Global Finance and Social Europe (June 2009)

Edited by **John Grahl**, Professor of European Integration, Middlesex University Business School, UK

EDWARD ELGAR PUBLISHING EE

Chapter 3. Europe's financial systems under pressure

Marica Frangakis

3.1 Introduction

Since the 1980s, the financial systems of the member states of the EU have come under increasing competitive pressure, as a result of developments both on the global and on the European level. On the global level, the collapse of the Bretton Woods agreement and of the system of fixed exchange rates, followed by the two oil crises in the 1970s, marks the end of the era during which governments stabilized their economies by fiscal and monetary policies and public sector activity, with limited or occasional interference from the financial markets[1]. This period is also known as the era of "financial repression", denoting the fact that restrictions on international capital movement permitted many governments to maintain very low rates of interest, sometimes even negative in real terms Toporowski (2005).

Thus, the post World War II dollar standard system of fixed exchange rates gave way to a liberalization and privatization thrust in economic policy both in the advanced and in the less developed countries in the late 1970s, introducing greater reliance on markets domestically and internationally[2].

On the European level, developments were equally dramatic. As early as 1983, a White Paper on financial integration by the European Commission called for greater liberalization in the area of European finance[3]. Following the 1986 Single European Act, the 1988 Council directive on the liberalization of capital controls, the 1992 Treaty on the European Union, the introduction of the single currency in 1999 and the Financial Services Action Plan (1999-2005), various legal and economic barriers to an integrated financial market were progressively dismantled[4].

---

[1] The demise of the Bretton Woods Accord officially dates back to 1971. This was followed by the Smithsonian Agreement and the European Joint Float, both of which failed in 1973. Governments then moved to pegged, semi-pegged or freely floating currencies. In 1978, the free-floating system was officially mandated by the IMF.

[2] Around that time, the so-called "Washington Consensus" - a term first used by John Williamson to describe the view that economies should increase their reliance on markets - prevailed in World Bank and IMF recommendations towards the less developed countries. The recommendations included privatization and deregulation and in terms of external policies, the opening of highly regulated domestic markets to cross-border transactions. Also, it was recommended that the current account be liberalized first, followed by rapid liberalization of the capital and financial accounts (ECB, 2003).

[3] European Commission (1983)

[4] Dermine (2002)

More specifically, in most member states – with the exception of the UK, the Benelux countries and Germany – finance, and especially banking, had been subject to a wide range of regulations which now came under pressure. Table 3.1 below portrays the range of financial regulations that were in place in 1980 in the member states of the EU.

Table 3.1
Financial regulations in EU member states in 1980

	B	DE	DK	E	F	GR	I	IRL	L	NL	P	UK
Control of interest rates	*	*	*	*	*	*	*	*	*		*	
Capital controls	*		*	*	*	*	*	*			*	
Stock exchange membership			*	*	*		*				*	*
Bank branch restrictions					*		*				*	
Foreign bank entry				*		*	*				*	
Credit ceilings			*	*	*	*	*				*	
Mandatory investment requirements				*	*	*				*	*	
Restrictions on insurance		*	*	*	*	*				*	*	
Leasing				*		*					*	

Where B: Belgium, DE: Denmark, DK: Germany, E: Spain, F: France, GR: Greece, I:Italy, NL: Netherlands, P: Portugal and UK: Britain Source: Dermine (2002)

It is worth noting that capital controls co-existed with the European Monetary System, an early attempt to coordinate exchange rate policies in the EU. In fact, the existence of such capital controls is considered to have been instrumental in the long duration of the EMS, i.e., spanning more than a decade (1979 to 1989 approximately). In particular, France and Italy maintained such controls during most of the 1980s, only eliminating them towards the end of the decade in conformity with the strategic EU policy decision to move towards a fully integrated internal market, whereby the free movement of capital was seen as an essential part of complete market integration[5]. In practice, capital mobility destabilised the EMS.

On a global level, financial market liberalization was virtually complete in the industrial countries by the early 1990s, while developing countries followed suit, making substantial progress in liberalizing their financial systems throughout the 1990s. As has been argued, by the end of the 20th century, for all intents and purposes, the shift from a government-led to a market-led international financial system had been accomplished[6].

In the case of the EU, these trends were intensified by the introduction of the single currency in 1999, as well as the preparation for it throughout the 1990s[7]. The direct effects of the European Monetary Union on financial markets, put forward by the European Commission (1990) report "One Market, One Money", comprise standardization and transparency in pricing, the shrinking of the foreign exchange market, the elimination of currency risk, the elimination of currency related investment regulations and the homogenization of the public bond market and of bank refinancing

---

[5] As De Grauwe (1994) has argued, the existence of capital controls tended to reduce the size of funds that could be mobilized for attacking a currency. In so doing, they gave the authorities some time to organize an orderly realignment of the foreign exchange rates.
[6] Borio (2005)
[7] The transition to a single currency area was divided into three phases. Stage I – 1/7/1990 to 31/12/1993 – provided for the freedom of capital flows and the coordination of national monetary policies. The European Monetary Institute was created in Stage II; this was the predecessor of the European Central Bank. Its mission was to prepare the monetary institutions and the European System of Central Banks (ESCB). Lastly, Stage III led to the European Economic and Monetary Union on 1/1/1999. Euro notes and coins were introduced in January 2002.

procedures. These are all drivers of financial market integration, the implications of which will be discussed below.

Although the indirect effects of the introduction of the euro are especially difficult to assess, it is believed to have further strengthened the tendency toward a more market-led financial system in the EU. For example, Danthine et al (2000) found that the increased activity in the EU capital markets signified a "shift from banks to markets", benefiting the more market-based asset management and investment banking activities, by comparison to the traditional deposit and lending business of commercial banks. Further, EMU had a major effect on bank restructuring in Europe, mainly through increased M&A activity. Pertinent though these results may be, they were recorded at a time of exuberance of the world financial markets, also known as the dotcom bubble, which burst in the early 2000s. How far these trends persist some years later is a key question to be examined here.

On the whole, both the direct and indirect changes induced by the introduction of the single currency in the EU signify a more competitive environment not only for the financial players, but also for the economy at large. What has been the response of European finance? More specifically, does the relationship or bank-based financial system, traditionally associated with Germany, or Rhenish Capitalism, converge towards the market-based, or arm's length one, generally associated with the UK and the USA, or Anglo-American Capitalism[8]?

At the height of the financial markets boom in 1999-2000, there were signs that such a shift was the case. So much so, that some analysts have claimed that a "financial revolution" was in progress in the EU[9]. Some years later, as the effects of the protracted economic slowdown the EU entered, following the collapse of the stock markets, become clearer, can this be claimed to be the case?

Further, how have banks reacted to their changing environment? Does the increasing presence of market-based finance denote the deepening of financial integration, a central goal of policy under the Lisbon Agenda which set out the EU' s strategy for the decade 2000-2010?

Lastly, we must consider twelve new member states, of which ten were former transition countries, which joined the EU in May 2004, followed by two more in 2007, Romania and Bulgaria[10]. The financial systems of most of the transition countries were transformed from a mono-bank system at the end of the 1980s to the institution of market capitalism by the end of the 1990s. A defining characteristic of these systems is their lack of institutional maturity. The very large presence of foreign-owned financial concerns goes some way towards compensating for such a lack of experience. At the same time, it gives rise to a different order of problems. Hence, the case of the transition countries needs to be especially considered.

In dealing with the questions raised above, this chapter is organized as follows. The next section (3.2) reviews the main tendencies in European finance, in terms of structural

[8] "Arm's length" finance refers to market-based financial systems – where capital is raised from and returned to arm's length parties – as opposed to "relationship" finance – where capital essentially circulates within a set of related firms and institutions (Rajan and Zingales, 2003).

[9] Rajan & Zingales, 2003

[10] Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and the Czech Republic. The two non-transition countries are Malta and Cyprus. For some purposes, it is necessary to distinguish Slovenia from the other "transitional" financial systems because the Yugoslav system was different from, and more sophisticated than, those in the Soviet sphere.

changes in relation to the USA and Japan. The so-called "Continental" vs. the "Anglo-Saxon" financing models are discussed. Also, the evolving structure of financial assets and liabilities by type of user and financial product in the euro area are examined, as are the particular characteristics of financial intermediation in the new EU member states. The following section (3.3) takes a closer look at the different segments of the EU financial services sector; developments therein, as well as actors. In particular, the banking sector and the response of the EU banks to the challenges of increasing competition are analyzed, followed by an overview of developments in the EU capital markets, namely, the bond, equity and derivatives markets. There is then then a review of the role of institutional investors and of the main features of the European security exchanges. The next section (3.4) is concerned with the degree and prospects of integration of the various EU financial services segments. Has the response of European finance led to a more integrated financial services sector and in which areas? These are pertinent questions not only from an analytical point of view, but also from the point of view of policy, to the extent that financial integration is a core measure of the revised Lisbon Agenda. The final section (3.5) summarizes and concludes.

3.2 EU financial trends and developments

Comparative financial structures

The financial system of the EU member states is generally regarded as bank-dominated, with the exception of the UK, which, together with the USA, represents the so-called "Anglo-Saxon" model, where capital markets take up a considerable share of the financial services sector. This pattern has been gradually shifting in favour of the capital markets in a number of ways. Namely, the significance of capital markets has been increasing over time, albeit not necessarily in a consistent pattern from year to year; banks have developed their presence in capital markets both on their own account and on behalf of their customers, e.g., by offering their services in security trading and underwriting; market participants tend to adopt a more market-type competitive behaviour under the perceived prospect or threat of increased competition (Grahl & Teague, 2003).

The run-up to and the adoption of the single currency and of the common monetary policy by 12 out of 15 member states of the EU intensified these trends, so that at the turn of the century, a structural transformation was perceived to have taken place[11]. For example, Rajan & Zingales (2003) found that the main features of what they term the average "Continental Europe" model came considerably closer to those of the average "Anglo-Saxon" model over the space of twenty years (1980-2000), although there remained significant variations on a per country basis. Thus, Germany, a bank-dominated country, remained so, in spite of the increasing presence of the capital markets, while the UK, a market-oriented economy, also retained its main character, in spite of the great rise in bank loans.

Table 3.2
Financial indicators (%)

Country	Bank Loans to Private Sector/GDP	Stock Market Capitalization/ /GDP	Equity Issues/GFCF	Bank Loans to Private Sector/GDP	Stock Market Capitalization/ /GDP	Equity Issues/GFCF
		1980			*2000*	
USA	35.4	46.0	4.0	49.3	154.9	20.7
UK	27.6	38.0	4.0	132.0	184.0	14.9

[11] Initially, the eurozone included Austria, Belgium, France, Ginland, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal and Spain. Slovenia joined in January 2007 and Cyprus and Malta in January 2008.

EU-14 average « Continental »	60.1	7.8	2.0	93.7	104.6	32.2
France	73.1	9.0	6.0	86.4	108.7	14.5
Germany	86.4	9.0	1.0	120.7	66.8	6.5
Italy	55.5	7.0	4.0	77.0	70.3	4.1
Spain	na	8.7	2.8	101.2	88.2	86.6

Source: Rajan and Zingales (2003)

On the other hand, the downturn of the world financial markets after the bursting of the dotcom bubble in the early 2000s hampered the rate of transformation in EU financial structures, while the unwinding of the financial imbalances induced an economic slowdown of varying duration and intensity across the member states, which further dampened activity on the financial markets. As a result, the trends of the late 1990s slowed down considerably, albeit not reversed entirely. Furthermore, by the mid-2000s, the growth of the financial markets had resumed on the global, as well as on the European level (Table 3.3).

Table 3.3
Regional composition of global financial stock

		Global Financial Stock	USA	Europe	Japan	China	Rest of World
1993	US$ trillion	53					
	% Share	100	36	27	23	3	11
1996	US$ trillion	69					
	% Share	100	37	29	19	3	12
1999	US$ trillion	96					
	% Share	100	40	28	18	3	11
2003	US$ trillion	117					
	% Share	100	37	31	15	4	13
2006	US$ trillion	167					
	% Share	100	34	32	12	5	17

Sources: McKinsey & Co. (2005 & 2008)

Notes: 'Financial Stock' includes amounts outstanding at end year of equities, private debt securities, government debt securities and band deposits; 'Europe' includes the following countries: UK, Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Switzerland, Sweden, Denmark, Norway and Eastern Europe.

As we can see, over the period under review, the size of the global financial stock recorded the greatest rate of increase in 2006 (43% over 2003) and 1999 (39% over 1996)[12]. Of course, the world financial turmoil of the late 2000s, which began as a credit crunch in the financially developed countries in 2007, is bound to influence negatively the rate of growth of world financial markets. It is however unlikely to reverse the long run trends that appear to have been established since the 1980s[13].

The size of the financial markets in relation to GDP – also known as "financial depth" – and their structure by different products across different regions, as well as globally, is shown in Table 3.4 below.

---

[12] The measurement of financial depth by way of comparing a 'stock' concept (financial stock) to a 'flow' concept (GDP) is common because of the ease of conceptualization and of data availability (see McKinsey, 2005, p.44).

[13] According to London Economics, the prospects of the financial sector appear especially subdued in the short term (2008-2009), highly uncertain in the medium term (2009), albeit sanguine in the long run. In particular, the size of the wholesale financial services – i.e., transactions conducted between financial institutions – is predicted to fall by 2.6%-11.6% below its 2007 level according to four different scenarios, ranging from the "stressful" to the "positive surprises" one ("The importance of wholesale financial services to the EU economy", 2008: 4)

Table 3.4
Depth and structure of financial markets (% GDP)

	Globally	USA	Eurozone	UK	Japan	Eastern Europe
1980						
Equity securities	25	52	8	38	36	
Private Debt securities	15	28	14	1	17	
Government Debt securities	20	25	13	31	50	
Bank deposits	49	74	43	33	97	
Global financial stock: US$12 trillion						
% GDP	*109*	*179*	*78*	*103*	*200*	*N/A*
1993						
Equity securities	57	77	27	120	69	
Private Debt securities	48	81	47	31	48	
Government Debt securities	43	61	44	33	48	
Bank deposits	67	67	57	61	108	
Global financial stock: US$53 trillion						
% GDP	*215*	*286*	*175*	*245*	*273*	*N/A*
2003						
Equity securities	88	130	61	134	71	31
Private Debt securities	85	143	92	115	49	3
Government Debt securities	56	46	66	29	143	20
Bank deposits	96	78	95	107	148	45
Global financial stock: US$117 trillion						
% GDP	*325*	*397*	*314*	*385*	*411*	*99*
2006						
Equity securities	110	148	82	160	107	37
Private Debt securities	89	153	114	106	45	4
Government Debt securities	54	47	61	34	156	33
Bank deposits	93	76	99	122	138	56
Global financial stock: US$167 trillion						
% GDP	*346*	*424*	*356*	*422*	*446*	*130*

Sources: McKinsey (2005) Taking stock of the world's capital markets (Exhibit 3, 10 and 15: own calculations) & McKinsey (2008) Mapping global capital markets – 4th Annual Report (Exhibit 1.1 and 1.2: own calculations). Notes: (a) Eurozone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain; (b) Eastern European countries: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Ukraine.

