EU FINANCIAL SERVICES MARKET: FROM THE IDEA OF COMMON MARKET TO FINANCIAL SERVICES ACTION PLAN

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Single Market as the Underlying Idea of the European Union

The single market is the basic underlying economic principle of the European Union. This principle goes back to the Treaty establishing the European Economic Community (EEC), signed in 1958. The idea to establish Europe without internal frontiers was originally to be implemented only in trade. The objective was to expand business opportunities for companies by opening up new markets and enhance competition. The consumers will benefit from tougher competition through a broader range of products and services, lower prices and higher quality. **Initially, the customs union** (established in the European Economic Community in 1968) **was considered a tool in establishing a common market.** Duties and quotas between Member States were abolished and common customs tariffs were imposed on the third countries. The only exception was agriculture that has remained a highly regulated field in the European Union until today.

Although customs tariffs and quotas were abolished among EEC Member States, it was not easy to establish the common market as several non-tariff barriers (eg safety and packaging requirements) set major obstacles to trade between Member States. The Single European Act, which entered into force in mid-1987, modified the EEC Treaty and foresaw establishment of a single market by the beginning of 1993: **the customs union was supplemented with an internal market**. In other words, within the Community apart from duty- and quota-free movement of goods also non-tariff restrictions were abolished and free movement of goods, services, people and capital became possible. Although, in principle, the EU internal market has existed for ten years already, it has not been completed, as it is a complex issue and intensive refining continues.

Financial Integration in Theoretical and Empirical Literature

Theoretical and empirical research evaluates the impact of the international financial integration in different ways, at times the results are even controversial. A typical approach is that international financial integration accompanied by an open economy, will simplify sharing of risks and enhance specialisation in production, efficient capital allocation and economic growth. In reality, interstate financial integration with its existing market distortions may even dampen economic growth. For example, the crises in Mexico and Argentina in the 1990s emerged from large capital inflow reversed into a sudden outflow. Theoretically it is not entirely clear whether the financial sector developments have an impact on the real sector or *vice versa*. **Nevertheless, economists hold that the development of the financial sector promotes investments and economic growth,** whereas they dissent only on the magnitude of the impact. Sound economic policy and good governance render international financial integration positive.

Several studies largely referred to in the EU underpin the benefits of the EU financial integration. For example, a single market for securities should result in an increase of 1.1% in EU GDP in the next decade and the elimination of the present inefficiencies in the banking sector could result in potential gains of about 1.4…1.6% of GDP[1].

The natural development of the financial services sector should be accompanied by legislative changes, as the consumer-confidence based field is well regulated. Quite often legislation is also resorted to in order to deepen a proposed development trend. Thus, **financial sector integration is the outcome of natural development whereas sustained by evolving legislation.**

Internal Market for Financial Services

In the field of financial services several factors have facilitated general development parallel to the evolution of the single market. Herewith a few of the major reasons are presented:

- The customs union and establishment of the internal market have intensified trade between Member States (see Figure 1). Active trade between Member States requires broader international financing and, thus, contributes directly to internationalisation of financial services;
- Full benefits of the euro cannot be put to use without a single financial market. The single currency enhances transparency of markets and thereby also corporate competitiveness as well as has an impact on consolidation of capital markets;
- Progress in technology has brought along development of e-services, making international financial business remarkably easier and more accessible. Business, including in the financial sector, has become more transparent, competitiveness has improved and several international mergers have taken place in the financial sector. A number of financial conglomerates has appeared[2].

Integrating different parts of the financial sector – banking, securities and insurance markets – regulation focused primarily on banking as the part, which started to develop first. **In**

[1]See Financial Services Action Plan, Seventh Report, 3 December 2002, http://europa.eu.int/comm/internal_market/en/finances/actionplan/progress7_en.pdf

[2] A financial conglomerate is a financial group operating in banking, investment services and insurance sector.

