I - Financial services liberalisation and integration in the European Union

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Outline Part I –
Financial services integration in the EU

1. Rationale – The case EU financial integration
2. History – from the Treaty of Rome to the euro
3. Recent policy developments (FSAP)

Outline Part II – Perspectives and challenges in financial integration in the EU

1. Post-FSAP
2. The new EU Member States
3. Lessons

1. Rationale – The case for EU financial integration

Defining financial integration

"Financial integration may be defined as a situation whereby there are no frictions that discriminate between economic agents in their access to – and their investment of – capital, particularly on the basis of their location." (ECB 2003)

Not always easy to move from abstract to operational definition : What can realistically be achieved? At what cost ?

Direct impacts of integration

- **Consolidation** : scale and scope economies, revenue diversification
- Stronger **competition**
- **Deep** and **liquid** financial markets → lower transaction / trading costs
- More **innovation** in larger markets
- Agents in less developed areas get **access** to large and sophisticated financial markets
- Better **institutions** (upgrading of national regulation, eg in new EU MS)

→ **More efficient and competitive financial services markets**

Benefits from integration

Key economic role of the financial markets: ‘Oil of the economy”, i.e. allocate resources across time and space and provide ways to manage risk

Benefits:

- Better allocation of savings to investment
- Lower funding costs for companies and consumers
- Better risk/return for investors
- Less exposure to external real and financial disturbance
- Increased capital inflows (outflows?)
- Financial stability?

→ Higher potential output growth

Quantification of benefits from EU financial integration

EU experience : politically important to have good economic case

EU Financial sector ca. 6% of EU-15 GDP and 2.5% of employment

Estimation of benefits plagued by data / model uncertainty, but available studies point to sizeable benefits :

- 1988 – **Cecchini report**: 1/3 of macroeconomic gains from SMP from the financial sector
- 2001 - **London Economics** . Security markets. Static gains → - 0.5 pp cost of capital → + 1.1% level of GDP. Potentially larger dynamic gains.
- 2001- **CEPR** . Manufacturing. If EU companies gained same access to finance as US companies → + 0.7-0.9 % in growth rate of VA in EU manufacturing sector

Essential conditions

To reap the economic gains, policy measures that foster integration should at the same time aim at:

- Cost-effectiveness
- Competition
- Market integrity
- Financial stability
- Consumer confidence

2. History – From the Rome Treaty to the euro

Milestones

1957 - Rome Treaty

1985 – COM White paper : completing the internal market
1987 – Single European Act
1991 – Maastricht Treaty
1992 – Single Market Programme deadline

1999 - The euro
1999 - The FSAP and RCAP
2001 - Lamfalussy

2005 – Post-FSAP

1957 - Rome Treaty

Treaty : freedom of movement of goods, services, persons and capital, but …

…in 1960s and 1970s , emphasis on CU for goods (eliminating quantitative restrictions and discrimination based on nationality)

EC cautious on capital liberalisation : fears of market instability and BoP considerations ; preserve autonomy of national monetary policy

→ EU adopted directives to liberalise K flows only to the extent required by movement of goods and FDI

Early 1980s: heterogeneous financial systems in the EC

- **Capital movements** : South MS extensive controls on K movements (esp. sh-term); North MS liberalised

- **Regulation** - Universal bank model in D, F, I , NL; other MS, separation of commercial/investment banking. Non-market regulatory instruments widespread

- **Market structure**: large state ownership in F, GR, I, PT ;
- B, UK, LUX more open to competition

- **Obstacles to foreign entry** (eg authorisation procedures, K endowment requirements, restrictions on foreign takeover).

→ **Little integration, large price differentials**

1985 – The Single Market Program

- White Paper "Completing the Internal Market" → 279 measures + a timetable for their adoption

- Some key features of the White Paper:
  - Supply-side (prevailing economic climate)
  - Clear timetable
  - No apparent financial cost (elimination of barriers)
  - Technical, low key – no apparent risk to sovereignty

- 1986/7 - SEA : IM by 1992 as an objective. It extends QMV (also to capital liberalisation)

SMP strategy for financial services liberalisation and integration

liberalisation of capital movements

+

harmonisation of regulatory frameworks (essential rules)

+

mutual recognition (home country control)

Capital movements

1988 Directive : complete liberalisation of K movements by July 1990

Politically , made possible by:

general trends of deregulation and internationalisation of financial activities in 1980s

+

recognition of declining effectiveness of K controls

+

emergency safeguards (if threat to XR or MP) and temporary exemptions for less developed MS

SMP financial legislation

- Banking - 1989 directives, effective from Jan.1993
- Insurance – solvency regime based on margins
- Investment funds – Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) → "single licence" regime for collective investment
- Investment services in the securities field → single passport for investment firms and banks

