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Newsletter on Financial Services

The Fin-Focus Newsletter gives an overview of European Commission initiatives in the field of financial services, while focusing on those aspects of financial services most relevant to users and consumers. This newsletter is part of the Commission's Financial Services Policy for 2005-2010 and will be published twice a year. For further information, consult the homepage http://europa.eu.int/comm/internal_market/finances/index_en.htm

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US sub-prime mortgage crisis – does it affect Europe?

How did the crisis start?

The sub-prime mortgage financial crisis began in the United States in 2006. Loans were made to borrowers with weaker credit histories, who would not normally qualify for a standard mortgage. Unfortunately a fall in US house prices meant that many home owners were now unable to meet their financial commitments, and as such, there was a sharp increase in the number of foreclosures in the sub-prime mortgage market. These circumstances led to several major sub-prime mortgage lenders to either close or file for bankruptcy. So why does this effect us in Europe? The answer lies in the extent to which the global financial markets are inter-connected.

Traditionally the risk of someone defaulting on a home loan, the credit risk, was held by the company who issued the loan – traditionally a bank. However, through securitisation, the credit risk associated with these sub-prime mortgages was transferred to the wider financial markets, including to European investors. Once there were foreclosures on sub-prime mortgages in the US, there were no longer mortgage repayments to cover these loans, which made the sub-prime mortgage backed securities lose value. A further problem was that nobody actually knew where the asset-backed securities were located in the market, only that the investors were spread across the globe. This uncertainty made the global financial markets highly volatile and cautious. As a result, credit became more difficult to obtain. The US-specific sub-prime mortgage crisis had now become a world-wide financial crisis.

Does the US mortgage crisis affect European investors?

Financial markets are closely inter-connected. A downturn in one country affects other countries' economies. In order to address challenges arising from the recent financial turmoil, the Commission has set itself an objective to improve transparency, risk management practices and valuation of financial instruments. The Commission's work in areas such as mortgage credit and consumer education should help achieve this goal.

Moreover a number of new issues have been identified as requiring further work. There is a need to be able to better locate risks in financial markets, to find good valuation methods for securities, to ensure that non-bank investors manage their risks properly and to look into the role played by credit rating agencies in the crisis. EU Finance Ministers have invited the Commission to start work in these areas before the end of 2008.

Single Market Review

The Single Market has brought tangible benefits to Europe's citizens; stimulating growth; enabling people to live, work and study abroad; and bringing consumers a wide choice of products and services at lower prices.

However, at the outset of the 21st century, consumers do not use all the opportunities the Single Market offers them. The Single Market has untapped potential. Therefore it has to be adjusted constantly to new conditions and new opportunities. One of the key areas where there is considerable potential to make the Single Market work better is retail financial services. Bank accounts, means of payment, home loans, insurance, personal investments – these are financial services that consumers and small businesses use every day.

In the consultation following the Commission's Green Paper on Retail Financial Services in the Single Market (published in May 2007), stakeholders complained about Single Market fragmentation in areas such as consumer credit, bank accounts, cross-border payments and mortgages. In view of these problems, the Commission plans action to increase competition and achieve better integration in retail financial markets.

In November 2007, the Commission brought to a close its review of the Single Market with a report entitled "A Single Market for 21st century Europe". Among the policy developments set out in the report, it sets out some new initiatives in the area of retail financial services. The following is a brief overview.

To read more: http://ec.europa.eu/internal_market/finservices-retail/index_en.htm

Facilitating switching and opening bank accounts

Consumers regularly complain about obstacles which they face when attempting to switch from one bank services provider to another or open a bank account in another Member State. Only around 5% of consumers switch their current account each year, although the proportion of unsatisfied customers is much higher. This is due to a number of obstacles, identified in the recent Commission's sector inquiry into retail banking and the Report of the Expert Group on Customer Mobility: insufficient price transparency, bank practices of tying and bundling (see below), closing charges, and administrative burden for customer, such as moving all the regular payments to a new account, informing third parties about the change.

In order to make the switching process and cross-border opening of bank accounts easier, the Commission has invited the European banking industry to develop, by mid-2008, a Code of Conduct. This Code should contain two parts: (1) a switching service, to be made available to customers within each Member State, which should considerably facilitate the operation of switching by ensuring, for example, that there is adequate cooperation between both banks involved in a switching transaction; (2) a commitment not to discriminate customers on the basis of nationality or residence when opening bank accounts cross-border. The Commission will provide the banking industry with the benchmarks, based on existing best practice, for the development of the Code. Should the industry fail to deliver the Code, the Commission would consider initiating legislation.

