated activity although this is likely to take 3-5 years to occur. Changes in consumer behaviour because of increased disclosure are likely to take considerably longer to occur.

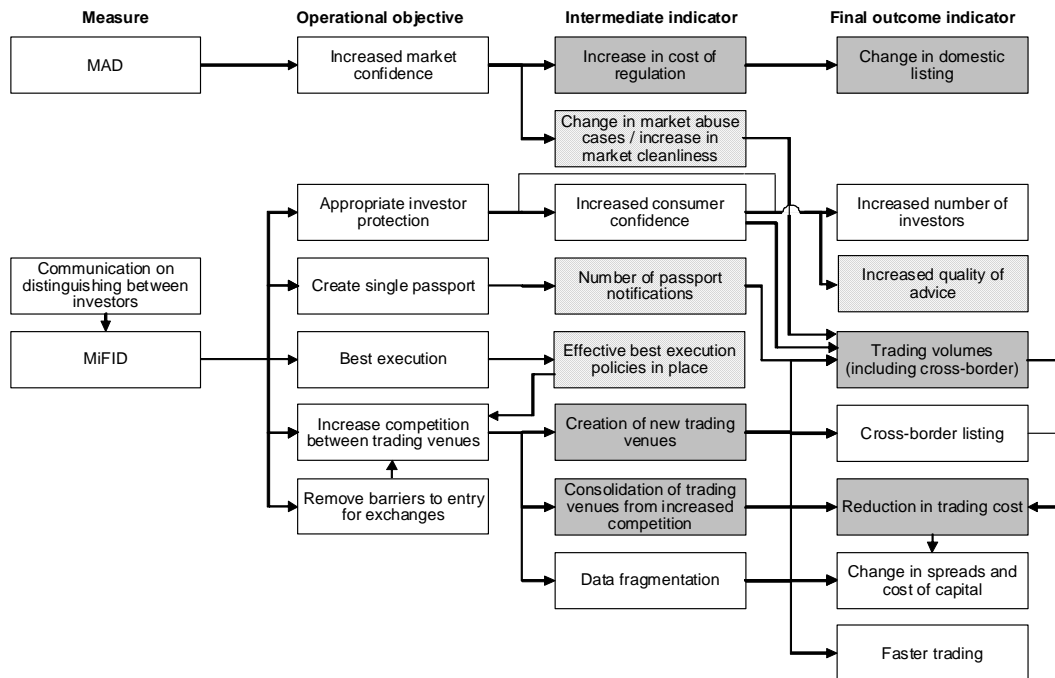
Overall, the FSAP has played a role in the increase in cross-border trading, although market forces and the impact of the Euro were seen to be more significant than the FSAP.

Most market participants viewed MAD positively, believing that it had enhanced supervision. Where market cleanliness has been examined by member states there is some evidence of an improvement. Yet the evidence suggests that legislation alone is not necessarily sufficient to lead to changes in market abuse. Many interviewees see the importance of enforcement of the directive and believe that high-profile investigations and convictions will discourage abuse. Thus an increase in market abuse cases is likely to be viewed as evidence of enforcement although qualitative evidence will be essential to understand whether this is correct. Given the speed of some court systems it is likely that

this will take some time to observe hence an assessment of this would be appropriate in 3-5 years time.

Figure 100 provides details of the conclusions as to the elements of the FSAP which are currently having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 100: Conclusion on causality tree related to trading measures in securities



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

5.5. INDICATORS - POST-TRADING MEASURES

There are two measures which are explicitly focused on the post-trading environment. The Settlement Finality Directive (SFD) took effect from December 1999 and the Financial Collateral Directive (FCD) applied from December 2003. In addition, MiFID also impacts post-trading activities and applied from November 2007.

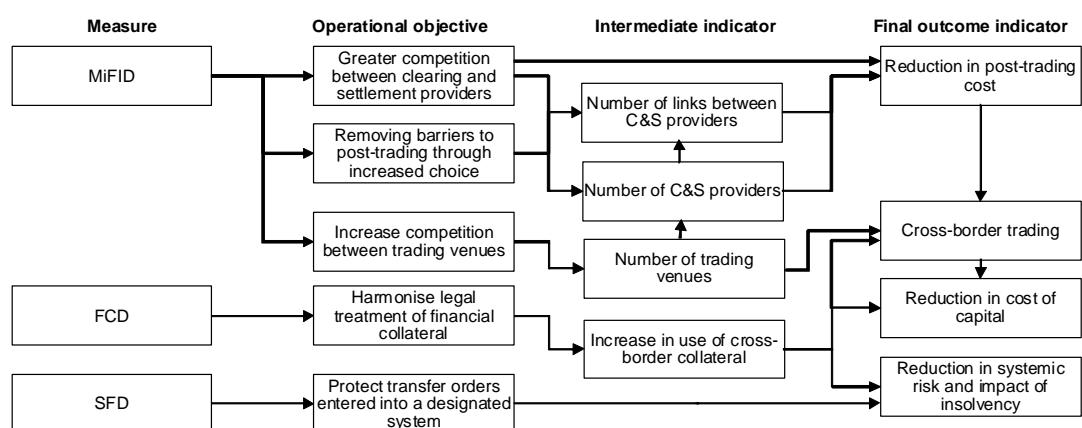
Understanding the impact purely of the FSAP measures on the post-trading sector is made complicated by a number of regulatory developments which have arisen outside of the FSAP and which are therefore outside the scope of this assessment. Many of these are expected to have, or have already beginning to have, a significant impact on the post-trading sector and include: the Code of Conduct; Target 2 Securities; the LinkUp project; the mandate for the CESAME 2 group; the request by the EC for recommendations from CESR, in conjunction with ESCB, regarding post-trading and continuing progress to overcome the Giovannini barriers. Market participants universally viewed these changes

as much more significant than either the SFD or the FCD, and also noted that the recent implementation of MiFID meant that it was too soon to assess the impact of MiFID on the post-trading environment.

It should also be noted that the FSAP measures may have been necessary facilitators for these later measures and hence later measures may only be effective because the SFD and FCD are in place.

The causality tree relating to the FSAP measures is set out in Figure 101 below.

Figure 101: Causality tree relating to post-trading aspects of the securities market



Source: CRA analysis.

The EC has also announced its intention to amend both the SFD and FCD to reflect the evolution of the post-trading market, in particular extending the SFD to include cross-border links between post-trading systems; and also by extending the FCD to cover credit claims.¹⁴⁹ The extension of the SFD to include cross-border links is viewed by the EC as especially important in the light of the parts of MiFID aimed at encouraging such links to be developed. The proposed changes to the SFD and FCD are outside the scope of this report.

5.5.1. Intermediate indicators – post-trading

Number of trading venues

As set out, above MiFID has removed barriers to new trading venues and has already been seen to be having a significant impact on the number of trading venues and on competition between these. In addition to increasing competition in trading, this also increases competitive pressure on the post-trading environment. For example, as new trading platforms are set up, these new platforms require post-trading services to be

149 See Securities markets: Commission proposes amendments to Settlement Finality Directive and Financial Collateral Directive, EC press release, 24th April 2008.

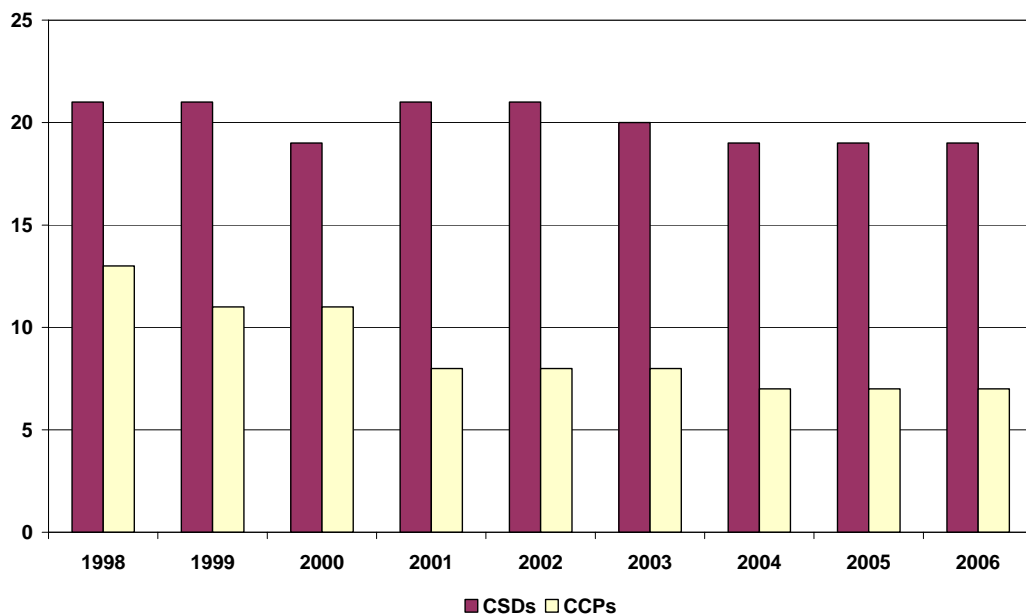
supplied as well. Hence the number of trading venues will be expected to have an impact on the number of clearing and settlement providers.

Number of clearing and settlement providers and links between them

The number of trading venues was considered in section 5.4.1 where it was noted that there had been consolidation of existing exchanges over a number of years, although this was believed to be due mainly to market trends rather than to FSAP measures. In turn, the consolidation of exchanges may lead to consolidation of clearing and settlement (partly depending on the extent of vertical integration of trading and post-trading activities).

Figure 102 below shows the number of Central Securities Depositories (CSDs) and Central Counter Parties (CCPs) in the euro area over time.