General remarks on SMP in financial services

- QMV crucial for SMP
- In banking, in one stroke EU went further than US!
- Harmonisation + mutual recognition relying on few agreed and transparent rules (8% capital ratio)
- Home country control → competition amongst regulatory systems
- Universal banking model → stronger competition between and within countries

1999 - The euro

Single currency needs to be underpinned by integrated financial markets

→political boost to financial integration → the FSAP

1. Financial markets is where the most immediate impact of the euro was felt (standardisation and transparency of prices ; elimination of XR risk ; elimination of XR-related investment restrictions)

2. Integrated and efficient financial markets are crucial to the smooth operation of the single monetary policy

3. Recent policy developments

- Barriers
- FSAP
- RCAP

1990s – Remaining barriers to integration

- Lack of harmonisation
- Regulation and supervision
- Taxation
- Natural barriers

Lack of harmonisation

- National markets developed independently according to national preferences. Not necessarily inefficient , but may combine badly

- Gaps in EU financial rule book

- Areas of national discretion: (eg consumer protection left to MS)

- Four main legal traditions
  - English, French, German , Scandinavian → differences in protection of creditors and enforcement of contracts

Regulatory process and supervision

- Much EU regulation, but lack of consistency in :
  - National **transposition** of directives
  - **Implementation** of directives

- Lengthy and cumbersome regulatory process

- Too detailed and inflexible regulation

- Different supervisory structures and practices

→ **Lamfalussy 4-level framework**

Taxation

- National tax systems different wrt :
  - tax on savings
  - privileged products
  - tax on revenues
  - procedure

→ High compliance costs

→ Obstacle to pan-European (or even multi-country) products

→ Obstacle to X-border business (eg double taxation)

- Unanimity requirement: difficult to make progress

Others barriers

- ‘Natural’ : language, culture
  →hard to overcome

- Technical
- Market practices
  → often a co-ordinating role for authorities

- “Attitudinal” barriers
  → fight vested interests, national protectionism

Financial Services Action Plan

- May 1999 - COM adopts the FSAP: 42 measures to complete/ update the regulatory framework by 2005 (transposition date)

- Written in co-operation with market experts

- Not only legislation :
  - Commission communications and recommendations
  - Directives and regulations

- Initiatives were to be considered in isolation

Strong political support

- European Council (Spring):
  - Lisbon (2000) set a deadline of 2005 for FSAP implementation ;
  - Stockholm (2001) shortened deadline to 2003 for securities markets and RCAP;
  - Barcelona (2002) 8 key measures by end-2002

→ **FSAP a resounding success: 95% completed on time**

FSAP Objectives

1. A single wholesale financial market
2. Open and secure markets for retail financial services
3. State-of-the-art prudential rules and supervision
4. Wider conditions

1. A single wholesale financial market

Raising K on EU-wide basis
- Prospectuses
- Reporting requirements

Common legal framework for capital markets
- MiFID
- Market abuse

Securities settlement
- Settlement finality
- Cross-border use of collateral

Financial statements for listed companies
- IAS , other accounting provisions

Cross-border restructuring
- Take-over bids
- European company statute

Single market for investors
- UCITS directives
- Supervision of supplementary pension funds

2. Open and secure markets for retail financial services

- Single market for payments
- Fraud and counterfeiting in payments
- Distance selling of financial services
- E-commerce
- Code of conduct for mortgages

3. State-of-the-art prudential rules and supervision

- Capital adequacy (Basel II)
- Financial conglomerates (co-ordinating supervisor)
- Winding up and liquidation of banks
- Solvency margins for insurance
- Creation of CESR

  (Lamfalussy → CEBS and CEIOPS, perhaps one committee for conglomerates)

4. Wider conditions

- Taxation of interest payments
- Code of conduct on business taxation
- Taxation of x-border occupational pensions
- Review corporate governance

Added along the way

- 11 September, Enron , etc. → re-assessment. FSAP tackled most regulatory issues raised by Enron (IAS, regular reporting, market abuse)

- New actions in "horizontal" policy areas:
  - Auditing (auditor independence, quality of audit)
  - Corporate governance : High Level Group of Company Law Experts (Winter Group)
  - Money laundering

RCAP

- 1990s US productivity boom: availability of risk capital **key to innovation and growth**
- Lacking in Europe (exception: UK). Segmented private equity markets
- RCAP: Actions on both **demand and supply** side
  - Financial legislation : prospectuses, pension funds, IAS
  - Entrepreneurship, research and innovation
  - Public funding

→ **RCAP completed by 2003, but obstacles remain:**

- limits to institutional investment; taxation; lack of exit mechanisms (stock market for growth companies)

Questions ?