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

Report to European Financial Services Round Table

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PREFACE

This report represents a continuation, in a much more sophisticated way, of the study of the “Cost of non Europe in financial services” in 1988, as part of the global analysis of the economic impact of a fully established EC Internal Market by 1992. At that time the European economic model used evaluated the potential benefit of the liberalisation of financial services as 1,5% of the EC 12 GDP out of a total of 4,5%, to be accrued after the completion of the Internal Market programme. Many commentators consider that this 4.5% evaluation was nothing more than a propaganda stunt as shown by the real evolution since then. This is however forgetting that the 1988 evaluation was clearly presented as a scenario of maximum success depending on the convergent behaviour of all the actors of the economy, business, trade unions and above all the member states’ governments: unhappily this has not been the case, especially on the governmental side.

This said, the essential merit of this ZEW/IEP-report is to show that in spite of a number of legislative decisions already made, much remains to be done. This clearly requires not only the swift implementation of the Financial Services Action Plan, but also a number of other actions by the EU, its member states and the involved business actors. The list of the missing aspects is quite impressive and requires what, by the present operating standards of the EU, could well be considered an almost unreachable target in the light of the present mood of soft legislation and subsidiarity. Against this background and by taking two of the major obstacles to fully integrated financial markets as analysed in this report, the tax problem and the problem of consumer protection, the following approach might be considered:

In the cases of open tax discrimination against “EU-foreign” suppliers of financial services in an EU country, the procedures should be clear, as stressed in this report, since this would be an evident violation of the Treaty-based rule of non-discrimination. In all other cases, which relate either to national hidden protectionism or to differences in legislation aimed at the protection of legitimate interests, among others consumer protection, the major difficulty will lie in the complexity of making the appropriate EU-wide legislation in a rapidly changing environment. However, one method for taking more efficient action could be based on the concept as expressed by the Council in its conclusions on normalisation approved on the 16th July 1984. In this text the Council noted that “the objectives being pursued by the Member States to protect the safety and health of their people as well as the consumer are equally valid in principle, even if different techniques are used to achieve them”.¹ This declaration opened the way to what was then called “the new approach to product legislation” which later has been largely applied to other areas like professions.

¹ Council Resolution of 7 May 1985 on a new approach to technical harmonization and standards (85/C/136/01), Annex I Conclusions on Standardization, Approved by the Council on 16 July 1984.

For financial services also, it should be possible to express in a short and essential legislation the ruling principles which, in every area of proved public interest, would be common to all member states, including the candidate countries. This would create consistency across the EU's Single Market. The operational content of these ruling principles of a permanent nature would then be defined by one or a number of Committees. These should be funded by the EU budget and bring together – in presence of the Commission and without forgetting the prerogative of the European Parliament – high level representatives of both the interested branches of business and the control bodies of the member states. In fact, this concept would represent a merger of the operating system of the standard bodies in industry and of the “Lamfalussy” committees. In other words, such an approach would leave the protection of the essential public interest in the hand of the public authorities while entrusting jointly to the private and public technicians under control of the EU-Commission and the European Parliament the implementation of the common principles defined by the legislation.

Clearly such a suggestion goes well beyond the task entrusted to ZEW and IEP and so brilliantly executed. Given however the interest not only of the businesses involved but essentially of consumers and the entire economy in creating a real level playing field for financial services, I considered it useful, in view of my past experience in the legislative activity of the EU, to suggest a possible approach with the aim of completing finally the Internal Market in such a relevant area. That it is worth attempting energetically, this report on the “Benefits of a working European Retail Market for Financial Services” has carefully outlined.

Paolo Cecchini
Director General, ret., European Commission, Brussels

February, 2002

PREFACE

The vision of a single European market is central to the future of Europe, bringing real benefits to all who live in the member states of the European Union. Great progress has been made in completing the single market for goods and services. Completing the single market for financial services, however, has taken longer than we had hoped. This is partly because of the careful regulation of financial services by each member state. This and other factors are impeding the development of a single retail financial market in Europe.

This has a high cost for European consumers, in terms of reduced choice, higher costs and lower economic growth.

We cannot afford to continue to move at the slow pace of recent years. Indeed, the successful recent introduction of the Euro will increase consumers' interest in purchasing the best products available anywhere in Europe. Political leadership and commitment are now needed on all sides to deliver the current plans for financial services reform and to agree the further steps needed. I am quite sure that the European Commission, the European Parliament and the Governments of member states do recognise the importance of completing the single market for financial services. The forthcoming discussions at Barcelona will provide an ideal opportunity for renewed commitment to faster progress.

The European Financial Services Round Table funded the preparation of this independent report, by respected academic institutes, because we believed it was important that the current debate on priorities should benefit from an objective economic assessment of the benefits to be gained from completion of the single market. The report emphasises not only the benefits for consumers of greater product choice and competition between providers, but also the significant benefits for economic growth of a more efficient financial services sector in Europe. Ultimately, a single market for financial services will strengthen Europe's competitiveness.

Completion of the single market will require not only radical thinking, but also strong management of the extensive changes needed, both in the regulation of the industry and also in its operations. The transition, however, will also provide a much needed opportunity to simplify regulations and to build a clear and consistent regulatory framework for the forthcoming accession of new member states.

Given the considerable benefits which can be achieved and the costs of standing still, it seems clear that the initiatives required to complete the single market in financial services should be given high priority and increased urgency.

Pehr G. Gyllenhammar
Chairman, European Financial Services Round Table

February, 2002

EXECUTIVE SUMMARY

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 cross-border 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 cross-border 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 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 dispels 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. World-wide 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 its global 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 cross-border 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 harmonised 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 harmonisation 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.