Figure 102: Total Number of CSDs and CCPs in the euro area

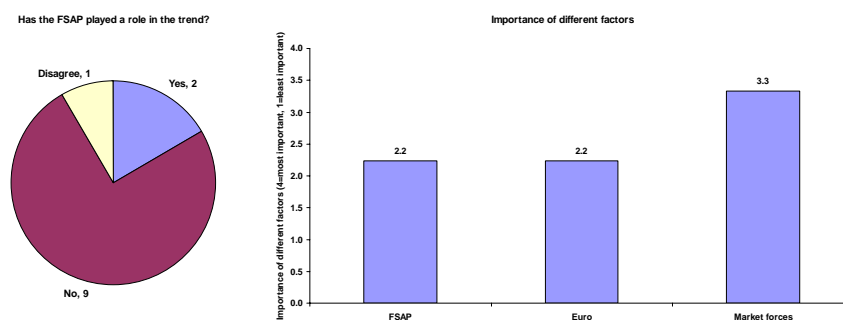


Source: ECB. Financial Integration Indicators 2007.

As expected, Figure 102 shows a reduction in the number of both CSDs and CCPs over time although the reduction is more dramatic for CCPs than CSDs. It is also notable that the decline in CSDs arose between 1998 and 2001 before the Financial Collateral Directive suggesting that this trend was not a result of the FSAP.

The majority of market participants believed that consolidation in the clearing and settlement sector was mainly due to consolidation of exchanges. Most interviewees believed that this, and the consolidation of clearing and settlement more generally, was due to market trends rather than FSAP measures.

Figure 103: Impact of FSAP on consolidation of clearing and settlement



Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

Among those who did think that the FSAP played a role in the trend towards consolidation, the majority believed that this was due to MiFID. Given that MiFID was recently implemented, the full impacts have not yet occurred and neither are they captured through the currently available data.

The number of links between CSDs has remained reasonably stable over the last few years with 66 links in place since July 2001, with 61 of these in place at the end of 2000.¹⁵⁰ The European Commission has also noted that,

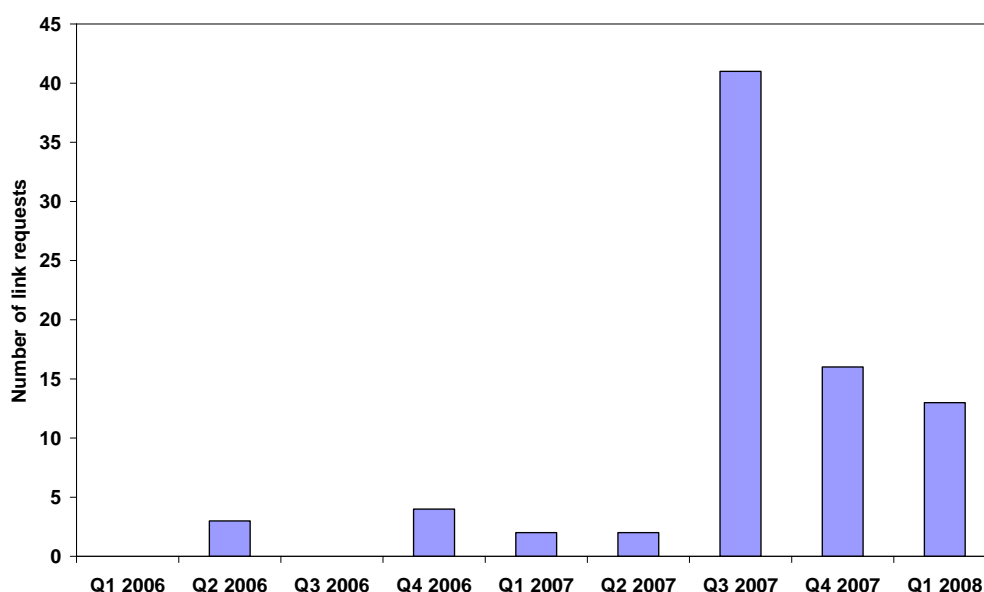
“Links are also emerging between CCPs. Two existing examples are CCP-clearing arrangements between LCH.Clearnet SA (France) and CC&G (Italy) for MTS61 (Italy) and the arrangements between LCH.Clearnet Ltd. (UK) and SIS x-clear (Switzerland) for virt-x (UK)”¹⁵¹

Evidence on the number of links that have been requested is provided in Figure 104 below where it is clear that there was a significant increase in the number of links around the time of the implementation of MiFID. This is likely to partly reflect the timing of agreeing the Access and Interoperability guidelines under the Code of Conduct which were signed on 28th June 2007.

150 See ECB press releases: Update on the assessment of links between securities settlement systems, 4th July 2001 and CBISSO (Ireland), CAT (Italy) and LDT (Italy) withdrawn from the list of securities settlement systems eligible for Eurosystem credit operations, 28th December 2000.

151 Commission Staff Working Document accompanying the proposal for a Directive of the European Parliament and of the Council amending the Settlement Finality Directive and the Financial Collateral Directive, Impact Assessment [COM(2008)213 final SEC (2008)aaa]

Figure 104: Number of link requests



Source: Improving the efficiency, integration and safety and soundness of cross-border post-trading arrangements in Europe, Third Progress Report to Economic and Financial Affairs Council (ECOFIN), March 2008, European Commission. Note that this counts the different types of links (Interoperability, Standard or Customised Access, Transaction feed access etc) separately.

While there have been a number of links requested, this neither means that the link is operational nor that it is actually being used. The number of links should be monitored overtime to identify both which links are in place as well as where links are actually being used. However, it is a weak indicator as theory suggests that the FSAP could affect it in two offsetting ways: increases in links might be expected to arise through MiFID, yet increased competition may drive consolidation in post-trading which, other things being equal, would reduce the potential for links to be developed. However, most market participants believed that these links would be a result of the Code of Conduct rather than MiFID per se.

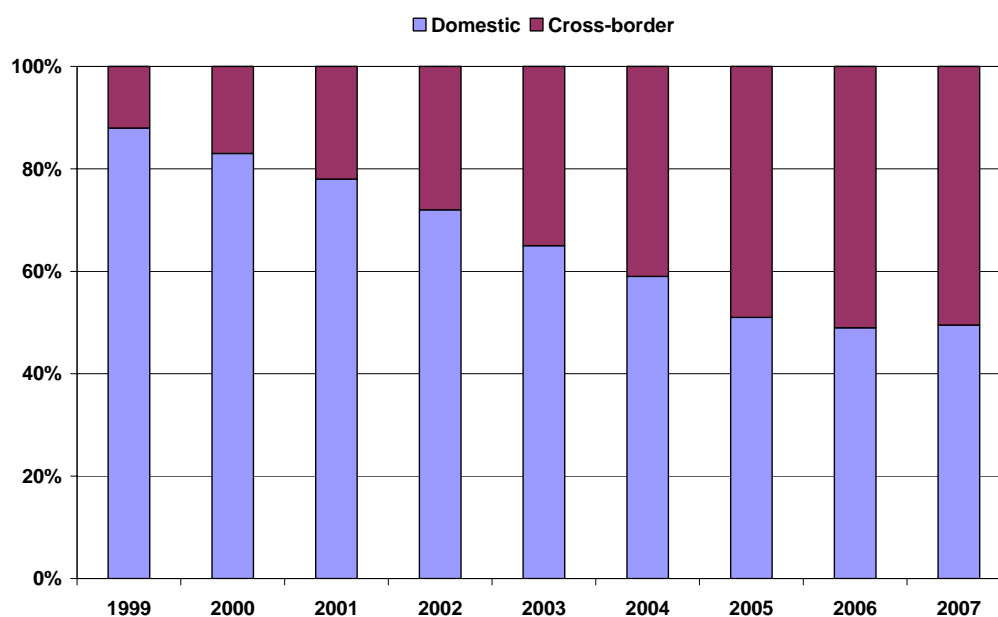
Both the number of clearing and settlement providers and the links between them is also expected to be impacted by the later measures that have been taken since the FSAP and hence when examining any changes in this it will be difficult to distinguish between the impact of the FSAP and the impact of these later measures.

Use of cross-border collateral

The main aim of the Financial Collateral Directive was to strengthen and harmonise the legal framework in place regarding the treatment of collateral. In addition it would be expected to lead to an increase in the use of collateral in cross-border trading after it was implemented. Further, by reducing the risk of trading, those who accept collateral would be expected to be willing to accept lower returns on the lending arrangements thereby reducing the cost of capital for the borrower.

As shown in Figure 105 below, over time there has been a steady increase in the proportion of collateral which is cross-border collateral. This trend was already occurring before the FCD was implemented and continued after FCD implementation. For example, collateral used on a cross-border basis increased from around 12% in 1999 to over 35% in 2003 and then to nearly 50% in 2005. Since 2005, this trend has flattened out.

Figure 105: Domestic compared to cross-border use of collateral for euro-system credit operations



Source: The 1999 – 2005 data is taken from “The single list in the collateral framework of the Eurosystem”, ECB Monthly Bulletin, May 2006, page 78. The 2006 and 2007 data is based on the ECB statistics found at: <http://www.ecb.int/stats/payments/securities/html/coll4.en.html>

The City of London Law Society attributed the growth to globalisation rather than the Directive and interviewees concurred with this view.¹⁵² Market participants did not believe that the FCD had led to an increased use of cross-border collateral but rather that this gave greater legal certainty, simplified the process and gave more protection to traders where cross-border trades were already arising.

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See “Evaluation report on the Financial Collateral Arrangements Directive (2002/47/EC)” including Annex 1, European commission, 20th December 2006.

5.5.2. Final indicators – post-trading

Reduced impact of insolvency and reduction in systemic risk

A reduction in the impact of insolvency and systemic risk would be expected via both the SFD and also the FCD (as the impact of insolvencies on other participants is reduced and as counterparty risk from cross-border trading is also reduced).

While market participants agreed that a reduction in the impact of insolvency and systemic risk were the aims and the theoretical results of the FCD and SFD, it was noted that there are practical difficulties related to measuring this. In particular, it is not possible to measure the change in the impact of insolvencies since the impact of them would primarily be seen in whether or not contagion or systemic risk arises as a result.¹⁵³

Market participants were not aware of any payment or settlement system that has been substantially harmed through insolvencies, but it is not possible to attribute a benefit from the FSAP to this since there is no evidence that the absence of the FSAP would have caused such harm either.¹⁵⁴ However, September 2008 saw Lehman Brothers' Chapter 11 filing and it has been reported that different approaches have been taken to their default in different member states despite having the SFD in place.

