

Evaluation of Economic Impact of the Financial Services Action Plan
Workshop on Methodology, 25 October 2006
RESUME OF CONTRIBUTIONS

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Introduction

On October 25, 2006 the Commission organised a Workshop on Methodology (**the Workshop**) in order to obtain expert advice on the appropriate methodology for evaluation of the economic impact of the Financial Services Action Plan (**the Evaluation**). This was done with a view to using the received advice in drafting the Terms of Reference for the Evaluation Study, a tender for which is planned to be launched in 2007.

The Workshop was composed of four panel sessions, each of them corresponding to one of the four general objectives (**the FSAP Objectives**) as set in the original Action Plan of 1999¹. 16 experts representing the EU financial services industry, supervisory authorities, academic institutions and consumers delivered short presentations in the panels. The Commission aimed at encompassing various points of views in terms of the experts' background and nationality. After the interventions of the speakers, in each session an exchange of view was held with the Workshop participants. In addition, the Commission encouraged all stakeholders to send their views on the methodology in writing. This summary takes account of all contributions voiced in the Workshop and submitted by other channels by the end of November 2006.

¹ COM (1999) 232

A) General advice on the Evaluation

Expectations

The experts were nearly unanimous that the Evaluation should allow the Commission to **learn lessons from the FSAP experience**: in terms of the efficiency of action plans as a policy tool, the importance of proper ex-ante impact assessments, areas in the EU financial markets lacking integration, loopholes in the EU regulatory framework and, finally, policy priorities for the period after 2010. Therefore, although nearly all experts judged that the Evaluation comes too early to provide robust final results, they saw it as providing added value from the policy point of view. However, some experts suggested caution in using the Evaluation results for policy purposes. In general, there was a consensus to focus on the effects of the FSAP (output) rather than its measures (input).

The major challenge identified by experts was the question **how to distinguish the effects of FSAP** from other market effects. Some experts suggested to keep the analysis simple and not to invest too much energy or resources. Others claimed that the Evaluation ought to aim to provide highest quality evidence, given the scepticism on the part of many stakeholders on the benefits brought by the FSAP. Another view was that the accuracy of the analysis would not have to be perfect, but should be fit for the purpose (i.e. identify market and regulatory failures to point to the direction for change). Many supported the idea of repeating the Evaluation in the future or conducting it on a regular basis.

The experts advised to measure the **level of integration** to assess the effectiveness of the FSAP. Some experts interpreted the FSAP objectives more broadly and suggested analysing the competition, efficiency and financial stability within the EU, as well as the EU's attractiveness for foreign investors and competitiveness of European companies on the international stage. Many experts believed that integration should not be seen as an end in itself and that consideration should also be given to the concept behind the official objectives, i.e. the EU's growth strategy under the Lisbon process.

Obstacles

The experts almost unanimously agreed on two major difficulties for carrying out the Evaluation: separating the effects of the FSAP from other factors and early timing. Many experts also mentioned problems with data availability.

Separating the FSAP effects

The experts stated that it was very difficult – if not impossible – to filter out the impact of the FSAP from other factors, such as:

- **The introduction of the Euro** (reducing costs of transactions thanks to elimination of exchange risk and enhancing comparability of prices),
- **Single Market measures other than the FSAP,**
- **Globalisation** (in particular, market entry by branches or subsidiaries of firms not based in the EU),
- **Differentials in legal and economic conditions across European countries,** in particular **taxation** (cross-border capital flows stemming from tax differences should be excluded when assessing progress of integration),

- **General conditions for competition** (e.g. new split between the Commission and national competition authorities),
- **Changes in the boundaries between state and private provision of financial services** (e.g. pensions),
- **Progress in information and communication technologies,**
- **Market innovation** – e.g. the role of derivatives markets (the development of derivatives, in particular credit derivatives and ABS, which have opened the way to certain cross-border transactions such as loan securitisation and risk hedging); fund supermarkets (distribution of UCITS); improved management practices (e.g. changes in supply brought about by development of networks of financial advisors),
- **Evolution in the strategies of financial intermediaries** (e.g. significant recent activity in European cross-border banking consolidation),
- **Demographic and social developments** (changing demand for financial products, in particular linked with investment and retirement saving).

Timing

Most experts were of the view that it was **too early** to evaluate the economic impact of the FSAP. The experts underlined the fact that some of the "cornerstones of the FSAP" (such as MiFID, CRD) will only take effect in 2007, while many others will by then have been implemented for a very short time (e.g. IFRS, Prospectus Directive). Thus the data reflecting their impact and, specifically, the long time series necessary for some types of analysis, will not be available. The importance of the impact of MiFID was particularly highlighted. There was also a suggestion that one should take account of later implementation of the FSAP in the new Member States.

A suggested **solution for the timing concern** was to do a **baseline evaluation now**, including establishing the appropriate methodology and indicators, and to repeat the exercise in the future. This should be done, for example, in 2011 and 2015 to take account of the full economic cycles in the MS. Another suggested option was conducting **regular evaluations**, e.g. on an annual or biannual basis. It was also mentioned that the methodology could be constantly refined for further evaluations.

A specific proposal in this regard came from Tom Van Dyck (K.U.Leuven and Harvard Law School), who suggested that the Commission rely on **independent academic centres of excellence** to provide a methodological framework for a backward- and forward-looking study, to be conducted on an annual or bi-annual basis. Such a study should be conducted by one or more academic centres (or groups) of excellence, and not influenced by any interest groups (including the Commission itself). Ideally, to foster and generate an academic "race to the top", the Commission could establish some form of competition, tendering the report to for instance two separate academic centres at the same time. The report would be then published for stakeholders' comments.

The transposition deficit in some Member States was another common concern, e.g. in the insurance area (IORP, Insurance Mediation Directive). The experts were of the view that the economic effect of the FSAP measures was dependent on their implementation in the MS, e.g. timely and accurate transposition of the directives by national governments, consistent interpretation of particular provisions by the supervisors, as well as on the common agreement reached on their content in the consultations accompanying the adoption process. In this context it was also noted that the Evaluation should not be based on the original directives but

on their final shape, as actually implemented in the MS. Other experts suggested evaluating the economic impact of the imperfect or late implementation of the FSAP measures. Many experts suggested that the evaluation of the economic impact of the FSAP should be closely linked with the evaluation of the process and implementation, as carried out by the Commission in the separate evaluation report.²

Data availability

Many experts emphasised problems with obtaining the relevant set of data necessary for the analysis. Some of them suggested that the Evaluation should result in the establishment of a **statistical database** that will provide a detailed, exhaustive overview of financial services in Europe and a comparison with the US. This would allow analysis to be based on the most reliable and homogeneous data. The recommended data sources included amongst others the Eurostat, ECB, national central banks, BIS, OECD, exchanges and companies. The experts also advised to draw on existing studies (see the list in the Annex).

The majority of experts emphasised the need to **combine the quantitative analysis with the qualitative analysis** in order to get the most out of the Evaluation. The experts suggested conducting structured surveys and interviews in the Member States with governments, supervisors, financial service providers, academics and users (see the exemplary questions for surveys in the Annex). When surveying the market participants, it was advised to distinguish between domestic, pan-European and global players. Some experts suggested that certain types of qualitative evidence may be more reliable than the quantitative evidence.

Approaches

The experts warned against the use of indicators without a rigorous market model and related causation analysis, as well as against making spurious links between the FSAP and economic events. They commented on the Commission's preliminary views on the methodology, adding much relevant advice. A number of experts also proposed alternative/complementary approaches and ideas.

Comments on the approach proposed by the Commission

As a preliminary approach the Commission had proposed comparing the status of the market before and after the FSAP and assessing the accomplishment of the FSAP Objectives.

