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Financial Market Integration in the Euro Area

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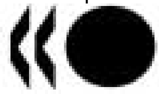

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FINANCIAL MARKET INTEGRATION IN THE EURO AREA

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by

Carl Gjersem

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ABSTRACT/RÉSUMÉ

Financial market integration in the euro area

Although there is no single yardstick to gauge the degree of integration, there is ample evidence that financial markets in the euro area have some way to go before national demarcation lines will effectively disappear and financial market integration is satisfactory. While there has been a push towards integration from the centre, global developments, such as advances in information technology, falling communication costs and standardisation of products, have been the main drivers, while national policies often acted as an impediment. The integration of financial markets finally became a policy priority with the adoption of the FSAP as part of the Cardiff process launched in 1998. For the European Union to have a fully satisfactory regulatory framework for financial markets in place in 2005, further efforts are needed. This paper takes stock of current developments and proposes a set of further suggestions for policy action.

JEL codes: F3, F15, F32, F36, G15, G18

Keywords: capital movements, economic integration, international capital markets, international finance, government policy and regulation

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L'intégration des marchés financiers dans la zone euro

S'il n'existe pas d'étalon unique pour jauger le degré d'intégration, il apparaît clairement que les marchés financiers de la zone euro doivent encore évoluer avant que les lignes de démarcation nationales disparaissent réellement et que l'intégration soit satisfaisante. Certes, l'intégration a bénéficié d'une impulsion centrale, mais les évolutions mondiales, notamment les percées des technologies de l'information, la baisse des coûts des communications et la standardisation des produits, en ont été les principaux moteurs, alors que les politiques nationales ont souvent agi comme un frein. L'intégration des marchés financiers est finalement devenue une priorité avec l'adoption du *Plan d'action pour les services financiers* (PASF) dans le cadre du processus de Cardiff lancé en 1998. De nouveaux efforts s'imposent pour qu'un cadre de réglementation des marchés financiers tout à fait appropriés soit en place dans l'Union européenne en 2005. Ce document fait le point sur l'évolution actuelle et formule une série de propositions d'action.

Classification JEL : F3, F15, F32, F36, G15, G18

Mots clés : zone euro, mouvements de capitaux, intégration économique, marchés financiers internationaux, politiques et règlement de gouvernement

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TABLE OF CONTENTS

Overview ... 4
The challenges in euro area financial development ... 5
Forces shaping financial market integration ... 7
The gains from efficient financial markets ... 8
The policy initiatives ... 10
Strong cross-border forces ... 11
The state of play: Convergence and integration ... 13
Capital market segmentation: an aggregate view ... 13
The euro area money markets are integrated but cross-border issues remain ... 15
Securities markets have a longer way to go ... 17
Is European venture capital being left behind? ... 24
Some cross-border issues remain to be settled in banking ... 24
Insurance markets continue to face important entry barriers ... 29
Align common and national interests ... 30
Current policies and their implementation ... 31
Scrutinise decision-making and co-ordination ... 37
The many views on supervision ... 38
Should the differences in supervision be reduced? ... 39
Glossary of Acronyms ... 47
Bibliography ... 48
Annex
The institutional framework ... 55

Tables

Table 1. Consumption and output growth correlations ... 14
Table 2. Operating income per transaction ... 23
Table 3. Recent changes in banking structure in the European Union and the United States ... 26
Table 4. Bank loans to the corporate sector in the European Union and the United States ... 26
Table 5. Overview of individual measures in the Financial Services Action Plan ... 32
Table 6. Status of the Financial Services Action Plan measures Legislative programme for 2003 ... 33
Table 7. Orientation of national supervisors ... 41

Figures

Figure 1. The EU's current foreign trade regime in financial services ... 12
Figure 2. Saving and investment across the OECD and the euro area ... 14
Figure 4. Total monthly issuance of bonds denominated in euro ... 18
Figure 5. Spreads on government bonds ... 19
Figure 6. Debt issued by the corporate and financial sectors in the European Union and the United States ... 20
Figure 7. Stock market capitalisation in the European Union and the United States ... 21
Figure 8. Key national mortgage interest rates ... 27

Boxes

Box 1. Synopsis of 2002 EDRC recommendations ... 6

FINANCIAL MARKET INTEGRATION IN THE EURO AREA

By Carl Gjersem[1]

Overview

1. The monetary union has been seen as boosting financial market integration by reducing costs, eliminating exchange rate risks and raising price transparency. The full potential of gains from monetary union will only be realised, however, if remaining barriers to integration are dismantled and competitive conditions in EU financial markets are ensured. Since the early 1970s the European Commission has pushed for the creation of a European financial area, and important progress has been made, as discussed in some detail below. Rather than establishing uniform regulation and supervision for a single financial market, the principles of home country control, harmonisation of essential principles and mutual recognition were applied, assuming that mutual recognition and market forces would interact to yield convergence in the regulatory environment. Accompanied by the global trend of financial market liberalisation, this sparked competition between financial centres, which had developed within their distinct national financial systems, changing the structure of financial markets over time. Competition between financial centres has intensified significantly with the introduction of the euro in 1999. Nonetheless, liberalisation has not yet gone far enough and deep integration of financial markets is still far from being a reality in several market segments. Major policy challenges lie ahead to reap the full benefits from monetary union:

- The remaining obstacles to deep integration, which are rooted in different legal, administrative, accounting, tax and consumer protection systems, will need to be dismantled. Ways should be explored to reduce the effects of other obstacles, such as differences in language, business culture or habit persistence, even if this necessarily will be a slower process.

- As financial market integration progresses, network industry issues will surface and require a robust competition framework. The authorities need to assume their role as guardian of fair competition by ensuring equal access to networks and compatibility of these networks as well as through information sharing.

- It is essential that the implementation of Community law at the national level and the co-ordination of national policies are adequate to the task of following the rapid developments in the financial markets. This will require a continuous adaptation of the current structure of decision-making and co-ordination.

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1. This paper was originally prepared for the Economic Surveys of the euro area 2002 and 2003, which have since been published under the authority of the Economic and Development Review Committee. This work was carried out while the author was seconded to the OECD Economics Department from the Norwegian Ministry of Finance. The author would like to thank Andrew Dean, Mike Feiner, Peter Hoeller and Laurence Boone for valuable comments and drafting suggestions; to Desney Erb and Isabelle Duong for statistical assistance and Celia Rutkoski and Miki Noguchi for technical assistance.

2. EU Heads of state and government have endorsed the FSAP and set the deadline 2005 for its final implementation. Integration of the financial sector is thus a top priority on the political agenda in the European Union, with the ultimate goal – agreed at the Lisbon European Council in March 2000 – of turning the EU into the most competitive and dynamic economy in the world by 2010. The intention to have the FSAP fully implemented by the European Union and national legislators in 2005 is very important and challenging, the more so since transposition into national law typically requires between one and two years. Looking beyond the FSAP, further reform efforts should focus on improving the infrastructure of financial markets in the European Union; aligning national and common interests; and scrutinising decision making and co-ordination.

3. Against this backdrop, this paper takes stock of the past and current liberalisation efforts and their effect on financial market integration. It first highlights the major challenges, and policy initiatives and other forces shaping developments in this field. This is followed by a review of the progress to date in different parts of the financial system, focusing on money and securities markets and the retail market in banking and insurance. It then evaluates recent reform efforts, in particular the FSAP.

The challenges in euro area financial development

4. The FSAP is the Community's central tool for attaining deeper integration in the financial sector. Progress in integration of financial markets in the euro area has been slow, especially in the retail markets. However, more than three quarters of the FSAP measures have been completed since the inception of the Plan in 1998. It is important to adhere to the timetable for implementing all the proposals in the FSAP by 2005, which were deemed necessary already in 1998. April 2004 is set as the final date for adoption by the Council of all measures – to allow 18 months for transposition in the member states after that. More particularly:

- Recent action to speed up the process of implementing the FSAP proposals, with more than ten measures being voted since the Barcelona Council, is a step in the right direction. However, the intention to have the FSAP fully implemented by European Union and national legislators in 2005 is very challenging, the more so since transposition into national law typically requires between one and two years – and examples for much longer time-spans exist, especially in the financial sector. Further work on fine-tuning existing measures and their implementation on the national level becomes crucial now.

- As the FSAP measures should soon be completed, the authorities should move from an approach where isolated measures are taken to a sector-wide approach. It would be important to integrate the financial sector in the regular economic surveillance programme, in light of its size and influence on other sectors.

5. Common financial markets in the euro area have matured in the areas where the infrastructure is simpler as in the wholesale business or where the public sector is most involved. By contrast, in areas where EU-wide public infrastructure is scant, markets remain regional and transaction costs for cross-border activity remain high. While the markets generate solutions around existing barriers they are often far from optimal from an economic efficiency point of view and costly. The authorities should focus on removing such barriers. Continued efforts on cross-border clearing and settlement arrangements following the Giovannini group's work (Giovannini, 2003) is an example. Looking beyond the FSAP, however, this framework should be supplemented by a wider set of reforms. Box 1 gives a synopsis of the recommendations given in the *OECD Economic Surveys: Euro area 2002.* To deepen integration further, the following policies need to be pursued:

- Further efforts should focus on improving the financial market infrastructure, where diverging national structures are hampering cross-border trade. Competition policy should focus more on cross-border issues also in the financial markets, to whittle away local entry barriers.

- Access to the existing infrastructure should be open to market entrants, possibly subject to fair fees. In particular, the clearing and settlement infrastructure for securities should be made accessible to cross-border trade. The authorities should let the market develop new solutions, but should take measures to stop solutions that hamper entry. A continued focus on international issues, such as the interfaces between EU and US markets and regulations, is also needed.

- National industries' interests often stand in the way of achieving a common financial market. A better balance should be struck between these interests and the common good based on the general acceptance that financial market integration cannot be achieved without free cross-border ownership and trade in financial services and products. The Commission should disclose information on "national champion" policies and reinforce its policing role. Especially, a new take-over bid Directive should be adopted with priority in order to clarify and establish a legal framework for cross-border mergers and acquisitions.

6. The current structure of regulation and supervision is the result of different administrative, legal and financial approaches across countries. The focus should be on legal and regulatory reforms that protect the rights of investors and enforces contracts, and thus supports the functioning of both markets and intermediaries. Admitting the slow process of adopting legislation, the authorities have taken steps to re-shape the regulatory process by separating first principles from secondary legislation. The new framework, based on the Lamfalussy proposals, has recently started working in the securities markets. The introduction of similar committee structures covering insurance and banking was a long overdue step. However, these committees, consisting of members with strong national interest, must be kept transparent and use consultation processes continuously.

Box 1. Synopsis of 2002 EDRC recommendations

An overriding and immediate recommendation is for the European authorities to adhere to the timetable for implementing the proposals in the FSAP by 2005, which were deemed necessary already in 1998. These measures should form the basis for EU proposals and pre-commitments in the ongoing set of General Agreement on Trade in Services (GATS) negotiations. Further efforts should focus on the following issues:

Improve the financial market infrastructure. Common financial markets in the euro area have matured in the areas where the infrastructure is simpler as in the wholesale business or where the public sector is most involved. By contrast, in areas where EU-wide public infrastructure is scant, markets remain regional and transaction costs for cross-border activity remain high. In order to improve the conditions for financial market integration in this regard, the following policies need to be pursued:

- Entry barriers related to sunk cost of existing market infrastructure should be offset by an effective competition policy. In particular, access to the existing infrastructure should be open to new market entrants, possibly subject to fair fees and licenses to be closely monitored by the EU competition authorities.
- To improve the clearing and settlement infrastructure for securities, the authorities should try to exploit the ECB's experience in cross-border transactions such as that stemming from TARGET, which uses similar technologies.
- The authorities should eliminate the remaining obstacles that hamper deep integration. While the markets generate solutions around existing barriers they are often far from optimal from an economic efficiency point of view and costly.

Align national and common interests. National industries' interests often stand in the way of achieving a common financial market. A better balance should be struck between these interests and the common good, based on the general acceptance that financial market integration cannot be achieved without free cross-border ownership and trade in financial services and products:

- A new Take-Over Bid Directive should be adopted with priority in order to clarify and establish a legal framework for cross-border mergers and acquisitions.
- Domestic policies towards favouring "national champions" should be discouraged. The Commission's task in this regard would be to disclose information on such policies and adopt a policing role.
- Consumers and businesses should be given increased scope for raising complaints when their home or prospective host country does not appear to apply the common principles within a reasonable time frame from adoption.

Streamline decision-making and co-ordination. Progress in adopting legislation in the pursuit of an integrated financial market has been slow, even though steps have been taken to re-shape the regulatory process by separating first principles from secondary legislation. The current structure of regulation and supervision is the result of different administrative, legal and financial approaches across countries. The following directions for change should be pursued:

- *Scrutinise the current committee structure.* There should be continual assessment of existing structures for financial regulation and supervision to ensure that they support the design and implementation of new legislation, the sharing of supervisory information and best practices to attain convergence, and more generally contain threats to financial stability. In this process, transparency and accountability should be aimed for.
- *Ensure convergence of practices across the internal market.* Facilitation of cross-border co-operation must be continued to avoid divergent local practices.

Forces shaping financial market integration

7. The integration of financial markets in Europe is part of a wider global development, driven by advances in information technology, lower communication costs and standardisation of products. Judged by aggregate measures of market segmentation, this process has already gone further in the Union than in other groups of OECD countries. Indeed, financial market integration has been an ongoing process for several decades, notably because of the liberalisation of capital movements within the European Union between 1980 and 1994. This is corroborated *inter alias* by the de-coupling of aggregate investment from aggregate saving in individual countries giving rise to a withering away of the "Feldstein-Horioka puzzle". Overall, it appears that the degree of capital market integration between euro area countries lies somewhere in between the international capital markets and national ones. Some of the factors underpinning home bias, such as government restrictions, have lost in importance over time, especially in the European Union. This could explain the reduced home bias observed in recent data.

8. The remaining impediments to financial market integration in the Union include the lack of a common infrastructure, reflecting the fact that national infrastructure evolved to meet domestic needs. In some markets, sunk costs can act as a barrier to entry and a disincentive to consolidation of infrastructure across borders. Other factors are the favourable treatment of "national champions," and the sometimes cumbersome procedures for policy co-ordination. In addition, major segments of financial markets, especially retail markets, feature a strong attachment of consumers to their provider, while entry barriers, including cultural, linguistic and legal differences (for instance, in company law and accounting systems), may further slow down integration. Differences in legal procedures and regulatory practices still make a number of cross-border transactions complicated and expensive. Further liberalisation should boost integration in the future. The next sections examine the state of play in this regard.

The gains from efficient financial markets

9. Well-functioning financial markets can reduce the frictional costs associated with the acquisition of information and the transaction costs of writing, issuing and enforcing contracts. If financial markets perform well, supply and demand for capital are brought together efficiently as pricing of financial instruments will better reflect the risk-return profiles of the underlying real assets and, ultimately, economic growth is enhanced. More specifically, well-functioning financial markets may provide four broad types of services (Leahy *et al.*, 2001):

- *Mobilising savings*. Financial intermediaries and securities markets attract and collect the small-denomination savings of individuals, so that large-scale investments can be funded, thus raising the overall level and efficiency of investment. Without the pooling of savings, investment will be constrained.

- *Allocating savings*. For individual savers the costs of acquiring and evaluating information on prospective projects can be high, making it more likely that worthy projects will not be funded. Financial intermediaries that specialise in acquiring and evaluating information on investment projects enable small investors to fund higher return investments. Securities markets can also allocate savings efficiently across investment projects, provided the profit opportunities as compared to the information costs are sufficiently high.

- *Diversifying risks*. Financial markets can provide insurance to individual savers by increasing the number of projects a single saver may participate in, offsetting the risk that a single investment pays no or a negative return and mitigate the liquidity risk if savings need to be withdrawn. This will improve the risk-return trade-offs for individual savers. As a result, high-return projects with a long gestation period or high, but diversifiable, risks are more likely to be funded.

- *Monitoring managers*. Financial intermediaries monitor investments for large groups of savers and thus reduce monitoring costs. Securities markets may also act as a market for control, functioning as a disciplining device. If concerns about bad management can be reduced, a wider range of investments will be funded and growth enhanced.

The gains from integration may be sizeable…

10. The original Cecchini Report (European Commission, 1988) argued for a total integration bonus of 4.5 per cent of which financial market integration would contribute one-third (*i.e.* 1.5 per cent). Since the report was presented, ongoing integration must have eroded the remaining bonus. However, the size of gains up to now may not be that large, as several studies suggest that deep integration is still lacking in some market segments. Based on long-run co-movements in the biggest EU stock markets (United Kingdom, France and Germany), Pascual (2003) finds that while French stock market prices became more closely integrated with UK and German markets up to the mid 1980s, evidence of changes in the degree of financial integration for the UK and German stock markets or continued change for France in the last decade and half are not found. For retail credit bank markets in Europe, Heinemann and Schüler (2002) conclude that these are far away from deep integration. Kleimeier and Sander (2002) find some limited evidence of an integrated retail banking market prior to 1 January 1999, but point to possible structural changes for the corporate lending market after the introduction of the single currency. However, Adam *et al.* (2002) find a distinct lack of integration of short-term corporate loan markets.

