Financial Services

The Single Market in Financial Services (SMFS) represents the European Community's attempt to forge a Europe-wide market for financial services. The SMFS was born in the landmark 1985 White Paper by Lord Cockfield called "Completing the internal market". It was a highly detailed report that identified all the remaining barriers to a fully integrated European market and proposed, in detail, measures for removing these barriers by the end of 1992.

Given the projections that liberalization of the sector could account for fully one-third of the economic benefits of a single market, financial services was given a place of honor in the forefront of the White Paper's proposals. Greater moves towards full economic and monetary union (EMU) also gave an added urgency for financial markets reform. In fact, EMU and the single market in financial services grew to have a symbiotic relationship: the single market could not be maximized without EMU, and EMU would not be feasible without unified, Europe-wide capital and financial markets.

The Single Market in Financial Services

The Commission forged ahead with the SMFS in order to improve Europe's economy, principally by allowing for manufacturing industries to benefit from cheap and competitive financing from a healthy financial services sector. In order to do so, they would need to grapple with a wide variety of barriers impeding the effective construction of a single market. The two major barriers in the financial sector were exchange controls and different regulatory frameworks in each member state. Because of questions of systemic risk, capital flight, and balance of payments problems, liberalization of capital movements among member states had progressed only very slowly despite its inclusion in the 1957 Treaty of Rome. Normally, capital controls are designed to preserve exchange rate stability and grant the national government more control of its monetary policy. Therefore, the White Paper plans called for complete liberalization of capital movements. Capital regulations were liberalized via two directives in 1986 and 1988 that provided for full liberalization by July 1, 1990, with short extensions for Spain, Ireland, Greece and Portugal.

The second major challenge was differential regulatory regimes. Heavy financial sector regulations date back for decades, and generally strike a balance between economic efficiency and financial sector stability. Most regulations are designed to ensure protection of consumers as well as the savings of the general population through avoiding systemic collapse. Other rationales for regulation include a desire to avoid over-concentrating banking power, financing public sector deficits, and the problem of moral hazard as witnessed in the case of the British bank Northern Rock (October 2007 and still ongoing in February 2008). Despite deregulatory moves across industrialized

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states in the early 1980s, national regulatory systems remained quite divergent. As a result, the Commission gave up on its old approach of complete harmonization and deliberately adopted the principles of minimum harmonization and mutual recognition. Minimum harmonization is intended to protect investors and borrowers while simultaneously avoiding a regulatory "race to the bottom". With basic rules in place, mutual recognition allows the financial supervisors of one state to recognize the rules and practice of other Member States.

The SMFS proposals grew out of this philosophy in a multitude of ways. In the banking sector, for example, the Commission went ahead with a "single license" based on home country control. This license allows any credit institution[1] authorized to act as such in one member state automatically to set up branches or to supply cross-border services in all the other member states without having to obtain further authorization. The supervision of such credit institutions will be carried out by the credit institution's home state financial supervisory authority; the host state retains the right to control the level of market risk undertaken by foreign banks in their jurisdiction. Pressure from US businesses and the Federal Reserve ensured that US firms already established in an EC member state could benefit from equal treatment under the directives.

To be sure, safeguards including prudential controls, minimum capital requirements, and opening subsidiaries continued to pose potential threats to the smooth functioning of the SMFS. However, the integrating effect of the proposals on both the banking and securities fields has been substantial. The example of the Second Banking Coordination Directive is just one of many; similar legislation was extended to insurance and investment services as part of a raft of nearly two dozen directives establishing the SMFS.

Industry Consolidation

The single market in financial services heralded a sweeping set of changes to the European financial services industry. Companies could have access to each Member State and virtually all forms of national protection were eliminated. This set up a process of consolidation and rationalization within the financial services industry itself, and there was a great deal of companies who needed to adapt. The European banking industry was bloated, inefficient and uncompetitive. With too many banks and the promise of intensified competition after the creation of the single market, profit margins were going to shrink and companies were looking for ways to prepare themselves for the maelstrom. One promising avenue was via universal banking, and some firms looked for synergies between banks and insurance companies. In the run-up to 1992, no less than two-thirds of Europe's publicly traded banks entered into alliances, joint ventures, or takeover negotiations. Remarkably enough, this process did not create any truly pan-European banking conglomerates; rather, national banking industries consolidated in order to

[1] *Defined in the First Banking Coordination Directive as "an undertaking whose business is to receive deposits of repayable funds from the public and to grant credits for its own account".*

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defend themselves against banks from other member states. This was a process that remained constant through the end of the decade.