To read more: http://ec.europa.eu/internal_market/finservices-retail/baeg_en.htm

Untying services

Product tying, whereby the purchase of one financial product is only permitted if another is purchased at the same time, is a clear obstacle to customer choice, binding consumers to a particular financial services provider. Product tying impedes price transparency since the prices of individual products are not visible. What is more, product tying raises switching costs – consumers cannot buy complementary products from various providers, e.g. hold their bank account at one bank and take a mortgage at another. This clearly weakens competition and efficiency at the market.

A recent enquiry by the Commission found significant levels of current account tying in the European credit markets. For instance, consumers wishing to take out a mortgage are frequently obliged to open a current account with the credit provider.

The Commission is currently trying to identify areas other than credit and bank accounts, such as payments and insurance, where tying could limit competition. To accomplish this, the Commission intends to study the practice of tying in the EU. Based on its findings, the Commission will assess the merits of a regulatory approach and consider further action.

Credit data

The availability of credit data is a very important factor in a competitive retail financial services markets. The current cross-border credit data flows in the EU are not totally efficient, which results in credit market fragmentation. Customers seeking to take out a loan with an institution in a foreign market often face higher prices or are denied access to credit because of the lender’s inability to access complete credit information on the consumer.
One of the Commissions' policy objectives in this area is to facilitate the smooth flow of credit data to the benefit of lenders and consumers alike. To achieve this objective, an Expert Group will be created in 2008. It will help the Commission to analyse measures to improve the circulation of credit data.

Retail insurance markets: motor insurance

The Motor Insurance Directives are fundamental to the free movement of vehicles in the European Union. These directives oblige all motor vehicles in the Community to be covered by compulsory third party insurance and abolish border checks on insurance. They also guarantee a better protection of victims of accidents, including those caused by unidentified or uninsured vehicles. As a result, vehicles can be driven as easily between Member States as within one country. In early 2008, the Commission plans to launch a Motor Insurance Leaflet for EU citizens. It is aimed at explaining to the public the basics of the Motor Insurance Directives.
The Commission tries constantly to make the European retail insurance market work better and eliminate any restrictions that may exist. The Commission plans to undertake a study on the factors influencing the final price of insurance. The study will also review innovative solutions used by insurers in the process of price calculation, such as "pay as you drive" schemes.

To read more: http://ec.europa.eu/internal_market/insurance/motor_en.htm

Substitute retail investment products

Retail investors have access to an increasingly wide range of investment products. The distinction between financial, banking and insurance products has blurred, with investment funds, structured notes and unit-linked life insurance products, among others, all providing similar investment opportunities, despite having different legal forms. These substitute investment products are also sold through similar channels: many banks, for example, offer financial and insurance products as well as traditional banking products.

Greater competition in this market will undoubtedly benefit consumers, especially retail investors. However, there is a concern that the EU regulatory framework has failed to keep pace with the evolving product landscape. This is because different EU regulations - many of which pre-date the recent innovations - apply to the marketing and/or selling of different types of investment product. As a result, the level of investor protection may vary depending on the legal form of the product or on the status of the intermediary providing such products.

In this context, consumers, the industry and Member State authorities have made frequent requests to the Commission to review the consistency of EU rules applying to the different types of retail investment product and to assess whether there is a need for a more coherent regulatory approach to marketing and selling across the full product range.

As a first step in this assessment, a call for evidence on substitute retail investment products was launched in October 2007, with responses requested by 18 January 2008. The main purpose of this call for evidence is to establish whether there is a real risk to investors resulting from differences in rules on, for example, the disclosure of product information and on conduct of business by intermediaries. This issue will be discussed at an open hearing in June 2008. On the basis of the responses to the call for evidence and other inputs, the Commission will issue a Communication, probably in autumn 2008.

Financial education

Financial education enables individuals to improve their understanding of financial products and concepts, and develop the skills necessary to improve their financial literacy; i.e. to be aware of financial risks and opportunities and to make informed decisions in their choice of financial services. In order to promote the provision of high-quality financial education in the EU, the Commission will issue a Communication on Financial Education by the end of 2007. The paper will explain why financial education provision is important and what benefits it brings to the individual, the economy and society. The Communication will also present an overview of the initiatives in place in the Member States concerning financial education, will present some principles for best practice, and announce some future initiatives to encourage and promote the provision of financial education

Mortgage market integration

Mortgage credit linked to a house purchase is, for most EU citizens, the biggest financial investment of a lifetime. The Commission plans to adopt a White Paper on the Integration of EU Mortgage Credit Markets by the end of 2007. The paper will draw the conclusions of a comprehensive review process and will set out what needs to be done to create more efficient and competitive mortgage markets and improve the range of products for consumers. The White Paper will be accompanied by an impact assessment.