11. Neimke *et al.* (2002) suggest that the remaining gains could be close to the 1.5 per cent of the Cecchini Report. Moreover, Heinemann and Jopp (2002) found that "...worldwide cross-country samples show that differences in financial integration between countries amounting to one standard deviation of the relevant integration indicators can explain annual growth differences of 0.5-0.7 per cent." Although these results do not seem very relevant for the EU member states, the authors suggest that they may indicate a rough potential for growth through financial integration. Two reports published on the behalf of the Commission in late 2002 also suggest that the potential impulse form stronger market integration may be sizeable. The first of these, a study from London Economics (2002), looks at savings for businesses following a restructuring from bank to bond financing, *i.e.* a move towards the US model. Large savings would come from reductions on cost of bond finance in combination with an increase in its share, and from competition induced reductions in the cost of bank finance. Further, the study suggests that integration of equity markets will reduce trading cost substantially. These changes would also translate into increased investment, consumption and employment. Over a decade, this could raise the level of GDP by 1.1 per cent. Based on similar ideas of convergence with US financial markets, the second report, Giannetti *et al.* (2002), tries to establish a connection between financial markets development and business growth. This study suggests that European manufacturing industry would grow up to 1 per cent faster if financial markets across the Community developed to US levels. As other sectors of the economy may experience smaller gains, the overall effect could be smaller. While partly overlapping and thus not additive, these two reports underline that financial market integration, and concurrent development towards very efficient levels, in the long run may generate sizeable returns.

12. A number of papers based on cross-country studies have found indications that finance causes economic development beyond simple correlation. The European Commission (2001a) pointed to evidence of a positive correlation between financial development and growth for a large panel of countries. OECD research found robust positive effects of financial variables in investment and growth regressions (Leahy *et al.*, 2001 and Bassanini *et al.*, 2001). Beck and Levine (2002) concluded that stock markets and banks on balance appear to positively influence economic growth (after eliminating potential biases induced by simultaneity, omitted variables or unobserved country-specific effects). Levine *et al.* (2000) found that the exogenous components of financial intermediary development is positively associated with economic growth and that cross-country differences in legal and accounting systems help account for differences in financial development. Together, these findings suggest that legal and accounting reforms that strengthen creditor rights, contract enforcement, and accounting practices can boost financial development and accelerate economic growth.

... but not all studies concur

13. However, major methodological issues in the measurement of the impact of financial markets still remain to be resolved (Tsuru, 2000 and Thiel, 2001). Recent papers on finance and growth have illustrated that there still are problems in showing a positive impact of financial development on economic growth that go beyond simple correlations. Favara (2003), using a large sample and a long time period, fail to find significant coefficients on finance in instrumented growth regressions. Neither does he find a robust long-term positive relation between finance and growth. Prasad *et al.* (2003) also find it difficult to detect a strong and robust causal relationship between financial integration and economic growth. Further, they find that financial integration appears to be associated with increases in consumption volatility in many developing countries. Finally, they suggest that sound macroeconomic frameworks and institutions – in particular, good governance – are a decisive factor for the effects from financial globalization.

14. European business finance is still dominated by bank finance. However, recent studies are suggesting that there is evidence that financial structures such as the mixture of financial markets and intermediaries is not important for explaining differential growth rates across countries (Dolar and Meh, 2002). Countries do not grow faster, and firms' access to finance is not systematically easier in either market or intermediary-based systems, while an important factor is a sound legal system that protects the rights of investors and enforces contracts. This conclusion is consistent with the broad empirical analysis of financial structure and economic growth by Demirgüç-Kunt and Levine (2001): "Through a diverse set of analyses, the answers are surprisingly clear... Overall financial development matters for economic success, but financial structure *per se* does not seem to matter much." This suggests that the European authorities should focus on legal and regulatory reforms that support the functioning of both markets and intermediaries, rather than concern themselves with the degree to which national financial system is market or intermediary-based. Further, the overall institutions and framework are the field where the authorities should focus, leaving it to markets to find solutions and detailed approaches.

The policy initiatives

15. Financial market integration has been spurred by initiatives to liberalise financial markets as part of the Single Market programme, especially the 1985 White Paper on "Completing the internal market." The single most important act concerning banks was the Second Banking Co-ordination Directive, which formalised the principle of mutual recognition and provided a passport for banks to offer services across the European Union and ended the requirement on EU subsidiaries to maintain separate endowment capital for their activities. In 1986, the European Court of Justice ruled on several insurance cases elaborating on mutual recognition, home country control and establishing criteria for permissible host-country restrictions. As the cases were concerning the freedom of establishment, their impact went beyond the insurance sector. The third generation of insurance directives secured more open markets, requiring closer co-operation between member state authorities. From 1993, the investment services directive in turn provided for easier access to securities markets.

16. In 1998, the European Council held in Cardiff acknowledged that there still remained considerable scope for boosting financial market integration. Already prior to the Cardiff Council, the Commission had laid the groundwork for a Risk Capital Action Plan to build a stronger venture capital base. This Plan includes initiatives to be taken at the Community and/or member state level by reducing institutional, regulatory and tax barriers, and fostering high-tech small and medium-sized enterprises and human capital. The Cardiff Council lifted financial market issues to a top political priority, stipulating that financial market integration is a requisite for greater efficiency, not only in the financial sector itself but also for the economy as a whole. Thus, it asked the Commission to take initiatives towards accelerating the process of financial market integration. This resulted in the Financial Services Action Plan (FSAP), containing a large number of concrete steps to reduce or remove obstacles, which was endorsed by the Cologne Council in 1999. The Cardiff process that was initiated in 1998 is described in more detail in the *OECD Economic Surveys: Euro area 2002.*

17. The 2000 Lisbon Council subsequently made financial market integration one of the "pillars" of the economic and social agenda, together with macroeconomic, employment and social policy. A deadline of 2003 was set for the implementation of the Risk Capital Action Plan and for those elements of the FSAP relating to securities markets. For the FSAP, the deadline for full implementation, *i.e.* including transposition of measures into national law, is set for 2005. During 2000, anxiety about the slow progress of the FSAP resulted in the establishment of a Committee of Wise Men on the Regulation of European Securities Markets under the chairmanship of Alexandre Lamfalussy. It was asked to assess how the mechanism for regulating securities markets can best respond to developments, and, in order to eliminate barriers, to propose scenarios for adapting current practices to ensure greater convergence and co-operation in day-to-day implementation. The Lamfalussy Committee published its final report in February 2001

underscoring the need to rapidly adopt the measures in the FSAP, especially the establishment of a Securities Committee. It also recommended specific changes to the process for approving financial market legislation at Community level. Subsequently, measures suggested by the committee have been adopted independently or are now included in the FSAP.

18. Up to the deadline of 2005, the remaining measures in the FSAP will dominate the agenda. For the European Union to have a fully satisfactory regulatory framework for financial markets in place in 2005, further efforts are needed. With the overarching aim of achieving financial integration, the FSAP is being adjusted to take new developments into account. At the same time, the financial markets show continuous and rapid change, and national structures are seen to evolve in different directions (witness, for example, the growth of dissimilar legal rules for similar securities such as asset-backed bonds). There is thus a need for continuity in policy formulation and implementation, which will also necessitate a stronger will to allocate sufficient resources to the competent authorities.[1]

Strong cross-border forces

19. Foreign trade in financial services has been liberalised as well and trade policy conditions are favourable overall. Extra EU-trade in financial services has risen rapidly over the 1990s, but is still very small (0.3 per cent of GDP and about 5 per cent of the sector's value added). This partly reflects the fact that the Balance of Payments Statistics record transactions between residents and non-residents, even though services are often supplied through commercial presence.[2]

20. Financial services are subject to liberalisation commitments under the GATS and specifically the 1997 financial services agreement, which entered into force in March 1999. The liberalisation approaches underlying the single market and the GATS differ significantly. The Treaty of Rome imposes the same rules for trade in goods and in services. Concerning services this requires liberalisation of cross-border and establishment-based trade within the framework of mutual recognition and minimal harmonisation. In contrast, the GATS defines four modes of supply (cross-border supply, consumption abroad, foreign commercial presence and movement of persons) and leaves open the possibility of liberalising only certain modes, thereby limiting the extent of liberalisation. At the core of the GATS are specific commitments. Each member first negotiates which service sectors will be subject to the GATS market access and national treatment disciplines. It then negotiates what non-confirming (or GATS-inconsistent) measures will be maintained in sectors and sub-sectors where national treatment and market access commitment are made.[3]

21. Various indicators suggest that the EU's trade regime is fairly liberal. A trade restrictiveness index developed by the Australian National University and the Productivity Commission (Findlay and Warren, 2000), for instance, suggests that the Union has one of the most liberal trade regimes. The index summarises the nature and extent of restrictions on establishment and on ongoing operations. Scores range from 0 to 1, with greater stringency of a restriction raising the score. The EU countries' score is 0.07, very close to that of the United States and Canada, and considerably below that of Japan (0.19) or that of Australia (0.12). The EU countries have made commitments that largely reflect the high degree of access already afforded by the regulatory status quo (*i.e.* single passport privileges), and most EU members' commitments provide for unrestricted access under mode 1 (Figure 1). For the other modes, there are virtually no limitations on national treatment, while limitations on market access are more frequent. Commitments on the movement of persons are governed by commitments under mode 3. GATS limitations do not apply to third-country subsidiaries established in the Union. Moreover, the number of most-favoured nation exemptions maintained by the EU (three) is small. [4,5]

Figure 1. The EU's current foreign trade regime in financial services

Schedule of sector-specific commitments[1]

Sector	Insurance			Banking		
Mode of supply	Cross-border supply	Consumption abroad	Commercial presence	Cross-border supply	Consumption abroad	Commercial presence
Austria	Gray □ Gray ○	Gray □ Gray ○	Gray □ Black ○	Black □ Black ○	Black □ Black ○	Gray □ Black ○
Belgium	Black □ Black ○	Black □ Black ○	Gray □ Black ○	Gray □ Black ○	Black □ Black ○	Gray □ Black ○
Denmark	Gray □ Black ○	Gray □ Black ○	Black □ Black ○	Black □ Black ○	Black □ Black ○	Gray □ Black ○
Finland	Gray □ Black ○	Black □ Black ○	Gray □ Gray ○	Black □ Black ○	Gray □ Black ○	Gray □ Black ○
France	Gray □ Black ○	Gray □ Black ○	Gray □ Black ○	Black □ Black ○	Black □ Black ○	Gray □ Gray ○
Germany	Gray □ Black ○	Gray □ Black ○	Black □ Black ○	Black □ Black ○	Gray □ Black ○	Gray □ Black ○
Greece	Black □ Black ○	Black □ Black ○	Gray □ Black ○	Black □ Black ○	Gray □ Black ○	Gray □ Black ○
Ireland	Black □ Black ○	Black □ Black ○	Gray □ Black ○	Gray □ Black ○	Black □ Black ○	Gray □ Black ○
Italy	Gray □ White ○	Gray □ White ○	Gray □ White ○	Gray □ White ○	Gray □ White ○	Gray □ Black ○
Luxembourg	Black □ Black ○	Black □ Black ○	Black □ Black ○	Black □ Black ○	Black □ Black ○	Gray □ Black ○
Netherlands	Black □ Black ○	Black □ Black ○	Black □ Black ○	Black □ Black ○	Black □ Black ○	Gray □ Black ○
Portugal	Gray □ Black ○	Gray □ Black ○	Gray □ Black ○	Black □ Black ○	Black □ Black ○	Gray □ Black ○
Spain	White □ Black ○	Black □ Black ○	Gray □ Black ○	Black □ Black ○	Black □ Black ○	Gray □ Black ○
Sweden	Gray □ Black ○	Black □ Black ○	Gray □ Gray ○	Black □ Black ○	Black □ Black ○	Gray □ Gray ○
United Kingdom	Black □ Black ○	Black □ Black ○	Black □ Black ○	Black □ Black ○	Gray □ Black ○	Gray □ Black ○

Legend Limitations on: □ Market access ○ National treatment. Sub-sectors with commitments: White - None; Gray - Partial; Black - Full

An indicator of trade restrictiveness[2]

1. Excluding horizontal restrictions.
2. Foreign restrictiveness index with scores ranging from 0 to 1. The higher the score, the greater are the restrictions for an economy.

Source*:* WTO (1999), *Trade Policy Review - European Union* (Geneva); and Kalirajan *et al.* (2000).

22. Against this backdrop, the European Union should use the ongoing GATS negotiations to lock in new liberalisation measures embodied in the FSAP. The GATS allows countries to pre-commit to future liberalisation, and most OECD countries will be requesting that non-OECD countries do precisely that in financial services. This would be most useful in the field of cross-border trade in financial services, where the Union may be ahead of the curve and where commitments could have useful multilateral demonstration effects. The EU should pre-commit (with a clear timetable) to future liberalisation in those areas where a fully open market is likely to be achieved over the medium-term (*i.e.,* beyond the end 2005 scheduled completion of the next GATS round).

The state of play: Convergence and integration

23. Even within an integrated financial market the sub-markets could show very different stages of development. Convergence has been observed, as the forces affecting outcomes have become similar, but this does not necessarily imply deep integration between national markets.

Capital market segmentation: an aggregate view

24. Despite the sharp rise of international capital flows, a large body of evidence shows that individuals hold too little of their wealth in foreign assets – the so-called home bias. Moreover, cross-country correlations of consumption are often lower than cross-country output correlations, suggesting a low degree of risk sharing across countries. Individuals could buy claims on other countries' output, thereby reducing domestic income risk. In this case, consumption growth would have a high correlation, even when output growth rates do not. The same phenomenon is addressed by the so-called Feldstein-Horioka puzzle, which is based on the observation of a high correlation between saving and investment rates across countries (Feldstein and Horioka, 1980), suggesting home bias and a lack of financial market integration.[6] A significant home bias can be explained by various factors (Lewis, 1999): home assets are a better hedge against country-specific risks; the tax, information and other costs of diversification exceed the gain; not all wealth (human capital being the largest item) and goods are tradable; and government restrictions can impede investment in foreign assets.[7]

25. Table 1 shows the output and consumption correlation matrix for the EU countries, the United States and Japan. A striking feature is that the correlations for both output and consumption are fairly high for the euro area countries and typically much lower for the other countries, indicating closer integration within the euro area than across the other OECD countries. While there is some tendency for consumption correlations to be lower than output correlations for the euro area countries (not shown in the table), this is not uniformly so and differences are often not large. This contrasts with the results for the G7 countries for 1950-92 by Lewis (1999), who finds lower correlations overall and larger differences between output and consumption correlations in the more distant past. The same exercise for Canadian provinces shows that consumption growth correlations, indeed, tend to be high and much higher than output growth correlations (De Serres *et al.,* 2001). Crucini and Hess (2000) show for both Canadian provinces, US states and Japanese prefectures that a much larger share of consumers pool risk across regions within a country than across countries.

26. Feldstein and Horioka (1980) showed that national borders divert flows of capital to domestic investments. A high saving retention rate in a simple linear relationship between savings and investment has also been found in later research to hold under numerous alternative specifications. Rolling regressions suggest that the saving retention rate has drifted down over time to 0.5 for the 16 OECD countries in the original Feldstein-Horioka sample, but that it has remained significantly different from zero (Figure 2). For a sub-sample of the euro area countries, the coefficient started already at a lower level in the mid-1970s and has drifted down towards 0.2. The correlation between saving and investment is lower within than across countries. Helliwell and McKitrick (1998), for instance, find that Canadian provincial borders are not barriers to capital mobility in the way that a national border is.

Table 1. Consumption and output growth correlations[1]

1980q1 to 2000q4

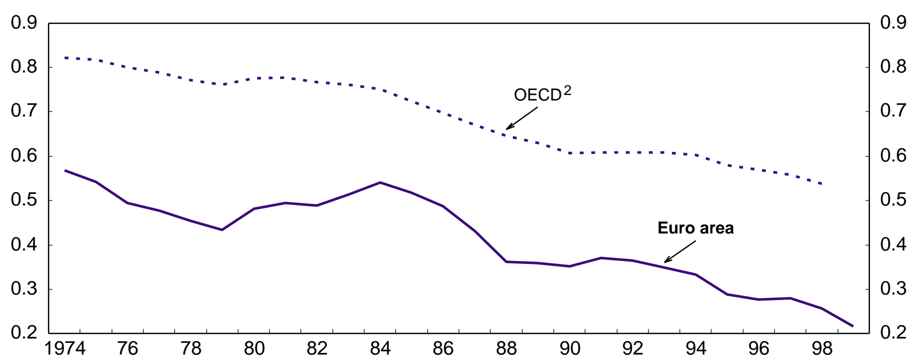
	Consumption	Output
Austria	0.36	0.70
Belgium	0.74	0.83
Finland	0.21	0.25
France	0.53	0.71
Germany	0.47	0.57
Greece	0.45	0.61
Ireland	0.33	0.38
Italy	0.46	0.65
Luxembourg	0.67	0.35
Netherlands	0.55	0.67
Portugal	0.59	0.62
Spain	0.78	0.72
Denmark	0.23	-0.02
Sweden	0.55	0.57
United Kingdom	0.31	0.27
United States	0.29	0.05
Japan	0.39	0.24
Memorandum item		
United States correlation with Japan	-0.07	-0.05

1. Correlations of individual countries' output or consumption growth with the area aggregate for euro area countries (the aggregate excludes the output or consumption of the euro area country concerned).