As we can see, not only has the size of the financial markets been increasing in absolute terms, but also in relation to GDP across all regions. This was especially pronounced in the Eurozone countries, where the relative size of financial markets increased more than fourfold between 1980 and 2006, although the rate of increase slowed down in the early 2000s and it is likely to do so again in the late 2000s, following the upheaval of the financial markets experienced in 2007/2008. A high rate of increase was also recorded in the UK, in spite of its comparatively more developed financial system, more akin to the

US, rather than to the “Continental” Europe type. Lastly, the East European countries are steadily establishing their position in the global financial system.

In terms of structure, the eurozone countries’ financial system is steadily becoming more market oriented, although the emphasis appears to be on private debt securities, more than on equities. In fact, by the mid-2000s, securities as a whole represented a higher percentage of GDP in the eurozone countries than in Japan, thus reversing the situation of the previous years. The East European countries also appear to be going through a transformation process towards a more market oriented system, albeit at a more gradual pace. The UK, on the other hand, maintains its position as the most market oriented financial area within the EU.

As we can see in Table 3.5 below, within the eurozone, in 2006, the volume of financial assets was largest in Germany, followed by France and, at some distance, Italy and Spain. In terms of structure, the share of bank deposits in total financial assets was largest in Luxembourg, Europe’s “banker” along with Switzerland, followed by Germany, Portugal and Austria. On the other hand, the share of debt securities is prominent in all countries, accounting for approximately one-half of all financial assets, with the exception of Luxembourg and Finland, where they account for about one-third.

Table 3.5
Size and structure of financial markets in the eurozone countries, 2006

	Total financial assets	Equities	Private debt securities	Government debt securities	Bank Deposits
Germany	*US$ 9.5 trillion* 100	17	36	16	32
France	*US$ 8.2 trillion* 100	30	28	15	27
Italy	*US$ 5.9 trillion* 100	17	29	30	23
Spain	*US$ 4.9 trillion* 100	27	36	11	26
Netherlands	*US$ 3.1 trillion* 100	25	45	9	21
Belgium	*US$ 1.6 trillion* 100	25	25	26	24
Austria	*US$ 1.0 trillion* 100	19	33	18	30
Greece	*US$ 0.9 trillion* 100	23	11	41	25
Ireland	*US$ 0.8 trillion* 100	20	47	5	27
Finland	*US$ 0.7 trillion* 100	40	15	18	27
Portugal	*US$ 0.7 trillion* 100	16	31	23	30
Luxembourg	*US$ 0.3 trillion* 100	24	29	0	47

Source: McKinsey & Co (2008)

Overall, it would appear that the financial systems of the EU are in a state of flux, under the pressures of increased competition both on the global and on the European level. In spite of the periodic setbacks, the general trend towards a more market-based financial system is evident in Europe and especially in the euro area, which we shall now examine in greater detail.

Investment and financing in the euro area

In the course of the 1990s, financial products and instruments accounted for an increasing share of investment and financing in the euro area, in spite of periodic setbacks. More specifically, the net acquisition of financial assets by the non financial sector, including corporations and households, exceeded gross fixed capital formation in 2000 - the year of "exuberance", to use the famous expression of Alan Greenspan, then Chairman of the Federal Reserve Bank - falling sharply in the next four years, only to bounce back to a level approaching that of the late 1990s by the mid-2000s (Table 3.6)[14].

A similar rise in the share of external financing both by non financial corporations and by the households – other than their own savings - was recorded over the same period. Namely, the noticeable increase recorded in the late 1990s was followed by an equally noticeable drop over the following four years (2001-2004), reversing and ascending again by the mid-2000s (Table 3.6).

Table 3.6
Investment, saving and external financing of the private non-financial sector* in the Eurozone, 1993-2006 (%)

	Gross fixed capital formation as % GDP	Net acquisition of financial assets as % GDP	Gross Saving as % GDP	External Financing as % GDP
1992	18.8	13.5	21.0	10.2
1993	16.8	13.0	20.8	7.7
1994	16.9	13.7	20.7	9.6
1995	17.3	13.9	21.9	7.4
1996	17.1	12.9	21.4	8.8
1997	17.1	13.4	20.6	9.5
1998	17.4	15.8	19.9	12.2
1999	18.8	17.8	18.5	17.1
2000	19.4	21.1	18.1	22.7
2001	18.5	15.4	18.5	14.5
2002	17.1	12.5	18.8	10.0
2003	16.9	12.2	17.8	9.8
2004	17.1	11.2	19.1	8.8
2005	17.3	14.1	18.0	12.1
2006	17.9	14.1	15.9	15.2

* Includes the non-financial corporations and households.

[14] Financial assets include bank loans, debt securities and equities.

Source: ECB, Nonthly Bulletin, Various issues; own calculations[15]

The structure of the main liabilities of the non financial sector in the euro area, reveals (i) the increasing indebtedness of households; (ii) the steadily high share of loans; (iii) the significance of debt securities; and (iv) the relatively smaller share of equities, which are back on the increase since 2002 (Table 3.7).

Table 3.7
Main liabilities of non financial sectors in the euro area
(EUR bio - outstanding amounts at end period, %)

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Euro billion	13,328	15,132	15,789	16,063	15,592	16,567	17,755	19,525	21,146
Structure by sector	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*
Households	20.4	19.6	20.2	21.0	23.0	23.2	23.7	23.7	23.6
Non financial corporations	44.8	50.1	50.2	48.3	43.6	43.9	43.4	44.5	47.3
General government	34.8	30.3	29.7	30.7	33.4	32.9	32.9	31.8	29.1
Structure by instrument	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*
Loans	47.8	45.0	47.0	49.2	52.9	52.2	51.4	50.8	51.0
Short term	9.9	9.5	10.4	10.7	11.0	10.3	10.0	10.1	10.1
Long term	37.9	35.5	36.6	38.5	42.0	41.9	41.4	40.7	40.9
Securities other than shares	31.1	27.3	27.2	28.8	31.7	31.3	31.8	30.4	28.0
Short term	3.9	3.3	3.2	3.5	4.0	4.2	4.5	4.2	3.9

[15] ECB Monthly Bulletin Issues and tables:

JAN 2001, T. 6, P. 120	FOR 1992	
OCT 2001, T.6.2, P.126	FOR 1993-1997	
FEB 2006, T.3.4, P.S29	FOR 1998	(own calculations)
JAN 2007, T.3.4, P.S29	FOR 1999-2004	(own calculations)
JUNE 2007, T.3 & T.4, PP. S32 & S33, FOR 2005-2006		(own calculations)

Long term	27.2	24.0	24.1	25.3	27.7	27.1	27.2	26.2	24.1
Shares	21.1	27.7	25.8	21.9	15.4	16.5	16.8	18.8	21.0

Source: ECB, Monthly Bulletin, various issues; own calculations

SOURCES: ECB, MONTHLY BULLETIN - JAN 2003 (T.6.1, P. 58), JAN 2004 (T.3.2,P.S27), JAN 2005 (T.3.2,P.S27), JAN 2006 (T.3.2,P.S27), JAN 2007 (T. 3.2, P. S27), MAY 2007 (3.2, P. 140)

As we can see, the share of households in total liabilities increased between 1998 and 2004, remaining nearly constant after that, whereas that of the non-financial corporations increased, after an intermitent decline between 2002 and 2004. Lastly, the share of the general government declined, in spite of periodic upward shifts .

In terms of types of financial liabilities, much of the increase in loans, as well as in debt securities, has been directed towards long-term products, largely as a result of the low-inflation environment, encouraging long-term investment. The significance of equities, on the other hand, displayed a strong increase in the late 1990s, falling sharply in 2001 and 2002, while it appears to be recovering since then.

Overall, financial developments in the euro area are indicative of the changes taking place in the EU financial services sector. In particular, bank loans retain their dominant position, even strengthening it, through the growth of “leveraged” loans used to finance mergers and acquisitions as European corporations have restructured, as well as the increase in household credit. At the same time, capital markets are gaining in importance, although they only recovered from their severe set-back after the boom years of 1999-2000 in the mid-2000s. Bond market issues were much less affected by the crisis than issues in the equity markets.

Although relevant data are not available at the time of writing, it is to be expected that the financial turmoil experienced in 2007/2008 will take its toll on both the total amount of financial liabilities in the euro area and their structure. It would, however, appear unlikely that the trends set in motion since the 1980s and especially since the 1990s will be reversed, although they may well be slowed down in the medium term.

On the whole, market-based finance appears to be contesting relationship-finance. This is however best seen as a long-term trend, which evolves gradually and in a non-linear fashion. In this sense, claims that a “financial revolution” took place in the EU after the 1980s are as misplaced as is the view that European finance remains anchored in the traditional bank products.

Financial intermediation in the new member states (NMS)

Of the twelve new member-states that joined the EU on 1/5/2004, eight are transition economies, i.e., they were formerly planned economies opening up to market competition in the early 90s. Thus, a distinction needs to be made between Cyprus and Malta, the financial system of which was already close to that of the EU in terms of size and structure, and the central and eastern European countries and the Baltic states.

More specifically, the NMS rely more heavily on bank finance than on direct market finance, while stock markets are relatively small, by comparison to those in the older member states (Table 3.8; see also Table 3.4 above).

Table 3.8
Financial structure in new member states (%GDP)

	Domestic Credit to the private sector		**Stock market capitalization**	
	2003	**2006**	**2003**	**2006**
Bulgaria	26.7	47.7	7.9	31.2
Czech Republic	30.7	39.9	17.6	31.5
Estonia	31.4	78.4	39.3	34.6
Hungary	41.0	54.6	18.3	34.1

Latvia	34.2	77.9	9.5	12.8
Lithuania	20.2	47.7	16.9	32.6
Poland	29.2	33.4	16.5	41.0
Romania	13.7	26.3	9.2	24.6
Slovak Republic	31.8	39.2	7.5	8.9
Slovenia	42.0	67.1	28.9	49.9

Sources: EBRD, Transition Report 2007; Structural Indicators
Notes: Domestic credit to private sector: total outstanding bank credit to private sector (households and enterprises) at end of year; Stock market capitalization: market value of all shares listed on the stock market at end of year.

Generally, despite their different starting points and development trajectories, the NMS share a number of common characteristics. Financial intermediation is strongly dominated by banks, although retail banking is still below the Western European levels of significance. Equity markets are weak, while stock market capitalization fluctuates greatly over time. As a result, firms tend to rely largely on internal finance and foreign direct investment, while banks are oriented towards funding government needs.

As these countries prepare for membership of the monetary union, the pressures leading to the convergence of their financial systems are expected to intensify. Thus, in the long run, the financial structures of the NMS will move closer to Western European standards. It is however hard to know how long this is going to take. Nor is it going to be a trouble-free process.

3.3 EU financial market structures and institutions

The banking sector

Many financial institutions, systems and techniques in today's markets have their roots in early Europe. The terms "banks" or "bankers" first appeared in the 12th and 13th centuries; they are rooted in the benches or "bancos" Italian merchants established at European trade fairs (Reszat, 2005). In 2006, there were 8,441 banks in EU-25, of which 6,130 (73%) were in the 12 eurozone countries. They employed just over 3 million employees (approximately 2,2 million in EU-12), while their total assets amounted to 322% of GDP (298% in EU-12). As noted earlier, EU banks continue to play a dominant role in intermediating savings through the traditional means of collecting deposits and extending loans. Thus, in 2006 the total loans of EU-25 banks to the non-financial sector amounted to 132% of GDP (129% in EU-12), while bank deposits amounted to 109% of GDP (108% in EU-12) (ECB, 2007a).

EU banks are mostly commercial banks, although other types also exist, such as savings, co-operative or mutual and public banks (Table 3.9). In particular, savings banks mostly originated from local or regional banks supplying credit to farmers, artisans or other social groups, which were unable to obtain credit elsewhere. Nowadays, savings banks often focus on small and medium-sized enterprises, while they may be partly or entirely owned by state or local governments and municipalities. In fact, the most common type of public banks in Europe is savings banks. Co-operative banks, on the other hand, are typically owned by their depositors or creditors and their services are restricted to those who own them, although many now offer their services to others, as a result of liberalization. Other types of banks include specialized lending institutions, such as mortgage banks, agricultural banks, postal savings banks and banks servicing specific sectors of the economy.

Table 3.9
Banking structure by type of institution in selected euro area countries

	% Total Assets (end 1998)	% Total Assets (end 2003)
France		
Commercial banks	54.1	68.4
Savings & coop banks	28.4	31.5
Others	17.5	0.5
Germany		
Commercial banks	47.9	46.9
Savings & coop banks	27.8	34.1
Others	24.2	19.0
Spain		
Commercial banks	55.7	47.4
Savings & coop banks	38.7	40.1
Others	5.6	12.5
Italy		
Commercial banks	81.1	80.9
Savings & coop banks	13.3	14.9
Others	5.6	4.2

Source: Belaisch (2001); OECD (2005)

It is worth noting that the size of the non-profit oriented segment of the financial services sector bears on the margins charged by private profit-oriented institutions. For example, in Germany, France and Spain, public and co-operative banks tend to reduce such margins, although this situation could evolve, as these institutions change their legal status, a case observed in the UK, with large building societies becoming PLCs[16] (Dermine, 2002). In Britain, however, the remaining mutually owned building societies have proved to be very competitive and their market share has been growing.

The EU single banking market operates under a "single passport", comprising a single banking license, home country control, mutual recognition and common regulations. Furthermore, it goes beyond the member states of the EU, encompassing the countries of the European Free Trade Association - Iceland, Liechtenstein and Norway, with the exception of Switzerland. These constitute the European Economic Area (EEA) as of 1992[17].

The corporate structure of EU banks today is a web of branches and subsidiaries. Although subsidiaries are considered to be domestic banks, as opposed to branches, which come under the Single Passport rules, there are nearly as many subsidiaries, as branches. Thus, in 2006 there were 641 branches from other EEA countries in EU-25, the assets of which were equal to 8.5% of the total bank assets and 499 subsidiaries, with a 10.5% share of total bank assets (471 branches with a share of 2.6% and 343 branches with a share of 8.2% respectively in EU-12). Generally, in 2006 the presence of foreign banks (branches and subsidiaries from EEA and from third countries) as a percentage of the total assets of domestic credit institutions amounted to 27.1% in EU-25 (12.1% in EU-12).

