"The Benefits of a Working European Retail Market for Financial Services"

Report to the European Financial Services Round Table

The European Financial Services Round Table, in conjunction with the European Parliamentary Financial Services Forum, would like to present to Members of the European Parliament some of the key findings of the Report

Executive Summary

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1. Introduction

In spite of considerable progress toward European capital market integration following the completion of the Single Market and the introduction of the Euro, national borders still constitute a considerable de facto barrier for retail financial markets. Direct cross-border business between financial service suppliers and end consumers is still the exception. Against this background this report addresses the following questions:

– *How powerful is the integrating effect of ongoing market trends like internet and crossborder mergers and acquisitions?*
– *Which benefits could be realised if a higher level of integration could be achieved?*
– *Which obstacles are mainly responsible for incomplete integration?*

2. Deficits of retail market integration

Although stringent legal impediments to cross-border activities in banking and insurance no longer exist different indicators show a relatively low openness of national markets. The market shares of foreign banks in individual EU countries are relatively small compared to other wealthy industrial countries. Entry into national banking markets is largely occurring through mergers and acquisitions (M&A). Case studies on multinational banks reveal that factors like high fixed costs of market entry make greenfield investment less attractive than M&A based access strategies. The picture is not very different for the insurance sector where direct crossborder sales without physical presence in the target market play only a marginal role. Again, cross-border M&As are the predominant entry strategy. In addition, integration indicators show a

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markedly lower integration level for the life than for the non-life insurance market. European fund market data on the number of registered foreign funds seems to indicate a larger degree of integration. However, since many of these “foreign” funds are of the Luxembourg or Dublin “round-trip” type, this indicator is misleading. Market shares of true foreign funds only reach significant levels in big markets like Germany while some small markets are effectively completely dominated by domestic fund suppliers. The impact of the internet on the integration of retail markets for financial services does not meet optimistic expectations even in the case of the most developed e-finance market, the market for online brokerage. The analysis of price differences and direct cross-border activities dispells illusions: although the internet is increasingly becoming an alternative distribution channel it does not by itself overcome fragmentation of retail financial markets in the EU.

3. Potential integration benefits

The report advances the following arguments and quantified estimates on the beneficial consequences of further integration of financial services markets for consumers and the economy in the EU as a whole:

– *Product choice would increase*, in particular for consumers in small countries who today suffer most from incomplete retail market integration. In these countries, the supply of available funds for example could be augmented by a factor between 10 and 20.
– There is considerable scope for falling prices resulting from a higher integration level in financial retail markets. Economies of scale could be realised. Calculations for the fund industry indicate a large cost savings potential: on the assumption that integration would lead to an average fund size in Europe similar to that of the US, there would be a *cost saving potential of about 5 billion Euro annually* given the present size of the EU fund industry. These cost savings would be particularly helpful in the ongoing European reforms of pension systems since fund products will play an important role for funded old-age pensions.
– Private borrowers could benefit substantially through *lower interest rates*. A simulation for the period of falling interest rates in the second half of the nineties shows: if competitive pressure in a more closely integrated financial market forced banks to adjust mortgage interest rates more quickly to falling market rates private borrowers would benefit. In terms of a 100,000 Euro mortgage loan these integration savings in interest payments would have amounted in the period 1995–1999 to annually 2,550 Euro in Italy, 1,690 Euro in Spain, 1,580 Euro in Portugal and 790 Euro in Ireland.
– Retail market integration would probably also reduce the well-known home bias in private investors’ portfolios. Performance calculations for national, European and world portfolios show that investors could significantly increase the Sharpe ratios of portfolios. Often the Europe-wide diversification is already sufficient to harvest all the *benefits of international diversification*.
– Furthermore, a larger degree of financial integration would be associated with *higher economic growth*. Theoretical considerations and insights from the relevant empirical

literature back the assumption of a significant link between financial integration and growth. 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 cover all present EU member states they indicate roughly the potential for growth through financial integration: in terms of the EU GDP of the year 2000 the lower per cent figure of 0.5 would mean an additional growth effect of 43 billion Euro annually. A quantification of potential employment effects associated with more financial integration is difficult to make. They crucially depend on the flexibility of labour markets and the progress in labour market reforms.
- Finally, more financial integration is rewarded by a growing *international role of the Euro*because the efficiency of a currency's financial markets is among the determinants of itsglobal acceptance. A greater acceptance of the Euro could in turn lead to additional benefits due to higher seigniorage, falling liquidity premiums and transaction costs.

4. Obstacles

A number of obstacles impedes the development of unified financial retail markets in Europe. There are policy-induced obstacles like different taxation, consumer protection or supervision arrangements that are capable of alteration, and there are natural obstacles like differences in language and culture that can not realistically be addressed by national or European policymakers. The impact of the different types of obstacles varies according to product type.