Source: OECD.

Figure 2. Saving and investment across the OECD and the euro area[1]

Cross country regressions in per cent of GDP



1. The figure shows the coefficient estimates when the sample size is kept fixed at 15 years but moves over time. A declining coefficient points to financial market integration.
2. Using a sample of 16 OECD countries: Australia, Austria, Belgium, Canada, Denmark, Finland, Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Sweden, United Kingdom and United States.

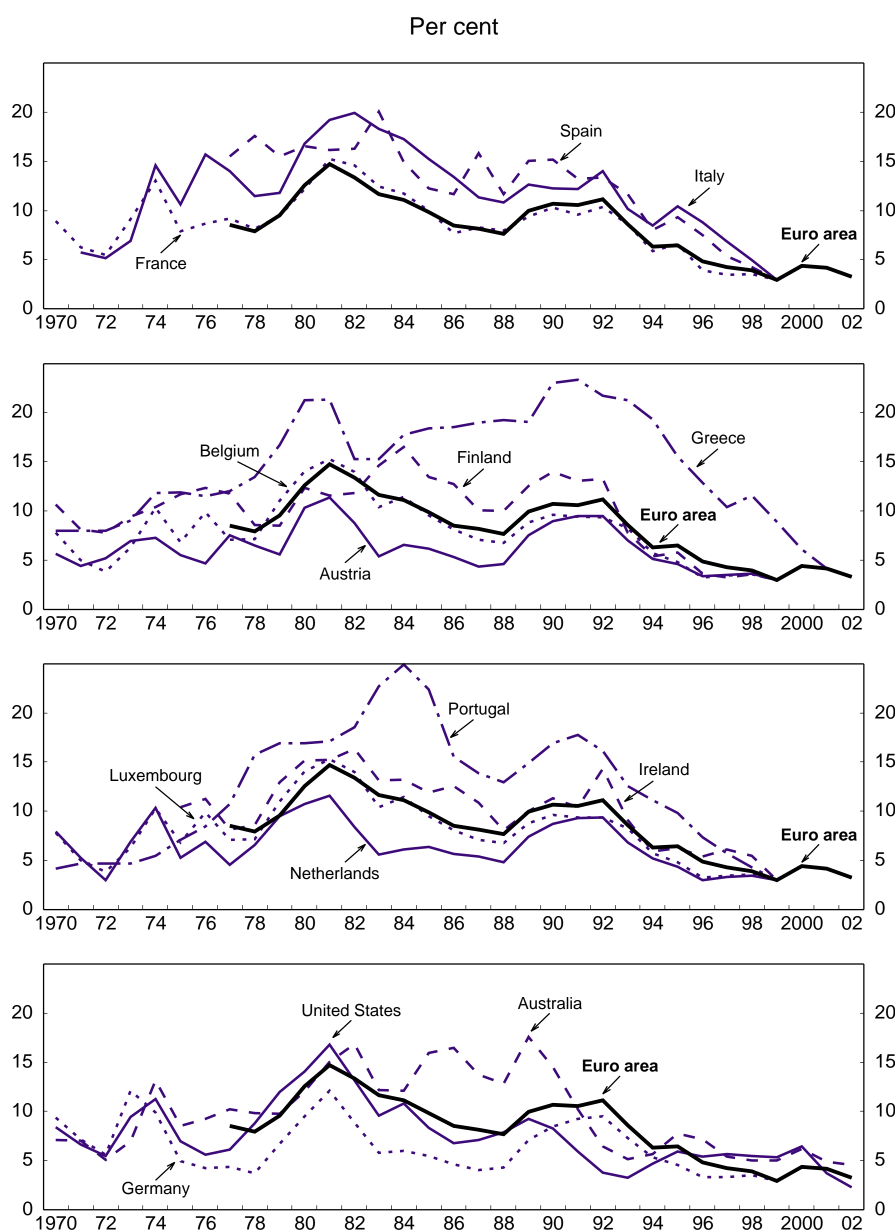
Source: OECD.

The euro area money markets are integrated but cross-border issues remain

27. Integration of the euro area money market has progressed rapidly since the introduction of the euro, not least because a common infrastructure emerged from the need of the Eurosystem to manage liquidity for the conduct of monetary policy. In this market, money and other liquid assets are lent and borrowed for periods ranging from a few hours to a few months. Convergence in nominal interest rates in these markets towards a common rate has been pronounced (Figure 3).[8] However, progress has not been equally rapid across the various sub-markets, depending most importantly on the extent to which collateral is involved and the extent of local characteristics with regard to this collateral.

Figure 3. Convergence of short-term interest rates

Per cent



Source: OECD (2002), OECD Economic Outlook No. 71.

28. With respect to the unsecured market, the *interbank* deposit market, there is virtually full convergence in interest rates across the euro area (European Commission, 2001*b*) with little or no differences in the rates wherever the money is exchanged. This is a consequence of monetary union, as all the regional money markets prevailing before the European Monetary Union (EMU) formed a large euro area money market. The ability to move funds across the euro area enabled the emergence of a big, liquid and homogeneous money market. If minor differences still persist from time to time, they more reflect the credit quality of the institutions. A number of other factors have also contributed to rapid integration:

- The development of pan-European Union reference rates (*i.e.* Euribor[9] and Eonia[10]) by the European Banking Federation (EBF) and ACI, the Financial Markets Association rather than the strictly London-based Libor. The construction of these rates reflects the wide diversity of banks located across the euro area countries.

- In view of the need to redistribute liquidity among banks in euro area countries, including liquidity provided by the ECB as part of its refinancing operations, a payment system in euro (TARGET) was developed. Now, banks in all EU member states have access to TARGET. It has facilitated an equalisation of prices in most segments of the money market by encouraging arbitrage.

- The Settlement Finality Directive has now been implemented in all member states. It aims to reduce the risk associated with participation in payment and securities settlement systems (along with clarifying conflicting legal rules governing collateral transactions).[11] This has supported the development of an integrated money market.

29. A striking development in the interbank market is the move towards a two-tier structure, as large banks dominate cross-border transactions while smaller banks continue to rely on national inter-bank transactions for their funding (European Commission, 2001*b*). This also reflects that informal banking networks exist in several member states (Worms, 2001).

30. Money markets are currently mostly developing on a secured basis, *i.e.* money is exchanged against collateral, and so-called *repos*, or repurchase transactions, are becoming the most common instruments in the money market. A repo is a secured transaction, consisting of the exchange of a security and money with an agreement to reverse the transaction at a later date and at a given price. Through this type of transactions, risk is reduced and the efficiency of markets is enhanced. The ECB mainly uses secured transactions for the implementation of monetary policy by tendering funds on a weekly basis. This liquidity is provided for two weeks.[12] The average weekly allotment in this market has recently been close to EUR 60 billion. Participation and collateral are subject to ECB regulations, which gives both participation and associated collateral an increased standing. Securities that are eligible as collateral for the ECB have also become widely accepted as collateral in the market for *private repos*, which is very much larger than for ECB liquidity operations.[13] This market is used by private sector institutions to manage their liquidity requirements and has remained more segmented. The so-called Giovannini Group[14] highlighted a number of reasons why the private repo market has remained segmented (European Commission, 2001*c*). These include the fragmented infrastructure and differences in legislation and market practices. Apparently, current practices and infrastructure are not well equipped to handle cross-border trade, which frequently involves multiple, up to five, jurisdictions, implying often very complicated transfers.[15] Furthermore, in the event of the insolvency of either the counterparty or a financial intermediary, the collateral taker needs assurance that it has a perfect interest in the collateral, free from the grasp of other creditors. The recent Settlement Finality Directive has helped in this respect, and the recently adopted directive on financial collateral arrangements should also improve the legal certainty with regard to the private repo market. However, since such transactions may still result in complex situations, it remains to be seen how integration will evolve.

31. *Short-term securities* are among the basic instruments used in the money market. The markets for such securities, such as T-bills issued by governments, Commercial Paper issued by corporations and Certificates of Deposits issued by private financial institutions, are at different stages of development. This reflects the lack of harmonisation of trading environments, issuance policy, settlement and legal systems and taxation (ECB, 2001a). The use of short-term securities in cross-border private repos mostly covers securities on the ECB's list of accepted collateral in its refinancing operations. Differences in codes of conduct, documentation, clearing and settlement systems and the multiplicity of securities depositories still create operational risk and increases transaction costs (Galati and Tsatsaronis, 2001). There are also national differences on short-selling and restrictions on holdings of certain types of securities. The Directive on financial collateral arrangements will simplify and clarify some of the issues related to the cross-border use of collateral in wholesale financial markets, for instance in situations where securities and cash are used as collateral. It should ease uncertainty related to the treatment of collateral under insolvency law and the determination of what set of national laws applies, imposes some restrictions on the national imposition of formalities and ensures that the collateral taker may re-use the collateral.

32. The derivative markets are also an important element of the money market. Among the futures, options and different types of swap operations, overnight indexed swaps deserve special attention. The so-called EONIA swap market has expanded rapidly after the introduction of the single currency, as it became an attractive tool for managing interest rate risk. In fact, the outstanding positions amount to somewhat more than the USD-denominated market and are markedly higher than the yen-denominated market. This market is highly integrated, reflecting a high degree of standardisation and competition, and the fact that no settlement of underlying securities is required. It is dominated by the major financial market participants in London, Frankfurt and Paris and largely used for hedging purposes (ECB, 2001a). Generally, short-term derivatives markets are characterised by very low bid-to-ask spreads, large transaction sizes and deep liquidity.

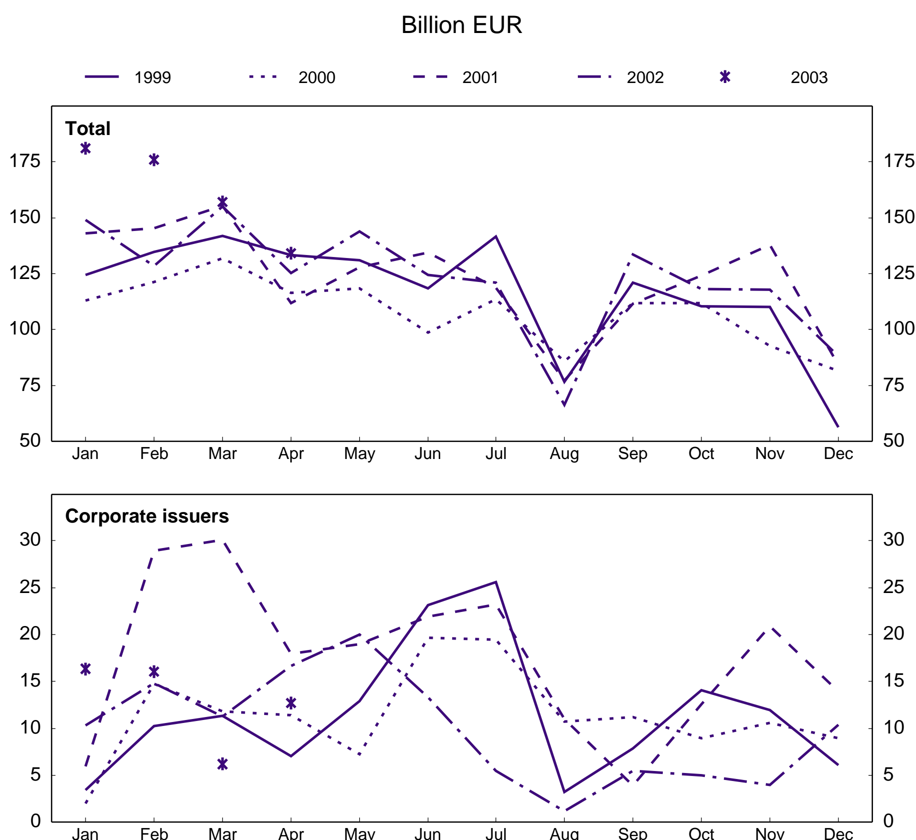
Securities markets have a longer way to go

33. While the integration of securities markets across the euro area had begun well before the launch of the single currency, its introduction accelerated the process and efforts to harmonise market practices intensified (BIS, 2001).[16] Much of this harmonisation was achieved ahead of the launch of the euro in the context of work by a special sub-Group of the Economic and Financial Committee on Government Bills and Bonds, the so-called Brouhns Group. Further progress has been made since the launch of the euro. For example, euro area governments now publish indicative calendars of bond issuance, common trading platforms have emerged that facilitate cross-border trading and competition in the market for investment banking services has increased. One indication for the latter is the convergence of underwriting fees in the euro-denominated segment of the international bond market towards US levels (Galati and Tsatsaronis, 2001). Prior to the introduction of the euro, regulations and prudential policies restricting currency mismatches on the balance sheets of financial institutions and institutional investors had led to a strong home bias in portfolio allocations. The single currency effectively relaxed such restrictions and enabled investors to achieve a greater degree of diversification by investing across the euro area. Many large investors now take a euro area-wide perspective rather than a national one when deciding their portfolio allocations. While this has broadened the investor base, it has also reduced the number of captive investors who previously had purchased securities issued domestically for lack of alternative investments.

34. Outstanding *government bonds* of the euro area countries were re-denominated in euros in early 1999. All new debt issues have since been issued in euros and the trading conventions of these bonds have been harmonised. Up to the launch of the euro, total bond issuance grew strongly along with the other parts of the securities markets. Figure 4 shows that new issuance of euro denominated bonds by corporate issuers, after being rather stable over the first years of the euro and a strong showing in 2001, fell dramatically during the slowdown in summer 2002. The stagnating total issuance after 1999 was due to net issuance of government bonds declining due to the marked reduction in government deficits through the 1990s.[17] This effect is disappearing as deficits have gone up (*OECD Economic Surveys: Euro area*, 2003).

35. Differences in yields on different government bonds within the euro area now appear very small if compared to those prevailing before 1999, when foreign exchange risk still played a role (Figure 5). While yield convergence would suggest that the euro-denominated government bond market is relatively integrated, it should be recalled that there remain eleven separate issuing agents using different issuing techniques. The remaining spreads may be affected by these issuance techniques and instruments, by liquidity, which is low for some maturities, and by differences in governments' credit ratings.[18] The Giovannini Group (2000) focused on the co-ordination of debt issuance throughout the Union, but did not issue recommendations, as the group's views did not converge. However, measures such as a co-ordinated calendar have been implemented.

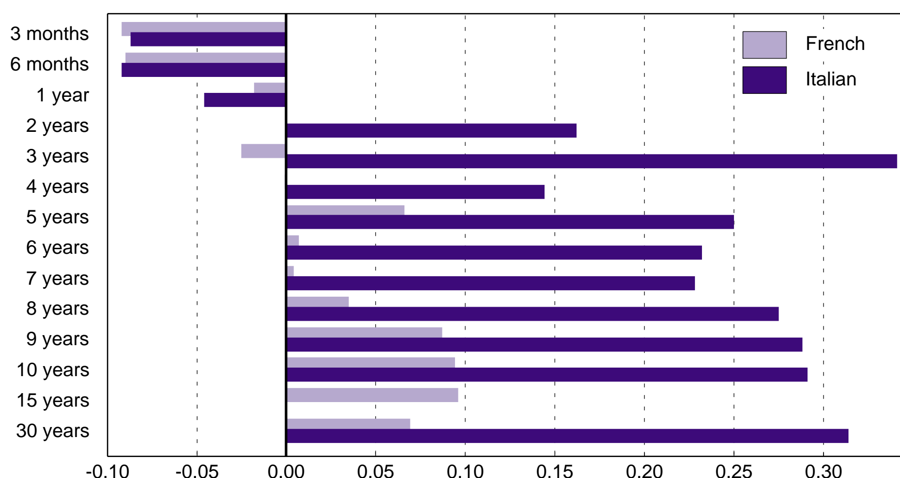
Figure 4. Total monthly issuance of bonds denominated in euro



Source: European Commission, Monthly Bond Market Note - Developments in the Euro-denominated Bond Markets.