[16] Public Limited Company – I.e., the shares of which are traded on a stock exchange
[17] Austria, Finland and Sweden joined the EU in 1995.

The response of EU banks to the mounting pressures of the economic environment included disintermediation – selling on their claims on debtors in the form of securities, rather than holding them on their own books; consolidation; technological innovations, such as the setting up of new distribution channels, e.g. through ATMs and the internet; rationalization through cost-cutting measures.

In particular, banks diversified their income sources both across products and countries. On the liabilities side, they turned to the management of mutual funds, in which they have secured a prominent role. In fact, in several EU countries, most of the institutional investors are included in banking groups, operating under a common corporate strategy. On the assets side, EU banks developed trading activities and securitization operations, which significantly boosted their economic results, especially during the time capital markets were booming. However, in the case of securitisation, when the tide turned, what served as an engine of growth became a source of concern.

More specifically, securitisation enables a bank to convert a future stable cash flow arising from a financial asset, usually some form of loan, into a lump sum cash advance, by means of converting the future cash flows into tradable securities, which are then sold, thus raising capital. This is also known as the "originate and distribute" model, which became popular in the EU banking sector towards the late-2000s, although it originated in the USA in the 1970s and the US remains by far the largest market for securitising assets. Within Europe – not just the EU member states – the UK, Spain and Netherlands hold a dominant position (Table 3.10).

Table 3.10
Securitisation issuance based on originating country or region

	2003	2004	2005	2006	2007
World total $ billion	4,094.00	3,154.00	3,780.00	4,138.00	3,826.00
Of which (%):					
USA	89.67	83.99	83.04	78.69	75.59
Europe	6.06	9.61	10.77	14.60	17.80
Of which (%):					
UK	2.10	4.12	4.15	5.85	6.19
Spain	1.07	1.30	1.32	1.33	2.20
Netherlands	0.59	0.73	1.30	0.87	1.46
Italy	0.93	1.36	1.08	0.92	0.94
Germany	0.20	0.32	0.50	1.14	0.68
Ireland	0.10	0.10	0.03	0.31	0.37
France	0.22	0.32	0.24	0.24	0.13
Portugal	0.29	0.32	0.26	0.17	0.39

Source: IFSL Research (2008), Table 1 (own calculations)

Mortgage-backed securitisation (MBS) accounts for the largest share of deals in the US and Europe. However, there are a range of other financial assets that are securitised, including home equity loans, credit card receivables, car finance, collateralised debt obligations (CDOs), student loans, equipment leases and manufactured housing contracts[18]. In 2007, 61.8% of European securitisation consisted of MBS and 26.5% of CDOs.

[18] CDOs refer to a debt obligation whose underlining collateral and source of payments consist of existing bank loans and other forms of debt obligations, such as emerging market and high yield debt (IFSL Research, 2008).

While securitisation has been viewed as a way to diversify risks for the financial institutions which originate the securitised loans, allowing them to expand their lending activities, the credit crisis of 2007 led to the serious questioning of the "originate and distribute" model. Although this resulted in the rapid expansion of activity within the financial sector itself, the redistribution of risk from the originator to other financial and non-financial institutions and the total lack of knowledge as to where risk is located has led to a loss of confidence in the creditworthiness of many financial institutions, including several 'too-big-to-fail' ones.

In the short to medium term, securitisation issuance is likely to decrease. For example, it fell by 42% from $432bn in the first half of 2007 to $249bn in the second half of 2007. In the long run, it is unlikely to disappear, although the relevant institutional and policy framework is expected to become tighter, benefiting the banks themselves, too.

Consolidation was another strategy the EU banks adopted, under the pressure of increasing competition. Such consolidation mostly took the form of mergers among relatively large private banks and among bank and non-bank financial institutions. A wave of merger and acquisitions took place in the 1990s, especially in the run up to the introduction of the single currency. Most of these deals were domestic ones. In the early 2000s, M&A activity declined considerably, picking up again after the mid-2000s[19]. Over the period 2003-2007, there was a clear trend towards ever larger deals, while the previous dominance of domestic over cross-border deals was reversed. Banking dominated in terms of the value of deals (Table 3.11).

Table 3.11

Merger and acquisitions deals in the EU financial services sector

	2003	**2004**	**2005**	**2006**	**2007**
Number of deals	154	170	198	175	281
Total value (Euro million)	33,526	44,798	77,537	136,875	207,743
Average value (Euro million)	217.7	263.5	391.6	782.1	739.3
Cross-border deals as % of total value	32.18	61.99	66.80	44.44	64.44
Sector share in total deal value (%)	100.00	100.00	100.00	100.00	100.00
Banking	47.88	49.95	60.88	71.96	68.09
Insurance	33.93	32.20	24.51	18.57	21.57
Asset management	8.01	6.82	8.96	1.36	6.25
Other	10.17	11.03	5.65	8.11	4.10

Source: PricewaterhouseCoopers; Rupert Taylor Rea and Nick Page kindly provided the above data. *Note:* The above deals do not include those concerning minority stakes below 30%.

As a result of the consolidation process and organic growth of the sector, the size of the average bank in the EU-25 more than doubled between 1997 and 2006, reaching €4.4 billion of assets (€4.1 in the eurozone). Furthermore, the degree of concentration is quite high so that a small number of banks dominate the banking sector, especially of the smaller member states.

[19] CEC Financial Integration Report 2007, chart 2.3

As we can see in Table 3.12 below, the degree of concentration in the EU25 on average is larger than in the eurozone. In fact, the market share of the 5 largest banks accounted for more than 60% in 17 of the 25 member states, a percentage that was as high as 97% in Estonia!

Table 3.12
Share of the 5 largest banks in total assets of sector
(%; unweighted average)

	2002	**2003**	**2004**	**2005**	**2006**
EU25	59.3	58.9	58.8	59.6	59.2
Eurozone	52.7	53.1	53.3	54.3	53.7
Countries where the share of the 5 largest banks exceeded 50%					
Belgium	82.0	83.5	84.3	85.3	84.4
Czech Republic	65.7	65.8	64.0	65.5	64.1
Denmark	68.0	66.6	67.0	66.3	64.7
Estonia	99.1	99.2	98.6	98.1	97.1
Greece	67.4	66.9	65.0	65.6	66.3
France	44.6	46.7	49.2	52.3	52.3
Cyprus	57.8	57.2	57.3	59.8	63.9
Latvia	65.3	63.1	62.4	67.3	69.2
Lithuania	83.9	81.0	78.9	80.6	82.5
Hungary	54.5	52.1	52.7	53.2	53.5
Malta	82.4	77.7	78.5	75.3	71.4
Netherlands	82.7	84.2	84.0	84.5	85.1
Portugal	60.5	62.7	66.5	68.8	67.9
Slovenia	68.4	66.4	64.6	63.0	62.0
Slovakia	66.4	67.5	66.5	67.7	66.9
Finland	78.6	81.2	82.7	82.9	82.3
Sweden	56	53.8	54.4	57.3	57.8

Source: ECB (2007)

The EU banks further responded to the challenges of increased competition by taking measures in two areas – those of rationalization and of technological innovation. In particular, cost-cutting has in many cases entailed a restructuring of branch networks and a scaling down in the number of employees. For example, between 2002-2006 the number of employees in the banking sector of the EU25 fell by 96,403 (of which 47,877 in the eurozone), i.e. by 3% in relation to 2002 (2% in the eurozone).

Other measures have included the centralization of services across institutions, especially in the area of credit risk management, settlement, invoicing and payment transactions, as well as outsourcing non-core activities, especially IT and back-office functions. In the area of technological innovation, the substantial growth in the number of ATMs in all EU countries must be noted, enhancing the distribution channels. More recently, telephone and internet banking operations have also been introduced.

Internet banking is the fastest growing electronic distribution channel for banks. The majority of large European banks offer internet banking to their clients, while almost all banks offer internet banking at least as a service channel, i.e. their clients can use internet banking for information and transaction services. As we can see in Table 3.13 below, the percentage of individuals over 16 years of age who use the internet is steadily, albeit slowly, increasing.

Table 3.13
Use of internet banking (%)

	2003	2004	2005	2006
EU25	n/a	18	19	22
EU15 ('old')	19	22	22	24

Source: ECB (2007) *Note:* The table shows the percentage of individuals over 16 years who used internet banking at least once during the previous three months.

Overall, EU banks have been undergoing a process of transformation in the past decade or so, which is still not complete. In dealing with the challenges of an increasingly competitive environment, they have had to restructure and reposition themselves within the financial services sector, domestically, as well as internationally. This has allowed most of them to adjust successfully to the new challenges facing them. However, certain policy issues have emerged in the process.

More specifically, the diversification of risk through the "originate & distribute" model of securitisation has led to a dispersion of risk across the financial services sector, that is difficult, if not impossible, to control at a time of crisis. Furthermore, the high concentration of the banking sector gives rise to competition concerns. Similarly, the prevalence of large financial conglomerates gives rise to consumer and investor protection concerns. These are policy issues, which will be discussed in greater detail in the context of the EU financial services policy.

The banking sector in the New Member States

As mentioned earlier, the NMS, especially the former transition ones, rely mainly on bank finance, as opposed to direct market finance. Most banks are commercial ones, employing over 80% of all staff and covering more than 90% of all assets. In some countries – Cyprus, Hungary and Poland – there is also a significant number of small cooperative banks, while in some, specialized financial service providers are present[20].

Foreign presence is very large in most NMS. Furthermore, with few exceptions, the largest banks are foreign. In 2007, the share of foreign owned banks in total bank assets was greater than 80% in 7 of the 10 NMS (Table 3.14).

Table 3.14
Banks in the new member states

	Number of banks (foreign owned)		Asset share of foreign owned banks (%)		Asset share of state owned banks (%)	
	2003	**2006**	**2003**	**2006**	**2003**	**2006**
Bulgaria	35(25)	32(23)	82.7	80.1	2.5	1.8
Czech Republic	35(26)	37(28)	86.3	84.7	3.0	2.2
Estonia	7(4)	14(12)	97.5	99.1	0.0	0.0
Hungary	38(29)	40(28)	83.5	82.9	7.4	7.4
Lithuania	13(7)	11(6)	95.6	91.8	0.0	0.0
Latvia	23(10)	24(13)	53.0	62.9	4.1	4.4
Poland	58(46)	64(53)	71.5	74.3	25.8	21.1
Romania	30(21)	31(26)	54.8	87.9	40.6	5.9
Slovak	21(16)	24(16)	96.3	97.0	1.5	1.1

[20] In Cyprus, these are international banking units; in the Czech Republic and in Slovakia, building societies; in Hungary, building societies and mortgage banks.

Republic						
Slovenia	22(6)	25(10)	18.9	29.5	12.8	12.6

Sources: EBRD, Transition Report 2007; Structural Indicators

Largely, this situation is the result of the privatization of former state-owned banks. By the early 2000s, the privatization programmes in most NMS had been completed, so that state bank-ownership was considerably reduced. In fact, in 2007 state bank-ownership became completely extinct in Estonia and Lithuania, while it was minimal in Bulgaria, the Czech Republic, Latvia and the Slovak Republic (Table 3.14). During the same period, the presence of state banks declined in the other EU member states, too. For example, in Italy, Spain and Belgium, it disappeared, while it was drastically reduced in all other EU member states.

Overall, the NMS face certain challenges arising out of the structure of their banking sectors. Namely, (i) financial intermediation is still low; (ii) technological change is on-going, influencing risk measurement and management systems; (iii) the very high presence of foreign banks raises questions of stability, e.g. in relation to credit growth and/or balance sheet restructuring. The domination of external banks may also make the identification of opportunities and the measurement of risks less precise than if domestic actors were more involved. Another danger is that the NMS may be excluded from some of the most complex and valuable activities in the financial sector because the multinational banks will concentrate such activities in their home countries. These will be reviewed in relation to the EU financial services policy below.

Market-based finance

Market-based financing in the EU has broadened in scope, as well as deepened in terms of liquidity, in parallel with the continuing predominance of bank financing. In particular, the range of financial instruments and techniques has broadened, as a result of financial innovation on a global level. In the case of the EU, the introduction of the single currency has had a major effect on capital markets, as it has expanded the investment opportunities on the supply side and the portfolio diversification possibilities on the demand side.

- **Money markets**

A large part of the secured transactions taking place in the euro area money market involves transactions with counterparties of the same nationality, using collateral issued in that jurisdiction. In particular, the 2006 Money Market Study of the ECB notes that "Despite the gradual increase in cross-border trading in recent years, the proportion of transactions carried out between national counterparties in the secured and short-term securities markets remained comparatively high. This shows that while the integration process of the repo and short-term securities markets across the euro area is continuing, it is still quite slow and complex" (ECB, 2007:4)[21].

Problems associated with collateral assets – their heterogeneity across countries as well as technical difficulties in the custody and transfer of these assets have tended to hold back integration of Eurozone money markets and, therefore, to impair the liquidity of the European financial system as a whole and its security markets in particular. It is notable that European banks often use dollar deposits, rather than European debt instruments, to

[21] A repo is a financial instrument which allows cash to be temporarily exchanged for securities for a predetermined period.

collateralize their lending to each other, a factor which swells the volume of foreign exchange swaps.
The unsecured market is driven largely by cash management and it is thus oriented more heavily towards short maturity transactions (of up to 3 months). Because problems with collateral do not arise, the definition of the product is fully standardized and all market participants (mostly banks) use the same products and market procedures. As a result, this is the most integrated financial market in the EU.

The global financial market turbulence during the second half of 2007 led to the emergence of liquidity problems in the short-term money markets, resulting in greater volatility of the overnight rates due to increased variability in credit risk among banks. Under extreme pressure, the EU money markets came close to freezing, so that the infusion of central bank liquidity became necessary for their operation. At the same time, they displayed enough resilience to allow them to continue functioning, albeit under stress.

- **Derivatives markets**

Derivatives fall into two categories: (i) over-the-counter (OTC) derivatives, which refer to those traded directly between two parties and (ii) exchange derivatives, which are traded through a financial intermediary. At the end of 2006, OTC derivatives accounted for 83% of the world derivatives market.

The introduction of the single currency impacted especially on the derivatives markets, as it expanded the opportunities to hedge risk, thus giving rise to new instruments allowing for more sophisticated risk-mitigating techniques through interest rate-linked options and futures. It also boosted the growth of over-the-counter (OTC) interest rate swaps.