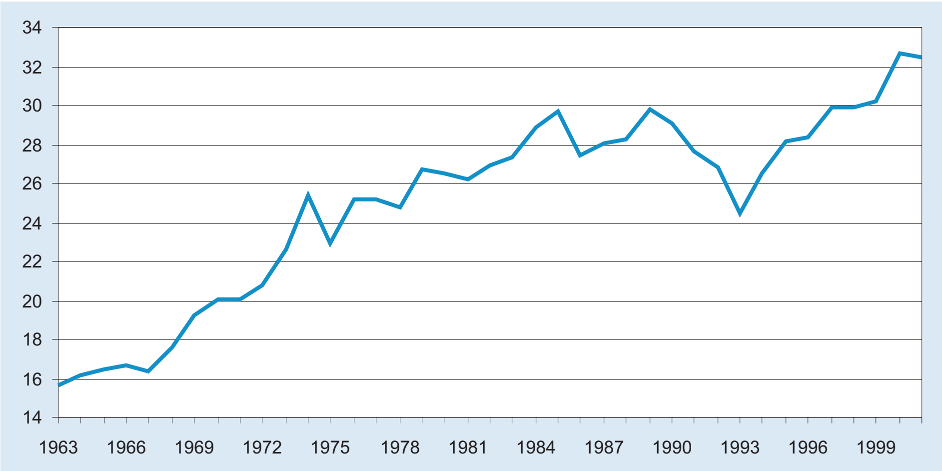

Figure 1. Intra-EU trade (in market prices, % of GDP)

banking, the establishment of an internal market goes back to 1958, when the EEC was established, and has been closely intertwined with general evolution of the integrated single market. In early years of the Community, cross-border banking was mainly sustained through deregulation of market entry with recognition of the right of establishment and if necessary, coordination of legislation. In 1973, the first directive was adopted, laying a foundation for legal harmonisation. At that time, upon entry to the market of other states, the discrimination of banks was very low but cross-border competition was hindered by restrictions on the movement of capital. Besides, also banking supervision was not coordinated and banks had to follow different prudential ratios in order to operate in different Member States.

Regulation of **the securities market** has developed similar to the banking market, although with a time lag – the most significant directives have been passed since 1979. In the 60s and 70s, **the insurance sector** became more and more regulated in the Member States. This made the operation of insurance companies in other Member States increasingly complicated and the number of insurance companies operating in Europe kept decreasing. As regulation of insurance companies, supervision and consumer protection legislation varied greatly and was numerous, the harmonisation of the EU insurance *acquis* fell considerably behind other sectors.

A pivotal change in the financial sector regulation came with internal market programme, which visualised the introduction of four freedoms – free movement of goods, services, capital and people – by the beginning of 1993. In the early 80s European banking market was highly fragmented. A large number of regulatory acts is characteristic of the period, including control of interest rates and movement of capital, restrictions on borrowing and reserve requirements, which varied from state to state[3]. Establishment was

[3] For example, in 1990 the reserve requirement was 0% in Belgium, the Netherlands, Luxembourg and Denmark, 7% in Portugal and 22.5% in Italy. Currently, 2% reserve requirement applies to short-term deposits of euro area banks.

hindered as branches in other Member States were to be established pursuant to the laws of that state, which involved additional costs. Both capital and solvency ratios in force in that Member State were to be met. However, the internal market programme aimed at a minimum number of regulations and common minimum standards. The Second Banking Directive[4] allowed the banks to operate on single authorisation[5] by the home Member State[6] throughout the European Union, recognised mutually imposed regulations and authorised the home Member State to exercise supervision. The control on the movement of capital, which had existed in many states and seriously impeded cross-border provision of financial services, was abolished with the directive on liberalisation of capital flows in 1988. This step completed one of the most important conditions of the free movement of financial sector services.

A couple of years after the banking sector, single passport was introduced also in the securities market and insurance market. The securities market has been regulated according to the similar principles than those of the banking market, taking into consideration the sector specificity. However, the insurance market has mostly been closed to the competition between Member States.

Financial Services Action Plan

The internal market is continuously evolving and therefore plans have to be updated. **Parallel to the new Internal Market Strategy, also Financial Services Action Plan (FSAP) was drafted in 1999.** FSAP measures aim at fully integrated banking and capital markets by 2005. The Action Plan is not as radical as plans made in early 1990s but rather improves on the achievements and adjusts the legal framework to market developments. The FSAP is also a significant link in reaching the goal set at the Lisbon European Council – to turn the EU economy into the most competitive economy in the world by 2010. This ambitious goal means that a one per cent difference in the potential economic growth with the US should be overcome.

The FSAP has three strategic goals:

- To complete a single wholesale market for financial services;
- To develop open and secure retail banking and retail insurance markets;
- To ensure state-of-the-art prudential rules and supervision.

In addition, a single financial market requires certain fiscal rules, ie cooperation in the field of taxation.

[4] Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC.
[5] A single banking licence means that banks recognised in a Member State can establish branches or provide cross-border services in other Member States without additional licences or certificates issued by that Member State.
[6] Home Member State is a Member State in which the head office of the bank is domiciled.