Figure 5. Spreads on government bonds

Italian and French against German rates,
percentage point difference by maturity, end January 2002

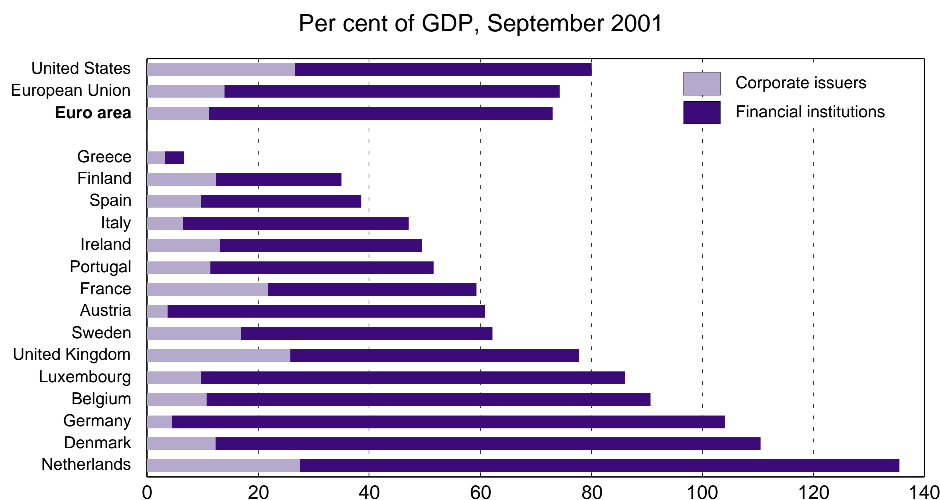


Source: Bloomberg.

36. Meanwhile, the European *corporate sector* has continued to use debt markets less than US businesses even though this has been the strongest growing part of the bond issuance market. After the surge in issuance in 1999, the private fixed income securities markets continued to grow due to several factors. Several businesses marketed large issues across the maturity spectrum to attain benchmark bond status in 2001 and the impact of large losses in stock markets after 2000 led many businesses into the bond market. However, the share of total issuance of euro denominated bonds from the private sector has not continued that increase, except a few markedly strong months early in 2003. It should be noted that roughly a quarter of the annual issuance has a shorter maturity than three years. The implication is that replacement issuance is growing, off-setting part of the total growth. It is notable that few member states are close to the United States corporate debt share in GDP. For the euro area as a whole, this share in 2001 was 11 per cent compared with 27 per cent in the United States (Figure 6).[19] The more equal share for the financial and the corporate sector together, at 80 per cent of GDP in the United States and 73 per cent in the euro area, illustrates that financial intermediaries play a stronger role in the Union. Closing the gap with the United States in bond market financing of businesses will be a very slow process. Over the last three years, the euro area has started to catch up, but the speed is not increasing.

Figure 6. Debt issued by the corporate and financial sectors in the European Union and the United States

Per cent of GDP, September 2001



1. Outstanding domestic and international debt securities.

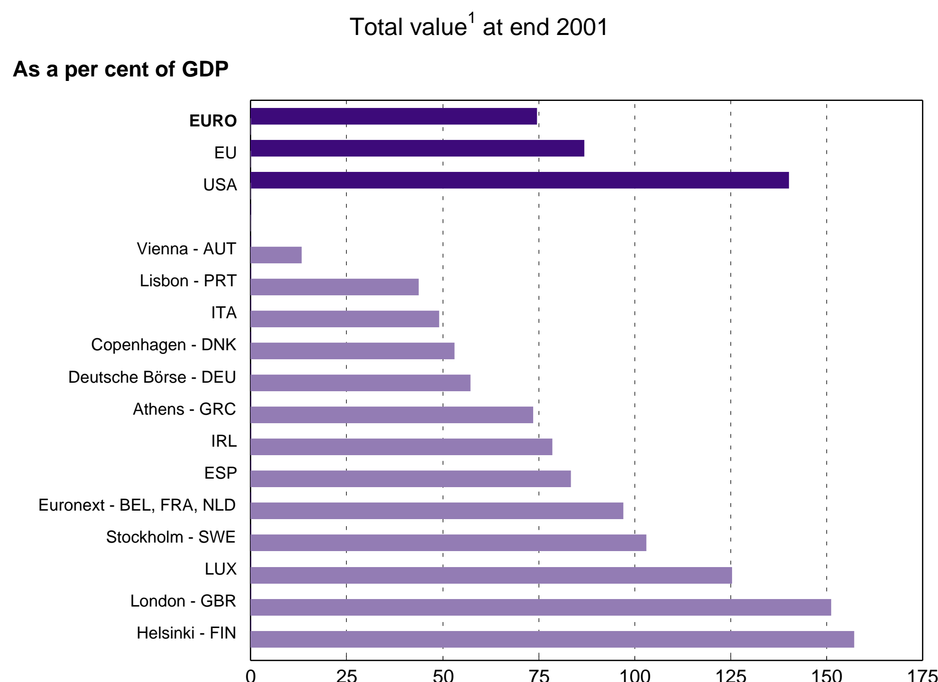
Source: Bank for International Settlements (2002), BIS Quarterly Review (March); and OECD.

37. The European *equity markets* are also integrating. The largest players in the Union are currently the London Stock Exchange, Euronext and Deutsche Börse, each pursuing a different development model.[20] But stock market capitalisation still varied enormously in 2001, ranging from 14 per cent of GDP in Austria to 163 per cent in Finland (Figure 7). This compares with 140 per cent of GDP in the United States. Of course, these ratios have varied along with the recent ITC-led boom and bust in the equity markets. Integration of stock markets is often thought to lead to increased correlation of stock prices throughout the euro area, following exchange risk elimination and convergence in economic structures and shocks, and as such is often taken as an indicator of integration (Fratzsher, 2001). Also, the global integration of markets raises the importance of common external shocks such as events in the United States or in other parts of the global markets. Such increased co-movement was indeed observed after the introduction of the euro, but studies based on a longer time period suggest that this might be a temporary phenomenon (Adjaoute and Danthine, 2001). Convergence may have been affected by greater demand, as euro-denominated equities were included in large, international portfolios. Other research has suggested that stock market correlations vary considerably through time and are highest during periods of economic and financial integration, suggesting that the diversification gains from global investing are not constant (Goetzmann *et al.,* 2002).

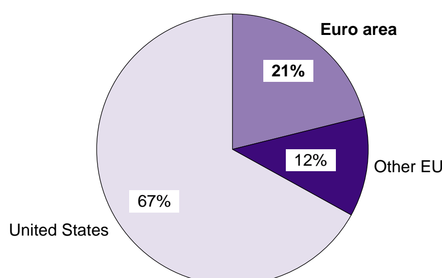
Figure 7. Stock market capitalisation in the European Union and the United States

Total value[1] at end 2001

As a per cent of GDP



As a per cent of total



1. Domestic companies excluding investment funds, rights, warrants, convertibles, foreign companies; including common and preferred shares plus shares without voting rights.

Source: World Federation of Exchanges and OECD.

38. The development of the exchanges is shaped by an increase in cross-border transactions, horizontal and vertical mergers and alliances, advances in selling and outsourcing technology, while new actors have entered the market. One illustration of this is the Visual Trader system developed in Madrid. This system gives real-time screen access and links national brokers to brokers in cross-border markets allowing for easier order placement in many markets. It is clear, though, that also this solution is costly as it involves a higher number of parties than in national markets. Cybo-Ottone *et al.* (2000) suggest some common trends in exchange consolidation, including that network effects seem to be relevant only after reaching a very large "customer base" in terms of listed firms and reputation, or by offering intermediaries remote membership. There may only be space for one or two such mega-exchanges in Europe. Other scale economies are hard to measure, but their relevance seems to be small as exchanges can increase scale easily by outsourcing technology. Many existing exchanges still survive; they have market power due to home bias of investors, and can establish connections through a network. In the long run, such networks

should eliminate the less efficient exchanges as traders concentrate on the more efficient ones. Thus fewer exchanges will survive, perhaps each specialising in one area of trading. Portes (2001), for instance, argues that it is unlikely that Europe will maintain so many separate institutions for long. He also points to a reduction in equity market segmentation through screen-based, remote-access trading and that pan-European indices now are common benchmarks.

39. Still, while investors may be taking an area-wide approach, most European companies apparently continue to consider their domestic capital market as their primary source of funds, and their decisions in this regard appear to be influenced primarily by liquidity and company law considerations (Weil, Gotshal and Manges, 2002). In May 2001, the Commission presented a draft directive on securities trading aimed at establishing common disclosure standards when securities are offered to the public or traded on regulated markets, thus reducing the existing close relationship between listing and trading (the *Prospectus Directive*). The draft directive formed part of the introduction of a single passport for securities and equity issuers, and aimed at simplifying regulatory compliance. A notable feature is the new language regime, whereby the prospectus only has to be produced in one language. A controversial part of the directive is the amount of information that has to be included in all issues, and that the directive does not differentiate between small businesses or small security issues and large ones in its information requirements. The European Parliament proposed extensive amendments to the directive during spring 2002, including the introduction of lower bounds on company size effectively reducing its coverage. Finally, by July 2003 Parliament and Council passed a modified Directive.

40. In contrast with the infrastructure for settling payments, which was integrated with TARGET, the infrastructure for settling securities remains fragmented. As a consequence, cross-border settlement (*i.e.* where at least two different domestic systems and jurisdictions are needed), is complicated due to the numerous parties and connections.[21] The EU securities settlement infrastructure is divided into two kinds of institutions. On the one hand, there are 17 central securities depositories (CSDs) maintaining direct relationship with issuers and providing settlement mainly within the national markets. On the other hand two international depositories (ICSDs) – Euroclear and Clearstream – acting as custodians have accumulated a critical mass of debt instruments from several countries and provide settlement to a more global market across their books.[22] For comparison, the US clearing and settlement system is concentrated in dedicated clearing houses for shares and other securities which keep track of all transactions that take place during a day and calculate the net position of each of its members.[23] At its peak in April 2000, the US National Securities Clearing Corporation (NSCC) processed 18.1 million transactions worth USD 722 billion. Through netting, the total value of financial obligations was reduced by 97 per cent. The Giovannini Group report on clearing and settlement (Giovannini Group, 2001) suggests that netting reduces the number of transactions in the Union by only around 40 per cent. By limiting netting opportunities, fragmentation results in higher costs and restricts the availability of collateral.

41. While domestic transaction costs in some euro area countries are even lower than in the United States, other euro area countries have cost levels that are much higher (Degryse and Van Achter, 2001). The Giovannini Group (2001) pointed out that cross-border transactions are more complicated and include more actors than domestic transactions, because they are typically hindered by a set of significant barriers. Such transactions are thus substantially more costly than domestic transactions, and in addition the cost will depend strongly on which countries are involved. As part of the Giovannini Group's analysis, the Centre for European Policy Studies published a report on the costs of cross-border securities settlement, pointing out that each institution operates its own complex tariff structure making comparisons very hard (Lannoo and Levin, 2001). Based on operating income per transaction, the study finds that customers in the Union pay around four times as much for domestic settlement than in the United States, and that the average for domestic and cross-border settlement together in the Union is around 8 times higher (Table 2). As volumes of cross-border settlement under this regime are rather limited compared with domestic settlement, this average conceals some very high costs. From a post-netting perspective (which compares

the cost for transactions actually settled, excluding the transactions that were simply netted against each other), EU settlement costs are close to US costs. The greater cost of EU settlement thus largely reflects lower netting opportunities, partly due to smaller and fragmented markets with smaller issues and thus fewer netting opportunities, and partly due to restrictions and other barriers to netting. The Lamfalussy Committee suggested that the future of European Union clearing and settlement structure should be left to market forces, but also that this is possible only if national differences in regulation, taxation and law are significantly reduced. The Giovannini Group report warns of difficulties in creating an efficient pan-Union clearing and settlement environment because of national sensitivities and the perverse incentives that exist for entities that profit by arbitraging inefficiencies in cross-border clearing and settlement. In a similar vein, the Lamfalussy Committee indicated that the Commission should evaluate the situation "… if in due course it emerged that the private sector was unable to deliver an efficient pan-European clearing and settlement system". Especially, the organisations that currently own Central Securities Depositories would probably be net losers, creating powerful incentives to protect those revenue streams.

Table 2. Operating income per transaction

2000

	Pre-netting	Post-netting
Including international central securities depositories	7.75 : 1	1.86 : 1
National central securities depositories	4.35 : 1	1.08 : 1

Source: Lannoo and Levin (2001).

42. The fact that no common system has been implemented to facilitate cross-border transfers of small funds, such as those associated with teller machines, credit cards and private transactions, even after decades, suggests that there are strong impediments to such developments taking place spontaneously. This is also evident in the equity markets, where not even specialists are able to compare prices for cross-border payments and settlement (Lannoo and Levin, 2001). While all these markets are open to cross-border trade, currently only second-best, costly solutions exist. Better settlement systems for cross-border transactions in securities markets should be implemented. As the existing players will be net losers from integration, incumbents and their sunk costs make change very hard.

43. In the financial markets, competition policy is very important but also difficult to implement. Looking at the importance of these institutions for the financial markets as such, and indeed the closed markets some of them operate in, there should be a case for increasing cross-border openness by stronger competitive vigilance. Looking at the importance of institutions for clearing and settlement for the financial markets as such, and indeed the closed markets some of them operate in, there should be a case for increasing cross-border openness by stronger national competitive vigilance. In particular, access to the existing infrastructure should be open to new market entrants, possibly subject to fair fees and licenses to be closely monitored by the EU competition authorities. Competitive distortion, such as where countries claim a monopoly over the clearing and settlement of trades, should also be focussed stronger. Regulators and supervisors should beware of being passive, and if gains can be shown to exist for consumers and businesses exceeding the private costs of implementing changes they should not hesitate to impose demands that will put current systems under pressure.

44. The authorities should provide stronger incentives to ensure that infrastructure for cross-border transactions will be put in place, including principles for access to clearing and settlement systems in other member states. The alternative is to wait, and to trust the market and the euro to change things over time. And certainly, growth in parts of the financial markets will nibble away at other parts, as arbitrage opportunities open up and erode current cost and price differences. Still, the experience so far suggests that this will move very slowly. The experience from cross-border transfers, such as in the money markets and for the transfers of private funds, suggests that the authorities should adopt a more pro-active role.

Is European venture capital being left behind?

45. In 2002, venture capital raised was down more than 40 per cent on the top year 2000, and buyout-focused funds had less difficulty in fundraising than venture stage funds (EVCA, 2003). The EU's initial tool in this area, the Risk Capital Action Plan, has been folded into the broader FSAP, suggesting that these issues are no longer receiving the interest they once did. Further, question marks have been put on how the upcoming framework for credit evaluation in banking (Basel 2) will affect bank lending to small businesses, where venture capital is most important. The Commission should evaluate whether harmonisation of venture and start-up funding rules and institutions in the Community may be superior to diversity. The answer is not obvious.

Some cross-border issues remain to be settled in banking

46. For European consumers, transferring money from one country to another is generally much more expensive than transferring money within a country. The issue of a single market in payments has been the target of different initiatives over the past ten years. Still, in May 2001, a survey commissioned by the Commission (IEIC, 2001) showed that differences in charges for national and international transfers may be huge. There are also considerable differences within the same country between banks and between payment methods. The banking industry has pointed out that cross-border payments remain more expensive due to the lack of an integrated pan-European retail payment system, and that parts of these payments have to be processed manually. Partly due to their high cost, the current volume is low (less than 1 per cent of total transfers). The banks argue that the volume is too low to justify the investment in costly automation and interoperability. The Eurosystem has also highlighted shortcomings in the area of cross-border retail payment services in various reports, urging the banking sector to substantially improve such services and helping the banking industry to identify and remove obstacles for inefficient services. The Eurosystem has also been operating under the assumption that the market itself should establish efficient structures and only if it did not succeed should authorities get actively involved. ECB (2001b) proposes technical options for a more efficient infrastructure for cross-border retail credit transfers and outlined a "road map" to which banks should commit in order to be able to decrease the prices of cross-border payments to the level of prices of domestic payments by the end of 2004.

47. In response to the lack of progress in reducing the costs of cross-border payments, the Commission proposed equalisation of cross-border and national charges in the euro area in a *Regulation on Cross-border Payments in Euros* in 2001.[24] Some member states expressed fears that instead of bringing fees down for cross-border transactions to the level of domestic charges, banks would increase their domestic charges to compensate for losses in the cross-border sector, or even withdraw from offering cross-border services. The banking industry pointed out that the Commission had failed to take into account the root of the problem: the lack of a single, multilateral payment system across Europe. Both the Council and the Parliament have endorsed the Regulation, which will become effective for smaller amounts (up to EUR 12 500) in July 2002 for withdrawals from cash machines and the use of bank cards, and for transfers between bank accounts a year later. From January 2006, the rules will extend to amounts up to EUR 50 000 also. Time will show whether lower cost will raise volume enough to make a cross-border system profitable.

48. In addition to regulations, which do not need national implementation, cross-border banking has been the object of several sets of directives which very much do. The first banking directive was implemented in member countries during 1978 to 1993, while the second banking directive was implemented between 1991 and 1994 (Buch and Heinrich, 2002). The freedom of establishment was the first step, as in insurance, but host country control was kept until the second directive. This measure introduced home country control along with mutual recognition of banking licences and minimum harmonisation rules, while local banking charters for branches and host country supervision for subsidiaries were eliminated.