The EU27 dominates the world OTC derivatives market, accounting for 65.9% of the interest rate derivative market and 60.4% of the foreign exchange derivative market in 2007. Within the EU, London is the major OTC derivatives trading centre, accounting for 38.6% and 44% of global trade in foreign exchange and interest rate derivatives, respectively.

- **Bond markets**

The increasing role of the European debt security markets, in terms of size and structure, was already discussed in Section 3.2 above, in relation to the comparative financial structures across regions. Table 3.15 extracts the relevant data from Table 3.4, in order to focus on the changes taking place in the area of debt securities between 1980-2006.

Table 3.15
Private and government debt securities in the Eurozone and in the UK as % of GDP

	1980		**1993**		**2003**		**2006**	
	Eurozone	**UK**	**Eurozone**	**UK**	**Eurozone**	**UK**	**Eurozone**	**UK**
Private debt securities (%GDP)	14	1	47	31	92	115	114	106
Government debt securities (%GDP)	13	31	44	33	66	29	61	34
Total debt securities (%GDP)	27	32	91	64	158	144	175	140

Percentage share of debt securities in total financial stock (incl. equities and bank deposits)	34.62	31.07	52.00	26.12	50.32	37.40	49.16	33.18

Source: See Table 3.4 in Section 3.2 above

As we can see, the debt securities market in the eurozone increased from 27% of GDP in 1980 to 175% in 2006, while the greatest increase was recorded in the private debt market. The UK also recorded an increase over the same period, although in a more volatile fashion. Further, the predominance of government debt is seriously challenged both in the eurozone and in the UK.

In the East European countries, on the other hand, most of which have already acceded to the EU, the debt securities markets are not quite as dynamic, while they largely, if not exclusively, deal with government bonds (see Table 3.4).

Domestic debt securities remain the dominant source of debt finance, although the international debt market has been growing at a fast rate[22]. On the other hand, the EU is an important player in the international debt market. For example, in 2006, the amount outstanding of international debt securities of EU27 amounted to €8.1 trillion, which accounted for 58.4% of world-wide outstanding international debt securities. Within the EU27, Germany, the UK, France, Spain, Italy and the Netherlands accounted for 81% of total outstanding international debt securities and the largest source country was Germany (13.1%)[23].

Generally, the size of the European bond market has grown significantly. As a result, he gap with other advanced financial systems and especially the USA, has narrowed considerably (see Table 3.4 above). Similar shifts can be perceived in relation to the market’ s structural characteristics, although, again, its initial structure bears a direct influence on its present one. As disintermediation gains ground, these tendencies will intensify, exerting pressure on the more traditional financial systems in the EU.

- **Equity markets**

As noted earlier, European stock markets grew strongly in the years to 2000 and then contracted, while they appear to be recovering as of 2002. During this period, the equity markets displayed a heightened degree of volatility, denoting their susceptibility to changing expectations. By 2006, the outstanding amounts of shares by euro area residents approached its boom level of 2000 (Table 3.16).

[22] The BIS definition of international securities, as opposed to domestic securities, is based on three major characteristics of the securities: the location of the transaction, the currency of issuance and the residence of the issuer. (Casey & Lannoo, 2005). However, in essence capital market liberalization has tended to reduce the importance of this distinction because the terms on which debt is issued in domestic and international markets have tended to converge.

[23] London Economics /2008) Table 20

Table 3.16

Quoted shares issued by euro area residents

	2000	2001	2002	2003	2004	2005	2006
Outstanding amounts							
Euro billion	5431.7	4656.4	3132.4	3647.3	4033.8	5063.5	6139.4
% GDP	82.60	66.55	43.26	49.03	52.29	63.00	72.98
% by NFC	74.92	75.77	76.56	74.83	73.94	72.78	72.64

Sources: ECB, MONTHLY BULLETIN - JAN 2003, T.3.7, P.48, SEPT 2004, T.4.4, P.S36, JAN 2006, T.4.4, P.S36,JULY 2007, T.4.4, P.S40

It should be noted that since equity market growth picked up in 2003, gains in developed countries have mainly reflected higher earnings, rather than higher P/E ratios. For example, the P/E ratio recorded in the eurozone was on average equal to 16 in 2003, 15 in 2004, 16 in 2005 and 15 in 2006. This is due to the slow recovery in stock market capitalisation, following the burst of the dotcom bubble in the early 2000s. The same can be said of the USA, where the P/E ratio has in fact declined from 23 in 2003 to 18 in 2006, and of Japan, where it has been more volatile, although also on the decline[24].

Institutional Investors

These include insurance companies, pension funds and investment funds. The relative importance of the different segments of the fund industry varies across the EU member states and in relation to the EU average. Thus, pension funds are more important in the UK and the Netherlands, investment funds in France and Germany, while the life insurance sector is an important repository of private savings in all member states and especially in the UK and in Germany.

Table 3.17

Funds under management in EU25, the Eurozone and in selected countries, 2006

	Total	Pension Funds	Insurance Companies	Investment Funds
UK € million	6,133,617	2,351,452	3,173,492	608,673
% GDP	*321.75*			
Percentage distribution		38.34	51.74	9.92
France €million	2,446,867	n/a	1,290,591	1,156,276
% GDP	*136.55*			
Percentage distribution			52.74	47.26
Germany € million	2,062,446	510	1,033,295	1,028,641
% GDP	*89.32*			
Percentage distribution		0.02	50.10	49.87
Netherlands € million	1,143,311	696,271	331,923	115,117

[24] McKinsey (2008) Exhibit 1.6, p.24

% GDP	*216.57*			
Percentage distribution		60.90	29.03	10.07
Italy €million	916,155	21,016	554,448	340,691
% GDP	*62.10*			
Percentage distribution		2.29	60.52	37.19
EU25 € million	17,011,150	3,293,728	7,227,498	6,489,924
% GDP	*148.79*			
Percentage distribution		19.36	42.49	38.15
Eurozone € million	10,229,544	834,812	3,846,401	5,548,331
% GDP	*122.09*	8.16	37.60	54.24

Source: ECB, Banking Structures 2007, Tables 8, 9 & 14 (own calculations)

On a world level, the USA is the dominant player, accounting for approximately one-half of total fund industry assets. The EU however has been catching up fast, especially since the introduction of the single currency. On the other hand, assets under management in three out of the ten NMS – Poland, Hungary and the Czech Republic – accounted for just 0.74% of total assets under management in EU25 in 2006. These countries have relatively more developed bond and money market segments, but remain negligible by EU15 standards.

Sovereign wealth funds (SWFs) have increased their influence on global financial markets in recent years. In particular, the profile of SWFs has risen considerably during 2007, as a result of subprime capital infusions into large financial groups in trouble, such as Citigroup, Merrill Lynch, Barclays, UBS, etc. SWFs have also been active in cross-border M&A deals.

Although there is no universally accepted definition, SWFs are generally defined as large pools of capital controlled and owned by governments and invested in foreign assets for long-term purposes. SWFs fall into two major categories: commodity funds, funded predominantly from oil revenue and non-commodity funds, funded mainly from official foreign exchange reserves and, in some cases, from pension reserves. At the end of 2007, approximately 45% of SWFs came from oil rich countries in the Middle East, followed by Asia, with over a quarter of the total, and Europe, predominantly Norway (12%) and Russia (13%)[25].

Although SWFs are not new, their growing prominence is a recent phenomenon. The limited disclosure and transparency, as well as the multiplicity of objectives of many SWFs have given rise to concerns about their impact on global capital markets. Both the IMF and the OECD are working on a code of conduct for SWFs, while the European Commission is also working on its own proposals.

Overall, as market-based finance spreads across the EU financial services sector, both in terms of structure and in terms of market type of behaviour, the role of institutional investors is expected to increase, encompassing new regions and financial products. As

[25] IFSL Research (2008a)

with changes in the banking sector, this poses certain policy issues for the EU regulators, pertaining to the protection of investors and retail consumers more generally, as well as to the stability of the sector as a whole.

Securities exchanges

Most of the European securities exchanges were founded as mutual associations by their users – mostly brokers and traders. However, an increasing number of exchanges are being transformed into corporations. Further, there has been a number of mergers and acquisitions between security exchanges, which is indicative of the cut-throat competition and of the pressures the financial sector is under.

One of the first such mergers was that between the German and the Swiss derivatives exchanges, which became known as EUREX. Similarly, the French, Belgian and Dutch exchanged merged into EURONEXT, while in 2007 the merger between the New York Stock Exchange (NYSE) and EURONEXT was finalised. Further, in 2007 the London Stock Exchange (LSE) bought Borsa Italiana and Nasdaq became a major shareholder in OMX Nordic Exchange.

As can be observed in Table 3.18 below, in 2007, 90% of all trading took place in six EU exchanges: London SE (34%), Euronext (18.4%), Deutsche Borse (14.2%), the Spanish exchanges (9.7%), Borsa Italiana (7.6%) and OMX Nordic Exchange (6%). If the SWX Swiss Exchange is included, then 96% of all trading in Europe was carried out in six exchanges in 2007. Further, these six exchanges accounted for a 29% share of world trading[26].

Table 3.18
Stock exchanges in Europe, 2007

	Capitalisation			Trading		
	Euro billion	2007/2006 %	Share of EU %	Euro billion	2007/2006 %	Share of EU %
Athens Exchange	181.2	19.1	1.5	122.4	43.9	0.6
Borsa Italiana	733.6	-5.8	6.2	1,680.2	33.6	7.6
Bratislava Stock Exchange	4.6	8.1	0.0	0.0	-69.3	0.0
Bucharest Stock Exchange	21.5	14.1	0.2	2.0	56.8	0.0
Budapest Stock Exchange	31.5	-0.5	0.3	34.6	40.5	0.2
Bulgarian Stock Exchange	14.8	89.3	0.1	4.6	227.5	0.0
Cyprus Stock Exchange	20.2	64.5	0.2	4.2	25.4	0.0
Deutsche Borse	1,440.0	15.9	12.3	3,144.2	45.2	14.2
Euronext	2,888.3	2.7	24.6	4,086.8	34.1	18.4

[26] London Economics (2008) Table 5

Irish Stock Exchange	98.4	-20.5	0.8	99.6	54.1	0.4
Lubljana Stock Exchange	19.7	71.1	0.2	3.1	113.0	0.0
London Stock Exchange	2,634.6	-8.4	22.4	7,545.0	25.9	34.0
Luxembourg Stock Exchange	113.6	88.4	1.0	0.2	-6.1	0.0
Malta Stock Exchange	3.9	12.8	0.0	0.1	-68.5	0.0
OMX Nordic Exchange	849.9	-0.2	7.2	1,321.8	27.5	6.0
Oslo Bors	241.7	13.9	2.1	399.1	24.3	1.8
Prague Stock Exchange	48.0	38.3	0.4	36.6	21.9	0.2
Spanish Exchanges (BME)	1,231.1	22.7	10.5	2,160.3	40.7	9.7
SWX Swiss Exchange	869.4	-5.4	7.4	1,368.8	24.1	6.2
Warsaw Stock Exchange	144.3	27.9	1.2	63.9	47.7	0.3
Wiener Borse	161.7	7.1	1.4	94.5	45.6	0.4

Source: London Economics (2008); Table 18

Stock exchanges are serviced by settlement and payment systems, the most important of which are organized as corporations, often owned by a stock exchange which makes use of them. Two such systems are dominant – International Clearstream in Frankfurt – owned by Deutsche Borse (50%) and CEDEL (50%), a joint venture of 90 international banks - and Euroclear in Brussels. It is estimated that a process of concentration and consolidation in this area will take place, as capital markets recover more fully from their recent downturn. (Huffschmid, 2002).

Financial Centres

There is no universally accepted definition of what constitutes a ‘financial centre’. The IMF distinguishes three groups of financial centres:

- International financial centres offer the full range of financial services, are characterised by deep and liquid markets with diverse sources and uses of funds, supporting large domestic economies, hosting several internationally active banks. They have the regulatory and supervisory frameworks to safeguard the reliability of contractual relationships.
- Regional financial centres feature well-developed financial markets and infrastructure, associated with smaller domestic economies and more regionally focused banks.
- Offshore financial centres are much smaller and provide more limited specialist services. It refers to countries or territories where the financial sector is large as compared with domestic economy, moderately regulated, taxed at a low level and providing services mainly to non-residents.

According to the above categorization, Europe hosts 4 international financial centres, 12 regional ones and 9 offshore centres, which is the highest concentration of financial centres in the world, at least in terms of numbers!

Further, in 2007 the City of London Corporation published for the first time the Global Financial Centres Index, which is a ranking of the competitiveness of financial centres based on 18,878 total assessments (in 2008) from an online questionnaire together with over 60 indices, published twice a year. The ranking is based on an aggregate of indices from five key areas: people; business environment; market access; infrastructure and general competitiveness. Table 3.19 below shows the financial centres in Europe, on the basis of the IMF categorization and the latest (March 2008) GFCI ranking amongst the world top 50 financial centres (in brackets).

Table 3.19
Financial centres in Europe and GFCI ranking in global Top 50

International Financial Centres	Regional Financial Centres	Offshore Financial Centres
London (1) Paris (14) Frankfurt (6) Zurich (5)	Madrid (42) Milan (38) Geneva (7) Brussels (34) Stockholm (32) Amsterdam (23) Munich (35) Luxembourg (17) Edinburgh (18) Glasgow (22) Dublin (13) Vienna (43) Copenhagen (44) Oslo (45) Helsinki (40) Athens (46 in 2007)	Jersey (16) Liechtenstein Monaco (37) Guernsey (19) Gibraltar (26) Isle of Man (21) Malta Cyprus Andorra

Source: Karel Lannoo (2007) Table 1 adjusted with data from GFCI (2008)

On the whole, the concept of a 'financial centre', albeit not new, explicitly introduces competition across regions as a strategy for the capture of financial business. Although this may be seen as the natural consequence of the expansion of the financial sphere in the economy, it internalizes the institutional and policy conditions that have led to the very state of financialization. Namely, market deregulation and privatization. In this sense, while the concentration of a large number of financial centres in Europe is indicative of the deepening of its financial markets, it may also be a sign of possible regulatory and fiscal laxity on the part of governments, in an attempt to attract increasing amounts of financial business. This exposes the local economy to increased competitive pressures, while it may also entail increased risks.

3.4 The state of financial integration in the EU

Diagnosing the state of the EU financial integration is a complex task, due to the definitional and measurement problems involved, as well as the diversity of EU structures. An overview of the main financial segments and their degree of integration in the eurozone is given in the following table, provided by the European Central Bank.