Comparing market pictures ex-ante and ex-post

Many experts found the approach proposed by the Commission to be pertinent: compiling as accurate a "snapshot" as possible of financial services integration both before and after implementation of the FSAP, and then measuring the change between the two "snapshots", with an attempt to determine the proportion that can be explained by the FSAP against a set of other factors.

But some experts considered it difficult to take a picture of economic situation ex-ante and ex-post because of the **staggered introduction** of the FSAP measures. While the ex-post data would be naturally the most recent data available (2007 possibly), it is not evident what the baseline of the Evaluation should be. In principle, there should be a different starting point for each measure. If 1999 (the year of the launch of the FSAP) is chosen as the baseline, potential

² Evaluation Report, *FSAP Evaluation Part I – Process and Implementation*, published for consultation in November 2005

distortions may result from the influence of the particular market situation at the time (the technology bubble). But much support was also expressed for the 1999 date, as it was the starting year both for the FSAP and the Euro.

Evaluation by four initial objectives

The vast majority of experts approved of focusing on the FSAP Objectives as intermediated goals for achieving the Lisbon goal.

Most of the experts found the idea of evaluating all FSAP measures individually too complex. Some experts suggested measuring the **cumulative effect** of the FSAP. For example, Jens Roder argued that the introduction of greater transparency in financial reporting, as provided for in the Transparency Directive, would have been severely weakened, if not negated, in the absence of other measures such as the IFRS or better and more informative prospectuses. In this context, there was a suggestion that the Evaluation should be delayed until the Action Plan is fully operational as a package and has had time to deliver its effects.

Some experts called for some measures to be singled out and evaluated separately (e.g. Clearing and Settlement). One contribution asked to distinguish between each single legislative measure and assessing its impact separately, assuming that there are no extra synergies.

Several experts recommended using a **sectoral and sub-sectoral** approach. But some also warned against making the analysis too complex by looking at all different sectors in all MS.

FSAP contribution to the Lisbon agenda

The contribution to the Lisbon agenda was broadly confirmed as a suitable criterion for evaluation. The following indicators were mentioned:

- **Economic growth** (also due to other factors).
- **Size of the pool of liquidity** available to companies (but the Euro a contributing factor here).
- **Volume of trading activity**
- **Volume of new issues**
- **Share of financial services in GDP / employment**
- **Returns to savers / investors**
- **Productivity**

Some experts advised to include the aspect of **market innovation**:

- Has the **variety of products offered in the EU** increased?
- What is the **cost of borrowing in the high-tech sector**?
- Has the FSAP-driven deregulation and the measures allowing remote access led to **technological improvements**?

There was also a suggestion to include statistics from the **wider economy**, given the role of the financial sector in capital formation and financial intermediation.

Francesco Giordano (Unicredit Group) made two specific recommendations on assessing the FSAP's contribution to the achievement of the Lisbon goals:

- **Extend the London Economics (2002) study** on the same issue: the effects of integrated capital markets on investment, growth and employment via access to and cost of capital, taking into account liquidity, risk diversification, and competition factors for equity, bonds, and banking credit markets.

- **Assess the effects of retail markets integration, via competitive pressures, on prices of simple and widely used financial products, and then on efficiency gains** for the economy. Examine the usefulness of the Heinemann and Jopp study (2001) on the benefits of an integrated retail financial market (competitive pressure and economies of scale factors on specific products).

Other remarks

Eclectic approach: many experts underlined that it would be very complex to conduct a comprehensive evaluation of the impact of the FSAP due to a number of major obstacles (early timing, scarcity of data, filtering problem). Therefore they suggested relying on **models focused on specific aspects**. The Evaluation could **pick out some exemplary areas** likely to be influenced by the FSAP measures and investigate the developments and the causal links therein.

Macro (top down) / micro (bottom up) approach: the Evaluation could draw on both perspectives. E.g. capital flows to the EU are partly due to economic growth and partly to the regulatory environment. But it seems that the majority of experts endorse a more micro approach, starting from an assessment of specific aspects and trying to build up a picture.

Distribution of the FSAP benefits between the industry and the consumers: a question whether is should this be included in the analysis. The answers were rather negative, underlining that this was not an initial objective of the Action Plan and that such an analysis would be very difficult to carry out. The experts advised to focus now on identifying the efficiency gains and postpone the distribution analysis until a later stage.

Costs caused by the FSAP: many experts stressed the need to estimate quantitatively not only the benefits but also the costs of the FSAP, in particular the **costs of compliance**, which are ultimately passed on to investors and issuers. The Insurance Mediation Directive was proposed as an example for calculating the costs of compliance (due to alleged excessive documentation duties). There was also a suggestion to compare the cost of compliance between the EU and the US.

"One-size-fits-all" regulatory approach: some experts recommended assessing the potentially negative economic impact of the ignorance of national circumstances by the FSAP. However, no detailed advice on the methodology was offered.

Approaches proposed by experts

A number of alternative approaches were suggested by the experts, both during the Workshop and in the written contributions submitted beforehand or afterwards.

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Malcolm Levitt (City of London) insisted that a **clear definition of the Single Financial Market** is needed in order to evaluate the extent to which it has been attained. He defined the Single Market as an innovative and competitive financial market place within which:

- borrowers, issuers of securities and insurance policies, providers of pensions and of financial market services, will interact freely, on a non-discriminatory basis, with lenders, investors and policyholders, and pension plan purchasers,
- on the basis of common and proportionate prudential regulation and investor or customer protection,
- on a remote, cross-border basis, if they choose,

- and have access to all necessary market infrastructures, wherever located, without necessarily requiring a local presence,
- the market for corporate ownership will safeguard the interests of investors and operate within a framework of sound, proportionate corporate governance and takeover arrangements,
- and be subject to high quality financial reporting and auditing standards.

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Ton Berendsen (ABP Investments) proposed to use a **binary approach to distinguish the impact of the FSAP from other factors**. For each objective, one should survey, per country, what percentage of changes can be attributed to FSAP only, the rest being attributed to other factors. He also advised to:

- Assess the situation before and after the FSAP for each objective, per country,
- Identify a few top (3-5) major positive and negative differences,
- Identify the top 3 reinforcing and hindering measures,
- Use a limited number of key indicators, such as: growth, inflation, budgetary deficit, employment; access to capital via primary and secondary markets; cost of capital,
- Evaluate institutional investors and retail investors separately.

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Francesco Giordano (UniCredit Group) proposed the following methodology for distinguishing the impact of the FSAP from other factors:

- **Wholesale markets**
 - Compare the evolution of price and quantity based indicators within the EU vs. (a sample of) OECD countries to highlight specific patterns of EU integration and to exclude the effects of worldwide dynamics (e.g. globalisation).

- **Retail markets**

Main hypotheses:

- Retail markets are segmented owing both to customers' behaviour/cultural barriers and regulatory barriers, deriving from differing or inconsistent frameworks (e.g. on consumer protection, prudential supervision, taxation),
- Barriers of the first type result in the supply-side integration model in the EU. The creation of multi-country banking groups is thus the main tool of integration, given the characteristics of retail markets. Their smooth functioning may nonetheless be hindered by regulatory barriers.

The methodology:

- Indicators of integration, analogical to the indicators for wholesale markets,
- Performance of multi-country banking groups (top-down approach) – to insulate the effects of obstacles deriving from the regulatory/supervisory environment:
 - From a quantitative perspective, one could try measuring the cost and revenue efficiency of multi-country banks. In an integrated market, these should not differ

on average from banks which are mainly domestic, after controlling for statistically relevant variables (e.g. size, business mix orientation).

- From a qualitative perspective, a way to be explored is evaluating the current organisation of multi-country groups (in terms of centralisation/decentralisation of decision powers and macro-functions, e.g. back office, risk management, product development, distribution) against a “would be ideal in an integrated market” benchmark, to highlight relevant trends. The expectation is that, with greater integration, all functions except distribution should tend towards more centralisation, although with differing degrees according to strategies of single banks³.