The prospect of economic and monetary union was also a further catalyst for industry consolidation. The adoption of the euro further reduced the number of banks needed in Europe, especially in a country like France where many banks earned their keep via franc-based currency exchanges. Given the prospect that nearly a quarter of European banks would disappear with the birth of the common currency, the European banking industry got caught up in a merger frenzy; in 1998, there were almost $107 billion in mergers. Between the single market program and the birth of the euro, the 1990s was a period of rapid consolidation and rationalization throughout the financial services sector. Recent years have seen another flurry of consolidation in the European banking sector. The rally was set off when Spain's Banco Santander acquired the British bank Abbey National in 2004. In 2005 Italy's Unicredit gobbled Germany's HVB Group and expanded further in 2007 by buying its domestic rival Capitalia. Also in early 2007, a consortium of three European banks, Royal Bank of Scotland Group, Fortis and Banco Santander acquired the Netherlands biggest bank ABN Amro.

Top European Banks by Market Capitalization

Company	Country	Capitalization (€ million)
HSBC	UK	160.463
Banco Santander	Spain	85.684
UBS	Switzerland	84.297
Unicredit Group	Italy	83.962
Royal Bank of Scotland	UK	76.323

Sources: European Banking Report, October 10, 2007

The Financial Services Action Plan (FSAP)

The single market program of the late 1980s passed largely because of its theoretical elegance and political pragmatism: minimum harmonization and mutual recognition were easily achievable goals and would require little in the way of political or regulatory sacrifice by member states. This proved to be the Achilles heel of the SMFS. By late 1998, the Commission regretfully announced that the SMFS had not been realized, the absence of which continued to undermine competitiveness and the stability of Europe's financial markets.

The initial problem was a continuous "spillover effect" from one area of financial services to another; more and more areas needed to be regulated to bring all financial activities into the single market. However, the existence of common rules does not imply equal levels of implementation or enforcement. The variation in the implementation of financial services directives was one of the critical shortcomings of the single market project and was the focus of strong criticism.

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The unsatisfactory outcome of the single market was made doubly damaging by the difficulty in the process of regulatory policy-making. The Community's decision-making architecture was seen as very inflexible, which prevented rapid and effective adaptation to changes in the market and new regulatory techniques. Even during the FSAP process, the fastest piece of legislation passed took 25 months, by which time the US had already captured the market. Institutional rigidity was the last thing needed with the advent of the euro on the horizon and the need for greater regulatory cooperation within the Community structure itself.

The first prong of the review of the SMFS was known as the Financial Services Action Plan, or FSAP. Having recognized that administrative and legal obstacles as well as divergences in supervisory practices continued to impede the smooth functioning of the single market in financial services, the Member States at their 1997 Cardiff meeting charged the Commission with identifying weaknesses that should be addressed. The FSAP was the product of an extensive period of consultation by the Commission and was announced in October 1998.

Consisting of 42 legislative measures, the FSAP was seen as an integral part of Europe's Lisbon Agenda, with its promise of turning the EU into the most "dynamic, innovative, knowledge-based economy in the world". On the wholesale side, the FSAP was aimed at raising capital, investment, securities and corporate legislation; on the retail side it emphasized information and transparency, charges for cross-border transactions, redress procedures and safeguards for e-commerce.

The FSAP was linked to a review of the legislative structure and procedures in the common market that became known as the Lamfalussy Process. This review took the form of a "Committee of Wise Men" appointed in July 2000 under the authority of Baron Alexandre Lamfalussy. Soon after the Committee began its work, Lamfalussy announced that the Committee had decided not to endorse the creation of a single European super-regulator but rather to reform the legislative process to make it more flexible and reactive.