Table 3.20
Financial integration in the euro area

Market	State of integration	Related infrastructure
Money Markets		
Unsecured money market	"Near perfect"	Uncollateralised money market: fully integrated; collateralised money market: cash leg fully integrated; collateral leg hampered by fragmentation
Collateralised money market	Advanced	
Bond markets		
Government bond markets	Very well advanced	Fragmented
Corporate bond markets	Fair	Fragmented
Equity markets	Low	Highly fragmented
Banking markets		
Wholesale activities	Well advanced	Fully integrated
Capital-market related activities	Advanced	Fragmented
Retail banking	Very low	Highly fragmented

Source: ECB, Monthly Bulletin, 10th Anniversary of the ECB, 2008, Section 6, Table 2

As we can see, financial institutions operate in the most integrated environment, as opposed to households, which operate in the most fragmented one, reflecting the diversity in market structures, arising from different borrower and product characteristics, business models, allocational practices, etc. Non-financial corporations operate in a financial environment, which is not yet fully integrated. We shall proceed to take a closer look at the extent of integration in each of the main financial markets in the EU.

- **Money markets**

These were directly affected by the introduction of the single currency. More specifically, spreads (between interest rates offered to lenders and rates required from borrowers) before and after 1999 were measured in basis points[27] and the corresponding German rate was used as a benchmark. Before 1999, the highest spreads existed in Greece, Italy and Portugal. After the launch of the euro, inter-bank rates in the 11 euro-zone countries (at that time, excluding Greece, which joined the EMU in January 2000) converged to a common Euribor rate and the spread became zero. In this sense, the euro area money market reached a stage of "near perfect" integration almost immediately after the introduction of the euro.

The spreads of the countries not included in the euro area – Denmark, Sweden and the UK – decreased after the launch of the euro. Thus, the euro had a strong influence even on countries outside the EMU.

However, not all segments of the money market have reached the stage of "near perfect" integration. More specifically, the euro area repo market segment is less integrated than the swap and the unsecured segments. This is explained by differences in practices, laws and regulations across member states, as well as remaining fragmentation of the market infrastructure (Baele et al, 2004).

[27] A basis point is one hundredth of a percentage point, 0.01%.

- **Derivatives markets**

Derivatives markets in the EU have closely followed developments in the underlying financial markets. As a result, they are becoming more integrated and more liquid. For example, in the case of equity futures, the DJ Euro Stoxx 50 future index has become the benchmark as the most traded equity index future. Similarly, with regard to interest rate derivatives on organised exchanges, the number of Euribor and Eonia@ contracts has grown rapidly and they could soon become the world's most liquid exchange-traded derivatives contracts[28]. Lastly, most market participants have centralised business functions, organizing them by type of product, rather than by intra-European geographical area.

- **Bond markets**

Since the introduction of the euro, the degree of integration in the government bond market has been very high. Furthermore, it has been found that in the euro area, government bond yields have become increasingly driven by common news and less by purely local risk factors (Baele et al, 2004). This is especially true of the 10-year maturity segment, by comparison to the 2 and 5-year ones.

In particular, convergence in long-term government bond yields – as measured by the coefficient of variation – decreased as of 1998, but has stayed at roughly the same levels since then. Such variation may reflect differences in perceived credit risks, as well as in liquidity, among individual countries. In other words, differentials in yields decreased but then stabilised, so that convergence first went ahead but then marked time. Hence, further integration is closely linked to the minimisation of such differences.

The corporate bond market also displays a high level of integration. For example, it has been found that country premia are low and only slightly above the country premia reflected in the sovereign bond yields (European Commission, 2004). In other words, investors' home bias is declining, although it would appear that a certain "regional bias" is emerging. For example, in 2005 within the portfolio of long term debt securities owned by foreign investors in the EU, on average 70% was owned by investors from other member states. This "regional bias" in the EU bond market is higher than in the equity market, reflecting the fact that the bond market has reached a relatively more advanced stage of integration.

- **Equity markets**

Equity markets have become more integrated to the extent that the "equity home bias" – i.e., the preference of investors for domestic stocks – appears to be waning. For example, the percentage of total foreign equity investments undertaken in another EU country has increased slightly between 2001 and 2005 (from 52% to 55%), which suggests that the declining home bias has been matched by an increasing regional bias in the EU. In most EU countries such regional bias ranges from 50% to 70%. However, in the Baltic states and Malta investors from other EU countries account for more than 90%

[28] Euribor - Euro Interbank Offered Rate - is the rate at which euro interbank term deposits within the eurozone are offered by one prime bank (of first class credit standing) to another prime bank and it is published daily at 11 am CET for spot value. It is the benchmark rate of the large euro money market. Eonia@ - Euro OverNight Index Average – is the effective overnight reference rate for the euro. It is computed as a weighted average of all overnight unsecured lending transactions undertaken in the interbank market, initiated within the euro area by the contributing banks (same as those quoting for Euribor).

of all foreign investments[29]. It should be noted that the US is the largest external investor in EU equities, with an approximate market share of 30%.

Further, local stock returns have become more sensitive to European market shocks, as compared with purely local ones. As Baele et al (2004) have shown, the proportion of local return variance explained by aggregate European and US shocks rose from 20% in the first half of the 1980s to more than 40% in the post-euro period. Also, the ECB estimated that shocks from the eurozone explained more than 80% of the variation of equity market returns over the period 1999-2007, more than twice as much as over the period 1973-1985. However, it should be noted that return correlations have been shown to be considerably influenced by cyclical phenomena, so that their economic significance needs to be carefully considered in terms of disentangling cyclical from structural effects in the underlying economy and financial system (Adam et al, 2002).

- **Banking markets**

Since the late 70s, EU banking markets have operated in an increasingly more harmonized regulatory and economic framework. In spite of this, however, integration is uneven in the different segments of the industry, while price differentials remain high, indicating that the local character of such segments is significant.

More specifically, the level of dispersion in national interest rates declined in the late 90s in anticipation of the single currency, with the exception of consumer loans. As of 2001, the convergence process has slowed down for most credit markets with the exception of medium to long-term loans to enterprises. Thus, in 2006 the coefficient of variation ranged from 20% for loans to enterprises with a maturity of more than one year to 28.4% for mortgage loans to households. In addition, fees for the most common banking products, such as current accounts, still differ substantially among member states (European Commission, 2007c).

The cross border flow of interbank loans has increased in the wholesale segment of the euro area banking sector, reaching the level of approximately one-third of total loans in 2006. On the other hand, the proportion of cross-border loans to non-bank clients is relatively small, at less than 5% of total loans during the period 1999-2005. This is indicative of the significance of local presence in gaining and retaining customer trust, as well as of the existence of switching costs, which make customers reluctant to change banks.

Cross border integration also takes place through the opening of branches and subsidiaries. As discussed above, in spite of the regulatory advantages of branches, the growth of subsidiaries in the EEA has rivalled that of branches. There are many reasons explaining such a tendency[30]. One such reason is the protection from risk-shifting, which is provided by a subsidiary structure and which weighs heavily in an uncertain environment.

Deepening integration has further led to increasing consolidation in the EU banking sector, while cross-border M&As constitute an internationalization strategy in the retail field. As we saw earlier, in the 1990s most M&As were mainly on a domestic basis signifying the existence of barriers, such as different market practices, taxation systems, accounting procedures, legal issues, as well as varying cultural and political influences

---

[29] CEE, Financial Integration Report 2007, ch. 2.1

[30] Dermine (2002) presents an exhaustive account of such reasons.

(Walkner & Raes, 2005). Since the mid-2000s however, cross-border M&As have been increasing in significance, pointing to the fact that the process of integration is gradually deepening.

Overall, integration in the banking markets of the EU is proceeding unevenly across its different segments. It is most advanced in the wholesale segment and least advanced in the retail one. This is due to the fact that retail financial services may be likened to non-traded goods, in so far as they contain a strong element of trust and confidence on the part of the customers and asymmetric information on the part of the service providers. Where such elements are not significant, EU banking has been following a process of integration, which is however not as fast as that observed in most EU capital markets.

- **Related infrastructures**

As shown in Table 3.20 above, infrastructure can help deepen financial integration. Conversely, the lack of infrastructure is one of the reasons for the continuing fragmentation of various segments of the EU financial sector (Norman, 2007).

More specifically, the "near perfect" integration of the EU money market has been greatly aided by the TARGET system for the EU-wide settlement of euro payments, established in 1999 and described as a "system of systems"[31]. In May 2008, a second generation system, TARGET2 replaced its predecessor. In addition, the integration of the euro area money market has been facilitated by the cross-border transfer of collateral through the Correspondent Central Banking Model (CCBM). For example, in 2007, 81.5% of cross-border collateral deliveries in the euro area were channelled through the CCBM.

In the case of bond and equity markets, progress in integrating securities infrastructures has not kept pace with that of large-value payment infrastructures. Since the TARGET system was launched in 1999, payments across national borders have represented approximately 20-25% of total volumes and 35% of total values. By contrast, the use of securities settlement systems has been scarce (less than 1% of total volumes/sales).

While the post-trading infrastructure is fragmented for bonds, it is even more fragmented for equities. The cross-border settlement for bonds is largely concentrated within two international central securities depositories, whereas the cross-border settlement of equities relies heavily on national central securities depositories. A new initiative – TARGET2-Securities – was proposed by the ECB and the national central banks that are members of the European System of Central Banks (Eurosystem), in order to provide a single platform for making payments in central bank money. However, the TARGET system relates primarily to the "cash leg" of financial transactions, that is payment by the purchaser of securities. The other side of the transaction – the transfer of the securities by the seller still gives rise to significantly higher transactions costs than is the case in the US. Thus even when TARGET2-Securities becomes operational, securities will still be held on multiple platforms (central securities depositories), although it is proposed that they outsource their securities accounts to a neutral single platform (the single platform for payments), which would be operated by the Eurosystem. The expected launch date of T2S is in 2013.

Cross-border banking has also been hampered by the high level of the retail payments infrastructure. Each country has its own national payment instruments and different

[31] Trans-European Automated Real-time Gross settlement Express Transfer.

standards for payments made by credit transfers, direct debits and card payments. In early 2002 the banking industry founded the European Payments Council, which consequently formulated a strategy to create the Single Euro Payments Area (SEPA)[32]. The Payment Services Directive, adopted at the end of 2007, forms the legal framework for payments in SEPA and is to be implemented by all EU member states by 1/11/2009.

3.5 Summary and conclusion

Since the 1980s, the financial systems of the member states of the EU have come under increasing competitive pressure, as a result of developments both on the global and on the European level. On the global level, the substitution of floating exchange rates for the system of fixed rates in the late 1970s led to greater reliance on markets both domestically and internationally.

On the European level, the shift in emphasis from regulation to liberalization and privatization in the financial services sector became evident in the early 1980s. Following the 1986 Single European Act, the 1988 Council directive on the liberalization of capital controls, the 1992 Treaty on the European Union, the creation of the single currency and the Financial Services Action Plan, various legal barriers to an integrated financial market were progressively dismantled.

What has been the response of European finance? Further, how have banks reacted to their changing environment? Does the increasing presence of market-based finance denote the deepening of financial integration?

In dealing with the above issues, the following areas were reviewed in some detail. (i) The main tendencies in European finance, in terms of structural changes. (ii) Developments in the different segments of the EU financial services sector, as well as among financial actors. (iii) The degree and prospects of integration of the various EU financial services segments.

(i) *In terms of financial structures*, the significance of EU capital markets has been increasing over time, albeit not necessarily in a consistent pattern from year to year Overall, market-based finance appears to be contesting relationship-finance. This is however a long-term trend, which is not expected to evolve in a linear fashion. In this sense, claiming that a "financial revolution" took place in the late 1990s in the EU overestimates the underlying trends, to the extent that what has been happening is both gradual and non-linear.

In the case of the new member states, despite their different starting points, policies and development trajectories, these share a number of common characteristics. Namely, financial intermediation is strongly dominated by banks, although retail banking is still below the Western European levels of significance. Equity markets are weak, while stock market capitalization fluctuates greatly over time. As these countries prepare for membership of the monetary union, the pressures leading to the convergence of their financial systems are expected to intensify. Thus, in the long run, the financial structures of the NMS will move closer to Western European standards.

(ii) *In relation to developments in the banking sector*, EU banks have been undergoing a process of transformation, which is still not complete. In dealing with the challenges of

[32] See the European Payments Council White Paper "Euroland: Our Single Payment Area!" (May 2002)

an increasingly competitive environment, they have had to restructure and reposition themselves within the financial services sector, domestically, as well as internationally. This has allowed most of them to adjust successfully to the new challenges facing them. However, certain policy issues have emerged in the process. More specifically, the increasing concentration of the banking sector gives rise to competition concerns. Similarly, the prevalence of large financial conglomerates gives rise to the need for stronger and more comprehensive consumer and investor protection regimes. Lastly, the credit crisis of the late 2000s revealed the weaknesses of the "originate and distribute" business model, implicit in securitization.

Banks in the NMS, on the other hand, face certain structural challenges bearing on future developments in the sector. Namely, (i) financial intermediation is still low; (ii) technological change is on-going, influencing risk measurement and management systems; (iii) the very high presence of foreign banks raises questions of stability, e.g. in relation to credit growth and/or balance sheet restructuring.

With respect to security market-based financing, this has broadened in scope, as well as deepened in terms of liquidity, in parallel with the continuing predominance of bank financing. Furthermore, as market-based finance spread across the EU financial services sector, both in terms of structure and in terms of market type behaviour, the role of institutional investors is expected to increase. As with changes in the banking sector, this poses certain policy issues for the EU regulators, pertaining to the protection of investors and retail consumers more generally, as well as to the stability of the sector as a whole.

(iii) Lastly, *in terms of financial integration*, this is most advanced in the money markets and least advanced in retail financial markets, reflecting differences in practices, laws and regulations across member states, as well as in market infrastructure. As these differences recede, financial integration is expected to deepen. However, this is not necessarily going to benefit consumers, while it probably entails certain dangers to financial and economic stability, especially to the extent that policy does not cater for such eventualities. The financial crisis experienced in 2007/2008 is a case in point.

Overall, the EU financial services sector is gradually being transformed, as new actors, products and practices are being introduced. As a result, it is becoming more market oriented than hitherto, although the EU banks continue to be major actors, adjusting to their new environment. This is a fast changing sector, largely under the lead of the US. The competitive drive the EU financial services sector finds itself in entails potential benefits as well as costs, the distribution of which is going to be critical with respect to its future development.