Retail banking focuses on domestic markets

49. The ongoing consolidation of banks is one of the most notable features of the financial landscape (Group of Ten, 2001). It is widely accepted that both Europe and the United States were over-banked at the beginning of the 1990s with many inefficient firms. Since then, banking in the United States has consolidated, with a large number of bank mergers, which have increased both the average size of banks and the area over which they operate (Danthine *et al.*, 2000). This process has created an increasing number of large, and in some cases very complex institutions on a global basis. Strikingly, in the euro area this has largely involved domestic mergers and acquisitions in the same industry segments, followed by domestic mergers and acquisitions across segments. Cross-border activity in the euro area has been rather low, but there were many acquisitions outside the area. The end of the 1990s also saw a trend towards dis-intermediation, as the corporate sector increasingly shifted their funding from banks to directly raising funds from capital markets. In response, banks in the Union have diversified their activities significantly. This is reflected in their balance sheets, with funds being raised more by securities issuance than by deposit-taking and interest income declining relative to fees and commissions. The number of banks also fell continuously throughout the 1990s, both in the Union and in the United States, increasing concentration ratios (Table 3). However, concentration in ownership has not resulted in any reduction in the total number of branches or in the number of employees. In fact, both these indicators show a slightly rising trend over the decade. At the same time, the assets handled per employee have increased and the number of employees per inhabitant has fallen. While profitability has increased, a return on equity of 7.6 per cent was far below the rates observed in both Switzerland (12.2 per cent) and the United States (15.7 per cent) in 1999 (Eurostat, 2001).[25]

50. The banks' role as important intermediaries in continental Europe is illustrated in Table 4, which compares the share of bank loans of the corporate sector in the euro area to that in the United States. While this share is 45 per cent in the euro area, it is only 13 per cent in the United States. The different roles of banks in the Union and in the United States are even clearer from the composition of financial assets. Among the various financial institutions, banks in the Union hold the highest share of financial assets at 49 per cent in contrast with the United States with only 18 per cent. Conversely, American pension funds and investment companies hold much higher shares than their European counterparts.

Table 3. Recent changes in banking structure in the European Union and the United States

	Number of			Per 100 000 inhabitants			Assets[2]	
	Banks	Branches	Employees (thousand)	Banks	Branches	Employees	Million USD	Million USD per employee
United States								
1998	8 814	..	1 612	3.3	..	596	5 382	3.3
1994	10 489	..	1 483	4.0	..	569	3 989	2.7
1990	12 370	..	1 513	4.9	..	605	3 373	2.2
Euro area								
1998	6 826	166 170[3]	2 148	2.3	55[3]	715	14 609	6.8
1994[4]	7 839	163 842	2 126	2.7	56	723	10 568	5.0
1990[4]	8 853	152 723	2 115	3.2	56	775	7 862	3.7
European Union								
1998	6 984	181 708[3]	2 639	1.9	49[3]	706	16 841	6.4
1994[4]	7 999	179 489	2 601	2.2	49	710	11 923	4.6
1990[4]	9 101	169 946	2 607	2.6	49	757	8 914	3.4

1. Commercial banks for Greece, Luxembourg, Portugal, Sweden, United Kingdom and United States; commercial and savings banks for Denmark.
2. Converted to USD using 1995 purchasing power parities.
3. Excluding Luxembourg.
4. Excluding Ireland.

Source: OECD (2001), Bank Profitability 2000.

Table 4. Bank loans to the corporate sector in the European Union and the United States

In per cent of GDP, 1999

	Loans
Euro area	45.2
United States	12.6
France	37.2
Germany	39.8
Italy	49.8
Spain	43.1

Source: Ehrmann *et al.* (2001).

51. The existence of the various banking directives has led some commentators to suggest that Europe might be considered as one of the most integrated banking markets worldwide (Buch and Heinrich, 2002). Still, while wholesale markets are closely integrated, consumers and businesses typically operate in national markets. Lack of harmonisation of consumer protection rules and the related issues of transparency of retail banking are among the main hurdles for cross-border activities of retail banks.[26] Centeno and Mello (1999) did not find evidence of closer links within the loan markets. Also in Sander and Kleimeier (2001) the same proximity result appears; banks do not seem to reach out for cross-border prospective customers, nor do consumers shop around for credit. With regard to the corporate market, they find some evidence of a stronger role for competition. Generally, though, there is lack of arbitrage, limited pass-through of interest rate changes into lending rates, and limited competition in retail banking. Still, the authors conclude that the single currency has the potential to "complete" the single market through more uniform pass-through of interest rate changes induced by the single monetary policy. By focusing on country-specific credit rates, Klemeier and Sander (2002) find only limited evidence of an integrated retail

banking market prior to 1 January 1999, which is explained by the limited effectiveness of the Second Banking Directive in integrating consumer credit markets. At the same time, they point to structural changes after the introduction of the single currency, which is more pronounced for the corporate lending market, while consumer lending markets have remained fragmented. Adam *et al.* (2002) find a distinct lack of integration of short-term corporate loan markets while Heinemann and Schüler (2002), on the basis of substantial reaction differences of national retail bank rates to changes in the cost of funds, conclude that also retail credit markets in Europe are far away from deep integration.

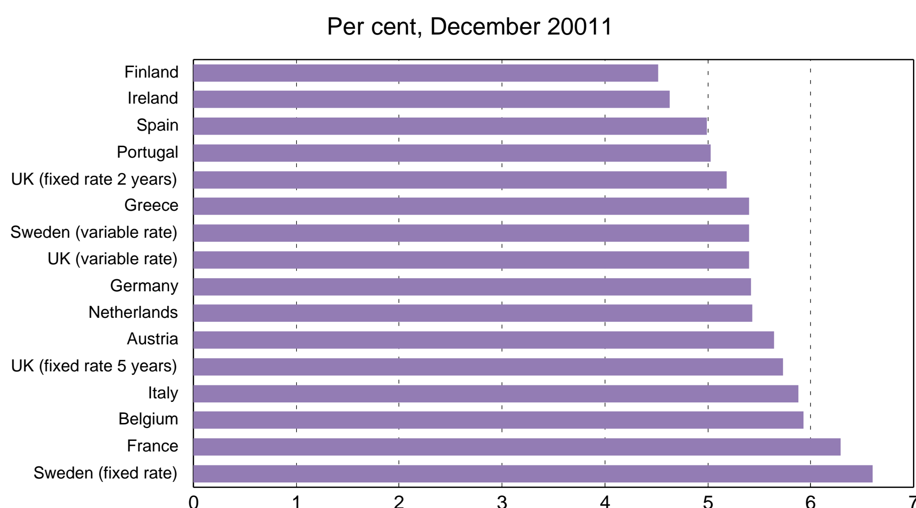
Mortgage markets are heterogeneous and domestically oriented

52. For most consumers, buying a property and taking out a mortgage loan are probably the most important individual financial decisions they ever make. The total volume of outstanding residential and non-residential mortgage loans amounted to nearly EUR 3.8 trillion at the end of 2000, equal to around 40 per cent of EU GDP. Mortgage credit has more than doubled since 1990, growing at an average annual rate of 8 per cent. But it has remained on the fringes of the creation of the single financial market: mortgage markets are segmented and remain largely within national frontiers.

53. The ECB publishes national interest rates for new mortgage loans to households (Figure 8).[27] These rates are not standardised, but instead reflect the dominant form of dwelling funding in countries. The differences in national rates and practices show that mortgage markets are still very different, reflecting the institutional set-up and practices in each country. In some countries, housing finance is organised through banks only and no mortgage market exists. Also, mortgage credit institutions have to date little used the single passport and the remaining differences between the various markets prove in many cases to be insurmountable obstacles when supplying services abroad.[28] On the basis of these rates, Heinemann and Schüler (2002) find that changes in funding rates pass through to mortgage lending rates only sluggishly. Even after six months the pass-through in two thirds of the countries is far from complete.

Figure 8. Key national mortgage interest rates

Per cent, December 2001[1]



1. Not harmonised (may refer to different products).

Source: ECB.

54. Interestingly, the market for securitized mortgages, *i.e.* asset-backed bonds such as the *Pfandbriefe* market, which has existed in Germany for a long time, grew quickly in the 1990s. Similar markets for asset-backed bonds have developed in other member states.[29] These have not gained the same international acceptance as the *Pfandbriefe* (Galati and Tsatsaronis, 2001). Legislation for such products is expected in more countries (such as Finland, Ireland and Italy), but no effort towards cross-border co-ordination of legal systems exists neither for the underlying mortgages nor the securitized products. Thus, there is and will probably remain a great variety of mortgage products, which hinders securitization.

55. To provide consumers with transparent and comparable information on home loans, the five European consumer organisations and six European credit associations offering home loans recently signed a Code of Conduct on pre-contractual information on home loans. The European Commission has also opened an internet-based Register of Lending Institutions adhering to the Code, but so far the information provided in the register has been meagre.

Wholesale banking is internationally oriented

56. Wholesale banking markets in interest rate products and currencies are rather homogenous and there is efficient arbitrage across national markets and financial centres. As national advantages count little and local currency based hedging and trading has vanished among the euro area countries**,** more activity will go towards area-wide homogeneous products. For such products, scale advantages may be important as the market is wide and customers are large. Major participants trade the liquid benchmark products on relatively efficient markets and provide wholesale financial services to the rest of the economy. A similar situation exists in the United States, where the number of "money centre" banks is limited (ECB, 1999). This may lead to further changes in banking structures, with a few large banks at the euro area level moving towards larger shares in these markets while others will aim for smaller size and retail banking activities in the home market. Departing from findings in earlier studies, Vander Vennet (2002) suggests that there are scale advantages to conglomerates or universal banks in Europe. This contrasts with research on the typically specialised banks in the United States for which evidence suggests that only small banks could become more efficient due to an increase in size. This seems to support the willingness of managers and shareholders to contemplate and carry out mergers, both domestic and cross-border.[30] Still, the main barriers to cross-border banking include problems of managing and monitoring institutions from a distance, such as differences in language, business culture, and in regulatory and supervisory structures. The ability to reorganise and acquire businesses in other member states is a necessary part of an integrated financial market. Basic issues regarding cross-border mergers and acquisitions, such as deciding on the competent authority for the regulation of a take-over and under which national laws the take-over should proceed, must be put in place. In addition, the influence of minority shareholders should reflect their part of total ownership in a harmonised way through the Union. If foreign investors are not able to participate in the potential efficiency gains from consolidation, cross-border consolidation will be significantly limited. A long-term test for integration will be for foreign universal banks to earn the same risk-adjusted returns as purely domestic universal banks in the Union.

Banks, competition and finance

57. From a competition point of view, market integration should increase competitive forces. However, the backbone of the equity and other securities markets, the clearing and settlement industry, has been lagging the dismantling of financial borders. As described, the sources can be found, *inter alia,* in national differences in technical requirements and market practices; in national differences in taxation; in issues relating to legal certainty; and in the existence of large incumbent players. The Giovannini Group (2001) has suggested a number of measures to reduce the differences in requirements and practices and thus increase legal certainty. Some of these, such as the framework for collateral, are FSAP proposals that are adopted and will be implemented by the member states in the coming months. The questions related to taxation are still open. Further, the Group has recently proposed alternative arrangements allowing for

improved cross-border clearing and settlement arrangements (Giovannini Group, 2003). The competition authorities should play a stronger role in this area, working towards ensuring that competition concerns are integrated into proposals by vetting them.

58. European business finance is still dominated by bank finance. In addition, in some states a close connection between governments and banks has raised concerns related to state aid, resource allocation within the banking industry and political influence on business decisions. In 2002, the French government reduced its ownership in the main French banks. Explicit German government guaranties to local banks will be ended by 2005, while similar guaranties are being dismantled in other countries. This development towards less public intervention and better pricing of risk will reduce distortions to competition and lead to a better allocation of resources. In 2002 the Commission adopted two antitrust decisions relevant to the financial markets, the first giving a conditional exemption to Visa International's multilateral interchange fee (for cross-border payment transactions) and the second fining eight Austrian banks for their participation in a wide-ranging price cartel (European Commission, 2003).

59. Little competition will result in higher prices and reduced scope of banking services. As shown, the restructuring in European banking has over the years resulted in falling overall numbers of banks, but not in a similar reduction in branches suggesting that branches may serve as a deterrent for entry. Neven and Röller (1999) consider corporate and household loan markets in Europe and find significant collusive cartel-like conduct in these markets. One measure for competition pressure in banking is entry of new banks. In the *OECD Economic Surveys: Euro area* (2003) it is shown that new banking licences are fewer in the Community than in other OECD countries, suggesting that competitive pressures are higher in the latter countries. Recent empirical studies from the United States have pointed to a link from bank competition to entry rates among small and medium-sized businesses. A bank will face a trade-off between restricting credit to new entrants while continuing its ongoing relationship with industry incumbents on the one hand, and allowing credit access to new firms thus establishing new and possibly more valuable relationships with them at the expense of the older clients, on the other. Empirical work seems to confirm that the less competitive conditions are in the credit market, the lower is the incentive to finance new-comers (Cetorelli, 2002). Banking market structure and competition may thus have heterogeneous effects across firms within an industry sector. Boyd and De Nicolo (2003) question whether banks that are faced with more competition will choose a more risky portfolio, and point to mechanisms that work in the opposite direction. They conclude that the current anti-competitive consolidation processes in banking which are often supported by central banks or other regulatory authorities, should be re-assessed with a view to such other essential mechanisms. For the Community, slow growth of new businesses and low exit among existing ones is a well-known feature, and the recent work suggests that banks could play a larger role.

Insurance markets continue to face important entry barriers

60. The global pension and insurance industry does not show the same trend towards concentration as the banking industry does. In fact, the Group of Ten (2001) found that the insurance industry does not show any consistent global pattern. In the Union, though, the industry showed some concentration as the number of enterprises fell by 8.4 per cent since 1996 to 3 900 enterprises in 1999 (Eurostat, 2002). The reduction in the number of enterprises was mainly in the non-life part of the industry. In the same period, premiums increased by 33.7 per cent to EUR 760 billion. Splitting the industry in the two main parts, non-life per capita spending varied from EUR 275 in Portugal to EUR 1 505 in Luxembourg, while the life sector had an even bigger dispersion from EUR 365 in Portugal to EUR 10 923 for Luxembourg. These data suggest that the EU's insurance industry is very heterogeneous. Part of the trend towards fewer enterprises consists of insurance companies merging with banks in several EU countries.

61. Cross-border insurance provision is limited and seems currently to be driven by tax and regulatory arbitrage. For the countries for which data are available (Eurostat, 2002), figures show that in 1999 the 2 400 EU enterprises active in life insurance had set up only 27 foreign branches in Union countries and nine outside the Union. Non-life insurers have developed their branch network far more, with 196 branches in the EU and 90 in the rest of the world. Branches are often set up in neighbouring countries. According to Eurostat, cross-border activities under the freedom to provide services, which do not require setting up a branch, in 1999 generated somewhat higher total premiums in life insurance than in non-life activities. Practically all such non-life cross-border provision activity is based in Ireland and Luxembourg.

62. In insurance, there has been a three-step development towards common policies. In the 1970s, a first set of directives (for life and non-life insurance, respectively, and in addition for motor insurance in the first and second step) founded the freedom of establishment, so insurance companies could open subsidiaries, branch offices and agencies in all member states under host country prudential supervision rules. The second set of directives from the 1980s made it possible to sell services cross-border, without having a fixed branch or subsidiary. Host country control was abolished for certain industrial risks. The third set of insurance directives was launched at the beginning of the 1990s, supporting the freedom to provide services. In principle, insurance companies should now only need a licence from the home country supervision authorities to conduct business across borders, by establishing branches or by providing services. This single authorisation (European passport) enables an insurance undertaking to carry out business anywhere in the Union after notifying the relevant authorities, either by opening agencies or branches in other member states or under the rules on the freedom to provide cross-border services. Still, if a member state invokes the "general good" it can justify national rules, such as requiring prior notification of policy conditions, certain rating systems or compulsory clauses in insurance contracts.[31] These national rules have to some extent made the common passport less attractive, and in its current incarnation has had a disappointing take-up. Beckmann *et al.* (2002) point to different national rules (taxation, regulation, contract law, consumer protection), low price sensitivity among consumers and the necessity of building trust for the long-term relationship between customers and suppliers that characterise life insurance products as important remaining barriers to a single market for insurance.

63. As the organisation of social protection and pension schemes is a matter for the member states alone, occupational pension schemes and related regulations differ significantly.[32] In October 2000, the Commission presented a proposal for a directive on institutions for occupational retirement provision (*i.e.* pension funds, super-annuation schemes etc.). The aim is to create a prudential framework, to ensure protection for the rights of future pensioners and that institutions enjoy sufficient freedom to develop an effective investment policy, and to enable an institution in one member state to manage company pension schemes in other member states. A qualitative approach to investment rules is proposed. As a general rule asset allocation must be prudent and ensure proper diversification in terms of issuers, type of securities, geographical zone, currency or sector. The co-ordination of prudential supervision is one of the necessary conditions for allowing pension funds to manage schemes on a cross-border basis. However, the cross-border portability of pension rights remains problematic. The proposal thus touches only on some of the relevant issues.