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Leonie Bell (Oxera) advised to assess if any reductions in the cost of capital and prices have reached the **final consumers / users**. The benefits of regulation should be measured with respect to improvements in market outcomes for end consumers (eg. firms raising capital; retail consumers making investment, savings or other financial decisions). The Evaluation should not (only) measure intermediate changes but also the **final market outcomes**. She proposed the approach consisting in three steps:

1. **Final market outcomes** – the main expected benefits generated by the FSAP. These would be more practical criteria for evaluation than the FSAP Objectives, which are very general. Final market outcomes could be, for example, cost reductions or quality improvements for end consumers. Greater efficiency in wholesale transactions or better processes or structures within firms are not the final outcomes and should be regarded as intermediate changes along the value chain. In addition to market outcomes in the financial services sector, one could also identify benefits for the wider economy, e.g. increased GDP growth linked with higher corporate investment due to a lower cost of capital.
2. **Causal links** – the mechanisms through which regulation delivers final market outcomes. The Evaluation may need to consider a number of FSAP measures separately, in order to establish the market outcomes the various measures are intending to improve, the mechanisms to achieve such an improvement and the manner in which the measures interact to achieve the intended results.
3. **Empirical methodology** – developing the tools of analysis for measuring improvements in final market outcomes and validating the causal links between the FSAP measures and market outcomes.

Furthermore, Leonie Bell put forward an idea of splitting the **Evaluation into two lots**: first, developing a methodology (i.e. determining how to filter out the impact of the FSAP, which dimensions to measure, by what kind of indicators); and second, applying the methodology in an empirical analysis (the economic impact of the FSAP on the EU financial sector and wider economy).

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Peter Andrews (UK Financial Services Authority) proposed to establish what the intended impacts of the FSAP were. He considered that the ultimate aim was increasing economic welfare by leading to a situation in which a greater quantity of a greater range of more competitively priced services is consumed in Member States. This should be achieved by:

³ c.f. Kiehlborn (2005)

- **Correcting legal and regulatory failures** – i.e. situations in which differences in legal and regulatory systems between Member States create welfare losses as a result of impediments to trade;
- **Correcting market failures** arising in the national markets of Member States – to achieve a common minimum level of consumer, investor and depositor protection; typically this will mean measures designed to address the market failures “information asymmetry” and “(negative) externality”.

He suggested to start any analysis of the impacts of FSAP by (a) identifying markets in which a single market can naturally be created across the EU (so called **economic markets**) and (b) identifying in which of those possible single markets there would be, in the absence of the FSAP, a material **failure** such that government intervention can improve. Only in these markets can one really expect FSAP to have produced economic benefits.

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In addition, Peter Andrews listed a **number of approaches**, which could be drawn on for inspiration in establishing the methodological framework for the Evaluation:

- **Index variables related to a high level descriptor of the financial sector**, for example: the financial sector's contribution to GDP correlated with (i) a cross-sectional ranking (by country) of the size and severity of pre-FSAP supervisory barriers to entry or with (ii) the extent to which individual Member States have implemented FSAP. Such a model could be expanded to look at the **special case of accession countries**: a growth model might be used, incorporating terms to deal with labour and tax reforms etc. and catch-up terms (inward transfers to new joiners), plus the above index variable reflecting the extent of FSAP implementation.
- **Defining relevant economic markets** – i.e. any EC-wide product markets that are likely to have been materially affected by FSAP but are unlikely to have been materially affected by any other factors. Then, given the short time series, one would be looking in an econometric analysis for a structural break in whatever data is available (e.g. by using a Chow test etc).
- **Event studies** – for example the change in stock prices in a sector on the day that a new regulatory measure is announced. However, the condition here is that there has been no previous leakage of the event (news) that has already been discounted in stock prices (or other variable of interest). This condition is difficult to meet in practice. Besides, the changes of stock prices may reveal little or none of the final benefits of FSAP (i.e. benefits to the consumers)⁴.
- **Identifying characteristic market developments** from which inferences about the benefits of FSAP can be made: for example, the recent announcement by the world's biggest investment banks to create a pan-European system for trading shares and thus cut the cost of trading by up to 80% (i.e. to levels seen in the US). According to P. Andrews, this seems to be possible in practice as a result of MiFID. If the expected reduction in transaction costs is associated with savings in resources and an end to (or a reduction in) the malign effects of monopolistic pricing, then this would be a huge benefit arising from MiFID ameliorating or correcting a legal/regulatory failure.

⁴ As explained by P. Andrews, stock prices measure only the change in supplier welfare. If it is true that FSAP both liberalises markets and makes them more competitive, one might expect suppliers' gains from FSAP to be quickly competed away. Instead, the gains will accrue to consumers.

- **Data envelopment analysis** – trying to use DEA to model **change in consumption efficiency** under FSAP. One would need to focus on price/feature factors, while abstracting from “suitability” considerations. The important advantage of DEA is that it would allow snapshots of consumption efficiency to be taken before and after the introduction of the relevant FSAP measure, thereby avoiding the problem of the short time series⁵ (particularly relevant for assessing retail aspects of the FSAP).
- **Laboratory experiments** – P. Andrews suggested that consumer surveys can be unreliable because, for example, consumers often do not do what they say they will or pretend to understand things that they do not understand or give responses that they think will please the questioner. Moreover, even if consumers actually do understand a mandatory disclosure, such as the Total Expense Ratio of a collective investment scheme, it does not mean that they will in practice act on the information: they may simply do what their adviser tells them to. Laboratory experiments in behavioural economics can, albeit at considerable expense, avoid these problems and reveal how, say, disclosures mandated under FSAP interact with consumers’ decision heuristics and responses to the presence of experts. An attractive aspect of these experiments is that they allow precisely the disclosures under FSAP and precisely the typical disclosures prior to FSAP to be tested against each other for effectiveness in counteracting ignorance and principal-agent problems⁶ (particularly relevant for assessing retail aspects of the FSAP).
- **Cost-benefit analysis of specific programmes** – as pioneered by Mirrlees et al for the World Bank; typically applied to less-developed economies undergoing far-reaching reforms. The crucial element of this model is definition of the counterfactual (what would have happened without the intervention). However, the counterfactual is likely to be difficult to define for the developed economies of the EU Member States, which have complex interactions with each other and with a wide variety of non-EC economies.
- **Adapting the approach to assessing the impacts of accession to the EU on trade** used by Lejour, Solanic and Tang, amongst others. To gauge the dynamic effects of accession, these authors use a two-step procedure in which a gravity equation for bilateral trade shows the trade effect of EU membership and a growth regression yields the income effect of trade.
- **Adapting the IMF's Article 4 reviews of countries** – a more qualitative model.
- **Europe Economics' assessment of the benefits of MiFD** (for UK FSA) – a mixed quantitative and theoretical study, which includes an impressive checklist of benefits, that might be useful in the wider context of FSAP. The expected "**first round**" effects are the benefits that accrue to the firms and consumers directly affected by MiFID, such as reduced costs (of obtaining and maintaining authorization, of compliance, of establishing and maintaining market reputation; operating costs; transaction costs), improved access to new markets, improved prices, improved functioning of markets and increased competition in the publication of firms' data. Europe Economics also expects "**second round effects**" such as a reduction in the cost of capital and more efficiently directed investment (which should increase the productivity of investment and therefore GDP). Moreover, there may be "**third round effects**", such as higher growth rates and GDP in trading partners, which in turn will create new benefits for those implementing MiFID.

⁵ P. Andrews informed that the UK FSA plans to publish shortly some work of this kind on the mortgage market, building on work by Damien Ward.

⁶ P. Andrews advised that laboratories potentially able to handle such experiments exist at the LSE – David De Meza – and UCL – Mark Armstrong.