A few market participants from the trading sector noted that there had been marginal benefits from greater legal certainty and a reduction of operational risk. Thus the directives were seen as having had a positive impact since they introduced extra security in transactions and more protection.

One concern that was noted was that future consolidation in the post-trading environment could increase the potential for systemic risk simply because with fewer providers of post-trading services, any detrimental impact would feed through to all market participants rapidly. In this regard, it is clear that benefits from increased competition in post-trading and the risks are inherently linked – increased competition is expected in part to lead to increased consolidation as companies seek to exploit economies of scale, but increased consolidation also brings greater concerns about the effect of systemic risk.

Reduction in the cost of capital

While a reduction in the cost of capital would be expected from greater certainty in cross-border trading, as noted in section 5.4.2, calculating the impact of the FSAP on the cost of capital has not been possible during the course of this study. Furthermore, no market participant described a reduction in the cost of capital as one of the likely impacts from the FSAP measures relating to post-trading.

153 See "Evaluation report on the Settlement Finality Directive 98/26/EC", European Commission, 27th March 2006 which notes that it is the effect of insolvency not the number of insolvency cases which is impacted by the Directive. The inability to measure systemic risk is acknowledged in this report.

154 It should be noted that interviews for the project mainly occurred in the spring and early summer of 2008 and were therefore undertaken before Lehman Brothers' Chapter 11 filing in September 2008.

Reduction in post-trading costs

As well as impacting trading, the impact of MiFID on the number of trading venues also has an impact on the post-trading environment and the competition between the providers of post-trading services. In particular, increased competition at the trading level also leads to increased competition in post-trading as owners of trading venues seek to ensure that the “all-in” price of trading and post-trading on their platform is competitive with the price at other venues. This would be expected to lead to reductions in the cost of post-trading.

The role of MiFID in increasing competition between trading venues therefore would be expected to increase competition at the post-trading level. In addition, competition may also be increased because of the potential within MiFID to allow for regulated markets and MTFs to have a choice of providers of post-trading services. Further, regulated markets are to offer their members the right to designate the system for the settlement of transactions. For example, it was noted that some of the new MTFs such as Turquoise had run tender mechanisms in order to obtain the best provider of post-trading services for their trading platform.¹⁵⁵

MiFID has also led to new providers of post-trading services developing or entering European markets such as EMCF (which provides clearing services for Chi-X, BATS Trading and Nasdaq OMX’s pan-European equities trading platform) and Euro CCP which is a unit of the US based Depository Trust & Clearing Corporation (DTCC) and provides clearing services for Turquoise and SmartPool.¹⁵⁶ These new entrants also have the impact of increasing competition and placing pressure on post-trading costs.

Some of the reductions in post-trading costs that have arisen include:

- From November 2008, Eurex Clearing has offered different service packages for clearing of cash market transactions. New prices which were brought in with the different service offerings allow cost savings of up to 40% for clearing customers depending on the selected clearing model.¹⁵⁷

155 The impact on quality of post-trading services is unclear. Competition might be expected to drive higher quality transactions for any given level of cost. However, an increase in the number of links and steps in the chain which transactions need to go through could lead to a greater chance of failure at one of these steps or greater time for the transaction to occur because of these multiple steps.

156 DTCC and LCH.Clearnet Group announced on 22nd October 2008 that they have signed non-binding heads of terms regarding the proposed merger of the two companies. See http://www.dtcc.com/news/newsletters/dtcc/2008/oct/lchclearnet_merge.php

157 Eurex Clearing to Expand Service Offering in Cash Market, 26th August 2008. See http://deutsche-boerse.com/dbag/dispatch/en/notescontent/gdb_navigation/investor_relations/60_News/10_Press_Releases/INTEGRATE/mr_pressreleases?notesDoc=140DA21ADF09A47EC12574B100310813&location=investor_relations&newstitle=eurexclearingerweitertservicea

- The LSE estimates that since it announced that it would support a choice of CCP, clearing fees per trade have declined by about 60% on average and up to 75% for the largest customers.¹⁵⁸
- Since 1st January 2008, LCH.Clearnet reduced its clearing fees for trades executed on the London Stock Exchange SETS and SETSmm platforms, and for trades executed on virt-x, by an average of 25%. LCH.Clearnet claims that cash equity markets clearing fees in London have more than halved since the start of the fee reduction programme in November 2006.¹⁵⁹
- LCH.Clearnet SA reduced its clearing and membership fees by an average of 25% for trades executed on NYSE Euronext cash markets, leading to an average clearing fee of €0.23 from April 2008. This followed previous reductions of 35% in October 2007 and 15% in January 2007.¹⁶⁰
- It is anticipated that when various CSDs establish Link Up Markets, a joint venture that will establish a common infrastructure allowing for easy implementation of links between CSD markets, cross-border settlement costs will fall by up to 80%.¹⁶¹

The EC has commissioned separate work to examine the evolution of prices, costs and volumes of post-trading activities.

In terms of the overall impact on post-trading costs, market participants did not believe that either the FCD or the SFD had led to any change to post-trading prices. Instead the combined role of both MiFID (in the FSAP) and the transparency requirements of the Code of Conduct (outside of the FSAP) were noted by many market participants as making a more significant difference. Given the relatively close timing of the Code of Conduct and the implementation of MiFID it is not possible to establish whether any changes in post-trading costs are due to the former, the expectation of the latter or would only arise with the two measures in combination. Nonetheless, it is clear that together these measures have, through transparency and through increased competition between trading and post-trading venues been partly responsible for a decline in post-trading costs.

158 Netting – Consultation Document, London Stock Exchange, 29th January 2008.

159 LCH.Clearnet announces further 25% cash equity clearing tariff reductions”, LCH.Clearnet, 12th December 2007. Available from: http://www.lchclearnet.com/press_and_publications/press_releases/2007-12-12.asp

160 LCH.Clearnet SA reduces cash equity clearing fees by a further 25%, LCH.Clearnet, 20th December 2007. The reductions also applied to the LSE Dutch Trading service and the Luxembourg Stock Exchange.

161 CSDs start joint venture to improve post-trade efficiency in Europe, Clearstream, 2nd April 2008. Available from: http://www.clearstream.com/ci/dispatch/en/listcontent/ci_nav/news/30_Press/Content_Files/030_press/2008/press_080402.htm

Increase in cross-border trading

The impact on cross-border trading has already been considered in section 5.4.2. Part of the increase in cross-border trading that has arisen may have occurred because of the post-trading measures as well as the trading measures considered. However, in practice, market participants did not believe that either the FCD or the SFD had led to an increase in cross-border trading, rather they supported the view that these measures gave greater certainty to trades that would have occurred anyway.

In terms of purely post-trading services, it was noted by a number of different market participants that the principles contained within MiFID remain high-level principles and that significant barriers remain in this area, notably related to tax and legal issues which may hinder cross-border activity from expanding as much as otherwise. The Code of Conduct is partly aimed at making these theoretical opportunities a practical reality. Since the Code of Conduct is outside the FSAP, we do not consider this in detail.

5.5.3. Summary for post-trading measures

The increased protection and security in post-trading that arose because of the SFD and FCD were seen as positive, but this was thought not to have led to an increase in cross-border trade. These directives were seen as an important, and necessary, first step to increased integration in post-trading but on their own were not seen as sufficient to have impacted either trading costs or cross-border trading.

In particular, some market participants believed that the additional legal protections in the SFD and FCD were needed in order for MiFID to be able to contain the possibility of choice of post-trading provider, and that in turn the possibility of this was required for the Code of Conduct (which is outside the FSAP) to have any effect.

Overall, most market participants agreed that the post-trading measures should be seen as the first steps towards integration in the post-trading environment, but that the existing FSAP measures (with the exception of MiFID) would not have had much impact thus far and that future changes would still be required to make progress in this part of the market. In particular, significant barriers remain in the form of technological solutions to choosing the post-trading provider, the additional risk from doing so and the tax and legal barriers that would need to be overcome to facilitate this. The number of links between clearing and settlement providers are expected to develop over time and this will need to be monitored to identify which links are in place as well as where links are actually being used.

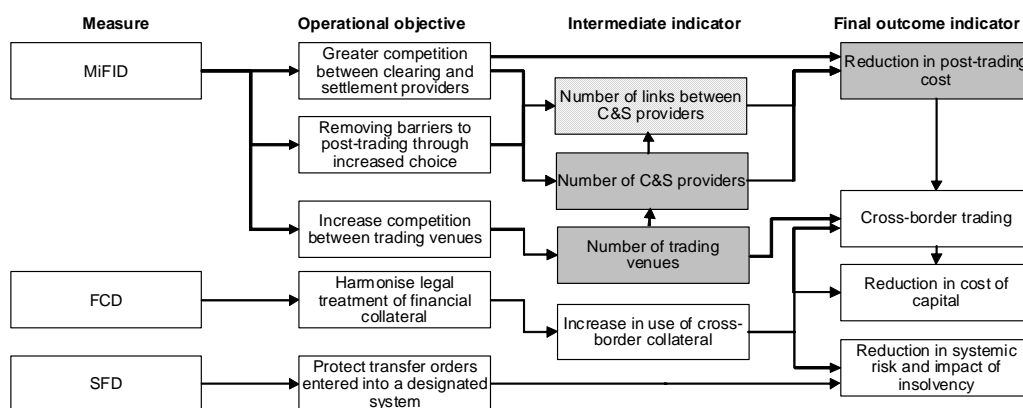
However, it is clear that MiFID is leading to increased competition in the post-trading environment. This has arisen both from increased competition between trading venues focused on the “all-in” price of trading and post-trading and also because of increased competition to offer post-trading services to trading venues. Both MiFID and the transparency requirements of the Code of Conduct (outside the FSAP) are in part responsible for the reductions in post-trading costs that have been observed.

There have also been a number of regulatory developments (the Code of Conduct; Target 2 Securities; the LinkUp project; the mandate for the CESAME 2 group; the request by

the EC for recommendations from CESR, in conjunction with ESCB, regarding post-trading and continuing progress to overcome the Giovannini barriers) outside the FSAP which may have much more significant impacts than either the SFD or the FCD. Furthermore, given the recent implementation of MiFID it is too soon to assess the full impact of MiFID on the post-trading environment.