Chapter 4. EU financial market integration policy

Marica Frangakis

4.1 Introduction and overview

The liberalization of financial markets that followed the collapse of the Bretton Woods Agreement soon spread within and across national borders. Industrial countries typically began partial liberalizations in the mid-1970s, pushing such reforms considerably further in the 1980s, so that by the early 1990s financial liberalization was virtually complete. According to Padoa-Schioppa and Saccomanni's (1994) phrase, for all intents and purposes the shift from a government-led to a market-led international financial system had been accomplished.

As a result, striking changes have been taking place in relation to both the intermediation processes and the institutional design across time and space of the financial services sector. In particular, classic banking functionality has been in relative long-term decline more or less worldwide, while disintermediation, financial innovation and expanding global linkages have redirected financial flows through the financial markets. Such financial flow transformation has been especially evident in the USA, while changes in the EU have been less pronounced.

The ongoing disintermediation and the faster pace with which US financial structures are evolving – e.g. by comparison to the EU - have had an impact on global market-share patterns, as US financial firms have come to dominate various intermediation roles in the financial markets. For example, in the early 2000s, over 77 per cent of lead manager positions in wholesale lending, two-thirds of security issuance mandates in global debt and equity originations and almost 80 per cent of advisory mandates (by value of deal) in completed M&A transactions were handled by US financial firms (Walter, 2003). In fact, it is estimated that in 2000 US-based investment banks captured about 70 per cent of the fee income on European capital markets and corporate finance transactions (Smith and Walter, 2000).

The reasons behind this evolution include the size of the US domestic financial market, the early deregulation of US financial markets dating back to the mid-1970s and performance pressure bearing on institutional investors, as well as on corporate and public-sector entities. One of the symptoms of this process is that small and medium-sized independent firms are taken over by larger banking institutions, resulting in ever more complex financial institutions.

In Europe, this has led to the emergence of pan-European banking groups through cross-border mergers and acquisitions and the increasing provision of wholesale financial services across member states. It is estimated that there are around 40 major banking groups which, on average, are present in probably more than six of the 25 member states, with some having establishments almost across the whole EU (Schinasi & Teixeira, 2006).

As Robin Blackburn (2006) has pointed out, the growing and systemic power of finance and financial engineering - defined as "financialization" – has come to permeate everyday life, as the increasing commodification of the life course leads to the proliferation of such financial products as student loans and pensions, credit cards and mortgages (Blackburn, 2006)[33].

Financial market integration has long been a declared policy objective of the EU. However, it was not until the late 1990s that it gathered pace, becoming a topical issue on the EU agenda. The primary driver was the introduction of the single currency, which eliminated foreign exchange risk. It was then realized by the EU political and financial elites that for the full benefits of the euro to be realized, a developed financial market was needed. Thus, a fast-track legislative and regulatory programme aimed at removing barriers to the cross-border flow of financial services, known as the Financial Services Action Plan (FSAP), came into existence in 1999.

The supranational legislative phase of the FSAP was largely completed by 2005, and the EU financial sector policy objectives for 2005-2010 focus on the implementation, consolidation and improvement of the existing legislation at the national level. New EU legislative initiatives are contemplated in relation to retail financial services and asset management, areas which are considered to be highly fragmented.

At the same time, a new EU policy implementation and enforcement framework has been devised, known as the "Lamfalussy process", aiming at achieving convergence of supervisory practices, consistent implementation of FSAP legislation and streamlined rule-making. The democratic accountability of the new process has been subject to criticism by the European Parliament.

While the new EU financial policy framework aims at increasing financial market integration, its provisions for stability and consumer protection are generally considered to be inadequate. In the case of financial stability, these rely on three basic principles: decentralization, segmentation and cooperation (Lastra, 2003). The adequacy of these arrangements has not so far been tested. As Lastra has argued: "It will take the first pan-European crisis to cast some light on this issue" (Lastra, 2003: 7).

In the case of consumer protection, this remains a national concern. Although certain new bodies have been set up at the EU level, these are of a consultative nature.

The rest of this chapter is organized as follows:

- Section 4.2 looks at the evolution of financial regulation in the EU prior to the FSAP;
- Section 4.3 presents the main features of the current EU financial market integration strategy, and the following sections, 4.5 and 4.6 look at the two key parts of that strategy, the Financial Services Action Plan and the Risk Capital Action Plan, respectively;
- Section 4.6 considers EU financial policy after the completion of these two main legislative programmes.

"The individual is encouraged to think of himself or herself as a two-legged cost and profit centre, with financial concerns anxious to help them manage their income and outgoings, their debts and credit, by supplying their services and selling them their products" (Blackburn, 2006: 39)

- Section 4.7 examines the new committee structure of the EU financial sector, set up by the Lamfalussy Process;
- Section 4.8 is devoted to the crisis management arrangements of the EU financial services policy;
- Section 4.9 takes a closer look at the existing consumer protection provisions on the EU level.

4.2 EU financial regulatory harmonization 1960s - 1990s

The construction of an internal market consisting of the home markets of all member states constitutes a generic goal of the EU. Furthermore, the Treaty establishing the European Community prohibits all restrictions to the free movement of goods, services, capital and labour. However, it is the implementation of these in-built freedoms and the distribution of power between the central and the national levels of decision-making that have been shaping policy in the financial, as in other spheres of the EU over time.

The EU has been described as a “polity sui generis”, where the member states continue to play a dominant role, as opposed to the federal nature of the USA (Petschnigg, 2005:4). This particular characteristic of the EU has been central in the evolution of financial regulation.

In particular, the early attempts at constructing an internal market concentrated on harmonizing those laws, regulations and provisions that affect its establishment and functioning through the issuing of directives (Art. 94 of the Treaty). These were aided by the establishment of a legal principle by the European Court of Justice in the Cassis de Dijon case in 1979, known as “mutual recognition”, aimed at enhancing market access across the EU[34].

In actual practice, beginning in the late 1960s and continuing until the early 1980s, the European Commission produced approximately ten directives per year. While this rate was clearly inadequate for the economy at large, it was even more so for banking and the financial services, in view of the large differences across member states and the existence of exchange and capital controls.

The period of “extensive harmonization”, also known as the Classical Approach, came to an end in the mid 1980s, with the 1985 White Paper, specifying that future legislative activity should be limited to harmonizing essential measures, beyond which mutual recognition should apply, as specified by the ECJ. Furthermore, the Single European Act introduced qualified majority voting instead of unanimity as the basis for adopting measures aimed at accomplishing the internal market (Arts. 95 and 251). This New or Minimal Harmonization Approach was seen to be a pragmatic response to the problems arising out of the previous extensive harmonization method.

The New or Minimal Harmonization Approach established the so-called “single passport” for financial services in the EU, on the basis of two principles. Namely, the mutual recognition principle and that of the home country control. Thus, products or services that are lawfully produced and marketed in one member state are granted free

[34] This section builds on Lannoo and Levin (2004).

access throughout the internal market, while the authorities of the member state where the goods or service provider has its seat are responsible for carrying out regulation and supervision of the entity, mainly relating to risk monitoring. Host country authorities, on the other hand, retained responsibility in the area of liquidity and they may interrupt the provision of services by the branch of a financial institution if any legal provisions in this regard are violated (Walkner and Raes, 2005). However, with the introduction of the euro and the establishment of the ECB, control over liquidity passed to the ECB for those countries in the eurozone.

More specifically, the Single European Act gave rise to three groups of directives defining the main elements that were deemed necessary for mutual recognition to be operational.

- The 2nd Banking Directive (1989), the Investment Services Directive (ISD, 1993) and the 3rd Life and Non-Life Insurance Directives (1992) established the right of financial institutions to provide their services across the EU on the basis of a single license[35].

- The 1985 UCITS – undertakings for collective investment in transferable securities - Directive enables fund managers to provide investment funds across the EU, while the 1989 Prospectus and Initial Public Offerings Directives (IPO) harmonized the information that firms have to supply when offering securities to the public.

- The 1989 Solvency Ratios Directive harmonized the capital standards for banks in the EU, implementing the Basel Accord I, while the 1993 Capital Adequacy Directive set minimum standards for banks and investment firms.

Under the policy approach instituted in the late 1980s, the EU member states still retained a significant role in the process of decision-making, through the allocation of competencies and the preference for directives over regulations as the legal vehicle for the transposition of Community law into national law.

In particular, although the delegation of power under the minimal harmonization approach was more significant than in the past, this differed from one function to another. Thus, member states retained considerable control over the Commission's right to initiate policy, as well as over the execution of policy through the "comitology system"[36]. On the other hand, member states cannot control the way the Commission monitors member state compliance in its role as the "Guardian of the

---

[35] It should be noted that the 1st Banking Directive, already adopted in 1977, had stipulated that national bank supervisors should co-operate and that a banking license could not be denied on the grounds of foreign identity, but it had not introduced a "single passport" or asserted home country control.

[36] According to the "comitology system", the Commission presents draft proposals to committees composed of member state representatives before adopting them, whereby Management Committees have the right to block proposals and refer them to the Council of Ministers, while Regulatory Committees must approve the proposals put forward by the Commission by qualified majority or refer them to Council.

Treaties". And they can only reverse decisions taken by the European Court of Justice in exceptional circumstances[37].

In addition to the allocation of competencies, member states retained significant control through their preference for the issuing of directives rather than regulations. While both measures take precedence over member state laws, a regulation has direct effect, whereas a directive offers member states the ability to choose the particular implementation mode that best suits their particular circumstances.

Overall, the Minimal Harmonization Approach of the 1980s was more successful than its predecessor in establishing a single financial market in the EU, although the "mutual recognition/home country control" left large areas of financial legislation in EU member states intact. One such area is that of taxation. In particular, the full liberalization of capital movements in 1988 and the adoption of the sectoral directives were not accompanied by any adjustments in the field of taxation[38].

Furthermore, political deadlock was reached in several legislative areas, including the winding-up and liquidation of credit institutions and of insurance companies, take-over bids and the European Company Statute. Lastly, the legislative process – adoption of legal measures and transposition into national law - proved to be slow by comparison to the ever increasing pace of financial market developments[39].

Thus, at the end of the 90s, financial markets in the EU remained considerably fragmented, in spite of the on-going process of internationalisation, disintermediation and globalisation of financial services.

4.3 EU financial market integration policy since the late 1990s

The advent of the euro in 1999 produced a new sense of urgency, because it made many economies of scale feasible for the first time and EU policy makers became aware of the importance of scale and scope for financial services and especially for the capital markets. This led to a new regulatory harmonization phase, beginning in the late 1990s and expected to have been implemented by 2010. This involves the further liberalization of financial services on the national level and their re-regulation along Community lines.

More specifically, financial integration was seen as a vital part of a broader economic reform package, the so-called Lisbon Strategy. The main objective of the Lisbon Strategy - adopted by the European Council meeting in Lisbon in March 2000 - is to increase the level of competitiveness of the EU economy and to close the gap with the USA, which is taken as a benchmark, by 2010 (see chapter 8). In view of the fact that

[37] Where the Court interprets treaty rules, the member states have to abide by the decision of the Court. Where it interprets EU legislation, however, member states may re-legislate.
[38] As the Commission has pointed out "It would be technically unbalanced and politically difficult to boost the full realization of a Single Market for financial services unless the parallel process of tax co-ordination currently under way delivers the expected results" (Press Release, CEC, 11/5/1999: 3).
[39] On past experience, the adoption of directives in the field of financial regulation takes 2-3 years, followed by a 1-2 year period for national implementation.

financial services cut across all other sectors of the economy, their reform has been placed high on the overall agenda.

The new EU financial integration policy consists of a number of initiatives, presented under two plans – the Financial Services Action Plan (FSAP) and the Risk Capital Action Plan (RCAP). Of these, the FSAP constitutes the "centre piece of the Community's efforts to integrate Euro financial markets" (European Commission, 2003a:31).

4.4 The Financial Services Action Plan

In June 1998, the Cardiff European Council invited the "Commission to table a framework for action … to improve the single market in financial services" (European Commission, 1999, p3) In 1999, the European Council and the European Parliament endorsed the Financial Services Action Plan. The duration of the Plan was set at 6 years, 1999-2005.

The FSAP was structured on the basis of the principal objectives guiding policy and the relative order of priorities. It was designed to tackle three "strategic" objectives. Namely, to ensure (i) a single market for wholesale financial services, (ii) open and secure retail markets and (iii) state-of-the-art prudential rules and supervision. A fourth objective, headed "wider conditions for an optimal single financial market", was also included. Under each of these objectives, a number of areas of action were outlined, while 42 legislative initiatives were proposed in total (Table 1).

Table 1
Areas of action envisaged by the Financial Services Action Plan 1999-2005

I. Wholesale – securities and derivatives - markets
➢ Removing outstanding barriers to raising capital on an EU-wide basis ➢ Common legal framework for integrated securities and derivatives markets ➢ Moving towards a single set of financial statements for listed companies ➢ Providing legal security to underpin cross-border securities trade ➢ Promoting cross-border restructuring through mergers, take-overs, etc. ➢ Creating the necessary conditions for asset managers to optimise the performance of their portfolios
II. Retail financial services
➢ Promoting information for cross-border provision of retail financial services ➢ Elimination of non-harmonised consumer-business rules ➢ Promoting the resolution of consumer disputes ➢ Creating a legal framework for new distribution channels and distance technologies on a pan-European scale
III. Prudential rules and supervision
➢ Adjusting prudential legislation to international standards ➢ Regulating the prudential supervision of financial conglomerates ➢ Promoting cross-sectoral and regional co-operation amongst authorities on issues of common concern.
IV. Wider conditions
➢ Eliminating tax obstacles to financial market integration

Source: European Commission 1999

Progress under the FSAP was impressive. Thus, by the 2005 deadline for its completion, 98% of the measures had been completed. I.e., 41 of the 42 measures have been adopted, with the exception of the proposed 14th Company Law Directive on the Cross-Border Transfer of Registered Office[40].

Progress under the FSAP was also impressive in terms of breaking the previous political impasse reached in a number of areas. Thus, with few exceptions, long-standing differences of opinion either among national governments, or among the Council and the European Parliament were resolved, or a compromise was reached, due to the political commitment of the EU political elites to monetary and financial integration. On the other hand, various loose ends still remain, while political consensus has not been entirely uniform, as displayed by the Take Over Bids Directive . We shall go on to look briefly into three of the most important new pieces of EU legislation. Namely, the Capital Requirements Directive, the Markets in Financial Instruments Directive (or MiFID), and the Take Over Bids Directive.