- **LECG study on CRD** (for UK FSA) – looks, inter alia, at changes in firms' cost functions that lower capital standards might cause (given the extent to which firms react to regulatory capital requirements) and, under the assumption that competition causes cost changes to be reflected in prices, considers for given demand elasticities the effect on consumption.
- **Studies for the European Commission:** PWC study on the CRD, London Economics study on mortgage regulation; London Economics (2002), CEPR (2002) and ISPC-ESAF (2005) on the benefits of financial services integration.

B) Specific advice and indicators

Panel I: Single wholesale market

Much advice was offered on ways to assess the impact of the FSAP on the wholesale financial markets, both on possible methodological approaches and on specific indicators.

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Ingrid Bonde (Swedish Financial Supervisory Authority) emphasised the difficulty in measuring success in regulation. She suggested some parameters of assessment from the supervisory / regulatory perspective:

- Economic growth (the last five years have seen strong growth in the financial sector, but what have been the contributing factors?),
- Number of financial failures (low in recent years, mainly attributable to financial growth),
- Development of international business (securities business fleeing the US to the EU: what are the causes?).

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Andrew Briski (Merrill Lynch) recognised that the Evaluation should be a first step in a long process. He confirmed that questions and indicators should be based on the Lisbon goals and on the original aims of the FSAP and suggested the following issues to be assessed:

- Where are the market efficiencies and inefficiencies?
- Is access to capital easier and cheaper?
- What is the EU global market share in attracting listings, and in innovating new products?
- Can global players act across borders?
- Has the clarity and robustness of cross-border regulatory systems been enhanced?

He also advised that the difficulty in distinguishing the impact of the FSAP impact from the impact of globalisation can be neutralised by **benchmarking** against progress in other major markets such as the US.

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Luca Filippa (Borsa Italiana) suggested analysing the impact of the FSAP on the EU capital markets from two perspectives: **internal and external** to the industry. He also suggested looking at the effects of **polarisation or diffusion** of common patterns in different countries.

Internal perspective:

- **Intermediaries** (the main market developments in this segment are likely to be FSAP-driven)
 - Concentration of operations in a few headquarters, with closure/ reduction of several local branches (if so, clear sign of being able to operate cross border)
 - (Increasing) direct membership in foreign Exchanges
 - (Increasing) direct membership in foreign post-trading systems
 - Evolution across time of rankings of main countries and Europe as a whole in M&A advisory services and underwriting
- **Stock exchanges**
 - Evolution of domestic listed companies' market capitalisation (need to identify causality)
 - Evolution of equity trading turnover (need to identify causality)

- Post-MiFID volume analysis of new trading venues (this needs the appropriate time delay and careful definition of metrics and statistical definitions adopted)
- Evolution of market share of foreign intermediaries in single exchanges' rankings for equities and derivatives (trade diversion vs. trade creation; polarisation vs. diffusion)
- Evolution of integrated cost structures of trading & post-trading services (end-to-end) (role of competition, benchmarking analysis)

External perspective:

- **Mutual funds and Pension funds**

- Changes in portfolio structure (checking if there is a trend towards convergence in the EU)
- Percentage weighting in the total assets at the Country level (checking if there is a trend towards convergence in the EU)
- Percentage weighting of domestic equities in the portfolio on single Exchanges market capitalisation (checking if there is a trend towards convergence in the EU)
- Evolution of assets under management, time series analysis
- Evolution of foreign assets in the overall AUM

- **Listed companies**

- Evolution of money raised through IPOs and (post-listing) capital increases
- (Where available) distinction of money raised from domestic versus foreign investors
- Evolution and taxonomy of takeovers:
 - Domestic versus foreign companies
 - Friendly versus hostile operations
- Evolution of the ownership structure by institutional sector (eg: households, institutional investors, banks, foreign investors, etc.)

- **Financial systems**

- Evolution of cross-border portfolio investments (clear opportunity to identify an FSAP/EU effect). Relevant source: International Monetary Fund Consolidated Portfolio Investment Survey (CPIS), based on single balances of payments, which, on an annual basis since 2002, has facilitated the identification of:
 - each country's gross and net position (see chart in next page)
 - a matrix approach for inflows and outflows (one country vs. all others)
 - overall values
 CPIS also offers the opportunity to consolidate a EU total figure.

Luca Filippa also mentioned it was important to look at **central bank activity's impact on household investments**.

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Malcolm Levitt (City of London) proposed the followign set of indicators to measure the success of the FSAP in integrating financial markets in the EU:

1. **Law of One Price** – for a comprehensive set of banking and insurance products (as selected in the Cecchini report); transaction costs for payments, clearing and settlement; issuance costs for debt and equity; returns on investment funds; asset management charges; interest rates and spreads; bid-offer spreads.
2. **Freedom of Entry** – market share of non-domestic institutions in sales of financial products.

However, two commercial considerations must be recognised:

- the costs of entry, even assuming there are no regulatory hurdles;
- the prospects for profitability post-entry in conditions of greater competition induced by entry into the market.

So long as profit prospects are low in relation to entry costs, non-domestic market penetration will be low. Similarly, the abolition of regulatory and other obstacles does not guarantee increased foreign market participation as consumer tastes differ and preferences remain varied among professional counterparties. Low foreign market share by itself cannot demonstrate non-market obstacles to entry.

3. **Investor Choice** – shares of non-domestic assets in institutional and personal investment portfolios.

However, the freedom of choice for investors does not imply convergence towards – or even the existence of – identical portfolios across Member States, including the ending of “home country” bias:

- institutional investors in different countries face different risk/liability profiles, especially demographic in the case of life and pensions business;
- economic risks against which investment hedging is sought, such as cyclical behaviour and inflation, have national characteristics which remain strong even within the Euro zone

4. **Issuer Choice** – share of non-domestic issues in total issues and share of issues by domestic companies made in other countries.

- the share of foreign issues in total issuance in a country will be a pointer to the openness of that country’s capital market
- the extent to which companies registered in a country make issues elsewhere will suggest their freedom of choice.

For any of the above, where differences across Member States and/or over time are found, a number of statistical questions arise:

- Are the differences significant or attributable to chance alone?
- Do any significant correlations exist which might indicate directions of causation? E.g. are there any statistically significant relationships between measures of (i) foreign presence and (ii) product prices or profitability? M. Levitt assured that a number of econometric techniques are available for this sort of analysis, provided that sufficient data (over a run of years) exists.

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Bernhard Speyer (Deutsche Bank Research) proposed a comprehensive range of indicators in four areas: price, volume, international comparisons and companies' internal organisation.

1. **Price indicators**

The law of one price⁷ should be a paramount criterion for measuring financial markets' integration.

Price convergence

- **β-convergence** – measures whether convergence is taking place (spread between interest rates, government bond yields) and provides an indication on the speed of adjustment of individual countries levels to some common benchmark value. Similar measures can be

⁷ Situation whereby assets generating identical future cash flows command the same return (Speyer)

constructed for other asset classes (loans, equity risk premia) provided that homogeneous asset classes are selected (e.g. corporate loans that carry the same rating);

- **σ-convergence** – measures whether the variability of interest levels for identical assets in different countries becomes smaller over time (e.g. for interest rates).

Both convergence indicators can be calculated and observed at different points in time providing evidence on the progress towards integration. They can also be calculated for different market segments thereby highlighting different speeds of market integration across product categories.

Cost of capital

In an integrated market there should be reduction in prices and cost of capital stemming from the economies of scale.

- **Cost of capital** – yields and risk premia. Reflect the overall efficiency of financial markets as well as overall economic conditions.
- **Transaction costs** – levelling out of commissions and fees in cross-border transactions. May be interpreted as a more straightforward expression of the level of competition between intermediaries. Care should be taken to look separately at fees and commissions paid to banks and other financial intermediaries on the one hand, and legal fees on the other hand (except for the Prospectuses Directive, the FSAP has not included measures that would have introduced greater competition in legal services).