- For *insurance* products, a lack of confidence in the long-run reliability of unknown foreign suppliers is a particularly relevant obstacle. Furthermore, discriminatory tax practices and national differences in consumer protection due to different national policies and interpretations of the "general good" are important obstacles in the insurance business.
– The *internet-based* financial retail business is confronted with the following obstacles in cross-border activities: the need to design a variety of national marketing strategies, market peculiarities related to regulatory differences in consumer protection and supervision, the high costs of cross-border payments, the problems of cross-border identification of new customers, the heterogeneity of technical systems of stock exchanges and the consumer preference for "handshake", the physical meeting with the agent of a new supplier.
– Since successful management of asymmetric information problems is crucial for successful *credit business*, limited cross-border access to public credit registers and private credit bureaux is a particular integration obstacle for the credit market.
– For *funds* the outdated definition of UCITS in the directives limits crossborder marketing of innovative fund products. In addition, the burden of registration in a target market raises the costs for entering a national market. Furthermore, host country responsibility for supervision of advertising and marketing together with tax discriminations hamper the emergence of a unified fund market. The problems are aggravated by distribution channels that are still biased in favour of domestic fund companies.

- There is the danger that new obstacles are created as a consequence of national pension reforms. The German example shows that very specific national requirements on new *pension products* can constitute additional barriers to entry for foreign suppliers.

5. Some policy conclusions

A strategy based on an attitude of "wait and see" is not justified because ongoing market trends indicate that integration is unlikely to be completed without adjustments to the regulatory framework. The substantial potential benefits for consumers and economic growth clearly show that it is worthwhile to push hard for more integration of retail financial markets. Any integration strategy should aim to simplify direct cross-border contact between suppliers and consumers. This contact would speed up convergence of prices and promote a wider product choice everywhere in the EU. The need for political action also comes from the delicate fact that the "costs of non-Europe" are higher in smaller and poorer member countries than in the bigger and richer ones. While the Financial Services Action Plan and other legal initiatives properly address a number of integration obstacles, more needs to be done. Proposals for reforms are listed below. This is not an exhaustive list of recommendations. It briefly addresses the most burning issues; a detailed specification of the reform options would certainly need further analysis.

– It is important to devote more effort to ending *discriminatory tax practices* that currently shelter some national retail financial markets from foreign competition, and which do not conform with the EU Treaty. Examples concern the markets for life insurance and investment funds.

– Differences in *consumer protection* rules among the 15 EU countries render a pan-European marketing strategy and standardised products impossible. This issue is a critical policy induced obstacle and could best be addressed by the creation of a consistent uniform level of protection with harmonisation on that basis. Three specific recommendations are:

- The debate on derogation from the principle of home country control in the e-commerce directive should be reopened.
- Furthermore, the interpretation of the "general good" provision should be harmonized and/or restricted.
- There is a need to arrive at a unified definition of pension products in order to improve the conditions for developing a pan-European market for this high potential market segment.

– With FIN-NET the Commission has initiated an important infrastructure for creating *consumer confidence* in the legal safety of cross-border financial services. However, the existence of FIN-NET so far is not common knowledge. An information campaign is necessary to make this network of European ombudsmen better known and better understood, at least to the financial media and the staff of banks and insurers.

– With regard to *supervision*, there are short-, medium- and long-term options:

- In the short-run it would be helpful if the supervisory committees devoted more effort to the consistency of rule-books, the standardisation of reporting requirements and the harmonization of supervisory practice.

- In the medium-term a serious reform debate should be initiated, reflecting the possible
- advantages of a two tier supervisory system where multinational companies could opt for supervision on a European level.
- With a long-term perspective, more thought could be given to the possibility of establishing a single European supervisory authority, especially if effective cooperation among 25 to 30 national agencies after enlargement proves to become too difficult.

– There is a huge gap between the *vision* of the EU as the most dynamic economy in the world and the *reality* of still fragmented EU-markets. In order to reduce this gap, the whole process of European regulation of financial services needs to be speeded up and member-states have to overcome their national policies of preserving market barriers or even re-establishing new ones. Otherwise it will be impossible to achieve the strategic objective of the Lisbon-process of a more deeply integrated European Union which will be able to match the challenges of globalization and to secure full employment by 2010.
– Finally, while the study has shed light on important aspects of the enduring "cost of non-Europe" further analysis is required. Two issues deserve to be looked at more closely given their enormous complexity: First, the implication of national pension reforms for integration and second, the adjustment of consumer protection regulation to the changing needs of the internal financial retail market.

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