- Following seven years of negotiations, the *Capital Requirements Directive* (CRD) got through the European Parliament in September 2005 and was formally approved by the Council of Ministers of the 25 member states in October 2005. This Directive transposes the Basel II framework on capital measurement and capital standards into EU law. All credit institutions and investment firms operating in the 25 member states will have to comply with the new Directive's provisions from January 2007 onwards for the simple approach and from January 2008, for the more advanced approach to measuring credit and operational risks.

  There remain however certain problems in the implementation of the new Directive. These include the impact of the new approach on the minimum required capital level and the uneven implementation dates between the EU and the USA, which only plans to introduce the Basel II rulesfor its internationally active banking institutions.[41]

  The key question for regulators is whether it is safe for the financial system to replace the previous capital requirements, based on prescribed ratios for different types of exposure, by requirements based on risk assessments carried out by the banks themselves (see also chapter 14). The outbreak of the sub-prime banking crisis in 2007 does not encourage confidence in the internal risk assessment procedures of the big banks.

---

[40] Single Market in Financial Services Progress Report 2004-2005, SEC(2006)17. The 14th Company Law Directive was abandoned by the Commission in 2008. The reasons are not altogether clear, but the Directive, which would have allowed, for example, a French company to become an Italian company without being liquidated in France and then established as a new company in Italy, was perhaps seen as undermining member state competence in the sphere of company law. The measure could thereby have affected employment rights where these are linked to the company status of the employer. The Commission could not disturb member state company law beyond a cetain point without assuming responsibility for the promulgation of company law at EU level and it may have been reluctant to do this. See the worker participation website of the ETUI : http://www.worker-participation.eu/company_law_and_cg/news/corporate_governance_and_company_law_news_march_2008

[41] The rest of the US banking system, composed of approximately 8,900 regional and community banks will operate a Basel IA set of rules, which is an improved version of Basel I.

- The *Markets in Financial Instruments Directive* (or MiFID) regulates the activities of brokers, exchanges and most financial corporations trading in securities, replacing the 1993 Investment Services Directive (ISD)[42]. It consists of a "framework" directive, adopted by the Council and the Parliament in April 2004 on the basis of the Lamfalussy Process - a new decision-making procedure, which we shall discuss in the next section – and a further implementing directive, which aims at securing a uniform, harmonised approach across the 25 member states. The aim of the Directive is to push forward the integration of the financial services sector by establishing homogeneous rules for the sale of securities across all member states. Key aspects of MiFID are: an obligation to secure the best terms when trading securities on behalf of a client; an obligation to avoid or to declare conflicts of interest which can work to the detriment of customers; and rules for the reporting of security transactions. In fact, the MiFID has been criticised for being "far more onerous … than its predecessor".[43] For example, the MiFID and its implementing measures contain 169 articles, numbering 67,192 words, as opposed to the principles-based approach of the ISD, which contained 32 articles and 14,381 words. In this sense, the MiFID is indicative of the shift of EU financial services policy from a principles-based approach to a rules-based one.

- An exception to the political consensus expressed by the FSAP was the Takeover Bids Directive[44]. The original proposals of the Commission were rejected by the European Parliament and the compromise version adopted in 2004 was very much weaker and allowed member governments much more scope to regulate takeovers (see chapter 7). Thus, under the "principle of reciprocity" member states may exempt domestic companies from the ban on anti-takeover devices, when the bidding company comes from a jurisdiction permitting their use. This concerns restrictions on securities transfers and voting rights as well as the right of the board of the target company to issue shares, without prior shareholder authorisation ("poison pills").

The Commission, whose ambition was to establish a thoroughgoing "market in corporate control" by blocking defences against hostile takeovers, is clearly dissatisfied with the Directive in its compromise form. A recent Commission report argued that member states were indeed blocking takeovers and that the situation should be closely monitored (European Commission, 2007b). As yet, however, there is no proposal for new legislation.

Generally, the FSAP expressed a clear political commitment to the liberalization of EU member states' financial markets and their re-regulation along EU lines, with special emphasis on the development of capital markets facilitating the cross-border flow of capital. Two significant policy areas were however underplayed, those of supervision and of the protection of consumers. In both areas, the Plan was especially

[42] Dir. 2004/39/EC
[43] Casey and Lannoo, 2006:2. For details of the legislation and the way it is being implemented in the British financial markets see the FSA website : http://www.fsa.gov.uk/pages/About/What/International/mifid/index.shtml
[44] Directive 2004/25/EC of the European Parliament and the Council of 21/4/2004

lightweight, insofar as it introduced no new measures, commensurate with the degree of market integration it sought to promote. In Sections 4.8 and 4.9 below we take a closer look into each of these two areas.

4.5 Risk Capital Action Plan

In parallel with the FSAP, the Risk Capital Action Plan was agreed upon. The rationale of this plan was the same as that of the FSAP, i.e., creating the necessary conditions for the free circulation of capital across the EU. Furthermore, to the extent that the RCAP pertained to a new, relatively underdeveloped area of finance, that of venture capital, it also aimed at stimulating its establishment and growth in the EU member-states.

More specifically, the RCAP was adopted in 1998 for a five-year period, which expired in 2003. The central objective of the RCAP was to develop an integrated market for equity financing – venture capital and buy-outs – of SMEs by way of eliminating the existing regulatory and administrative barriers to competition at both the Community and the national level. It included a number of measures, which were in common with the FSAP, as well as certain measures beyond the FSAP, such as taxation, research and development, entrepreneurship and public funding, through state aid and the European Investment Fund (EIF), the 'equity' arm of the EIB.

The model of equity financing adopted by the RCAP was that of the US venture capital market, which in 2002 was nearly twice as large as that of the EU - 0.20% of GDP as opposed to 0.11% of GDP in the EU. The full involvement of pension funds was considered as one of the preconditions for the development of a mature venture capital market in the EU.

According to the 5th and final Progress Report on the RCAP: “When taking the RCAP period as a whole (1998-2003) important progress can be reported. From the political point of view, risk capital issues are now at the top of the agenda in all regional, national and Community institutions. From the technical point of view most of the measures foreseen in the RCAP in 1998 have been completed” (European Commission, 2003c:18).

The RCAP received less attention than the FSAP because it only related to a relatively small part of the financial sector. However, as the RCAP ended there was an explosion of investment in European venture capital: from 27 billion euro in 2004, this leapt to 72 billion euro in 2005 and 112 billion in 2006[45]. This surge was one aspect of a general move to highly leveraged positions by pension funds, banks and other financial corporations; the venture capital (also known as “private equity”) organisations use a lot of debt in order to raise the rate of return on their purchases of companies. In fact, the venture capital groups were unable to use all the money they were raising.

Although sometimes the activities of the venture capital groups are useful – for example in supporting company start-ups or in attempting to rescue otherwise

---

[45] See the website of EVCA, the European Venture Capital Association : http://www.evca.eu/knowledgecenter/statisticsdetail.aspx?id=414

insolvent companies – in many cases their activities have been strongly criticised, because they purchase companies with a view to selling them again quickly and can make their profit by asset-stripping or by loading the companies concerned with debt.[46] These aspects of venture capital, however, were not a concern of the European Commission in its drive for market-led integration.

4.6 White Paper on Financial Services Policy (2005 – 2010)

On the successful completion of the FSAP, the emphasis shifted to the implementation and enforcement of the new legislation by the member states, the development of EU financial sector infrastructure, such as clearing and settlement and payments, as well as the removal of the remaining barriers to cross-border activity in certain areas, such as retail finance and asset management. The central objectives of the EU financial services policy for the period 2005-2010 were outlined in a White Paper published by the Commission in 2005[47].

Overall, the White Paper follows the general argument and financial policy framework already set out by the Plans and especially by the FSAP, extending it to sectors left out by it and in particular to the retail financial services sector. Although it recognizes the dangers to stability that are inherent in financial integration – in terms of the possible spill-over effects of a system failure affecting several financial markets and/or groups on a EU-wide basis – it introduces no new measures. Similarly, while acknowledging the need for consumer protection, no new policy initiatives are presented in this respect.

Generally, the financial services policy of the EU remains heavily oriented towards serving the interest of markets and of the financial industry, even to the extent of offering vague protection from instability, so as to minimize the regulatory burden for firms, systems and markets. Furthermore, member states are asked to demonstrate "renewed political commitment" to financial market integration, by pressing on with the transposition of new legislation. For example, member state actions are being monitored through a publicly available transposition matrix, showing which texts have been implemented by member states, when and how.

4.7 The Lamfalussy Process

Although the FSAP was concluded successfully, major problems arose with it. There were to begin with long delays in passing legislation and complaints, from the financial sector, about the quality of the legislation as it emerged from the European Parliament. It was becoming clear also that the FSAP would have to deal with some new issues, in particular the integration of clearing and settlement procedures related to trade in securities (see Norman, 2007). In addition there were problems in transposing the FSAP Directives into member state law: financial practitioners complained about "gold-plating" or the fact that in some member states the FSAP

[46] See for example the critical report on private equity by the House of Commons Treasury Committee (2007).

[47] COM(2005)629

financial regulation was more stringent than the Directives required. This was seen as a barrier to the integration of markets in financial services.[48]

It was felt that a new governance structure was needed, bearing on the allocation and exercise of power in the area of financial services policy. This should aim at increasing the speed and flexibility of rule-making in the EU, especially at the stage of the transposition of Community law into national law, as well as reducing the possibility for member states to "gold-plate" such legislation.

It was not possible simply to transfer these problems to a European regulatory agency, analogous to the American Securities Exchange Commission (SEC). Because the EU is not a federal entity, such as the USA, the creation of agencies with discretionary regulatory powers needs to be explicitly authorised by the Treaty[49]. This is the Meroni Doctrine, developed by the European Court of Justice in the 1950s. It implies that EU institutions cannot delegate discretionary regulatory powers which have been conferred on them by the Treaty to outside bodies, as this would threaten the balance of powers between the institutions[50].

A report was thus commissioned from the "Committee of Wise Men" under the chairmanship of Alexander Lamfalussy, on the governance measures necessary for more complete and effective integration. This gave rise to a new policy-formulation process, known as the Lamfalussy Process. Its main characteristic is that it distinguishes between "framework" legislation, to be decided on the political level via the Council and the European Parliament and legislation concerning the "technical details" of framework measures, to be decided by the Commission, which would be assisted for this purpose by a number of committees, the members of which include representatives of the Commission, the member states and the market participants. The users of financial services and the employees of the financial industry are not represented.

Accordingly, two new, intermediary levels of policy formulation now intervene between the passing of framework legislation by the Council and the European Parliament on the basis of a proposal by the Commission under the co-decision procedure and its implementation by member-states. A schematic representation of how the 4 levels of decision making are expected to work is shown in Table 2 below.

---

[48] These objections to "gold-plating" raise a serious political problem. It has always been the case that individual member states were entitled to impose higher regulatory standards than those promulgated by the EU, whether the regulation concerned the environment, worker protection or consumer protection. The resulting differences in regulation are certainly a barrier to trade among member states but they work to raise standards in general and it is always open to enterprises to penetrate the national markets concerned by meeting their stricter regulatory requirements. It is not clear that there is any good reason to adopt a different approach in financial regulation.

[49] See Meroni Co., Industrie Metallurgiche, SpA v. High Authority, Cases 9 and 10/56, ECR 11-48, ECJ 1958, as quoted in Petschnigg (2005)

[50] Such a delegation of powers to outside bodies should be seen as distinct from the delegation of implementing powers by the Council to the Commission under the "comitology" system, which is explicitly authorised by the Treaty (Art. 202).

Table 2
The Lamfalussy Process

Level 1 Community legislation adopted under the co-decision procedure – Legislation should be only about framework principles and define implementing powers for the Commission

Level 2 Community legislation adopted by the Commission to lay down the technical details for the principles agreed at Level 1. Particular features: * Technical advice prepared by the Committee of European Securities Regulators (CESR) following mandates issued by the Commission and based on consultation with market users; * Favourable vote of member states (qualified majority) as represented in the European Securities Committee (ESC). * European Parliament may adopt resolutions a) within 3 months on the draft implementing measure; b) within one month after the vote of the ESC if level 2 measures go beyond implementing powers.

Level 3 The CESR, in which the national supervisory authorities are represented, to facilitate consistent day-to-day implementation of Community law. CESR may issue guidelines and common, non-binding standards.

Level 4 The Commission checks compliance of member state laws with the EU legislation. If necessary, it takes legal action against member states before the Court of Justice.

First Interim Report Monitoring the New Process for Regulating Securities Markets in Europe, May 2003

The Lamfalussy Process was put into effect in the securities sector in 2002, following a temporary agreement between the European Parliament, the Council and the Commission, known as the "Sunset Clause", which is included in all Level 1 legislation. More specifically, this safeguards the Parliament´ s right to "call-back", i.e. to look again at implementing legislation, in order to ensure that it corresponds to the intention of the primary legislation. Furthermore, in the event of disagreement, the Parliament expects the Commission to modify the draft measure by taking account of objections, initiate a new legislative process, or withdraw it altogether.

The "Sunset Clause" is a temporary agreement, aiming at safeguarding the Parliament's role as equal legislator under the co-decision procedure, given that the Council has the right to exercise its implementing powers directly in specific and exceptional cases. That is, the Council is both a delegating institution and one that can exercise the delegated competence. In order to redress the institutional balance in matters governed by the co-decision procedure, the Parliament demanded the reform of the relevant Treaty provisions (Article 202). The commitment by the Council and the Commission to such a reform was a precondition for the Parliament's support of the Lamfalussy Process.

Thus, all legislation adopted under the Lamfalussy framework contains a "sunset clause", which means that the delegation of implementing measures to the Commission will expire four years after their entry into force, unless renewed prior to the expiry date under the co-decision procedure (Inter-Institutional Monitoring Group – 3rd Report, 2004, p.8). The failure of the Constitutional Treaty, which incorporated the new compromise, means that specific measures may be needed to ensure the continuity of the delegated legislation.

On the basis of the Lamfalussy Process, two new sets of committees have been set up, dealing with (a) regulatory matters and (b) operational matters in banking, insurance, incl. pensions, and securities (Table 3). The regulatory committees represent member state governments; the committees of supervisors represent the supervisory authorities of each member state.

Table 3
The EU organizational committee architecture of the EU financial services sector

	Banking	**Insurance and Occupational Pensions**	**Securities (incl. UCITS)**
Regulatory Committee (Level 1)	European Banking Committee (EBC)	European Insurance and Occupational Pensions Committee (EIOPC)	European Securities Committee (ESC)
Committee of Supervisors (Level 3)	Committee of European Banking Supervisors (CEBS)	Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)	Committee of European Securities Regulators (CESR)

Although the new committees operate within the political mandate given to them and the agreement reached by Council and the EP, they are to play a very significant role in the new phase the EU financial services sector is entering. In this sense, they are likely to acquire a significant autonomy vis-à-vis the other EU institutions. These structures seem likely to be very sensitive to the requirements of banks and financial corporations – the well-known danger of "regulatory capture", where regulators respond to the needs of the regulated corporations rather than to those of the public, is amplified here because of the central role of the regulators in the legislative process.