Figure 106 provides details of the conclusions as to the elements of the FSAP which are currently having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 106: Conclusion on causality tree related to post-trading aspects of the securities market

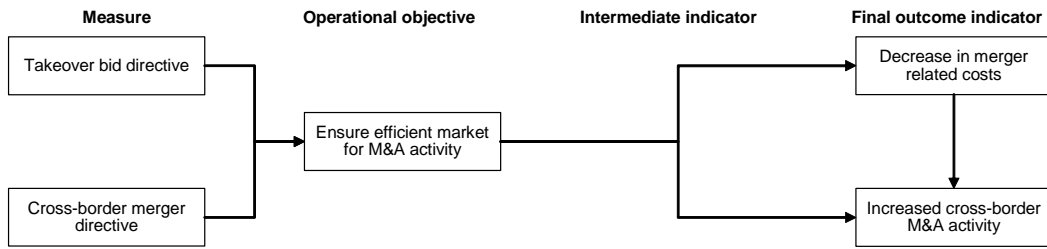


Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

5.6. INDICATORS - M&A RELATED MEASURES

There are two measures which are particularly focused on M&A activity as shown in Figure 107 below. The Takeover Bid Directive was applied from May 2006 and the Cross-Border Merger Directive from November 2007. As both of these measures have only recently been transposed, it is too early to be able to identify clear impacts from these directives although the section below sets out evidence regarding which impacts should be expected and data that can be usefully examined.

Figure 107: Causality tree related to M&A aspects of the securities markets



Source: CRA analysis.

As noted in the causality tree the Takeover Bid Directive and the Cross Border Merger Directive would both be expected to lead to an increase in the number of cross-border mergers and acquisitions (M&A) as member states use a more harmonised approach to M&A activity which may itself also reduce costs related to the merger.

An increase in cross-border M&A activity is dependent on member states removing barriers to foreign takeovers. However, the EC’s review on the implementation of the Takeover Bid Directive indicates that “the number of Member States implementing the Directive in a seemingly protectionist way is unexpectedly large” suggesting that the impact on cross-border merger and acquisition activity may be limited.¹⁶² For example, in some cases it was noted that the implementation of the Takeover Bid Directive had led to an increase in the ability of management to frustrate takeovers through the *introduction* of the reciprocity exception.¹⁶³

This limited impact expected was also supported by evidence from market participants across the EU where many interviewees noted that, since the Takeover Bid Directive was a minimum harmonisation directive, there had been considerable differences in implementation between member states which meant that the benefits that were hoped for, were not in fact materialising. Indeed, it was noted by one regulator (where the individual concerned was a member of CESR) that discussions within CESR make it clear that the Takeover Bid Directive has been implemented in very different ways and that this contrasted significantly with the Prospectus Directive where discussions revealed the much more harmonised approach. The issues for which differential implementation remained were believed to be sufficient as to have not led to changes in cross-border mergers. In addition, member states had different regulation in place before the directive was implemented which also led to different implications:

162 SEC(2007) 268, Commission Staff Working Document, Report on the implementation of the Directive on Takeover Bids, 21.02.2007.

163 This occurred in France, Greece, Hungary, Portugal and Slovenia.

- Spain saw more significant changes to the Takeover process as the rules changed regarding the need to take over a company once the shareholder has control rather than if their intention is to take control (which had previously been the case) hence the costs of building up a position in advance of a potential takeover would be expected to fall;¹⁶⁴
- In member states such as Ireland, Poland and the UK, limited impact was expected from the measures because they did not change compared to the requirements that were already in place; whereas
- In Italy, it was noted that the cost of takeovers had actually increased because when 30% of the shares of the company have been acquired, an offer must be made for the remaining shares at the highest price paid for the 30% whereas before the directive the price would have been set at the average price calculated over the previous 12 months. This would be expected to have the effect of reducing takeovers.

More generally, however, nearly all interviewees highlighted that the FSAP would be expected to have only limited impacts on cross-border M&A activity which would be more likely to be driven by strategic reasons and the business case of the underlying activities rather than simply the regulatory hurdles that would need to be overcome.¹⁶⁵

The main advantage of the M&A related measures which were highlighted by market participants were those of reduced costs after mergers arise compared to otherwise.¹⁶⁶ These reduced costs would only be seen over time as increased synergies result from the merger compared to those that would previously have been expected. However, such cost reductions were believed to be relatively small in comparison to the costs associated with the merger or the other synergies that would be expected to result. Over time it may be possible to observe whether the performance of merged companies improves after the Takeover Bid Directive was implemented, although currently it is too early to estimate whether such an impact has arisen.

164 In addition, one of the issues that was raised in Spain was the implication of the "squeeze out" rules when the shares are held under limitations from a court order as it was not clear whether these shares could be squeezed out or not when the shares can not be contractually sold. Banks in Spain were described as being proactive to work with the courts to sort out the problem. This reflects the fact that squeeze out rights were introduced for the first time in Spain following the implementation of the Takeover Bid Directive (as they also were in Greece, Luxembourg, Malta, Slovakia and Slovenia). Source: Interviews and SEC(2007) 268, Commission Staff Working Document, Report on the implementation of the Directive on Takeover Bids, 21.02.2007.

165 A number of market participants did suggest that the single currency had a positive impact on cross-border M&A activity.

166 This may also include reduced costs that arise from harmonisation following the various accounting measures within the FSAP. However, multiple reporting requirements were still cited as one of the major obstacles to cross-border M&A activity in 2005 (i.e. after most of the accounting measures had been transposed) according to research conducted by the European Commission. Cross-border consolidation in the EU financial sector, Commission Staff Working Document, SEC (2005) 1398, October 2005.

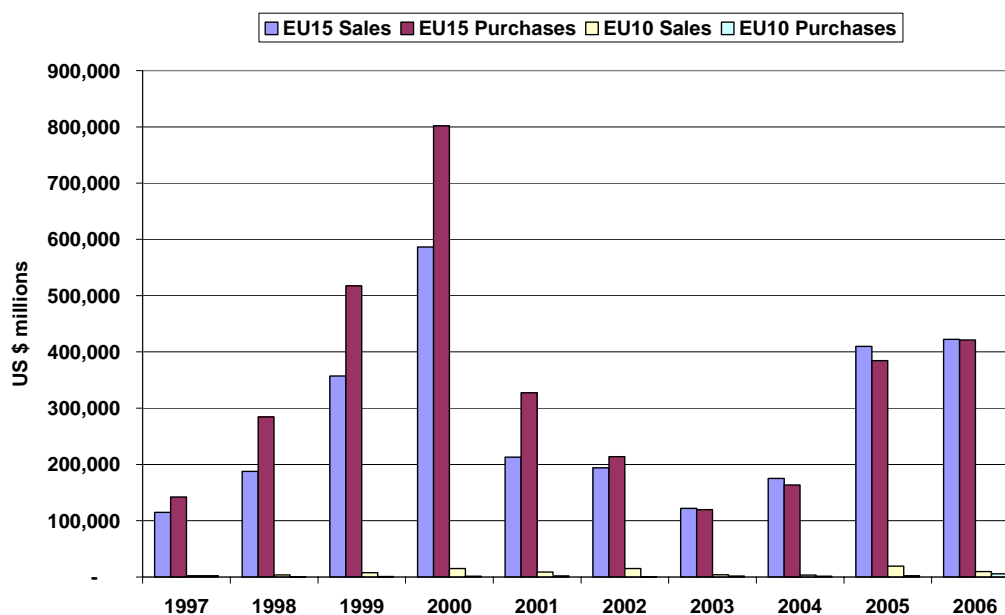
A number of interviewees indicated that the main value of the M&A measures was in the precedent set regarding a removal of protectionist tendencies rather than in any actual impact of increased M&A activity at present.

It should also be noted that in the case of the Cross-Border Merger Directive, at the time of writing there had been relatively poor implementation of the directive. Indeed in June 2008, the EC decided to pursue infringement measures against 11 member states.¹⁶⁷ In addition, the Takeover Bid Directive has only been recently implemented and in some countries has not been implemented at all and hence at this stage very limited impacts could be expected to be seen. For these reasons much of the evidence presented in this section should be seen as setting the baseline for later assessment of the FSAP measures.

5.6.1. Final indicators – M&A measures

The value of mergers over time is highly cyclical in nature and tends to move in line with general stock market trends. This is also apparent for cross-border mergers as shown in Figure 108 below. Figure 108 also serves to highlight the difficulty of identifying an impact from the FSAP compared to general market trends when the volatility of the latter is considerable.

Figure 108: Cross-border mergers over time



Source: Cross-border mergers interactive database, UNCTAD.

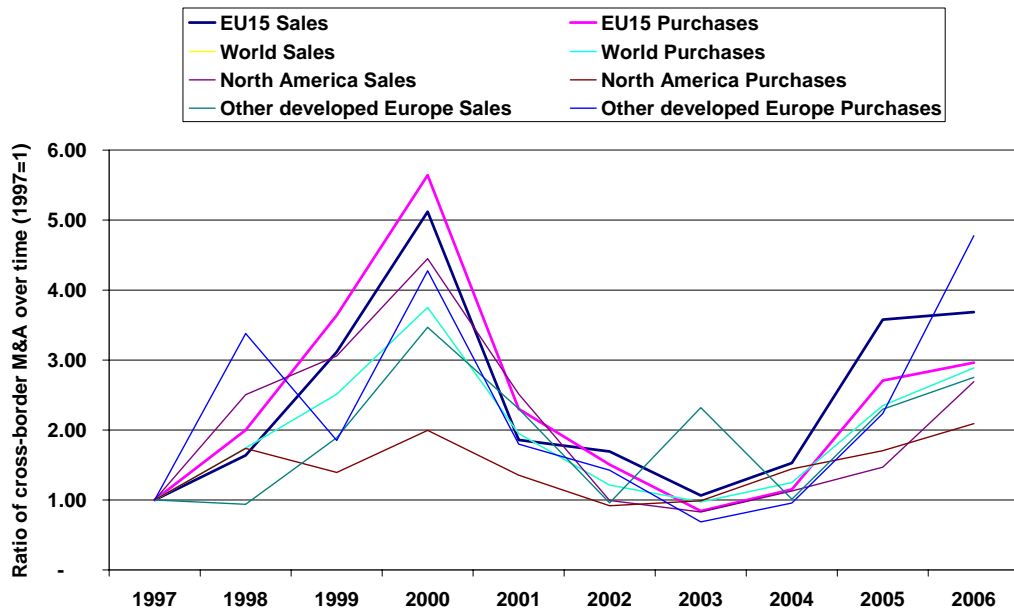
167

Company law: Commission takes measures against 11 Member States over non-implementation of EU rules on cross-border mergers, IP/08/872, 5th June 2008. The member states were: Belgium, Greece, Spain, France, Italy, Lithuania, Latvia, the Netherlands, Portugal, Sweden and Slovenia.