Align common and national interests

64. Internationalisation of financial services helps countries build more robust and efficient financial systems by introducing international practices and standards; by improving the quality, efficiency and breadth of financial services; and by allowing more stable sources of funds. An implication of the integration of markets for securities is concentration in fewer and larger marketplaces over time. The growth of such "money centres" in the Union, where major players are situated and which are the natural pools for larger issues will affect the national markets. In fact, the reaction in some local markets seems to

be that such concentration makes for easier establishment of a trading centre for national securities outside the country. Still, as countries stand to loose their existing local market centres, defensive pressures have developed. A balance must be struck between conserving the services that should be supplied at a local level, perhaps especially with a view to risk capital, which is closely related to local knowledge, and accepting the long-term gains that can be reaped by letting other areas depart for more efficient market places. For example, Gaa *et al.* (2001) suggest that globalisation will result in a single global market in the most-liquid assets based on equity-market linkages. On the other hand, they see also a role for national-level intermediated markets for less-liquid products.

65. In the same vein, a balance must be struck between consumer protection and industry interests in the approach to legislation. While protection is important, consumers and businesses gain from financial market integration and care should be taken not to mistake local industry interest for consumer protection. Some businesses have a tendency to appear as national champions, typically increasing barriers to external competition and acquisition. While some in fact may be important to national infrastructures, it should be made harder to disguise bad performance and high costs as being in the national interest. It is not in the general interest to allow managers to resist take-overs. Several member states allow the board of the targeted company to take defensive measures in the case of a hostile take-over bid without consulting the shareholders, while others raise the stakes by denying the buyer the right to condition the offer on supervisory or competition authority approval. It is notable that others have moved in the opposite direction by not requiring a bid to be launched in the case of a transfer of control. Minority shareholders benefit or lose from these rules: in some countries their influence is far above their ownership share and in others far below. Take-over bids are an important way of making inefficient businesses work better. A necessary part of an integrated financial market is the ability to acquire businesses in other member states.

Current policies and their implementation

66. While the huge differences once observed across the area are gone, there is still unfinished business. The EU's main tool for realising deep integration is the FSAP, endorsed by the Cologne European Council (June 1999). The FSAP is a set of measures, both legislative and non-legislative. Financial market integration received a second institutional boost at the Lisbon Council (March 2000), which reaffirmed the FSAP and set a deadline for its achievement in 2005.

The ingredients of the Financial Services Action Plan

67. The FSAP consists of more than 40 single measures (Table 5), some of which were highlighted in the previous. On the wholesale side of the markets, there are measures aimed at making it easier to raise capital on an EU-wide basis through common rules for the contents of prospectuses and other reporting, reducing heterogeneity in financial statements for listed companies and establishing a common legal framework for securities trading. Over-arching this are measures to improve prudential rules and supervision and measures concerning taxation. The measures in the Action Plan are very heterogeneous, varying from legislative measures such as Regulations and Directives, which have to be adopted by the Council and the European Parliament, to non-legislative measures such as Communications, Recommendations and Reports issued by the Commission. Thus, for some measures the Commission will be responsible for finalisation of non-legislative measures, while the Parliament and Council will be ultimately responsible for adopting the legislative measures. National legislation will be required to implement the Directives. To date most measures have been finalised. All non-legislative measures have been adopted by the European Commission, whereas most of the legislative measures have been agreed or are scheduled for adoption. Some important ones remain, though (Table 6). The remaining measures are important and it will be a challenge to reach consensus on them in time for the deadline of 2005 as earlier agreed by European Union Heads of state and government. Rapid implementation of Directives on the national level is very important and challenging.

Table 5. Overview of individual measures in the Financial Services Action Plan

Strategic objective 1: a single EU wholesale market

1. Upgrade the two Directives on Prospectuses.
2. Update and upgrade the Regular Reporting Requirements.
3. Directive on Insider Dealing and Market Manipulation (market abuse).
4. Communication on and Directive to upgrade the Investment Services Directive (ISD).
5. Communication on Conduct of Business Rules in the ISD (distinction between professional and retail investors).
6. Amend the 4th and 7th Company Law Directives to allow fair value accounting.
7. Communication updating of the EU accounting strategy followed by legislative action.
8. Modernisation of the accounting provisions of the 4th and 7th Company Law Directives.
9. Recommendation on EU auditing practices (quality assurance and auditor independence).
10. Implementation of Settlement Finality Directive.
11. Directive on financial collateral arrangements.
12. Adoption of the proposed Directive on Take Over Bids.
13. Political agreement on the European Company Statute.
14. Review of EU corporate governance practices.
15. Amend the 10th Company Law Directive.
16. 14th Company Law Directive.
17. Commission Communication on Funded Pension Schemes.
18. Adoption of the two Directives on UCITS.
19. Directive on the Prudential Supervision of Supplementary Pension Funds.

Strategic objective 2: open and secure retail markets

20. Political agreement on proposal for a Directive on the Distance Marketing of Financial Services.
21. Commission Communication on clear and comprehensive information for purchasers.
22. Recommendation to support best practice in respect of information provision (mortgage credit).
23. Commission report on differences between national arrangements relating to consumer-business transactions.
24. Interpretative Communication on the freedom to provide services and the general good in insurance.
25. Proposal for amendment of Insurance Intermediaries Directive.
26. Commission Communication on a single market for payments.
27. Commission Action Plan to prevent fraud and counterfeiting in payment systems issue.
28. Commission Communication on an e-commerce policy for financial services.

Strategic objective 3 : state-of-the-art prudential rules and supervision

29. Adopt the proposed Directive on the Reorganisation and Winding-up of Insurance Undertakings.
30. Adopt the proposed Directive on the Winding-up and Liquidation of Banks.
31. Adopt the proposal for an Electronic Money Directive.
32. Amendment to the Money Laundering Directive.
33. Commission Recommendation on disclosure of financial instruments.
34. Amend the Directives Governing the Capital Framework for Banks and Investment Firms (Basel 2).
35. Amend the solvency margin requirements in the Insurance Directives.
36. Amendment of the Insurance Directives and the ISD to permit information exchange with third countries.
37. Adopt a Directive on Prudential Rules for Financial Conglomerates.
38. Commission Decision for a Securities Committee and a Committee of Securities Regulators.

General objective: wider conditions for an optimal single financial market

39. Adopt a Directive for ensuring taxation of interest income from cross-border investment of savings.
40. Implementation of the December 1997 Code of Conduct on business taxation.
41. Review of taxation of financial service products.

Source : Progress Report (2001) and OECD.

68. Of eight prioritised measures for adoption in 2002 from the Barcelona Council, five were adopted by the beginning of December 2002. Several more have been adopted in 2003. For the legislative measures, co-decision necessitates adoption by both Council and Parliament. A continuous re-adjustment of the programme following new developments and set-backs has made the number of measures less relevant, as shown by the remaining measures listed in Table 6. Of these issues, several are new as compared to the original FSAP (examples are the proposals for a Follow-up Report of the High Level Group of Company Law Experts, which partly developed in the wake of the Enron scandal in the United States and for continued efforts on Cross-border Clearing and Settlement arrangements following the Giovannini group's work in the field).

Table 6. Status of the Financial Services Action Plan measures Legislative programme for 2003

Proposals scheduled for adoption by Parliament and Council
Take-Over Bid Directive
Modernisation of the Accounting Provisions of the 4th and 7th Company Law Directives (mid 2003 expected)
Transparency Directive (2004 expected)
Investment Services Directive upgrade (early 2004 expected)
Expected Commission proposals
Follow-up Report of the High Level Group of Company Law Experts
Proposal for a 10th Company Law Directive
Proposal for a 14th Company Law Directive
EU Legal Framework for Payments in the Internal Market
Reinsurance Supervision
Clearing and Settlement - follow-up of the Giovannini Group
Remaining key FSAP measures
Review of the capital requirements for financial institutions
Insurance Solvency II

Source: European Commission and OECD.

69. The effectiveness of some measures seems to have been affected by the lowering of goals. For instance, following the debate on supplementary pensions and the wide-ranging goals contained in the Green paper on supplementary pensions (European Commission, 1997), the number of issues tackled in the draft Directive is disappointing. Another example is the fate of the prospectuses directive, as the European Parliament proposed a number of changes during the spring of 2002. To meet criticisms on the new prospectus document being too extensive, and that many businesses will have to face the costs of producing annual prospectus supplements which they will never utilise, the Parliament chose to focus on company asset size. Thus, businesses with assets lower than EUR 350 million might be exempted from the new regime. According to the European Commission, this implies that less than one in four businesses across Europe will have to produce their prospectuses in accordance with the common format.[33] As the gain in information for these companies through the prospectus directive is small (larger companies are already followed closely by analysts and the financial press), the current suggestions will basically relegate legislation on prospectus content to the national domain and not create a common standard. As shown by the extensive debate surrounding recent initiatives, the remaining tasks may face even stronger resistance. Taking into account both the time for adoption and the following delays in national implementation, it will nevertheless take quite some time until the FSAP is implemented completely. Some issues, such as the portability of pensions across borders, will remain an important barrier to the free flow of labour and capital.

Recent steps in the Plan

70. A major difference between the United States and the European Union is the absence in the latter of both common and modern corporate laws and of accounting standards. The ability to evaluate securities, equity and businesses across borders would be facilitated by a common law and standards, opening up, on the one hand, opportunities for dis-intermediation and less expensive trades, and on the other, a larger pool of capital to tap. Recent initiatives address these issues:

- From October 2004, companies operating in more than one member state will get the option of being established as a single company. The European Company (known by its Latin name *Societas Europaea*, or SE) will let businesses operate governed by one set of rules only, with unified management and reporting systems rather than having to respect different national laws. The European Company statute may offer reduced administrative costs and a legal structure adapted to the internal market as a whole. Still, the directive also includes a number of rules and regulations that may increase cost and hamper its take-up. Especially, the rules for worker involvement seem to go much further than in national legislation generally. As the European Company will not appear for some time, neither the take-up among businesses or the practicality of the rules may be assessed for a while. However, the High Level Group of Company Law Experts is currently working on proposals to extend the Community-wide principle to other companies (private companies, co-operatives, and other forms of enterprise).

- From 2005, all EU companies listed on a regulated market must prepare consolidated accounts in accordance with *International Accounting Standards (*IAS*)*. Member states will have the option to extend this requirement to unlisted companies. The proposal will help to eliminate barriers to cross-border trading in securities by ensuring that company accounts are more transparent and can be more easily compared. This should in turn increase market efficiency and reduce the cost of capital. However, the market players are arguing for changes to the proposals on valuation of financial instruments, where especially banks have to comply with accounting rules as well as regulators' requirements in their risk management strategies. The Commission has also launched proposals to modernise the fourth accounting directive (on annual accounts) and the seventh accounting directive (on consolidated accounts) accordingly.

- Over the last decade, proposals on a cross-border *Take-over Bid Directive* have been presented to Council and Parliament regularly, as current legislation in this area dates back to 1989 and leaves many practical issues unsolved. The proposal was identified as a priority by the 2000 Lisbon European Council in view of its potential benefits in terms of facilitating restructuring and so boosting competition, expected in particular to offer Europeans engaged in take-over bids greater legal certainty and to protect the interests of minority shareholders. In 2000, an amended proposal was introduced. This proposal included a minimum level of harmonisation to increase legal certainty. In July 2001, the Parliament rejected the proposal, mainly based on the argument that the management of targeted companies would be left with no effective possibility for defensive measures – so-called poison pills – to frustrate a bid without consulting their shareholders and also, that the directive did not respect subsidiarity. Following the rejection, the Commission set up a High Level Group of Company Law Experts in September 2001 to assist in the preparation of a new directive and to define new priorities for the future development of company law. The Commission launched a new proposal for a Directive during October 2002, this time outlawing most defences, limits on individual shareholdings and restrictions on the transfer of shares but keeping dual shareholding structures, where some shares have greater voting rights and thus let their holders dominate company decisions. The proposal has again become the object of negotiations as additional goals and issues are being introduced.

- Among the restrictions on running cross-country businesses in the EU, the necessity of operating individual *occupational pension funds* in each of the countries where the business has a pension plan for its employees is ranked high. One common scheme operating cross-border would make equal treatment of employees easier and reduce the costs of running such pension schemes, but raises complicated tax and supervision issues and is not feasible under current rules.[34] Attempts to create a common prudential framework for pension funds in the European Union go back to the early 1990s. A directive was proposed by the Commission in October 2000, and the Barcelona Council set the end of 2002 as its deadline (adoption took place in May 2003, and will be followed implementation by Member States within 24 months). This Directive aims to enable institutions to accept sponsorship by, and run a pension scheme for, a company located in another member state subject to detailed rules of operation. However, the organisation of pension schemes falls under the subsidiarity principle and is a matter for member states only. The new Directive thus cannot touch a number of substantial issues.

- A Directive on *insider dealing and market manipulation (market abuse)* was proposed in 2001 and adopted under co-decision in January 2003. This basic framework for the allocation of responsibilities, enforcement and co-operation within the European Union is aimed at professional market participants. The directive was heavily amended late in the process, *inter alias* due to its effects on a diverse range of professions. Secondary and implementing legislation on the market abuse directive will represent the first use of the speeded-up Lamfalussy procedures.

- The draft Directive on *securities trading and prospectuses* was presented in May 2001 and updated two earlier pieces of EU legislation (acts from 1989 and 1990), with both the FSAP and the Risk Capital Action Plan listed as top priorities. The proposal aimed at simplifying regulatory compliance by establishing common disclosure standards when securities are offered to the public or traded on regulated markets, and forms part of the single passport for issuers. The Parliament suggested a number of changes during spring 2002. While the Barcelona Council (March 2002) had asked the Council and Parliament to adopt the Directive as early as possible in 2002, final adoption took place in July 2003. However, work on secondary legislation had by then already been started.

- Along the same lines, a directive on *transparency obligations of publicly traded companies* was proposed in March 2003. The proposed directive will apply to all companies whose securities are admitted to trading on a regulated market in the EU, such as the wholesale bond markets (*inter alias*, Eurobond markets). The directive updates and upgrades periodic information requirements for securities issuers, especially related to the introduction of International Accounting Standards (IAS). This is also a framework directive, expected to be adopted in 2004 (two years after the initial timeframe).

71. Several other initiatives of the same nature are forthcoming. The Commission will issue a communication in late 2003 on Company Law and Corporate Governance on the basis of the conclusions of the Report of the High level Group of Company Law Experts (the Winter Group Report). It is expected to cover issues such as disclosure of companies' corporate governance structures, the role of independent or supervisory directors, and corporate reporting. Further, the EU legislative framework on auditing will be revisited with a view to introducing, *inter alias*, provisions on auditors' independence and adequate public oversight of the audit profession. As to the need for reinforcing statutory audit, the Commission's Recommendation on Auditor Independence should be followed by a Communication which is expected to introduce a 10-point-plan for actions for reinforcing statutory audit in the EU. This is going slowly, though.

The framework for regulation

72. Admitting the slow process of adopting legislation, the authorities have taken steps to re-shape the regulatory process by separating first principles from secondary legislation. The Economic and Financial Affairs (Ecofin) Council established a Committee of Wise Men on the Regulation of European Securities Markets under the chairmanship of Alexandre Lamfalussy in 2000. It was asked to assess how the mechanism for regulating the securities markets sector can best respond to developments, and, in order to eliminate barriers, to propose scenarios for adapting current practices to ensure greater convergence and co-operation in day-to-day implementation. The Lamfalussy Committee published its final report in February 2001 (*i.e.,* the *Committee of Wise Men* (Lamfalussy Report, 2001)), underscoring the need to rapidly adopt the measures in the FSAP. As a second main topic in its report, the Committee recommended changes to the legislative process for approving legislation on securities market regulation.

73. The new framework for the securities sector was shaped by these proposals. The set-up is very similar to the structure of primary and secondary legislation that exists in most countries. The Lamfalussy proposals were endorsed at the Stockholm Council in March 2001. The committee structure was proposed to be in operation by the end of 2001. However, members of the European Parliament and the Committee on Economic and Monetary Affairs raised concerns about the proposed four-level approach for speeding up the adoption of new rules, and specifically the use of committee procedures. Their complaint was that the role of the Parliament, and specifically its right of co-decision, would be reduced. As a consequence, the adoption by Parliament was delayed until February 2002 and further transparency, consultation and co-operation measures were added to the proposal. The new approach consists of four levels:

> **Level 1:** Framework principles are to be decided by normal EU legislative procedures (*i.e.* by proposals by the Commission to the Council of Ministers and the European Parliament for co-decision).
>
> **Level 2:** Arrange for the implementation of details following the Level 1 framework decisions through two new committees – an European Securities Committee (ESC) and an Committee for European Securities Regulators (CESR) - which will assist the European Commission.
>
> **Level 3:** Enhanced cooperation and networking among EU securities regulators to ensure consistent and equivalent transposition of Level 1 and 2 legislation (common implementing standards).
>
> **Level 4:** Strengthened enforcement, notably with more vigorous action by the European Commission to enforce Community law, underpinned by enhanced cooperation between the Member States, their regulators, and the private sector.