Concerning price indicators, attention should be given to possible violations of the law of one price due to economic (asymmetric information) or regulatory reasons (capital controls, different tax regimes, accounting differences, bankruptcy laws, the relative status of creditors / investors vis-à-vis debtors).

2. Volume indicators

Cross-border flows

- **Cross-border trade with securities**
- **Inter-bank loans**
- **Extent of cross-border lending** – as an additional, separate measure for credit market integration (theoretically, the extent of cross-border deposit-taking could also yield additional insights, but due to distortions of banks' liability-side business – e.g. tax-advantaged deposits offered in some, but not in other Member States – an objective benchmark portfolio is harder to define for liability structures)

B. Speyer, supported by many other experts, insisted that **volume indicators are not a direct indication** of market integration and should therefore only be used as additional source of information:

- Higher cross-border flows are not necessary to bring about market integration: contestability, not actual competition is the requirement for a price alignment, the desired effect of market integration can be achieved without an actual increase in cross-border flows;
- The law of one price can be satisfied without higher capital flows if prices were similar in both markets ex ante;

- Higher cross-border flows may not be sufficient to bring about market integration, as markets may remain separated despite higher cross-border flows, e.g. due to legal restrictions or the market power of banks because of diverging demand structures.

Furthermore, any development in volumes in the EU should be compared to volume developments in other financial markets, in order to assess whether developments in the EU reflect a broader, global trend or a specific trend in the EU.

Portfolio allocation

- **Portfolio allocation of institutional investors**, e.g. pension funds (on a consolidated basis) – to measure the extent to which home bias is overcome. The appropriateness of asset allocation must ultimately be checked by looking at the portfolios of end-users, which should be optimally balanced and diversified. Therefore, the geographic diversification of institutional investors should be measured against the aggregate assets of all institutional investors (not by looking at individual firms or funds).
- **Geographical composition of banking assets** – can also be regarded as a portfolio, where a similar rationale exists for a geographical diversification of loans. This is best done by looking at group-wide data of individual institutions, as this captures all forms of non-domestic lending (via subsidiaries, branches and direct cross-border).
- **Geographical composition of banks' earnings from non-domestic lending activities** – would, in addition to giving insights into geographical composition of business, also offer insights into the pricing of lending in non-domestic markets, which, in turn, would give hints as to market entry strategies and the level of competitiveness in foreign markets (however, not all financial institutions provide a geographic breakdown of their earnings structure.)

Market share of foreign suppliers

Balance-based indicators:

- **Share in outstanding stock of assets** – for any asset class
- **Share in new business volume** – considering that stocks may be large relative to new business (e.g. in the corporate loan market)

Other indicators:

- **League tables** – is there less home bias in selecting book runners or lead managers for loan syndication?

3. **International competitiveness / benchmarking**

- To measure if the EU has become a more attractive area for non-EU issuers and if there has been an increase in inbound investment to the EU markets:
 - **Number of foreign issuers and their issuance volume**
 - **Number of third country listings on the EU markets**

All of the above measures both in absolute and in relative terms (i.e. relative to figures for EU-based issuers; relative to the total of global non-domestic issuers and issuance volumes).

- To measure if the EU has become a more attractive business location for non-EU intermediaries:

- **Number of offices set up**
- **Increase in numbers of staff employed**
- **Capital allocated to the EU operations of foreign companies**
- The same indicators could be used to measure foreign expansion of EU-based financial institutions.

Another point raised was that one should use different benchmarks for different market segments, because there is no single leading financial centre in all segments and leading financial centres may not be suitable benchmarks in some market segments. Specifically, as regards the US financial markets, the US mortgage backed securities market is heavily distorted by the existence of the government-sponsored entities (Fannie Mae, Freddie Mac).

4. **Firms' organisational structure**

Economic theory would suggest that, following the integration of financial markets in Europe, firms would adjust their internal organisational structures in order to take advantage of:

- a) economies of scale
- b) local comparative advantages.

In particular, internal structures that were dictated not by commercial, but rather by legal and regulatory logic, should be re-examined in a more integrated market.

Questions suggested for surveys:

- **Did firms centralise functions in order to streamline operations, to exploit economies of scale and to centralise management?** For instance, a unified regulatory environment would suggest centralising risk management and compliance functions. Similarly, convergence of regulation as well as convergence of preference would suggest a centralisation of product development and management.
- **Did firms allocate business functions according to the comparative advantage of different locations within the EU**, with services being rendered for customers within the entire EU from this location? Example: Have financial firms concentrated their asset management, their loan book, their trading operations for individual products, their issuing activity, etc. in a single location within the EU (not necessarily the same one for all functions)?

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Other proposed indicators and remarks:

Price

- **Country effect for corporate bond spreads and equity returns** – size and significance
- **Inter-banking market rates** – e.g. Euro base rate in accession countries over time
- **Price dispersion** – in product markets affected by FSAP
- **Absolute differences between levels of interest rates in MS** – for example, it could be measured how quickly a common interest shock is reflected by changes in interest rates in Member States.
- **News based indicators** – the proportion of asset price changes that can be explained by common shocks. This measure would assess to what extent interest rates and asset prices

are affected by common news as opposed to local news. If markets are perfectly integrated, local news should have no or negligible impact on asset prices as these news can be fully diversified away.

- **Competition and concentration indicators**

Volume – Portfolio allocation

- **Central banks' reserves** – e.g. share of Euro-denominated assets in non-Euro zone central bank reserves

International competitiveness

- **Evolution of investment by third country investors via the EU exchanges** – to approximate investors' confidence in and liquidity of the EU capital markets
- To be asked in surveys:
 - **Motives behind moves outside the EU** – using opportunities in other markets or lack of confidence in the FSAP?
 - Has EU increased its global **market share in the development of innovative products**?

The experts reminded that the **competitive environment outside the EU** is not standing still. For example, evaluating the reasons why any new listings have come to the EU, and how much of this was due to the FSAP, will be particularly difficult given the external events that may have tilted the global playing field. According to the example presented by Jens Roder, in the past 18 months the London Stock Exchange has attracted 152 international (non-UK) companies to its markets, whereas the NYSE and Nasdaq have only attracted 54 international companies. Some of this is clearly related to the negative externalities of the US Sarbanes Oxley Act. It will be also difficult to filter out impact of national taxation systems.

Panel II: Open and secure retail markets

The experts emphasised specific features of retail markets, such as their **local nature** and importance of **personal relationships**. This is linked with information asymmetries and customers' behaviour (deriving from structural, cultural and psychological factors, e.g. different languages, importance of trust, long-term relationships), which create barriers to remote provision of financial services. Nevertheless, legal and regulatory barriers to cross-border flow of services may also persist. The development of IT (the Internet in particular) and the related multi-channel distribution strategies are likely to gradually change the picture.

However, some experts disagreed with the thesis that retail markets for financial services are local by nature. For example, Bernhard Speyer (Deutsche Bank Research) stated that the percentage of EU citizens able to speak foreign languages and contract with foreign suppliers is still high enough to present an attractive market. He reminded that the purpose of creating a single financial market in the EU is creating trading opportunities, and not creating trade itself.

Some experts questioned the contribution of the integration of retail markets in financial services to the achievement of the **Lisbon goals**. Otto Lucius (Austrian Society for Bank Research) gave an example of the United States, where a ban on inter-state banking did not prevent the economy from becoming one of most competitive economies in the world. However, in other experts' views more integration in retail financial services would contribute to greater mobility and job opportunities.

Most experts suggested applying two types of analysis for the retail markets: **quantitative** (e.g. volumes for financial services distance selling, number of cases of fraud and counterfeiting in payment systems) and **qualitative** (based on surveys, e.g. information for consumers, transparency).