Given the difficulty of identifying any impact of the FSAP in the light of the cyclical nature of M&A, we use M&A activity in other regions as the counterfactual since this would also be expected to follow a cyclical pattern but be unaffected by the FSAP.

In order to compare M&A activity between different regions, we have converted the data into ratios so that the pattern over time can be seen for each region but to avoid differences in starting values. Hence all regions have a value of 1 in 1997.¹⁶⁸ If the M&A measures make this activity easier within the EU, there should be a more rapid increase in mergers within the EU compared to those outside the EU and therefore after implementation of the measures we should observe a more rapid increase in the ratio in the EU compared to in other countries.

Figure 109: Ratio of cross-border mergers over time



Source: Cross-border mergers interactive database, UNCTAD and CRA analysis.

Given that the data is currently only available up until 2006 (the year in which the Takeover Bid Directive was implemented), it is not yet possible to establish whether the FSAP measures have had an observable impact. However, in practice the evidence from Figure 109 suggests that the value of cross-border mergers involving EU15 member states appears to have been increasing more than in other regions for some time and thus it may not be possible to discern the impact of the FSAP measures even when later data becomes available.

Figure 110 below provides details of mergers involving EU bidders overtime and examines the different types of mergers that they represent. A successful implementation

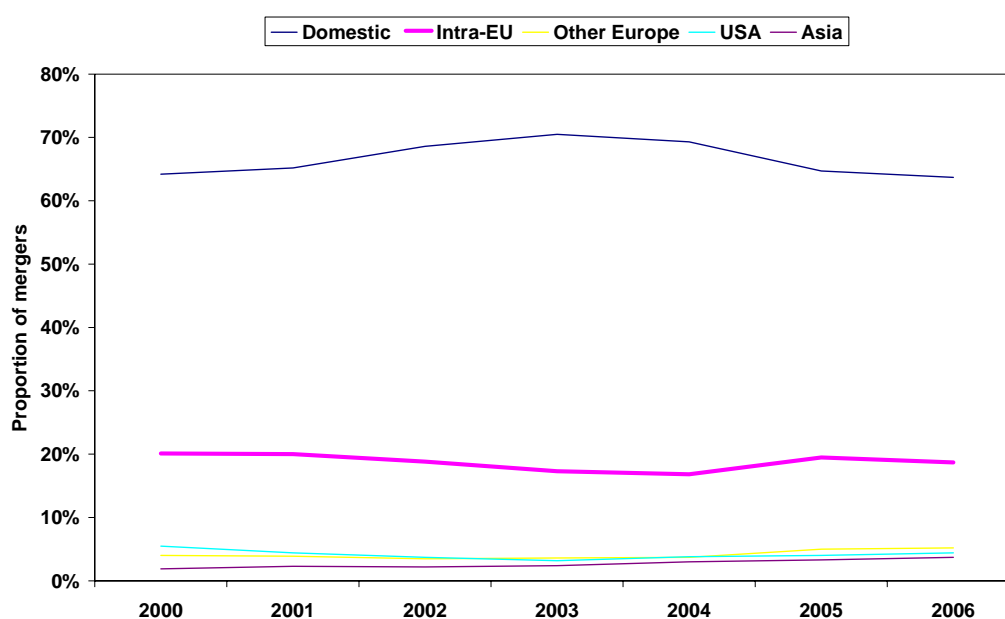
168

For each region the data series is divided by the 1997 figure leading all regions to have the value of 1 in 1997. A figure of 3 would therefore reflect the value being 3 times the value of transactions in that region in 1997.

of the M&A measures would be expected to lead to increase cross-border mergers within the EU compared to domestic mergers as cross-border processes become more harmonised.¹⁶⁹

As is seen in both Figure 110 and Figure 111, the proportion of M&A activity represented by domestic mergers has fallen slightly between 2004 and 2006. The growth of mergers involving companies in the rest of the world has been slightly faster than those involving intra-EU mergers. In the case of EU bidders for rest of the world targets this may reflect strong economic growth in countries such as China and India. However, since data is only available until 2006, no strong conclusions can be drawn at this stage.

Figure 110: Mergers involving EU bidders

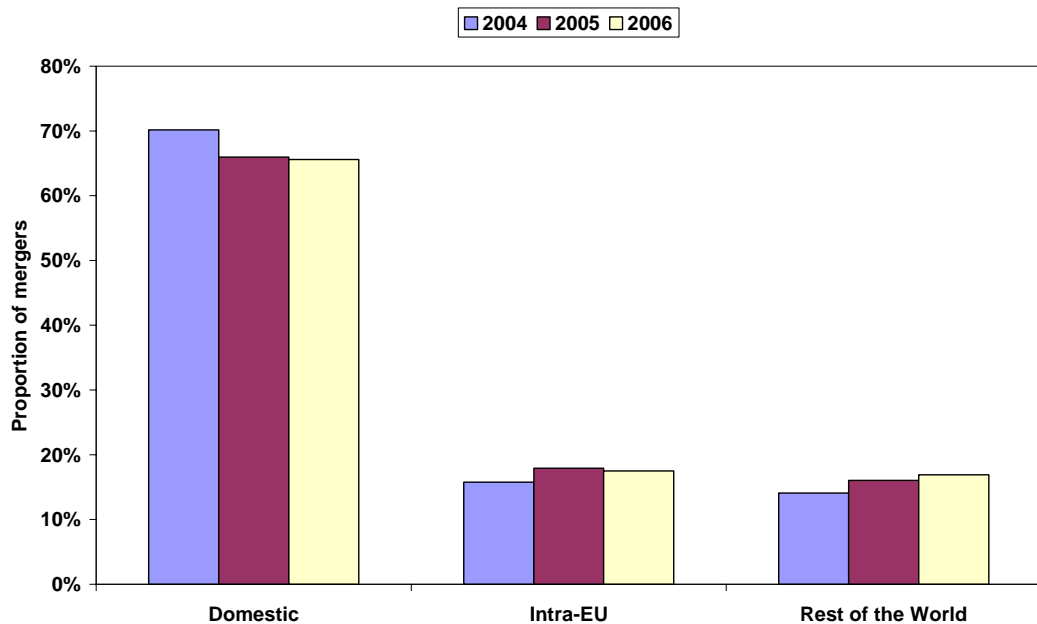


Source: Presentation by Christian Buelens (Directorate-General for Economic and Financial Affairs, European Commission), "A sectoral perspective on recent trends in mergers and acquisitions", 14 March 2008.

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It is possible that the directives could also lead to increased takeovers from non-EU companies especially if they undertake multiple takeovers within the EU since they would then be more familiar with the process within the EU although this effect is expected to be a second order effect in comparison to increasing mergers within the EU itself.

Figure 111: Mergers involving EU15 targets



Source: Mergers and acquisitions Note No 4, ECOFIN, April 2007.

Given the recent implementation of the directives, more time and data will be necessary before strong conclusions can be drawn. A review of some information in a number of year's time may also allow for data to be examined on a country-specific basis and to take into account the timing of the implementation of the directives. However, it is clear that there are a range of factors which determine whether or not firms will merge and whether they will do so across borders. As well as commercial decisions this will also be linked to cultural factors which is already observed when examining mergers within the EU. For example, it is clear that many cross-border mergers take place between countries which are geographically or culturally close to one another. For example, of the 75 intra-EU mergers involving Austrian bidders in 2006, 47 had German targets. Similarly, of the 79 intra-EU mergers involving Danish targets, 36 came from Swedish bidders, 9 from the Netherlands, 7 from Finland and 7 from Germany.¹⁷⁰

5.6.2. Summary for M&A measures

Given the recent implementation of the M&A measures (and their lack of transposition in some member states), data does not yet allow for a quantitative assessment of whether there has been an economic impact from these measures. However, interview evidence suggests that we should not expect such an impact. M&A is driven by strategic reasons rather than simply regulatory hurdles. The main potential gain from M&A related measures were reduced costs in the event of mergers although even these were believed to be small in comparison to other synergies.

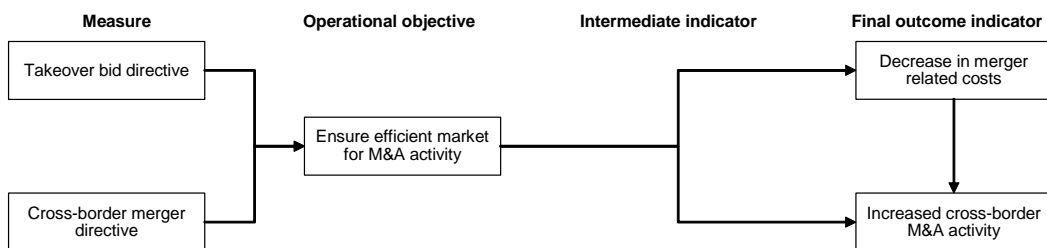
170

See Mergers and Acquisitions Note, DG ECFIN, No4 April 2007.

Furthermore, the Takeover Bid Directive has been implemented in a differential manner in member states with some evidence that aspects of cross-border mergers had become more difficult rather than easier. Differences in implementation between member states meant that the benefits that were hoped for were not in fact materialising.