74. The first use of the speeded-up procedures following the Lamfalussy proposals was during the second half of 2002 for the *Directive on Market Abuse*, which will soon come into force. Others, on *prospectuses* and *investment services*, are also recently adopted. These framework directives are adopted in co-decision between the Council and European Parliament (level 1). Secondary legislation (implementing rules) will be adopted by Committees of both Ministry representatives and technical experts (level 2). Supervisory committees will provide input for discussions at level 2 and will stimulate co-ordination between national supervisors (level 3). This committee structure was proposed to be in operation by the end of 2001, but was implemented a year late. A review of the proposed regulatory structure will be carried out in 2004.

75. The other measures on which the Lamfalussy Committee focussed, were the modernisation of the listing and issuing process including the introduction of a single prospectus and a single system document (passport) for providing authorisation for recognised stock markets, the introduction of common accounting rules, the generalisation of the home country principle to cover wholesale markets, and the modernisation of investment rules for investment and pension funds.[35] These were thought to be most important for completing a single European market in securities and to be adopted before the end of 2003. Under the increased impetus following the Lamfalussy Report, the proposals concerning the use of international accounting standards were adopted during the first half of 2002.

76. During December 2002, the Ecofin Council endorsed a report from the Economic and Financial Committee (EFC) on financial regulation, supervision and stability extending the principles from the Lamfalussy framework to the other financial sectors (*i.e.* banking, insurance, pensions and financial conglomerates). The introduction of a new committee structure in insurance and banking as in securities' markets was a step long overdue.

Scrutinise decision-making and co-ordination

77. As (retail) financial services are among the most country-specific markets, two pillars underpin financial markets' integration: "mutual recognition," whereby only essential standards should be harmonised hence allowing mutual recognition for the rest, and "home-country" control, whereby the regulations, laws and practices of the home country must be accepted as applying both to operation of branches and to cross-border provision of services. This section takes stock of the evolution of relations between the various EU actors involved in financial markets, to illustrate how the set-up of policy-making may impact on the efficient delivery of a process. Integrated financial markets are an essential element of the single market, but in some areas this has not been achieved or progress is slow. This slowness in delivering the necessary legislation is responsible for delays in financial market integration.

78. Thygesen (1999) argues that the development of a separate European profile in financial supervision should be an ambition, built around a focus on banking supervision with an increased role for the ECB. The paper admits that the issue of who is in charge of supervision is subsidiary to whether the task is sufficiently well co-ordinated at the European level. At the national level, the very varied structure of national supervision is combined with a wide range of approaches. Mishkin (2000) defines the "regulatory approach" to banking supervision as focusing on compliance with specific regulatory rules while the "supervisory approach" focuses more on the soundness of practices with regard to controlling risk. With an integrated and cross-border market, financial institutions in the Union will over time become less diverse as they operate in similar markets. The common principles in directives and regulations will also result in supervisors' tasks becoming more similar. A rising degree of interdependence will also require a similar euro area wide convergence in approaches towards supervision (Fratzsher, 2001). Thus, with time there is reason to expect less diversity in supervision practices and structures across the member states, first in the tasks the supervisory authorities face as financial enterprises and markets become more similar, and later followed by the need for more similar supporting structures within the supervisory authorities.

79. For the securities markets, the Lamfalussy Committee built on proposals from the FSAP and suggested orienting the legislative approach towards the over-riding issues and away from tedious detail. This should lead to a faster and more streamlined legislation process, provided the issues really stay separated and do not end in a continuous replay as legislators choose to re-evaluate secondary legislation. Still, a system of primary legislation followed by technical provisions is just the process in place in most countries and not an innovative process.[36] In fact, in its opening comments the report says that "The basic legislation for an integrated financial market is not in place. The mosaic of European regulatory structures is well documented – over 40 of them – with different powers and competencies. The current regulatory system is simply too slow, too rigid and ill-adapted to the needs of modern financial markets. Even when it

does work, which is rare, it often produces texts of legendary ambiguity – along with little or no common effort to transpose the agreed texts consistently – nor enforce their proper application." The divergence between analysis and proposals is striking. Indeed, this harsh judgement seems to deserve a much broader answer than reorganisation of committees and implementation of a regular decision system.

80. There has been quite some interest in the question of whether the current regulatory setting will deliver good results in the long run at low cost, or whether other set-ups would be superior. A large number of issues are related to the organisation of supervision.[37] In the European Union, the existence of significant differences across countries suggests that close relations should be maintained between supervisors and supervised institutions at the local level. These issues need to be taken into account when considering how best to achieve the objective of promoting convergence of supervisory practices to support the transition to an integrated market. This convergence has been pursued effectively through the current institutional setting for supervisory co-ordination based on sectoral committees consisting of representatives of the competent national authorities.

81. The set-up of committees also reflects the sectoral approach of financial market legislation in the European Union. In the rapidly changing financial environment, the structures for financial regulation and supervision are very important for the design and implementation of new legislation, for sharing of supervisory information and best practices to attain convergence, and more generally for the assessment of threats to financial stability. This raises the need for continued reassessment of these structures. The recently implemented proposals from the Lamfalussy Committee for re-organising the securities market regulation process do now serve as framework for the set-up in the other sectors of the financial markets. The use of subsidiary bodies is an efficient way of carrying out work on technical issues, but it should be recognised that the border between technical and political issues may be hard to draw.

82. Consumers and businesses in the Union will only benefit from reforms enacted by the Council and the Parliament after they are faithfully implemented at the national level. To avoid a long drawn out implementation process, there should be more weight on respecting deadlines for national implementation. The new legislative process as proposed by the Lamfalussy Committee leaves the Commission in charge of infringements and enforcement. Taking into account the low level of identified infringements and weak enforcement in both this and other areas, enforcement efforts should be stepped up.

The many views on supervision

83. An effective supervision of EU financial markets is crucial for their functioning and stability. The issues surrounding the architecture of supervision centre on the need to evolve in the light of closer market integration. Bilateral co-operation is central to the current approach. Present arrangements have succeeded in weathering the recent financial market turmoil, the arrival of the euro and the ongoing restructuring of the financial sector. Given its fundamental importance, the debate on changing the current set-up has continued.

84. Supervisory structures vary considerably in the Union:

- The traditional institutional approach follows the industry lines along banking, insurance and securities markets and firms, with one supervisor for each industry.

- Objective based supervision aims at reducing systemic risks, *i.e.* the channels for propagation of problems in one institution to the rest of the financial system. Another objective is the protection of consumers' interest, while a third is economic efficiency, competition policy being most important in this respect. This approach suggests separate supervisors for each objective, or perhaps a single supervisor with divisions covering these aspects.

- A third approach focuses on the central functions of the financial system such as the pooling of savings, diversification, management of risks, clearing and settlement, provision of price information and so on. This approach could again be pursued by separate supervisors, or a single supervisor covering all these functions.

85. The organisation of supervision may mean integration of tasks into one institution or into several. But it is also clear that the line between purposes and organisation is often blurred. Supervision may also be looked at from the supervised institution's perspective; then issues such as a set-up with a "one stop shop" and easy access to contact persons become important.

86. The systemic arguments often dominate the debate. These are strongest for banks, somewhat less for insurance and least for the securities markets as such. On the other hand, consumer protection issues are typically more pressing in securities markets, less so in insurance and least in banking. From an institutional and systemic point of view, this raises the question on whether supervision should concentrate on banking and perhaps insurance, while the securities markets should be left to the competition authorities and institutions for consumer protection. Then again efforts to create a level playing field may indicate a need to bridge the industry divides. The need for a "lender of last resort" is closely connected to the issue of systemic crises, traditionally giving rise to a role for central banks in supervision.

87. Developments in the financial industry are complicating matters. Today, conglomerates cross separate industries in most countries. And some actors operate across borders, which raises complicated issues for supervision; should these institutions be looked upon separately, who should set capital requirements, and who should approve their products? When they also cross industries, they become complex groups and raise issues about responsibility sharing across supervisors.[38]

88. The Lamfalussy Committee noted that in general, national moves to a single supervisor (with responsibility for all financial sectors) are mostly driven by different developments in national markets and concluded that the different national contexts mean that there is no appropriate common "model" for all member states at this juncture. Martinez and Rose (2003) show that harmonization of prudential regulation and supervision across the different segments of the financial system remains limited, despite the institutional merger in most countries that operate integrated supervision. One may thus argue that different supervisory set-ups will continue to co-exist, which may lead to regulatory arbitrage. While regulatory competition could be beneficial, it could also contribute to segmenting markets.

Should the differences in supervision be reduced?

89. Currently, the organisation of supervision at the national level is related to the legal and regulatory tradition of individual member states. The dominant forms of supervision in the Union are through separate entities for bank, insurance and securities supervision or one integrated supervisor for all industries (Table 7). Some member states integrate some, but not all of these functions.[39] A single set of

regulations and a centralised supervisory authority is not optimal where information asymmetries abound, and where the legal (*e.g.* the bankruptcy code) and financial practices differ across countries. It would probably not be compatible with the subsidiary principle or be the best safeguard for an effective supervisory structure. The alternative approach is to connect, rather than merge the existing regulatory spheres, with institutions complying with the rules of and being supervised by the country of principal location. Recent research has shown that regulatory competition does not necessarily lead to downward pressures on regulation, but may at times also push the level of regulation upwards (Genschel and Plümper, 1997). Such upward pressure may not only result directly from the dynamics of the competitive process but also from international cooperation.

90. On the regulatory level, it is expected that "regulatory arbitrage" across the Union could eventually lead to market-driven harmonisation. Licensing, regulation, enforcement and supervision are all based on mutual recognition, underpinned by regulatory networks and trust. The Commission should foster co-ordination and draft framework directives within which national institutional arrangement, regulation and supervision develop. In the Brouwer report (EFC, 2000) on arrangements for the prevention of financial crises, a favourable assessment of existing arrangements within the EU was provided. However, the report recommended that the practical functioning of the institutional arrangements should be enhanced by

> *i)* strengthened cross-sector co-operation at the international level, and greater use of "co-ordinating" supervisors for large cross border/cross sectoral financial groups;
>
> *ii)* improved and regular information exchange among supervisors and between supervisors and central banks and a regular exchange of views between Finance Ministries and supervisors on the adequacy of financial regulation at national and European level and on any necessary adjustments;
>
> *iii)* strengthened co-operation between supervisors and central banks to avoid risks of contagion of financial problems at a major financial group; and
>
> *iv)* a convergence in supervisory practices to enhance the efficiency of the national supervisory authorities involved in monitoring cross-border financial institutions.

91. Finally, the report argued that there is a need to keep existing arrangements for crisis prevention under review to ensure that they are adapted to a continuously changing environment. The second report was published in April 2001 and focused on financial crisis management. This report had two parts, assessing the implementation of the recommendations of the previous report and analysing crisis management procedures respectively. The assessment of implementation of the first report was favourable, and the report concludes that substantial progress is being made in improving information exchanges but that continued efforts should be pursued to improve further the functioning of existing institutional arrangements. On the institutional framework, also this report concluded that institutional changes are unnecessary with regard to crisis management but that closer co-operation among the authorities (supervisors, central banks and ministries) is required. For crisis management, the report gave a number of specific recommendations, among them that agreement should be reached on the co-ordinating supervisor and its responsibilities including information gathering and communication, particularly in crisis situations, for the major financial institutions (including conglomerates) which are domiciled in the European Union.

Table 7. Orientation of national supervisors

	Orientation of supervision	Supervision of conglomerates
Austria	Integrated supervisor for banking, securities, insurance and pension fund supervision. Central Bank participates in banking supervision.	Identity of lead regulator for a financial conglomerate is determined on the basis of principal activity.
Belgium	Sector-based but steps have been taken to give a co-ordination role to the Central Bank, *inter alias* through the creation of a Financial Stability Committee.	Financial conglomerates operate without a single or lead regulator.
Denmark	Integrated supervisor.	..
Finland	Separate legal entity responsible for the supervision of banks and securities companies, shares the support services of the Central Bank. Insurance companies and private sector pension funds in a separate authority.	Financial conglomerates operate without a single or lead regulator.
France	Sector-based (with Central Bank involvement).	No specific regulations on activities of financial groups, but an agreement to promote co-operation between relevant authorities exists.
Germany	Integrated supervisor (Central Bank co-operation in some cases). Recently established authority integrates supervision of insurance, banking and securities sectors.	Cross-sector oversight is based on a forum in which the Ministry of Finance, the Bundesbank and the three sectors of the integrated supervisor are represented.
Greece	"Largely" sector-based. Central Bank exercises prudential supervision of credit institutions and other financial institutions.	Identity of lead regulator for a financial conglomerate is determined on the basis of principal activity.
Ireland	Single regulatory authority for financial services in the Central Bank.	..
Italy	Largely sector-based. A division of competencies by objectives is adopted between the Central Bank (stability of financial intermediaries) and the securities commission (transparency and rules of conduct).	The Central Bank has responsibility for bank-dominated groups. Arrangements for information sharing between supervisory authorities have been established.
Luxembourg	One authority for supervision of banking, investment firms and financial asset markets.	Financial conglomerates operate without a single or lead regulator.
Netherlands	Objectives-based (Central Bank for banks).	Financial conglomerates operate without a single or lead regulator. Cross-sectoral aspects handled by the Central Bank and the Insurance Board in co-operation (Board of Financial Supervisors). A new legal framework is being developed.
Portugal	"Largely" sector-based.	Board of Supervisory Authorities, chaired by the Central Bank, has responsibility for bank-dominated groups. Working groups of representatives from each supervisory authority for information sharing have been established.
Spain	Sector-based (Central Bank participation).	A lead regulator is appointed in the case of financial groups or conglomerates.
Sweden	Integrated supervisor.	..
United Kingdom	Integrated supervisor (Central Bank co-operation in some cases).	..

Source: Institute of International Bankers (2000), Global Survey 2001, September, New York; European Commission and OECD.

92. In the euro area, many national central banks are either directly responsible for prudential supervision for banks or strongly involved in this activity. The arguments for combining central banking and supervision activities are the possible synergies in information gathering and financial market knowledge, as both institutions depend on a deep understanding of developments in financial markets. Moreover, the systemic issues that are at the centre of a central bank's task as lender of last resort are very much related to banks and the other credit and payment channels. As some of the information gathered by supervision authorities is confidential, it may not be transferred and utilised by central banks even if a formal information-sharing channel exists. ECB (2001) also argues that a systemic focus has become more relevant and suggests not only that monetary policy should be coupled with supervisory responsibility, but also that national central bank involvement should extend beyond banking. On the other hand, the arguments in favour of separation include the potential conflict of interest between supervision and monetary policy and the blurring of the distinction between financial products and intermediaries. If cross-border banks differ from local banks in technology or other relevant characteristics, then they may increase the systemic risk in a country, through changing the merged institutions or through the increased size of these institutions. Then again, Belaisch *et al.* (2001) argue that cross-border activity in itself may increase or reduce risk, depending on specific features of the financial system.

NOTES

1. The share of total staff devoted to internal market issues is now less than one tenth of staff engaged in research and education and culture (Alesina, *et al.*, 2001). Financial market staff constitute less than one-third of these again.

2. Karsenty (2000) provides a rough estimate including all modes of supply, which doubles the trade share for all services and would probably raise the trade share for financial services by significantly more.

3. Such limitations have to be specified by sector and/or by mode of supply, but there is also the possibility for World Trade Organization (WTO) members to maintain "horizontal" restrictions, which apply to all sectors, including financial services. Such restrictions are most commonly found in the areas of investment and labour mobility (i.e. modes 3 and 4 of the GATS).

4. Most-favoured nation treatment stipulates that "with respect to any measure covered by this Agreement, each member shall accord immediately and unconditionally to services and service suppliers of any other member treatment no less favourable than that it accords to like services and service suppliers of any other country". Exemptions are, however, allowed, which should not exceed a period of 10 years.

5. These data draw on a database developed by Martin Roy (Canadian Finance Ministry) for the OECD.

6 See e.g., Lane and Milesi-Ferretti (2003) for a recent empirical study of financial integration on a world, rather than an EU basis.

7. Portes and Rey (1999) find strong roles for information, market size and transaction costs in explaining bilateral cross-border equity flows in a sample of 14 countries, while adjacency, language, currency, "trade block" and "major financial centre" effects are small. Rose (2000) on the other hand finds a strong role for a common currency.

8. Along with the reduction and convergence of inflation expectations, the waning of exchange risks in the run-up to monetary union explains much of the apparent convergence that is depicted in Figure 3.