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Peter Andrews (UK Financial Services Authority) was concerned that assessing the impact of the FSAP on the integration of retail markets would give an inappropriate impression of failure, as **integration was not the original aim** (but making the retail markets open and secure). The retail measures formed a very small part of the FSAP as a whole.

He presented the **market scenarios** which – if they had happened – would have confirmed that the FSAP has had a positive impact on retail markets:

- If buyers buy a product at a lower price than would have been the case without the FSAP, or;
- If they have greater information about their product and are more aware of its risks and rewards, or;
- If they buy a different product.

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Francesco Giordano (Unicredit Group) advised that integration of retail markets is **more supply-related**, than demand related. Analysing the integration from the demand side would be flawed owing to differences in national characteristics. Therefore one should measure the integration from the supply side (*e.g.* products available on an EU scale). A number of experts supported this view. While demand remains local, integration on the supply side can be driven by expansion of multi-country banking groups, which can associate local brands and distribution with centralised functions (product development, back-office, risk management)

and group brand. Thus integration will result in increased competitive pressures, leading to sharing of production technologies and competitive advantages between countries.

Macroeconomic indicators measuring integration in general

Francesco Giordano proposed to employ macroeconomic indicators to measure the level of integration of retail markets:

- **Correlation between national savings and investment** – in integrated markets, this should decrease over time. However, one should take into account time varying factors which may induce endogeneity of the saving rate with respect to the investment rate.
- **Correlation of consumption growth rates among countries** – its degree signals risk sharing capabilities. In an integrated financial environment, there should be no correlation with country-specific shocks, but a perfect correlation with Europe-wide shocks.

However, F. Giordano expressed the reservation that relative volatility and short time series undermine the usefulness of these indicators for the Evaluation.

Banking

Some indicators for measuring the integration of retail banking were proposed by Remy Contamin (Credit Agricole), covering price and volume indicators. His input was complemented by suggestions of other experts.

Price indicators

- **Interest rate spreads in:**
 - **Mortgage markets**
 - **Consumer credit markets**

For a meaningful comparison the interest rates should be corrected for the average underlying risk.

- **Total revenues of financial intermediaries, including fees, commissions, insurance premiums.** Interest revenues as a percentage of total revenues in retail banks has been declining considerably in recent years, therefore the assessment of development of prices of financial services should not be limited to interest rate.
- **Price of cross-border vs. domestic payment services**
- **Product costs** (by product types)

Remy Contamin noted that for the price indicators comparisons can only be made on simple standardised products. This is greatly complicated by the current trend of offering diversified packages of goods and services by financial intermediaries, for which complex systems of charges are being put in place (e.g. low revenue products being supported by cross-subsidisation).

In other words, any analysis based on "mono-line" models would fail to grasp the generalisation of full-service bank models which are more complex in terms of their product offering and the related pricing systems.

Furthermore, Remy Contamin remarked that not only price convergence is a relevant indicator, but also absolute price levels (if too high, detrimental to consumers; if too low, detrimental to the industry).

Francesco Giordano questioned the applicability of the law of one price in the EU retail financial markets because of the lack of integration of the related markets (e.g. the labour market). Different labour costs and price indices between countries may be reflected in local financial product prices.

Otto Lucius warned against the use of price indicators. He claimed they do not measure the level of integration but rather of competition. He brought forward an example of the Austrian retail banking market: despite very few foreign suppliers, margins in Austrian retail banking are among the lowest in Europe, and therefore the prices for customers are very favourable.

Volume indicators

The volume indicators bear the risk of providing a very partial view, since the cross-border provision of retail financial services remains structurally limited (as explained above):

- **On-balance-sheet and off-balance-sheet flows** – e.g. cross-border provision of loans or bank accounts. A decline in flows should not always be interpreted negatively, because it could signal price convergence.
- **Measures of the degree of internationalisation of financial intermediaries** – i.e. M&A, branches, subsidiaries, joint ventures, banking and non-banking partnership agreements (resulting in transfers of expertise, knowledge and even products). A difficulty is to distinguish the extent to which such moves by companies are driven by integration rather than financial reasons such as risk diversification, especially within relatively short time frames.
- **Share of domestic loans/deposits controlled by cross-border banking groups.**
- **Autonomous international growth of certain retail financial products standardised on a pan-European basis** – in particular some types of consumer credit, but also asset management (UCITS) and insurance products (investigating the product characteristics and market integration trends)
- **Market share of direct banking activities vis-à-vis traditional distribution channels** – for example for savings, loans. Could be a proxy for the impact of the Distance Selling Directive.

Insurance

Paul Carty (BIPAR, Coyle Hamilton Willis) stated that the evaluation of the economic impact of the FSAP is irrelevant to retail insurance at this stage. There is very little cross-border offering of services and business will remain local for some time to come. Many of the key measures in the retail insurance area (e.g. IORP, Insurance Mediation Directive and MiFID) will not be fully implemented in time to allow for collection of data for the Evaluation. Lack of the relevant economic indicators throughout the insurance sector for analysis is a major problem. Also, insurance's contribution to Lisbon strategy is probably indirect and not immediately measurable. So it would be more relevant to only pose certain questions now and try to answer them later.

Paul Carty made the following points on methodology:

- **Link between Part 1 and Part 2 of the Evaluation** – aspects that should be assessed include incoherence and inconsistency in application of insurance legislation; e.g. “general good”/ goldplating provisions creeping in, particularly in Insurance Mediation Directive.
- **Cost of regulation** – e.g. of information requirements and compliance.

- **Innovation in products** – e.g. does FSAP allow products to offer social protection alongside the state? Will new products be developed as a result of freedoms under FSAP?
- **Market failures** and their impact on consumer confidence (some market failures in the insurance sector in recent years).
- **Consumer attitudes, awareness and confidence** – measuring of these should be started as a benchmark now.

Jens Roder (PwC Denmark) raised the issue of provision of **private pension schemes**, which is a very fragmented market because of the inability to carry tax incentives across borders in pension schemes. He suggested evaluating the impact that that has on allowing retail consumers to choose freely those pension schemes that would give them the greatest benefits in terms of return.

Investment funds

Bernard Delbecque (EFAMA) stressed the success of the **EU harmonised funds (UCITS)**, which have become reliable popular savings product, with increasing cross border participation. He suggested that the experience built up with UCITS could be applied elsewhere e.g. concerning investor protection, information disclosure.

Consumers and users

The experts suggested that the benefits for customers and investors resulting from the FSAP measures are particularly important in the Evaluation, based on the assumption that growth of financial markets should be translated into increased consumer welfare, i.e. greater variety of financial products at lower prices.

The suggested indicators were of rather of a qualitative nature: **level of consumer/user confidence, satisfaction, availability of information and transparency**; but also quantitative: e.g. **lower costs for consumers and investors**.

Manfred Westphal (FIN-USE) advised **interviewing suppliers** on the reasons for which they (do not) offer products cross-border, **and consumers** on the reasons for which they (do not) buy financial services in other Member States. He stressed the importance of regular surveying of companies and consumers in order to monitor the **attitudes of market participants**. Some experts remarked that in framing questions to consumers one has to be careful not to influence the answers (e.g. in drawing attention to different consumer protection regimes, and not just obvious issues such as language and history).

Referring to psychological barriers on the consumer side, Manfred Westphal emphasised the importance of advice. Related to that, he recommended for the Evaluation to **distinguish between more complex products**, which must be explained in a face to face meeting with the customer, **and simple, standardised products**, which for example are suitable for distribution via the Internet. Some experts pointed to the difficulty in making comparisons owing to the **personalisation** of many retail financial products and services.

The Commission was also advised to take into account the aspect of **access to finance** with regard to certain categories of population (e.g. geographic coverage, lower socio-economic groups etc.). In particular, **SMEs' access to finance** should be given attention in line with the Lisbon Strategy. Otto Lucius (Austrian Society for Bank Research) claimed that the financial needs of SMEs, which constitute the vast majority of the EU enterprises, are not catered for by most of the FSAP measures. He also recalled that SMEs' behaviour and bargaining position are similar to those of retail customers.