Figure 112 provides details of the conclusions as to the elements of the FSAP which are having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 112: Conclusion on causality tree related to M&A aspects of the securities markets



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

As is clear from Figure 112, currently there is no evidence of any impacts from the M&A measures within the FSAP although impacts are possible over the longer term especially given the relatively recent implementation of directives and the evidence that implementation has not occurred in a number of member states.

However, given the cyclical nature of M&A activity, it is likely that it will remain very difficult to identify an impact from the FSAP compared to general market trends when the volatility of the later is considerable. For this reason, future assessments may need to focus on qualitative evidence regarding whether firms believe that cross-border M&A activity has become easier, whether synergies have increased and where barriers to cross-border M&A remain which prevent efficiencies from being exploited.

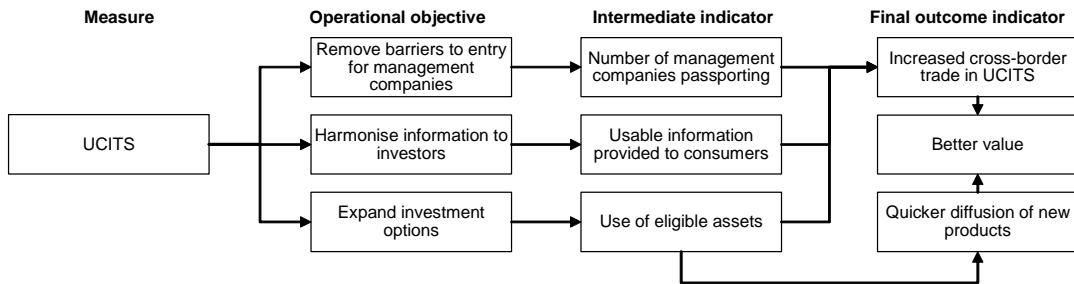
5.7. INDICATORS - UCITS MEASURES

UCITS has its own causality tree reflecting the unusual position among the FSAP measures since the UCITS III Directives primarily only impacts investment funds. UCITS III took effect in August 2003. There are three main elements to UCITS III including the:

- Management company passport;
- Simplified Prospectus; and
- Expansion of the eligible assets that could be used within UCITS funds.

Figure 113 below sets out the causality tree for UCITS.

Figure 113: Causality tree related to UCITS



Source: CRA analysis.

As is clear from Figure 113, the use of these three elements represent the intermediate indicators within the causality trees and hence we examine these first before considering the final indicators.

In addition to the direct effects from UCITS III, there are interactions between this and both the Prospectus Directive and MiFID, both of which have an impact in relation to information provision and are therefore discussed below alongside the Simplified Prospectus.

5.7.1. Intermediate indicators - UCITS

Use of the management company passport

The original intention of the UCITS III directive was to enable a management company to domicile a fund in a different member state to that in which the management company was located. However, in practice, the management company passport provisions are not considered by regulators to provide a sound basis for the effective supervision of a fund managed on a remote basis and not considered by fund managers to actually allow for this to be done. As a result no management company has been reported as being authorised to manage funds in another member state. If, in the future, changes are made that enable the management company passport to be used in practice, then capturing data on the number of such company passports over time will be useful.

Table 21: Number of management company passports

Number of management company passports, July 2008	
EU-15	0

Source: CRA analysis.

Use of the Simplified Prospectus

The aim of the Simplified Prospectus (SP) was to have usable information for consumers which could assist with cross-border trade since the same information would be available irrespective of the domicile of the fund.

In some member states the SP was viewed positively for the *domestic* market. Typically this was where it had been implemented without any, or with only limited, gold-plating. For example, this was the case in Ireland, Portugal, and Sweden. However, there was limited impact in Portugal where a document similar to the SP had already been in place since 1999. In Spain, UCITS III led to shorter documents compared to information that would have previously been given to investors although documents still include information that is not required under the directive. Despite market participants in these countries viewing the SP positively, no evidence was provided of a subsequent impact on the market from the use of such information.

In practice, the implementation of UCITS III has been subject to gold-plating and differential interpretations by member states (with some seeing the document as having a legal or regulatory status rather than being primarily an information tool for investors).

For example in France it was noted that before the SP was introduced there used to be a reasonably simple document that was used, but following the introduction of the SP the documentation actually increased because it is now perceived to be a legal instrument rather than one for the benefit of consumers. Both Italy and the Netherlands require a “risk indicator” to be added to the information in order that UCITS funds can be compared with other products which also apply a risk indicator. Similarly, in the UK, a “reduction in yield” and “table of effect of charges” are both required to be disclosed in addition to the requirements under the SP as they were already in place for investment products before the SP was implemented.

These differences between approaches in member states hinder both consumers who wish to compare information from funds domiciled in different places, but possibly more significantly, gold-plating adds to the costs of fund companies who wish to trade cross-border or who wish to have pan-European processes for the development of SPs in funds domiciled in different countries because they may need to find out about the local marketing rules. Most market participants believed this represented simply an increased cost rather than having a negative impact on the decisions as to which member states to operate in. The latter would be determined by other, more significant, factors such as access to distribution networks and customers.

Given the significant differences in approach taken, the SP has not had the effect of harmonising information requirements across borders (although if the implementation of the SP changes to a more harmonised approach through a “Key Information Document” this may change). Some market participants indicated that since tax systems vary in each member state, marketing documents would always need to be adapted to each location and therefore it was inevitable that there would be costs associated with the provision of information in each member state.

For example, in Sweden when considering the import of funds, the role of the Swedish pension system, the PPM, in which consumers invest in a wide range of investment funds, is important. The PPM requires a short prospectus or factsheet to be provided to customers and thus any foreign funds which enter the PPM will have incurred the cost of developing this information. It would then be anticipated that they would use these documents when selling funds outside the PPM since factsheets, while not compulsory,

would be expected by the Swedish investor. Thus simplified information would typically be provided in Sweden even by those funds that have a much longer SP in their home country.

The final issues linked to information provision relate to interaction between different FSAP measures especially the Prospectus Directive and MiFID. Numerous fund managers and their associations have expressed concern that the differential requirements between the SP for UCITS and the prospectus issued under the Prospectus Directive are distorting competition between substitutable products – this issue was considered in section 5.3. In addition, because UCITS III regulates a product and MiFID regulates some aspects of financial advice, fund management associations were also concerned that the combination of these measures meant there was over-provision of information potentially leading to consumers being confused or overwhelmed and therefore unable to process the information given to them. Quantitative evidence on consumers being overwhelmed by information is, by its very nature, difficult to establish and we are not aware of any empirical information supporting this claim.

Use of eligible assets

UCITS III expanded the types of eligible assets that can be used as investments for UCITS funds enabling the use of complex hedging, absolute return funds, certain money market funds as well as fund of funds. CESR issued guidance regarding the clarification on definitions on eligible assets in January 2006.¹⁷¹ The role of CESR in this regard was seen as important by a number of market participants since member states had previously interpreted the directive in different ways and thus the guidance was viewed positively in bringing greater harmonisation than would otherwise have arisen.

Fund managers and other interviewees universally agreed that the additional flexibility afforded by the expansion of eligible assets was indeed being used across all member states. In particular, absolute return funds and fund of funds were seen to have benefited from UCITS III although in many countries, these types of funds already existed as non-UCITS funds.

It was also noted that in some cases regulators were slow to allow the flexibility to be exploited. For example, in Sweden there were delays because of concerns regarding whether the use of newly eligible assets meant that the investment aims of the fund were being changed; and similarly in Italy, interviewees stated that the regulator took a conservative view at first which also slowed the use of eligible assets. In both cases, however, it was noted that consumers did not necessarily lose out from access to these types of funds under the UCITS badge since they were passported in, especially from Luxembourg.

¹⁷¹ CESR's Advice to the European Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITS, CESR/06-005, CESR, January 2006. This was subsequently superseded in March 2007 by the Directive on eligible assets (2007/16/EC) and CESR's guidelines concerning eligible assets for investment by UCITS, CESR/07-044, CESR, March 2007.

Data does not exist that enables all new UCITS funds that use the newly eligible assets to be identified nor those existing UCITS funds which started to include the newly eligible assets. Indeed, no market participant was aware of data that highlights whether or not funds have newly eligible assets. For example, data on the use of hedging is not systematically available and neither can data distinguish those funds investing in newly eligible money market assets.

Instead, it is necessary to examine indirect evidence on the use of eligible assets.

Derivatives

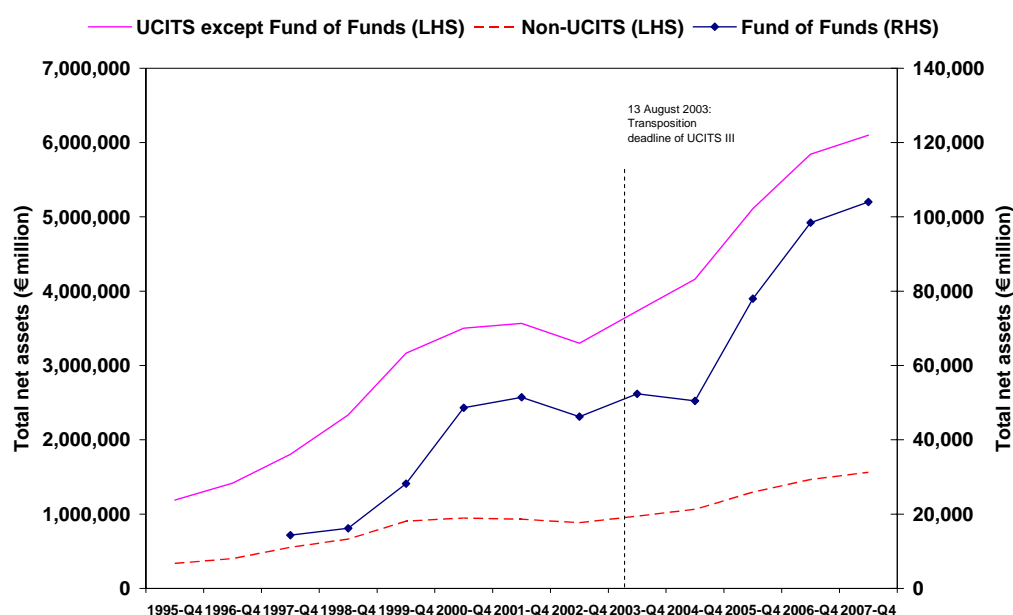
Identifying the use of derivatives is not a perfect indicator since simple derivatives could be used before UCITS III was implemented. PWC found that there has been an increase in the number of UCITS funds using derivatives since the implementation of UCITS III, although the use of derivatives was still limited.¹⁷² The extent of the use of derivatives and the trend varied between countries with strong increases in France, Germany, Spain and the UK although there is insufficient data from before 2003 to conclude that this was caused by the changes brought about by UCITS III.