At least in the short run, however, the Lamfalussy arrangements were successful. The legislative process was speeded up and the content of the legislation seemed better adapted to the functioning of the financial sector. It seems doubtful whether the FSAP could have been completed on time without this initiative.

4.8 Crisis management arrangements under the EU financial services policy

The integration strategies discussed in this chapter are essentially the responsibility of the European Commission, especially the Directorate-General for the Internal Market. However, the Commission takes no responsibility for the stability or otherwise of the market structures which emerge from the integration process. Crisis prevention and crisis management arrangements are based on three principles: decentralization, segmentation and cooperation.[51] That is, supervision is exercised by a multiplicity of bodies both at the EU and the member state level. Furthermore, in many instances, different segments of the financial industry are overseen by different bodies, while coherence across such a decentralized and segmented structure is sought through bilateral and multilateral cooperation. There are arrangements, largely under the auspices of the ECB, for the exchange of information and the possible coordination of policies relating to financial stability, but stability measures remain essentially the responsibility of the member states.[52]

Table 4 below depicts the institutional architecture of the EU single financial market, reflecting the above three principles.

Table 4
The Institutional Architecture of the EU Single Financial Market

Levels	Functions	Decision-makers	Cooperation structures
EU 27 member states	▪ EU legislation (min. harmonisation) ▪ Policy-coordination ▪ Policy shaping ▪ State aid control	▪ ECOFIN Council ▪ European Parliament. ▪ European Commission: **1.**Legislative proposals; **2**.Competition authority	▪ Econ & Financial Committee ▪ Financial Services Committee ▪ Regulatory committees
EMU 14 member states	▪ Single monetary policy ▪ Payment systems oversight ▪ Contribution to financial stability and supervision	▪ ECB Governing Council	▪ Eurosystem committees
NATIONAL	▪ National legislation ▪ Use of public funds	▪ 25 finance ministries ▪ 25 national parliaments	▪ At the EU level
	▪ Banking supervision ▪ Insurance supervision ▪ Securities regulation ▪ Supervision of financial conglomerates	▪ 13 national central banks ▪ 13 single (cross-sectoral) supervisory agencies ▪ 1banking supervisor ▪ ca. 12 insurance and pensions supervisors ▪ ca. 12 securities regulators	▪ Home/host country relationships ▪ Consolidated supervision of banking groups ▪ Supplementary supervision of financial conglomerates ▪ Supervisory committees ▪ Bilateral, banking groups, regional and EU-wide Memoranda of Understanding (MoU)
	▪ Central banking functions (members outside euro area) ▪ Lender of last resort (emergency liquidity assistance)	▪ 25 national central banks	▪ ECB Governing Council (euro area) and General Council (EU) ▪ Eurosystem committees (euro area or EU) ▪ EU-wide and regional MoU

[51] Lastra (2003) and Schinasi & Teixeira (2006)
[52] See ECB (2006a) for an account of the coordination arrangements.

	▪ Deposit insurance	▪ Ca. 35 schemes (with diverse features)	▪ Informal
Legal framework: EU Treaty + directly applicable national laws and regulations (min. harmonization through EU legislation) enforced by national authorities & courts			

Source: Garry J. Schinasi & Pedro Gustavo Teixeira, 2006, *The Lender of Last Resort in the European Single Financial Market*, IMF Working Paper 06/127, March

- ➢ As shown in the above Table, the institutional architecture of the EU financial industry is *decentralized* to the extent that the financial stability functions are largely the responsibility of the national authorities - banking supervisors, central banks, finance ministries and deposit insurance schemes. Likewise, the performance of the lender-of-last-resort function is a national responsibility, although its implications for the single monetary policy are closely followed by the ECB. Even in the euro area, the provision of emergency liquidity assistance is under the responsibility of national central banks[53].

- ➢ Furthermore, it is *segmented* across sectors and member states. That is, supervision is exercised by single supervisory authorities and/or by the national central banks.[54] Prudential regulations are largely harmonized across the EU, although their implementation may vary in view of its decentralized nature. In the eurozone, banking supervision is the responsibility of the national authorities.

- ➢ The third principle of the supervisory arrangements of the EU single financial market is that of *co-operation*. This is conducted on the basis of a web of committees, largely set up under the Lamfalussy Process, reviewed above, as well as EU-wide cooperation agreements between authorities, known as Memoranda of Understanding (MoU), which are not public documents. Neither are they legally binding.

In 2001, the EU banking supervisors and central banks adopted the Memorandum of Understanding on cooperation between payment systems overseers and banking supervisors under the EMU, setting out arrangements for cooperation and information in relation to large-value payment systems. In addition, two MoUs on financial crisis management came into existence in 2003 and 2005 respectively, dealing with cooperation between EU banking supervisors, central banks and the EU Finance Ministries. They include provisions and procedures relating to the identification of the authorities responsible and the cross-border flow of information in the case of systemic crisis with spillover effects in several countries.

While the above arrangements constitute a general framework for the supervision of the EU financial services sector, there are a number of challenges which may potentially raise problems. These include the role of the European Central Bank as a lender-of-last-resort and the mismatch between home-country control of supervision and host-country operational conduct of financial market surveillance.

---

[53] The "lender-of-last-resort" function and the "emergency liquidity assistance" are used here interchangeably.

[54] National central banks perform supervisory functions in 13 of the 25 member states: Austria, Cyprus, the Czech Republic, Germany, Greece, Italy, Lithuania, the Netherlands, Poland, Portugal, Slovakia, Slovenia and Spain.

As we saw above, the lender-of-last-resort function is primarily a national responsibility and liability. The issues that arise in this respect relate (a) to the role of the European Central Bank and (b) to the coordination between national central banks in the case of a pan-European banking group.

More specifically, the European System of Central Banks has only a limited role with regard to the safeguard of financial stability[55]. In particular, Art. 105.5 of the Treaty specifies that "The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". In this sense, prudential supervision is a "non-basic" task of the ESCB.

On the other hand, according to Art. 105.2 of the Treaty, the ESCB is responsible for the "smooth operation of payment systems". That is, should there be an explicit *payment system failure*, the ECB has competence to act as LOLR. For example, the Bank of England was asked to put up a substantial collateral with the ECB to take part in TARGET (Trans-European Automated Real-time Gross-settlement Express Transfer), whereas this is not the case for the central banks of the member states participating in the EMU[56]. Thus, although payment system supervision is difficult to dissociate from banking supervision, the Treaty does so. However, should a crisis occur outside the payment system, then the role of the ECB is at best ambiguous.

In particular, Art. 105.6 of the Treaty, also known as the "enabling clause", allows for a possible expansion of an ECB supervisory rule on the basis of a unanimity rule, rather than the formal amendment of the Treaty:

> "The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning the policies relating to the prudential supervision of credit and other financial institutions with the exception of insurance undertakings."

Therefore, in case of an emergency the ECB may be enabled to intervene. Whether this is will happen, how long it will take and how effective it may be is not clear. With now 27 member states the unanimity requirement could be an obstacle to prompt action. It has in fact been argued that such ambiguity is "constructive", insofar as it does not reveal the predisposition of the authorities to intervene in case of difficulties and therefore it reduces moral hazard. However, ambiguity about the procedures and responsibilities in such an instance may well reduce public confidence, accountability and even the effectiveness of crisis management in the EU[57]. Hence, the role of the ECB in the case of a financial crisis with broader repercussions needs to be clarified. Furthermore, as Lastra (2003) has argued, the

[55] The ESCB consists of the ECB and the national central banks of all EU member states. By contrast, the Eurosystem consists of the ECB and the national central banks of the states that participate in the EMU.
[56] Lastra (2003)
[57] Kremers et al (2003)

centralization of the LOLR function does not necessarily imply the centralization of other supervisory functions, which may appear premature at the present time.[58]

The exercise of the LOLR function may further give rise to problems of coordination between national central banks in the case of a pan-European banking group. In particular, a gap between micro and macro prudential controls may arise out of the mismatch between home-country control of supervision and host-country operational conduct of financial market surveillance[59].

This is even more so in the case of a foreign financial institution that is especially large in relation to the size of the host economy, as is true of many of the new member states of the EU, the financial industry of which is dominated by a small number of foreign owned concerns. Further, where the foreign-owned concern is small in relation to the parent institution or group, the home-country authorities may not even have the incentive to intervene. That is, there arises a case of a possible conflict of incentives.

Overall, the existing EU crisis arrangements are both ambiguous and inadequate. As pointed out by Petschnigg (2005), regulatory agencies in the USA appear to have sprung out of political &/or economic crises. Should the same happen in the EU, then the tale told by Dermine (2003) is not completely unlikely:

"During a week-end, the Banking Supervisory Committee met in Frankfurt to consider the need to launch the bail out of a large international bank. As it was becoming rapidly clear that the ECB should not increase the money supply to restore the solvency of than bank, and that tax-payers' money would be need to finance the bad debts, ECOFIN was invited to take the decision to bail it out. On the following Monday, due to a public outcry, that supervision of the problem bank had not been handled properly by the national supervisors, a decision was taken to transfer supervision to a European agency."
(Dermine, 2003:71)

Some light is thrown on EU stability arrangements by the events of the sub-prime banking crisis which broke out in 2007. In general crisis management procedures seemed to work reasonably well. The European Central Bank undertook to provide exceptional liquidity to the eurozone banking system as a whole, while national central banks dealt with the specific problems of individual banks in difficulty, such as the British bank, Northern Rock, which was eventually taken over by the British government. There did not seem to be disputes over responsibilities between member states and the EU, although it might be a cause for concern that the ECB, responsible for monetary policy in most of the major European economies and the Bank of England, supervising the most important financial markets in Europe, adopted rather different approaches to crisis management.

On the other hand, crisis prevention policies and prudential supervision were clearly inadequate. In general the obvious move of the financial system as a whole to riskier positions and in particular the vast accumulation of US mortgage-backed securities by

[58] On existing stability arrangements see also de Boissieu (2003)
[59] Schinasi and Teixeira (2006)

the banks and other financial corporations took place without any effective control or intervention by the authorities, who indeed were busy relaxing the existing regulatory regime by the introduction of the Basel II agreement which gives the big banks in particular increased scope to adopt speculative positions. The ECB, at the apex of Europe's financial system was surely at fault in doing nothing to prevent or limit these threats to stability. (se also chapters 6 and 14).

4.9 Consumer protection provisions under the EU financial services policy

Consumer protection is generally a national concern, governed by the "general good" concept, as provided for by Article 153(5) of the Treaty on "Consumer Protection"[60]. According to the rulings of the ECJ, the following are legitimate motives for invoking this concept:

- Depending on the risk level and the complexity of the financial service in relation to the degree of vulnerability of the recipient of the service. While professional clients are able to assess risks associated with specific services properly, this may not be the case for individual consumers (Case C-222/95 Parodi).
- Ensuring fairness in commercial transactions may necessitate restrictive rules on advertising and selling methods, as well as price transparency for financial services.
- Maintaining consumer confidence allows for measures aiming at the protection of financial market integrity at the firm level (Case C-204/90 Bachmann, Case C-80/94 Wielockx, Case C-484/93 Svensson and Gustavsson).
- Lastly, for the effectiveness of fiscal supervision member states may take measures restricting the cross-border trade in financial services (Case C-315/02 Lenz and Case C-319/02 Manninen).

Generally, EU legislation on retail consumer protection is limited in scope. Not surprisingly, its policy for financial integration pays little attention to this area.

More specifically, both the FSAP and the financial policy framework for 2005-2010 put on consumers the onus of protecting their own interests, given that the provisions made in this respect are hardly adequate. These provisions include an out-of-court complaints network (FIN-NET), which aims at resolving cross-border legal disputes between consumers and financial service providers and a forum of financial services experts, advising the Commission from a user perspective (FIN-USE). This is a newly established group, which is to deliver opinions on legislative initiatives of concern to users of financial services and to identify key financial services issues affecting them.

Although both initiatives represent positive developments, they are inadequate by comparison to the multiplicity and complexity of financial developments. Also, they address computer-literate consumers – be they individuals or SMEs – a limitation which is of particular relevance for the less developed areas of the EU.

[60] The ECJ rulings are cited by Walkner & Raes (2005)

Generally, consumers of retail financial services are suspicious of enterprises in this sector. This suspicion is justified by the boom and bust pattern of financial developments in the late 90s and early 2000s both in the EU and globally. Furthermore, the suspicions of consumers will impact not only on retail services but also on the financial markets and the general process of integration as their concerns for safety and liquidity will hold back the development of financial intermediation in general.

Therefore, if the EU objective of an integrated financial sector is to be achieved, consumer confidence needs to be reinforced. However, in the absence of a Europe-wide drive for substantively higher standards, the EU approach – involving market liberalisation, minimal harmonisation of regulatory standards, mutual recognition of supervisory regimes and home country control over financial enterprises - makes this difficult. As argued by Grahl and Teague (2003), the "not obviously legitimate desire for rapid integration" impedes the pursuit of more complete and effective consumer protection. (See also chapters 10 and 12.)

4.10 Conclusion

At one level the EU's strategy for financial integration, centred on the FSAP, has to be regarded as very successful. A very complex programme of legislation was enacted at both EU and member state levels. When serious difficulties arose, the Lamfalussy initiative made a realistic analysis of the problems and proposed major changes which were accepted and speedily implemented by the political actors and this got the strategy back on track. Although the outcome will certainly not be the tightly integrated and highly efficient financial system which was promised by EU leaders, substantial progress was made towards large, liquid security markets in the EU and this progress has contributed to Europe's current ability to challenge US hegemony in the financial sphere.

It is clear that the basis of these successes was political – European leaderships, at both member state and EU levels – believed in the project and were prepared to make the necessary adaptations in existing systems and procedures to ensure that it was carried out. If a similar measure of commitment could be achieved in other spheres the EU could become a very effective and dynamic force indeed.

The limitations of the financial integration strategy are just as clear. It has been a narrowly economic project, focussed on the imitation of US models, with no wider social objectives. As the remarks above on financial stability and consumer protection indicate, market integration was driven through with insufficient concern for its social consequences. The challenge for the EU now is to mobilise the same kind of unity and determination in the pursuit of broader objectives more closely related to the wellbeing of its citizens.