Otto Lucius proposed some customer-related indicators of retail banking integration (expressed as share of total number / volume):

- **Non resident customers**
- **Accounts held by non residents**
- **Deposits held by non residents**
- **Products sold to non residents**

Panel III: Wider conditions for an optimal single financial market

Much of advice received in panel three pointed to the difficulty of assessing the impact of corporate governance, company law, accounting and auditing measures and the even greater difficulty of separating their impact out from the impact of other FSAP measures. Many of the proposed indicators repeated the indicators proposed for the assessment of the other FSAP Objectives, for example in the area of the wholesale markets or supervision.

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Marco Becht (Université Libre de Bruxelles) stressed the importance of Corporate Governance in the field of financial services, linked to policy makers' increased awareness of the importance of the control rights. The misallocation of such rights, in particular when caused by badly conceived or insufficient regulation, can have significant negative **effects on the real economy and economic growth**. In this context Marco Becht mentioned examples of control rights linked with equity (voting rights), debt (control takeovers in the event of insolvency according to bankruptcy and insolvency laws) and Private Equity funds (combination of cash-flows and control rights). Broadening the scope, he mentioned the issue of governance of financial intermediaries (banks, insurance companies, mutual and pension funds), which is important both for their shareholders and for the companies in the governance of which intermediaries are becoming increasingly involved.

Concerning the methodology, Marco Becht made the following points:

- The Evaluation is an extremely difficult exercise because of the **absence of the counterfactual** – the lack of picture without the FSAP makes it impossible to discern the difference the Action Plan has made. Possible solutions include devising a model of the EU without the FSAP; comparing the EU to countries which have not had the FSAP or look at historical examples in other countries (example of Israel mentioned for the case of "one share one vote" principle).
- Difficulty in obtaining **reliable and comparable data** in the EU, especially in contrast to the US (one of the reasons: different disclosure systems for listed companies in the Member States).
- Need to invest more in **research in the area of financial services**: little was spent on research on the FSAP under the 6th Framework Programme, so an effort should be made to improve the situation under the 7th FP.

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Rob Pieterse (EALIC – VEUO) proposed the following set of indicators for assessment of the FSAP impact on corporate governance:

- **Foreign listings and IPOs**
- **The market engagement of foreign investors** – including examination of UK investors' engagement in the continental Europe (Mr Pieterse informed that 85% of the Dutch market is in foreign hands)
- **Participation in annual general meetings**
- **Listings on more than one stock exchange** (the number expected to fall)
- **Consolidation of stock exchanges**
- **Rating / ranking of companies by consultancy bureaus**

R. Pieterse advised also to try to assess the impact of **shareholder activism** on EU companies and on the wider economy, which he considered to be both positive and negative (in extreme cases).

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Jens Roder (PriceWaterhouseCoopers Denmark) advised to assess the evolution of the **risk/return ratio** in the EU. Given the increasing competition from emerging markets, the EU and other “old economies” find it difficult to compete on returns, so efforts have to be exerted to ensure a low risk business environment to attract investors. Another indicator could be **efficiency of the EU markets in brokering the best deals**, which depends on the conditions for capital transactions.

J. Roder was convinced that the **introduction and thorough application of International Financial Reporting Standards** was crucial for enhancing investor confidence and the international competitiveness of the EU capital markets. He proposed to assess the level of consistency, speed and efficiency of IFRS implementation in the EU to measure the success of the FSAP. Other indicators he suggested:

- **The increase in cross-border financial M&A transactions** and decrease in domestic M&A transactions (by segment), also in comparison with the US.
- Evolution of the **costs of transactions** within the EU
- Volume of **third country investment into the EU financial services sector i.e. in the form of listings or investors investing through EU stock exchanges** (to approximate third country investor confidence and the increasing liquidity and cash flow throughout the EU capital markets).

Discussion on data

The exchange of views following the interventions of the speakers focused specifically on problems with the availability of data that would enable the assessment of the situation in the EU Corporate Governance area. The difference in the quality and completeness of databases available in the EU and in the US was deplored. Different languages and the two- level reporting structures (national statistical offices and the Eurostat) were identified as major complicating factors. Many experts (also in other panels) emphasised the need to have the right database in the EU to foster research in financial services.

Panel IV: Prudential supervision and the Lamfalussy process

The experts confirmed that the Evaluation should examine the efficiencies of the cross-border regulatory system in the EU by analysing "intangible" factors of financial markets' attractiveness, such as supervision and prudential soundness, quality of regulatory systems (including implementation and enforcement), flexibility and innovation.

Still, some experts were ambivalent about extending the analysis to the area of prudential supervision, pointing to the difficulty in measuring the economic effect of prudential measures and arguing that supervisory quality and cooperation varies considerably between measures (e.g. the Settlement Finality Directive is just a legal structure whereas the Market Abuse Directive and the MiFID require closer cooperation between supervisors).

Many experts pointed to the importance of distinguishing the quality of regulatory supervision from its complexity.

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Francesco Giordano (UniCredit Group) suggested evaluating the progress in the area of supervision by assessing two aspects:

1. **Qualitative:** impact of the Lamfalussy process on improved **effectiveness of prudential supervision**, resulting from the promotion of convergence (Level 3) and streamlining of supervisory practices and requirements (as well as more generally of supervisory cultures). The expected outcomes of the Lamfalussy process are financial stability (both at individual and systemic level) and resistance to systemic shocks. The qualitative assessment could focus on convergence in specific areas, such as: national discretions, CRD model validation, Pillar II issues, reporting (cf. the work on common reporting framework by CEBS – COREP for supervisory reporting, FINREP for statistical information reporting).

However, Francesco Giordano stated that in many instances it is still too early to have a comprehensive assessment of the Lamfalussy process in the banking sector. The implementation of Capital Requirements Directive (CRD) in the coming months and years would provide more evidence.

2. **Quantitative:** the **cost of regulatory obstacles** for banks. However, several difficulties are presented:
 - The limitations of internal data
 - The complexity involved in allocating costs per function instead of per unit
 - The difficulties in distinguishing the effects of regulatory requirements from those of risk technology advancement (interdependence between regulation – market best practice)

F. Giordano informed that some research on the costs of regulatory obstacles had been undertaken by the European Financial Services Roundtable.

He also mentioned that another aspect of the Evaluation could be to assess the **changes resulting from progress in risk management** generated by CRD, for example by looking at changes in companies' (banks') structures. This, however, would depend on data provision by banks.

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Isaac Alfon (Prudential) suggested prioritising between the various prudential measures of the FSAP and focussing on the strategic issues. He suggested to concentrate on the **Financial**

Conglomerates Directive (FCD), rather than on Directives which have not yet been fully implemented (CRD) or are still subject to change (Solvency I). He advised to conduct a cost-benefit analysis to assess the impact of the FCD on financial conglomerates, concentrating on the following aspects of the Directive:

- It takes into account risks in financial conglomerates (“double gearing”) but does not take into account the benefits of group diversification.
- Group supervision is just an add-on to supervision of legal entities.

I. Alfon also enquired how to take into account the specific context of prudential regulation, for example capital holdings by insurance firms, which are not necessarily determined by regulatory capital requirements as they often exceed the requirements. He stressed the need to look at firm behaviour rather than regulation per se. He also suggested that the effects of regulation on the international environment should be taken into account.