Fund of funds

As noted above, fund of funds were one of the categories that were included in UCITS following UCITS III although the funds themselves existed in a number of countries before this. Figure 114 below shows the net assets of fund of funds compared to other types of investment funds.

¹⁷² Investment funds in the European Union: Comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets, PWC for the European Commission, February 2008.

Figure 114: Total net assets of investment funds



Source: EFAMA Factbooks from various years.

As is seen in Figure 114 above, there is some evidence that fund of funds have grown faster than other funds. Although they remain a small percentage of investment funds, they have increased from 1.1% of investment funds at the end of 2003 to 1.34% at the end of 2007.

Table 22 below reports details of the net assets of fund of funds by different member states over time.

Table 22: Net assets of fund of funds in EU €million

	1997-Q4	1998-Q4	1999-Q4	2000-Q4	2001-Q4	2002-Q4	2003-Q4	2004-Q4	2005-Q4	2006-Q4
Austria		1,364	4,927	10,359	12,463	16,850	18,880	12,907	15,563	17,516
Belgium	2,113	3,688	6,166	9,422	10,518	5,995	6,034	6,526	12,091	16,300
Czech Republic			9	35	28	19	12	15	209	488
Germany			745	5,007	7,171	5,915	6,468	7,382	10,787	13,143
Greece									809	2,950
Hungary						51	48	104	331	949
Poland						9	9		52	168
Portugal	3,641	4,084	3,652	2,937	1,884	1,114	945	1,018	1,794	2,061
Slovakia						2	4	7	148	564
Spain					1,652	1,601	2,476			

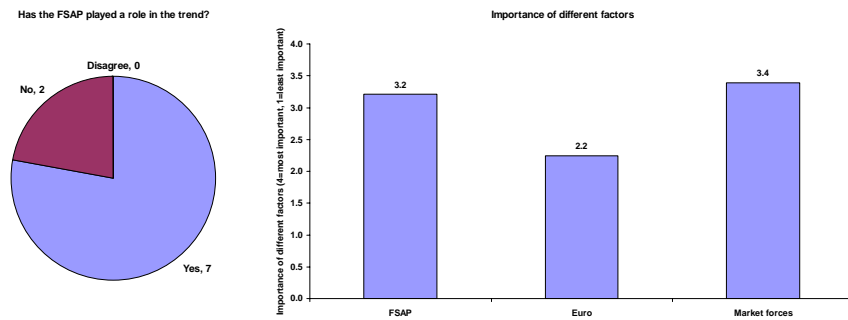
Sweden				15	10	49	501	1,336	2,600	3,463
United Kingdom	8,585	7,050	12,572	20,119	16,802	13,505	15,741	19,135	30,756	38,025
Total	14,339	16,186	28,071	47,894	50,528	45,110	51,118	48,430	75,140	95,627

Source: EFAMA Factbook 2007. Note that for France, Italy and Luxembourg, funds of fund are included in the underlying funds. No data is reported for other countries in the EU.

As is clear from this, substantial increases in the net assets of fund of funds among the EU15 have been seen in Belgium, Germany and the UK since the UCITS III directive was implemented. Some of the growth in these countries and in fund of funds more generally may have arisen because of UCITS III, although it is possible that this simply reflects a growth in funds that would previously have been categorised as non-UCITS funds.

However, as is clear from Figure 115 below, the great majority of member states indicated that the FSAP was at least partly responsible for the growth in the use of fund of funds.

Figure 115: Impact of FSAP on the increase in the use of Fund of Funds



Source: CRA survey and analysis. Note that “Disagree” implies that multiple respondents in one member state gave different responses to the question.

This result is also supported by evidence from PWC which found that following UCITS III, asset managers sought to develop new funds as soon as possible to benefit from a wider range of eligible assets and that this was done mainly through the creation of “fund of funds, cash and money market funds”.¹⁷³

Absolute and total return funds

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Investment funds in the European Union: Comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets, PWC for the European Commission, February 2008. Note that this is in contrast to the position for more sophisticated funds where asset managers waited for regulatory clarifications which were typically issued in 2007. The research was based on examining the investment approaches of a selection of UCITS funds, an online questionnaire and detailed understanding regarding investment decision of asset managers gained from interview evidence.

A further example where the impact of eligible assets may be seen quantitatively is for absolute and total return funds. In particular, there has been a development of new categories for data collection and statistical purposes for these funds. For example in the UK the Investment Management Association (IMA) has developed a new category for its statistical information which is that of an “absolute return sector”. In June 2008, there were only 12 funds in this sector and at the time of writing data was not yet available since the new categorisation is being trialled. Similarly, Feri has started to present information on absolute and total return funds. Both of these developments are likely to reflect existing and expected growth in this sector following their inclusion within UCITS funds.

Table 23: Absolute and total return funds

	Absolute and total return funds net assets in Europe (€billion)	Total funds net assets in Europe (€billion)	Absolute and total return funds as proportion of all net assets in Europe
2006	150.18	5,083.30	2.95%
2007	127.95	5,251.50	2.44%

Source: FERi, European Fund Market Data Digest 2007- 2008.

At present, however, with data available only for 2006 and 2007, and given that the value of net assets was impacted by general economic conditions, it is not possible to draw any conclusions regarding this data. Nonetheless, this may be a useful benchmark for the future.

Non-UCITS funds

As with some of the other measures, UCITS III also gave the opportunity to change the regulation of other funds rather than simply UCITS funds. For example, in Portugal, new local regulation allowed special funds (equivalent to the SIVs in Luxembourg) to enter the Portuguese market in 2003/4. This was brought in at the same time as UCITS III because the directive prompted consideration of new funds and processes. Similarly in Spain the regulation of non-UCITS funds mirrors that of UCITS funds with the primary difference being fewer restrictions on the underlying investments and hence changes to UCITS also led to changes to non-UCITS funds.

5.7.2. Final indicators – UCITS

Given the evidence above regarding the intermediate indicators, it is clear that rather than expecting a cumulative effect on the final indicators, in fact the only driver of any changes to the final indicators is currently coming from the expansion of eligible assets.

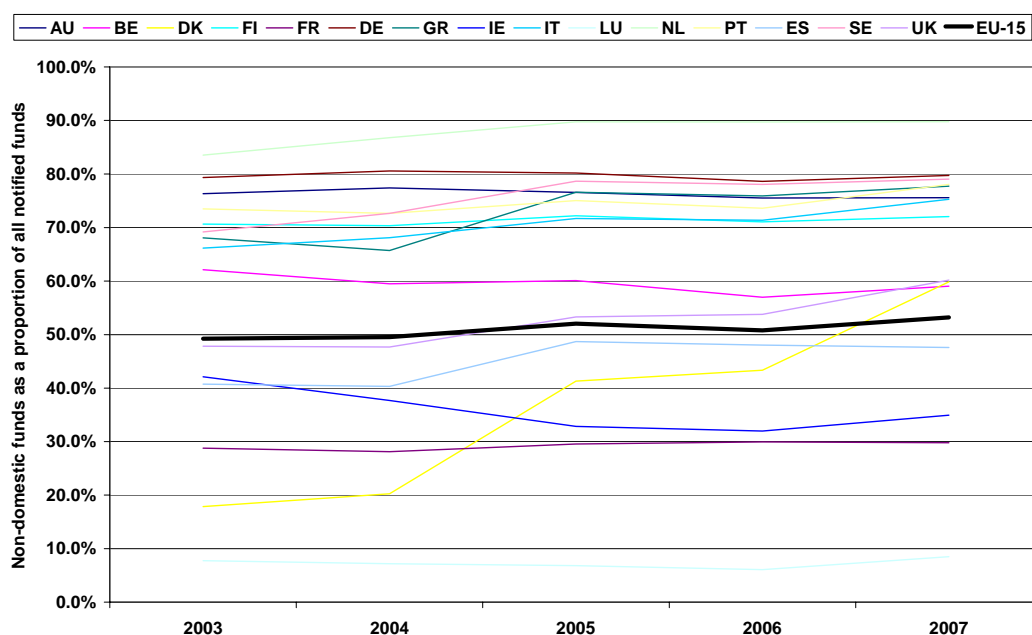
Increased cross-border trade in UCITS

If UCITS brings benefits from cross-border trade, we would expect to see cross-border trade accelerating due to the newly eligible assets which can now take advantage of the UCITS badge when selling across borders. Hence the relevant indicator is to consider

the extent of cross-border trade in UCITS funds and to establish whether this has changed in the light of UCITS III.¹⁷⁴

Figure 116 below shows non-domestic funds as a proportion of all funds notified in each member state. For the EU-15 as a whole there has been a slight increase in the proportion of funds which are non-domestic which have increased from 49% to 53% between 2003 and 2007 which is consistent with the impact expected from UCITS III (data is not available before 2003).

Figure 116: Cross-border notifications



Source: FERI, European Fund Market Data Digest various years.

Ideally, data should be examined to consider the cross-border growth of UCITS funds and of those funds which include newly eligible assets. As noted above, it is not always possible to distinguish these funds. Furthermore, data is not available over time that enables a comparison to be made as to whether there has been an increase in the cross-border notification of fund of funds which could be attributed to UCITS III, or of funds involving newly eligible assets.