9. Euro Interbank Offered Rate, calculated daily at 11.00 in Brussels as the unweighted average of offered rates for interbank deposits of prime banks on the basis of transactions by 57 banks. Forty-seven are euro area banks, four are from other EU member states and six are international banks. Fifteen per cent of the highest and lowest rates are omitted when calculating the rate.

10. Euro Over Night Index Average is calculated daily between 18.45 and 19.00 in Brussels as a weighted average of all overnight unsecured lending transactions in the interbank market initiated within the euro area among the same panel as for the Euribor.

11. The Directive, which is part of the FSAP, concerns finality and irrevocability of payments, and aims to resolve the conflict of legal rules governing collateral transactions in EU settlement systems. It stipulates that the law of the jurisdiction where the holder's rights are legally recorded should be applied.

12. The ECB operates a two-tier system for collateral, with one list of EU-wide acceptable collateral and one for acceptable collateral at the national level. Since June 2000 the interest rate on repos issued by the ECB has been set through price auctions with a minimum interest rate. This minimum rate is the ECB's key policy rate.

13. A recent survey commissioned by the International Securities Market Association (ISMA) put the gross value of European participating banks' outstanding repo business at EUR 2 300 billion in December 2001.

14. The Giovannini Group is a group of financial-market participants, under the chairmanship of Alberto Giovannini, which advises the European Commission on financial market issues. The Group was formed in 1996 and has focused on identifying inefficiencies in EU financial markets and has proposed practical solutions to improve market integration. It has issued several reports.

15. The possibilities are: the jurisdiction under whose laws the security was issued, the jurisdiction where the securities are physically located, the jurisdiction where the register recording the interest is maintained, the jurisdiction where each intermediary maintains its records evidencing the book-entry interest and the jurisdiction where the investor is located.

16. From 1996 to 1999 bond issuance in euro and the euro legacy currencies more than doubled (Santillán, et al., 2000), while corporate issuance nearly tripled between 1998 and 1999.

17. While total issuance fell by nearly 8 per cent from 1999 to 2000, it rose by nearly 14 per cent again in 2001. The total issuance in 2001 was thus nearly 5 per cent above the 1999 issuance.

18. The launch of the euro was preceded by convergence in euro-area bond yields to historical lows. The elimination of exchange rate risk was a main driving factor, but the existence of fiscal rules and their surveillance are likely to have contributed by reducing the default risk premiums. This is reflected in the convergence of credit ratings to the highest level, which are now AA or higher in all euro area member states except Greece whose local currency long-term debt rating is currently A (according to Fitch Rating).

19. In addition to domestically issued securities, this includes international debt (i.e. securities issued in foreign markets or in foreign currency).

20. While Euronext links together the stock exchanges of Amsterdam, Brussels, Lisbon and Paris with the futures and options exchange LIFFE in London in addition to a number of other alliances, Deutsche Börse is developing a vertically integrated structure. The London Stock Exchange has not entered into formal alliances with other service providers.

21. The process of buying stocks or securities includes the placement of the order, margin payments, clearing of orders between brokers, transfer of funds from buyer to seller, transfer of proof of ownership or transfer of actual documents and possibly other transfers. Cross-border, there will usually be contact between a local and a foreign broker (i.e., someone admitted to the exchange), and the same set of transfers executed with the brokers as actors instead of with one broker acting as middleman. Institutional actors will usually be able to effect cross-border transfers much more effectively than smaller players.

22. The European System of Central Banks (ESCB) has promoted some harmonisation among securities settlement systems (both CSDs and ICSDs) by issuing a set of user standards in 1998. The ESCB accepts only collateral held at securities settlement systems that meet these standards. More recently, the ESCB and the Committee of European Securities Regulators (CESR) have initiated a regulatory process to provide standards and/or recommendations for securities settlement systems and for central counterparties at the European level. Common standards will over time contribute to creating a level playing-field for the providers of securities clearing and settlement services and to overcoming the significant heterogeneity within the legislative frameworks of European countries.

23. The Depository Trust & Clearing Corporation (DTCC) is a holding company with two subsidiaries that provide the primary infrastructure for the clearance, settlement and custody of the vast majority of equity, corporate debt and municipal bond transactions in the U.S. For government securities, the Government Securities Clearing Corporation (GSCC) provides centralised, automated clearance and guaranteed settlement. Similarly, the MBS Clearing Corporation (MBSCC) is the sole provider of automated trade

comparison, confirmation, risk management, netting and electronic pool notification to participants in the mortgage-backed securities market.

24. While Directives must be transposed in national legislation after adoption in Parliament and council, Regulations are directly applicable and thus become effective much faster.

25. There are still significant differences in profitability of banks among member states, as in their risk and capitalisation profiles..

26. The existing differences in taxation rules, definitions and practices add to the cost of cross-border transactions. This creates barriers to holding assets and to purchasing financial services, and slows down integration. Thus, the increased mobility of capital implied by integration of financial markets may erode tax bases throughout the Union. The taxation of cross-border savings has also been a long-standing issue. In 1998, the Commission proposed a directive on the taxation of cross-border savings of individuals, consisting of a withholding tax and an automatic exchange of information. Two years later the Council agreed to an automatic exchange of information system as the preferred regime in the long run, while providing a transition period for withholding taxes for some countries (Joumard, 2001). Moreover, in areas such as pensions, the principle of delayed taxation (i.e., premiums are deductible and interest income not taxed while payments of pensions are taxed) implies that countries may have to change the special tax treatment in the interest of simplicity.

27. For the United Kingdom, the figures refer to outstanding credit and not new business.

28. The mortgage markets in Europe differ much due to differences in owner occupation, regulations and taxation, and the ratio of the value of a property that a mortgage can be raised against.

29. Some of these are France, Luxembourg and Spain, which launched respectively, Obligations foncières, Lettres de Gage and cédulas hipotecarias. There are institutional differences to the Pfandbriefe in areas such as the extent of preferential claims on these products.

30. The Group of Ten (2001) points out that mergers and acquisitions transfer wealth from the shareholders of the bidder to those of the target as being a global observation, as do Berger et al. (2000) in a broad review of the literature on cross-border banking performance.

31. These concepts have been interpreted by the Commission repeatedly (see Communications of February 2000 and June 1997), but as they are developed by case law the Commission's influence is somewhat limited.

32. The heterogeneity in the EU's insurance and pension industry is partly explained by different approaches to saving for old age in the member countries. Existing pension financing varies from national pay-as-you-go systems to pension schemes funded in life-insurance companies or separate pension funds. Eurostat estimates the total membership in autonomous pension funds in the Union at around 21 million (Eurostat, 2002). The geographical distribution of autonomous pension fund investment (where data is available; that is only for Finland, Portugal and Spain) is in fact already surprisingly broad; the share of foreign assets varies from 29 to 38 per cent.

33. Commissioner F. Bolkestein cited in Financial Times, 14 March 2002.

34. The special issues related to occupational pension funds are related to the long time period between the obligations arises (premiums are paid) and the actual pay-out of pensions. This creates i) the need for long term overview of such schemes by pension fund supervisors on behalf of members to ensure that funds are not diverted to other purposes; ii) the same from tax authorities as taxes on pension premiums are deferred today but are often imposed on the much later pension pay-outs; and iii) the possibility that the country giving the tax break in the first place is not the same as the one receiving the tax receipt later, a situation countries have tried to avoid to protect their tax bases.

35. In addition, the Lamfalussy Group suggested that the Commission conduct and publish research quantifying the benefits of and indicators for the ongoing integration process in financial markets.

36. It is interesting to note that after failure to agree on harmonised standards in the draft directive on credit institutions, Robert Hutton, the former Director of the Banking, Insurance and Financial Institutions in the Commission, said that subsequent drafts should concentrate "on basic principles rather than details" (quoted by Story and Walter (1997), p. 251). As this was in 1972, implementation will hopefully be more successful this time around.

37. Especially, there are concerns that national supervision may not work well as financial services cross borders. Complex financial groups (i.e. businesses that operate both cross-border and/or cross-industry) increase the need for information sharing, co-ordination and co-operation among supervisory authorities. It is still a matter for discussion whether this necessarily requires the establishment of a consolidated supervisory authority, but a growing number of countries worldwide have moved to some form of consolidated supervision (OECD, 2001). The Lamfalussy Committee argued against the creation of a super-regulator, such as the powerful US Securities and Exchange Commission (SEC), citing the incompatibility of the legal systems and business cultures in different states.

38. Also questions about the costs and benefits of supervision are still around. Could money used for costly supervisory systems be better spent or saved? During the consultation process related to Basle 2, the issue has been raised, whether simpler solutions than establishing heavy monitoring systems would not be more effective (The Banker, January 2002). Does the supervision "industry" really add value by extending its reach or should the financial industries be regarded as any other service provider and be subject to consumer protection and competition policy only?

39. Di Giorgio and Di Noia (2001) suggest four different approaches; the institutional, the objective based, functional supervision (based on functions such as clearing and settlement, pooling of savings, diversification, managing risks, providing price information, etc.) and a separate category – the "single-regulator supervision" (where all functions, objectives, etc. are concentrated in one entity).

Glossary of acronyms

BAC	Banking Advisory Committee
BSC	Banking Supervision Committee
CSD	Central Securities Depository
ECB	European Central Bank
ESCB	European System of Central Banks
Ecofin	Economic and Financial Affairs Council
EU	European Union
EUR	Euro currency
FESCO	Forum of European Securities Commissions
FSAP	Financial Services Action Plan
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
ICSD	International Central Securities Depository
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
US	United States
USD	United States dollar

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Annex

The Institutional Framework

93. The central policy co-ordinating body within the Union is the Financial Services Policy Group (FSPG), comprising representatives of the EU Finance Ministers. It meets regularly as a forum for discussion and aims at building consensus between national ministries involved in financial services regulation. Among its current tasks is the review of progress in the implementation of the FSAP. The FSAP also included proposals for the securities markets, the area of regulation and supervision least included in the process so far. In 2000, the Lamfalussy Committee ("The committee of wise men") followed up on these proposals by suggesting rearranging the committee structure. The former High Level Securities Supervisors Committee and the Forum of European Securities Commissions (FESCO) received recognition and were upgraded to the European Securities Committee and European Securities Regulators Committee, respectively. The existing committee structure basically follows the financial sectors and includes committees for cross-border discussion, advisory committees and committees with regulatory powers. Beside these, the need for cross-sector co-operation has given rise to committees for co-operation, and the international dimension of regulation and supervision has resulted in membership of some or all the member states in international committees.

94. In the field of securities, the recently established European Securities Committee (ESC) was set up in June 2001 following the Lamfalussy report and will have both advisory and regulatory functions. In its advisory capacity the ESC will advise the Commission on securities issues relating to the drafting of directives and on regulations under co-decision. Also, it will formally function as a regulatory committee once its regulatory functions have been defined by forthcoming legislation. In its capacity as a regulatory committee, the ESC will assist the Commission in the exercise of implementing powers conferred on it by legislative acts adopted under co-decision. The Committee of European Securities' Regulators (CESR) is an independent Committee regrouping senior representatives (mostly heads of national supervisory authorities) and will act as an independent advisory group to the Commission on technical measures (established along with the ESC in June 2001, CESR follows the FESCO, an earlier and more informal group).[40] The CESR is in most areas rather parallel to the Banking Supervision Committee (BSC), and will receive mandates from the Commission to act within defined time-limits. Before the Commission finally decides on the mandates, the ESC will be consulted. According to the press statement following the first meeting of the ESC, its working groups will help the Commission prepare the scope of these mandates and the priorities. In addition, the CESR will provide regular activity reports to the ESC. The Commission will inform the CESR of ongoing political priorities, and will be represented at meetings and entitled to participate in debates. CESR will also have the central role in ensuring more effective co-operation between the member states' authorities so as to ensure more consistent day-to-day implementation of Community legislation, and in this function it will act as a forum for discussion in the field of securities regulation.

95. In the insurance industry, the Insurance Committee is composed of representatives of the member states' supervisory authorities and chaired by the Commission. It will give its assent on measures proposed by the Commission. The Insurance Committee also performs an advisory role with regard to the application of the Community provisions on insurance and the co-ordination to be pursued in that field. Besides the Insurance Committee, there is the Conference of Insurance Supervisors, which constitutes a discussion forum. This Conference has operated for a long time and has no formal remit. Banking is the area with the most extensive committee set-up to promote co-operation between the competent authorities for regulatory and supervisory matters within the individual areas of activity:

- The Banking Advisory Committee (BAC) operates in the regulatory area by providing the Commission with assistance in the preparation and proper implementation of new proposals and the adoption of technical adaptations to legal acts. In addition, the BAC is entrusted with amending existing Community banking legislation. BAC gained regulatory powers on banking issues as a consequence of the adoption of proposals in the Lamfalussy report.[41] Its function is reflected in its composition, which includes, in addition to the national central banks and the supervisory authorities, representatives of the Ministries of Finance.

- The BSC has tasks relating to both prudential supervision and financial stability, and serves both the supervisory authorities and the Eurosystem. It is an exchange of information between the Eurosystem and supervisory authorities. In particular, the BSC monitors the banking and financial sector and facilitates the exchange of information and analyses matters of a macro-prudential nature. In its tasks its effective functioning relies on the willingness by the supervisory authorities to co-operate. The BSC is composed of high-ranking representatives from the ECB, the national central banks and other national supervisory authorities. The secretariat of the BSC is provided by the ECB.

- The main forum for the exchange of information and co-operation among the banking supervisory authorities is the *Groupe de Contact* (GdC). This forum promotes contact among supervisors in the European Economic Area (EEA) on regulation and supervisory practices. It also considers individual cases. Hence, the GdC is composed solely of representatives of supervisory authorities.

- In addition to these committees, commercial, savings, co-operative and mortgage banks come under the wing of the *Comité des Organisations Professionnelles de Crédit* instituted in Brussels with the help of the Commission in 1979. Also in 1979, the Contact Committee for the securities markets was established to ensure regular consultation between member states. The UCITS Contact Committee (Undertakings in Collective Investments of Transferable Securities), which advises on these issues, was established in 1985.

- In the international arena, the Basle Committee on Banking Supervision (BCBS) is the central forum for banking co-operation. In 1988, the Committee proposed a capital risk measurement system – the Basle Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8 per cent. In June 1999, the Committee issued a proposal for a New Capital Adequacy Framework (Basle 2) to replace the 1988 Accord, consisting of three pillars: minimum capital requirements (to refine the standardised rules set out in the 1988 Accord), a supervisory review of an institution's internal assessment process and its capital adequacy, and use of disclosure to strengthen market discipline as a complement to supervisory efforts.

96. The FSAP states that following the new Accord from the Basle Committee, the Community should adopt a version proposed by BAC as a directive. However, the Basle Committee's schedule has been extended, and implementation of the new framework is currently planned for end-2006. The Commission is also reviewing the solvency framework in the insurance sector (the Solvency II review). The intention is to carry out this review based on the same broad principles as Basel II, while finding an approach that is suitable for the insurance sector.

97. The Commission, the ECB and the member states are all involved in a number of other co-ordinating groups. The International Organisation of Securities Commissions (IOSCO) was established to facilitate co-operation to promote high standards of regulation in order to maintain sound markets and has currently 172 member agencies. Established in 1994, the International Association of Insurance Supervisors (IAIS) represents insurance supervisory authorities of some 100 jurisdictions. IAIS issues global insurance principles, standards and guidance papers, provides training and support on issues related to insurance supervision, and organises meetings and seminars for insurance supervisors. The Committee on the Global Financial System (CGFS) is a central bank forum for the monitoring and examination of broad issues relating to financial markets and systems with a view to elaborating appropriate policy recommendations to support the central banks in the fulfilment of their responsibilities for monetary and financial stability. In carrying out this task, the Committee places particular emphasis on assisting the Governors in recognising, analysing and responding to threats to the stability of financial markets and the global financial system. The CGFS was established by the Governors of the G10 central banks.

98. The Financial Stability Forum (FSF) was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. FSF brings together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts and seeks to co-ordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk. The Joint Forum (formerly known as the Joint Forum on Financial Conglomerates) was established in early 1996 by the Basel Committee, IOSCO and IAIS, to continue the work of a predecessor group, the Tripartite Group, in examining supervisory issues relating to financial conglomerates. The Joint Forum comprises an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. Thirteen countries are represented on the Joint Forum: Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The European Commission attends as an observer.

Notes

40. The Forum of European Securities Commissions (FESCO) was founded in 1997 by the statutory securities commission of the European Economic Area. Its objectives, met through "working by consensus," were to develop standards that complement the legal framework established by the European directives, or that cover areas where no European law exists, for the realisation of the single financial market. Each FESCO member was committed to implementing these standards in its home jurisdiction.

41. BAC is formally responsible for: i) implementation of directives; ii) licensing procedures connected with the second banking directive, which instituted the Single Community Banking licence; and iii) supervision of the banking solvency ratio.

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