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István Farkas (Hungarian Financial Supervisory Authority) suggested an approach based on process, progress and results. On the process, he suggested to enquire if the most important objectives were identified in the FSAP to take account of changing market realities and if they are measurable. On the progress, he considered that the focus should be on the supervisory cooperation (the integrated approach) and on the transposition of the FSAP directives. On the results, he advised that the effects of the FSAP and the Lisbon strategy can be examined from three perspectives:

1. **Market** (e.g. depth and width of financial markets),
2. **Supervision**: cross-border (formal; e.g. Memoranda of Understanding, and informal; e.g. networking) and cross-sectoral (e.g. integrated supervision model, cooperation in Level 3 committees),
3. **EU institutions** (e.g. progress achieved with the FSAP measures, Better Regulation concept).

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Peter Andrews (UK Financial Services Authority) doubted if it would be possible to separate the supervisory impacts of FSAP from its other impacts using the market statistics. Therefore he proposed to use an “**economic analysis of principle**” for assessing the impact of the FSAP in the area of prudential supervision, which consists in the following steps:

1. **Identifying economic markets**– relevant segments of the EU financial sector likely to be affected by FSAP supervisory measures;
2. **Checking for existence of regulatory and market failures** – market imperfections which can be expected to be improved by a correct regulatory intervention (e.g. liberalisation) rather by sole forces of the market itself;
3. **Matching the failures with specific FSAP measures** – check which measures are justified and can in principle bring benefits;
4. **Assessing if the identified measures bring net benefits** – investigate whether a measure is likely to solve the problem and if there is a good fit between the nature of the problem and the nature of the regulatory intervention;
5. **Conducting "high level" cost-benefit analysis** – assess the scale of benefits likely to have been realised (using general market data).

In other words, for each relevant economic market, it should be investigated if one can identify a clear chain of causation in which the specific measures trigger economic mechanisms that operate to correct the failure(s) identified and improve market outcomes, without imposing large costs.

The “economic analysis of principle” is more straightforward than full empirical analysis and also less exacting in terms of data and methodology requirements. Yet it can yield reliable and credible results. It can also be complemented by empirical analysis of available data. The obstacles to the economic analysis of principle are the lack of impact assessment before the launch of the Action Plan, and, consequently, the lack of definitions of economic markets, failures and causal links.

Lamfalussy process

Peter Andrews advised to test the Lamfalussy process against the criteria of "**smart regulation**": an overall scheme of rules, principles, guidance, monitoring, detection and enforcement that drives outcomes in the market towards the ones that the regulator sought⁸. One would expect the Lamfalussy arrangements to **produce greater net benefits than the alternatives** of no arrangements or a single regulator. Consistent supervisory rules across Member States lower cross-border transaction costs for firms. This may encourage firms to trade, thereby increasing competition and lowering price of services, which benefits consumers. Relative to a single regulator, the advantage is that these benefits are obtained while the severe costs of insufficient sensitivity to local conditions are avoided.

Bernhard Speyer (Deutsche Bank Research) claimed that measuring the progress achieved thanks to the Lamfalussy process is one of the easier parts of the FSAP evaluation. Level 3 work to achieve convergence of supervisory practices could be measured by **comparing current supervisory practices**. It is equally straightforward to measure trust between supervisors by looking at how much supervisors make **use of delegation of tasks and responsibilities**.

Isaac Alfon found it useful to distinguish between the implementation of EU measures and **day-to-day supervision**, and suggested to tackle the two in different ways. He considered that progress on day-to-day supervision would be more difficult to assess. As an example, he mentioned peer reviews of supervisory practices to spread around best practices.

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Closing discussions in the panel, Phillip Hartmann recalled the new ECB paper (*The Performance of the European Financial System*, August 2006) covering 41 indicators for measuring financial system development, grouped by 8 dimensions:

1. Size of capital markets and financial structure
2. Financial innovation and market completeness
3. Transparency and information
4. Corporate governance
5. Legal system
6. Financial regulation, supervision and stability
7. Competition, openness and financial integration
8. Economic freedom, political and socio-economic factors

He emphasised potential synergies between the ECB work and the Evaluation.

⁸ Quoting: Malcolm Sparrow "The Regulatory Craft".

Annexes:

Recommended studies and sources

- Adam K., Jappelli T., Menichini A., Padula M., Pagano M. (2002) “*Analyse, compare and apply alternative indicators and monitoring methodologies to measure the evolution of capital market integration in the European Union*”
- Cecchini Report – the report noted the existence of economically significant price differences for a sample of 16 financial products across Member States. Suggestion that the Cecchini products/services should be re-surveyed and others added e.g management fees for retail investment funds.
- ECB (2005) “*Indicators of financial integration in the euro area*”
- ECB (2006) “*The Performance of the European Financial System*”
- European Commission (1997) “*Single Market Review*” – an attempt to update the Cecchini Report.
- European Commission (2004, 2005, 2006) “*Financial Integration Monitor*”
- European Commission (2006) “*Interim Report II - Current Accounts and Related Services*”
- Heinemann F. and Jopp M. (2001) “*The benefits of a working European retail market for financial services*” – sponsored by the EFR
- Kiehlborn T. (2005) “*Effects of EU financial integration on banking configuration and coordination strategies – Propositions and evidence*”
- London Economics (2002) “*Quantification of the Macro-Economic impact of integration of EU financial markets*” – sponsored by the Commission.
- Oxera for the UK Office of Fair Trading (2004); a study on the impact of the UK Financial Services and Markets Act 2000 on competition in the UK financial services industry, lot 1: the methodology, and lot 2: the empirical analysis;
- Oxera for UK FSA (2006) “*A framework for assessing the benefits of financial regulation*”
- UK FSA (2006) “*Guide to Market Failure analysis and High Level Cost-Benefit Analysis, Version 2*”

Exemplary questions for surveys

By Bernhard Speyer (Deutsche Bank Research):

- *Companies* should be asked about their sources of finance, incl. their motives for contracting with non-domestic banks (both from other EU member countries and non-EU countries) – or the reasons for not contracting with them. Survey could also include information on borrowing conditions, such as collateral requirements demanded by creditors from different countries. Moreover, firm-based surveys should be used to provide insights into the reasons for firms’ decisions for a specific finance structure, i.e.

the menu of financial instruments they use: Whereas, in segmented markets, firms are forced to use domestically available financial instruments only and to tap a domestic investor base only, in integrated markets firms have access to a wider range of instruments and a broader investor base. This will hold all the more true for medium-sized firms (large multinationals have had access to global capital markets for some time already) making it important that the selection of firms surveyed includes a representative number of medium-sized and smaller firms.

- *Institutional investors* should be asked about the reasons for their portfolio allocation, incl. reasons for home bias; reasons for their choice of intermediaries and execution platforms; their choice of distribution channels and their pricing models. All of these choices should also be rated against potential alternatives and it should be investigated why institutional investors chose to change or not to change amongst alternatives.
- *Financial intermediaries* should be surveyed about changes in their business range, business model and geographic market coverage. In addition, it could be canvassed whether these firms re-organised their internal organisations following FSAP as regards the geographic allocation of their business activities within the EU and beyond.
- *Surveys targeted at specific measures:* Surveys can and should also include questions directed at specific FSAP measures. To give a few examples:
 - *The Prospectus Directive:* issuers could be canvassed as to whether they issue in more Member States than they used to and whether they are able to use a single prospectus for this?
 - *The IAS regulation:* issuers can be asked whether it has increased the willingness of companies to use IFRS even if they do not have to do so on a statutory basis. In addition, institutional investors can be asked about how they judge the quality of IFRS based accounts.

By other experts:

- Is access to capital easier and cheaper than it was before the FSAP or than it is elsewhere?
- Can companies truly operate across borders in the EU without restrictions?
- To what extent have impediments to the attainment of a single market been removed?
- To what extent have specific FSAP market opening measures achieved their goals?
- Would any other measures (e.g. targeted amendments to pre-FSAP legislation) have been more cost-effective?
- Which single market/FSAP measures have been the most cost-effective and which the least?
- Did the FSAP measures play a role in strategic decisions taken by firms? If so, how?