Nonetheless, many market participants believed that the availability of the UCITS product passport for newly eligible funds was bringing additional demand for some products. For example, in Ireland there were a number of previously non-UCITS structured funds which gained from being able to obtain the UCITS passport and access other markets more easily. The Irish industry believed that there had been an especially large expansion of

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It is clear that cross-border trade of UCITS funds has been enabled by the first UCITS directive. It should also be noted that the ability to trade funds with newly eligible assets across borders will also be impacted by factors such as access to distribution networks and customers.

the fund management sector which represented more than a simple movement from non-UCITS to UCITS but rather that the UCITS badge had brought additional demand.

Hence while at present it is not yet possible to conclude whether UCITS III has led to an increase in the cross-border trade, we might expect to see changes in this in the future. If further data becomes available on the funds that include eligible assets such as fund of funds, money market funds or absolute and total return funds, it may be possible to observe changes in cross-border trade related to these funds in particular.

Better value UCITS products and quicker diffusion of new products

In general, market participants agreed that the expansion of eligible assets should lead to better value UCITS products as quality and returns increase, although it was noted that this was not possible to demonstrate quantitatively. Furthermore, a number of market participants indicated that there was no evidence of falling prices in UCITS funds generally that could be attributed to UCITS III. No interviewee believed that UCITS III led to the quicker diffusion of products to other countries. For example, in Poland, which might be expected to gain from such diffusion as fund managers from other countries seek to access the Polish market, market participants did not believe that UCITS III had led to a wider range of new products being available more quickly than would otherwise have been the case. In addition, participants in many countries indicated that the eligible assets were being used in non-UCITS funds and that competition was not especially impacted by allowing these assets into UCITS.

The limited impact on the value of products was also supported by evidence from PWC which found that there was no significant difference in behaviour or performance between those funds launched under the UCITS III framework compared to those funds launched under the older UCITS directive.¹⁷⁵

A number of market participants also indicated that UCITS III had assisted with the notification process that was already in place from earlier directives. In particular, it was believed to be easier to notify funds in other member states with fewer demands being made by the host regulators and therefore faster notification and faster access to the new market. Much of this was believed to be due to the CESR guidelines that had been developed.

Impact in third countries

One of the final issues which needs to be noted in the context of UCITS is the use of the UCITS badge beyond EU borders. Numbers of market participants noted that the UCITS badge is useful in being able to export funds to Hong Kong, the Middle East and Asia. Indeed, market participants in Luxembourg suggested that as much as 50% of net sales of funds domiciled in Luxembourg were made to Asia in the first half of 2008. Whilst most

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Investment funds in the European Union: Comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets, PWC for the European Commission, February 2008.

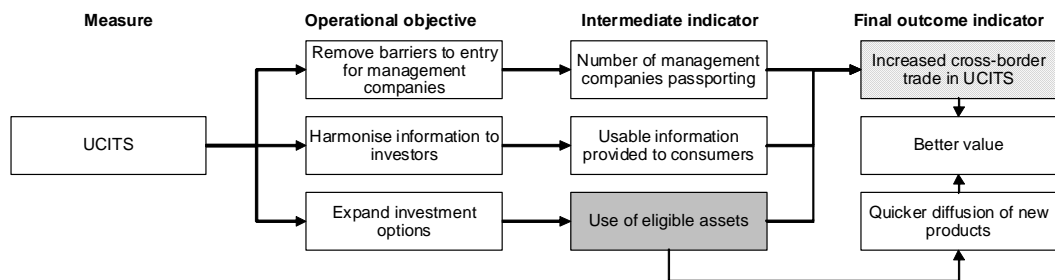
interviewees acknowledged that this had been a growing development before UCITS III, the widening of the eligible assets may have enabled European fund managers to gain at the expense of fund managers from other locations where eligible asset criteria is more restrictive. The issue of the impact in third countries is an important issue to note for future policy development since the market supplied by EU based fund managers has clearly extended beyond the EU.

5.7.3. Summary for UCITS related measures

Overall, UCITS III has had an impact on the market although not all components of UCITS III have been effective. In particular, there is currently no economic effect from the management company passport and there has been no cross-border impact from the Simplified Prospectus due to the differential manner in which it has been implemented and the tendency to treat it as a legal document rather than an information document for consumers.

However, the changes made to eligible assets have led fund managers to take advantage of the flexibility afforded. There has been growth in the use of fund of funds which the majority of interviewees attribute at least in part to the FSAP. There has also been a slight increase in the proportion of foreign notifications which is consistent with the impact expected from UCITS III. However, it is not yet possible to conclude that UCITS III has led to an increase in the cross-border trade, but if data becomes available on the funds that include eligible assets it may be possible to observe changes in cross-border trade related to these funds in 3-5 years. Figure 117 provides details of the conclusions as to the elements of the FSAP which are currently having an observable economic effect at this time and where we expect to observe market impacts in the future.

Figure 117: Conclusion on causality tree related to UCITS



Source: CRA analysis. Note fully shaded sections show where the evidence finds economic impacts from the FSAP measures on intermediate or final outcome indicators, semi-shaded sections show where measurable economic impacts are expected in the future but where it is not yet possible to conclude that impacts have already arisen.

APPENDIX A: LIST OF INTERVIEWEES

The following is a list of organisations that participated in the interview programme.

Asociación Española de Banca, Spanish Bankers Association, AEB, Spain

Associaacao Portuguesa de Seguradores, Portuguese Insurance Association, APS, Portugal

Associação Portuguesa de Fundos de Investimento, Pensoes e Patrimónios, Portuguese Association of Investment, Pension and Property Funds, APFIPP, Portugal

Asociacion de Instituciones de Inversion Colectiva y Fondos de Pensiones, Spanish Association of Investment and Pension Funds, INVERCO, Spain

Association des Banques et Banquiers, Luxembourg Association of Banks and Banquiers, ABBL, Luxembourg

Association Française de la Gestion Financière, French Asset Management Association, AFG, France

Association Luxembourgeoise des Fonds d'Investissement, Association of the Luxembourg Fund Industry, ALFI, Luxembourg

Association of British Insurers, ABI, UK

Associazione Bancaria Italiana, Italian Bankers Association, ABI, Italy

Associazione Nazionale fra le Imprese Assicuratrici, Insurance Association, ANIA, Italy

Assogestioni, Mutual fund association, Italy

Autorité des Marchés Financiers, Financial Markets Authority, AMF, France

Autoriteit Financiële Markten, The Netherlands Authority for Financial Markets, AFM, The Netherlands

Axa

Banca D'Italia, Bank of Italy, Italy

Banco de España, Bank of Spain, BDE, Spain

Banco de Portugal, Bank of Portugal, BDP, Portugal

British Bankers' Association, BBA, UK

Bolsas y Mercados Espanoles, Spanish stock exchange, BME, Spain

Borsa Italiana, Italian stock exchange, Italy

Bourse de Luxembourg, Luxembourg Stock Exchange

Bundesanstalt für Finanzdienstleistungsaufsicht, Federal Financial Supervisory Authority, BaFin, Germany

Bundesverband deutscher Banken , Association of German Banks, BdB, Germany

Bundesverband Investment und Asset Management, Federal Association of Investment and Asset Management, BVI, Germany

Comisión Nacional del Mercado de Valores, Spanish Securities Commission, CNMV, Spain

Comissao do Mercado de Valores Mobiliarios, Portuguese Securities Market Commission, CMVM, Portugal

Commissariat aux Assurances, Commissariat for Insurance, Luxembourg

Commission Bancaire Financière et des Assurances, Belgian Banking, Finance and Insurance Commission, CBFA, Belgium

Commission de Surveillance du Secteur Financier, financial supervisor, CSSF, Luxembourg

Commissione Nazionale per le Società e la Borsa, Italian securities market regulator, CONSOB, Italy

Committee of European Securities Regulators, CESR

De Nederlandsche Bank, Netherlands Central Bank, DNB, The Netherlands

Dirección General de Seguros y Fondos de Pensiones, General Directorate of Insurance and Pension Funds, DGSFP, Spain

Dutch Fund and Asset Management, DUFAS, The Netherlands

European Commission

Fédération Française des Sociétés d'Assurances, Association of Insurers, FFSA, France

Fidelity International

Financial Services Authority, FSA, UK

Finansinspektionen, Swedish Financial Supervisory Authority, Sweden

Fondbolagens Förening, Swedish Investment Fund Association, Sweden

Gesamtverband der deutschen Versicherungswirtschaft, German Insurance Association, GDV, Germany

Iberclear, stock exchange, Spain

Investment Management Association, IMA, UK

Instituto de Seguros de Portugal, Portuguese Insurance and Pensions Funds Supervisory Authority, ISP, Portugal

Irish Association of Investment Managers, IAIM

Irish Banking Federation, IBF

Irish Financial Services Regulatory Authority, IFSRA, Ireland

Irish Insurance Federation, IIF, Ireland

Irish Stock Exchange, ISE, Ireland

Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo, Insurance Regulator, ISVAP, Italy

Komisja Nadzoru Finansowego, Polish Financial Supervision Authority, KNF, Poland

London Investment Banking Association, LIBA, UK

London Stock Exchange, LSE, UK

Narodowy Bank Polski, National Bank of Poland, NBP, Poland

Nederlandse Vereniging van Banken, Netherlands Bank Association, NVB, The Netherlands

NYSE Euronext Lisbon, Portugal

OMX Nordic Exchange/Nasdaq OMX, Sweden

Polska Izba Ubezpieczen, Polish Chamber of Insurance, PIU, Poland

Svenska Bankföreningen, Swedish Bankers' Association, Sweden

Svenska Fondhandlareföreningen, Swedish Securities Dealers Association, Sweden

Tesoro Publico, Spanish Treasury, Spain

The Associação Portuguesa de Bancos, Portuguese Banking Association, APB, Portugal

Unión Española de Entidades Aseguradoras y Reaseguradoras, Association of Spanish Insurers, UNESPA, Spain

Union professionnelle des entreprises d'assurance, Belgian Association of Insurers, Assuralia, Belgium

Verbond van Verzekeraars, Dutch Association of Insurers, VVN, The Netherlands

Zwiazek Bankow Polskich, Polish Bank Association, ZBP, Poland