The Lamfalussy Committee has also had a lasting institutional legacy through its impact on the level of cooperation among financial services regulators. The development of Community rules has become a shared enterprise; with roles played by the Commission, supervisory authorities and market participants. By moving away from highly prescriptive directives and towards the multi-level implementation guidelines, Baron Lamfalussy has squared the circle between the legal certainty needed to ensure effective market access and the need to update the nuts and bolts of financial regulation in the light of market innovation. The inclusion of Member State supervisors in the process of Community rule-making and enhancing pan-European regulatory cooperation has helped the Community successfully implement and enforce the new rules.

The results of the FSAP have been impressive. According to the January 2006 Progress Report on FSAP, 98% of measures have been put into place and implementation was progressing smoothly. The FSAP has been credited with making profound changes in the European financial landscape through the convergence of interest rates and spreads, increased cross-border trading, and the growing presence of financial institutions on partner country markets. Moreover, the changes have meant much lesser reliance on bank lending as a form of corporate finance; a greater variety of financing sources has meant more options for businesses to fund investment and for consumer savings.

A Regulatory Pause: Financial Service Agenda 2005-2010

Following the timely implementation of the FSAP, the Commission set out its future strategy for the financial service sector in its White Paper on financial service policy 2005-2010. The White Paper determined that no new legislative push was needed and that over the next five years the Commission would focus on implementation, enforcement and supervisory convergence, with regards to FSAP measures. Still, some areas have been isolated for further legislative attention, including amongst others consumer credit, pensions, banking consolidation and the single payments area. Within the near future, the attention of the Commission will be focused on two specific measures: the Markets in Financial Instruments Directive (MiFID) and the Single Payments Area.

MiFID is one of the last major pieces of the FSAP still to be implemented. Replacing the existing Investment Services Directive (ISD), it promises to make securities trading in the EU substantially more efficient, and cheaper, by establishing a harmonized regulatory regime for transactions. Doing so entails massive changes to the way European financial markets operate – both in terms of the rules they apply, and in their day-to-day operations. Potential benefits resulting from greater competition and lower costs are great. A Commission study found that integration of financial markets in the then EU-15 would produce a reduction in the cost of equity capital of around 50 bp, a reduction in cost of bond capital for non-financial issuers of 40 bp, and an increase in GDP of 1.1%, with total business investment up 6% and private consumption up 0.8%

However, progress on MiFID has been somewhat slower than expected. The original January 2007 deadline for transposition had to be postponed until November, at which point three countries – Spain, Czech Republic, Poland – still had failed to make the necessary legal steps. Similarly, European firms have been dragging their feet, with reportedly only 55% completing MiFID preparations by July 2007. In the near future, the focus of the Commission will therefore be on implementation and evaluation, with a number of Commission reports due to appear throughout 2008.

Another priority for the Commission is the creation of a Single European Payments Area (SEPA) by 2010. The aim of SEPA is to make it as quick and cheap for an individual to make a payment in another member state than it is to make it in his home state. According to the Commission, SEPA will reduce costs to consumers and save the EU 3% of its GDP currently spent on payments costs. However the difficulties in harmonizing legislation and introducing a common technology and infrastructure remain large.

Moreover, fearing competition from non-bank actors, European banks have south to slow down the process, raising questions over the 2010 deadline. Finally, the introduction of a new Europe-wide clearing and payments system, TARGET2, in November 2007 is expected to give a further boost to the integration of financial markets.

Summary

With the implementation of the FSAP and the Lamfalussy rules, the European Community has taken a large step towards the creation of a fully-functional internal market for financial services products. The implementation of remaining measures, such as MiFID, SEPA and TARGET 2 will further integrate European markets and contribute to their efficiency. However, the emphasis for the foreseeable future will be on monitoring the development of this market and the effectiveness of FSAP measures. One of the main beneficiaries of recent changes have been American banks and other financial services firms; they have been allowed to benefit from the "single banking license" and consequently to do business throughout the Community. Indeed, US firms have played a major role in keeping the Community's financial services market open to foreign competition. Recent reforms will maintain this openness to foreign competition and ensure a vibrant and healthy market.

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