To read more: http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm

Payments

A well-functioning payment system is crucial for an efficient internal market. Thanks to some EU initiatives consumer within the Eurozone pay no more to withdraw money from cash machines or make card payments than in their home country. However, the European payment market still remains patchy. For example some national cards have limited acceptance abroad and the cross-border cards market is dominated by major multinational schemes. Transferring money from your home back account to an account in another Member State often takes a long time and some services, like direct debits, are not possible.

The Commission looks forward to the creation of a Single Euro Payments Area (SEPA) in Europe by 2010. SEPA will realise the vision of a single payment market in Euro, where all electronic payments are considered domestic, and where a difference between national and intra-European cross border payments in euro does not exist. Cross-border payments should be quicker (payments even within one business day), cheaper, secure and more comfortable (fewer cards in our wallets).

The first step towards SEPA is the Payment Services Directive 2007/64/EC, which provides the necessary legal platform for SEPA. The PSD also seeks to improve competition in the payment markets by opening them up to new entrants. The PSD should be transposed in full in all Member States by no later than by 1st November 2009.

Solvency II

In July 2007 the Commission made a proposal for new solvency requirements for insurance undertakings (known as Solvency II). The aim of the solvency rules is to ensure that insurance undertakings are financially sound and that they can survive difficult periods. This is to protect consumers, businesses and the stability of the financial system as a whole. Solvency rules set out the minimum amounts of financial resources that insurers must have in order to cover the risks to which they are exposed and guide insurers' overall risk management.

What is Solvency II?

The 'Solvency II' rules establish more harmonised regulatory requirements for insurance firms that operate in the EU. 'Solvency II' will introduce **economic risk-based** solvency requirements across all EU Member States. This means that solvency requirements will be "risk-sensitive", better related to the real risks run by any particular insurer. Insurers will now be required to hold capital against market risk (fall in the value of insurers' investments), credit risk (e.g. when third parties cannot repay their debts) and operational risk (e.g. risk of systems breaking down). These risks are currently not covered by the EU regime.

What does it mean for consumers?

The new regime will ensure a uniform and enhanced level of policyholder protection across the EU, reducing the likelihood that policyholders lose out when insurers get into financial difficulties.' Solvency II' will put downward pressure on prices, especially for mass retail insurance product such as motor and household insurance. Greater product innovation will give consumers more choice.

When will Solvency II be in place?

This will depend to some extent on how soon the European Parliament and the Council of Ministers can agree on the final form of the proposed Framework Directive, and how quickly the implementing measures can be developed and agreed upon. The Commission aims to have the new system in operation in 2012.

Consumer Credit Directive

Background

The current Consumer Credit Directive dates from 1987. Since then, consumer credit has radically changed. There are many new ways of obtaining credit such as installment loans, credit cards and overdraft facilities. What's more, the use of consumer credit has greatly increased.

The current consumer credit legislation lays down only basic standards for consumer protection, which enables the Member States to establish higher standards. Diverse consumer credit law in Europe makes the provision of cross-border consumer credit more difficult.

In order to strengthen the consumer credit market in the EU, the Commission proposed a new Consumer Credit Directive in 2002. The original 2002 proposal failed to gain the agreement of the European Parliament. In 2005 the Commission adopted a second, modified proposal, which is now being examined at the EP. A vote on the proposed Directive is expected in January 2008.

How does it benefit consumers?

The proposed directive includes all types of consumer credit (other than home loans) above € 200 and below € 100,000. Borrowers will gain improved transparency on products (costs, terms and conditions). Thanks to a harmonised percentage rate calculation, consumers will be able to compare offers on a cross-border basis. The directive will also give consumer new rights:

- to receive from the lender detailed information regarding fees, monthly repayment and the percentage rate of the credit contract,
- to withdraw from the contract within 14 days - free of charge and without justification,
- to receive the same standard list of essential information all over the EU if the credit is advertised and contains a figure.
- What is more, the directive confirms the right to repay early at any time and harmonises the compensation creditors are entitled to charge in case of early repayment.

Harmonised consumer credit rules should strengthen the functioning and stability of the consumer credit market in the European Union.

To read more: http://ec.europa.eu/consumers/rights/new_proposal_en.htm

Ongoing or upcoming consultations and events

Consultations	
Call for evidence on "substitute" retail investment products	Ongoing
CESR consultation on key investor information for UCITS (for more info on UCITS see Fin-Focus No. 2)	Ongoing
Publications	
European Financial Integration Report 2007	December 2007
Communication on financial education	19/12/2007
Survey of Financial Literacy Schemes in the EU27	19/12/2007
Results of Study on the EU Market for Long-Term Retail Savings Vehicles	January 2008
Events	
Open hearing on "substitute" retail investment products	June 2008

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