Single Wholesale Market for Financial Services

EU securities and derivatives markets have become more advanced – relations between securities markets have improved and tax systems have become more sophisticated. This has made it easier to issue and trade securities across the EU. The FSAP measures envisaged would focus on:

- the removal of outstanding barriers to raising capital on an EU-wide basis (updating the Directives on regular reporting and prospectuses);
- common legal framework for integrated securities and derivatives markets (*inter alia,* amendment of the Investment Services Directive, adoption of Directive on market manipulation);
- moving towards a single set of financial statements for listed companies (*inter alia,* implementation of International Accounting Standards);
- providing legal security to underpin cross-border securities trades (*inter alia,* adoption of Directive on Cross-border Use of Collateral)
- creating a secure and transparent environment for cross-border restructuring (adoption of Directive on takeover bids in order to protect minority shareholders);
- creating a sound framework for voluntary pension funds to promote labour mobility (adoption of Directive on prudential supervision and coordination of tax arrangements for supplementary pensions).

Open and Secure Retail Market for Financial Services

Most significant changes in EU financial markets have taken place in wholesale services. However, also the retail sector is adjusting as consumers shop around for basic financial services in different states, particularly because of the spread of electronic commerce and other methods of distance marketing. An array of legal and administrative obstacles, which hampers the cross-border purchasing or provision of these services is even more frustrating for retail consumers than for wholesale consumers. The FSAP visualises the following measures to abolish the obstacles:

- promoting enhanced information and transparency for cross-border provision of retail financial services (*inter alia*, adoption of Directive on distance selling of financial services);
- regulation of Internet trade (adoption of Directive on e-commerce and distance selling);
- harmonisation of insurance intermediation and consumer protection principles in the insurance sector (updating Directive on insurance intermediaries);
- harmonisation of fees for domestic payments and settlement of cross-border retail payments.

Ensuring Continued Stability of EU Financial Markets

Financial sector supervisors need to keep pace with new sources of financial risk and state-of-the-art supervisory practice in order to contain systemic or institutional risk and take account of changing market realities. Suggested measures are based on the following principles:

- EU financial sector prudential legislation should not be radically changed but updated, taking account of the work of existing bodies such as the Basel Committee and various EU committees (adoption of proposed Directives on winding-up and liquidation of banks and insurance companies and on electronic money, amendment to the money laundering Directive, proposals to amend capital adequacy framework);
- cooperation of national financial supervision authorities is sufficient to ensure financial stability and there is no need to establish a new EU institution. A Directive on prudential supervision of financial conglomerates has been adopted;
- arrangements to increase cross-sectoral discussion and cooperation between authorities on issues of common concern.

Fiscal Rules in Support of Financial Market Integration

One of the major obstacles in financial market integration lies in different taxation applicable in Member States, impeding the full realisation of an ideal Single Market for financial services. The Action Plan therefore underlines the need for measures to reduce tax competition between Member States, which hinders financial activity, but not to harmonise taxation in different states. Regulated fields will include taxation of life insurance and pension funds as well as taxation of savings income in the form of interest payments of persons operating in different Member States.

EU Financial Sector and Implementation of FSAP

Vigorous deregulation has boosted the EU banking sector. In most of the Member States the ratio of banks' assets to GDP doubled over twenty years (1981–2000). Reduced regulation has enhanced pan-European competition and financial products have become more specific and focus on specific client groups, although the speed and scope of development has varied from state to state.

Although EU banking is one of the fields most open to competition in the world, financial integration has remained relatively modest. Maybe because differences between states are sufficiently large, or the steps taken have not yet had an impact. **The level of integration varies from state to state and so do retail and wholesale sectors.**

In retail banking, domestic banks have several significant advantages, as according to several authors, banking services are not homogenous products and therefore the law of one price does not apply. Jean Dermine notes:

- retail customers value confidence and trust, offered by knowledge of the bank and proximity;

- retail customers prefer buying a package of financial services from the bank, which provides also payment services;
- asymmetric information in lending is often a problem. This can be mitigated by local knowledge.[7]

Similar reasons apply also for the insurance sector and therefore it is understandable why it has not been possible to establish a functioning single retail services market. The wholesale banking market, encompassing large financial institutions and other undertakings is evidently more integrated than the retail market. Here, an important factor has been the introduction of the euro, as a result of what fully integrated money markets have evolved, where interbank interest rates of short-term deposits are practically the same. Also the Real Time Gross Settlement System (RTGS) for cross-border large payments has facilitated integration in the wholesale market.

The European Union has been quite efficient in the implementation of the Financial Services Action Plan (FSAP) – over three quarters of the 42 original measures have been finalised by today (see Figure 2). Also, the implementation of the legislative work programme in the Member States has been more successful in the financial sector than in other fields of the internal market. Thus, it is realistic that the FSAP will be completed in 2005 (in securities market in 2003) with the adopted legislation implemented.

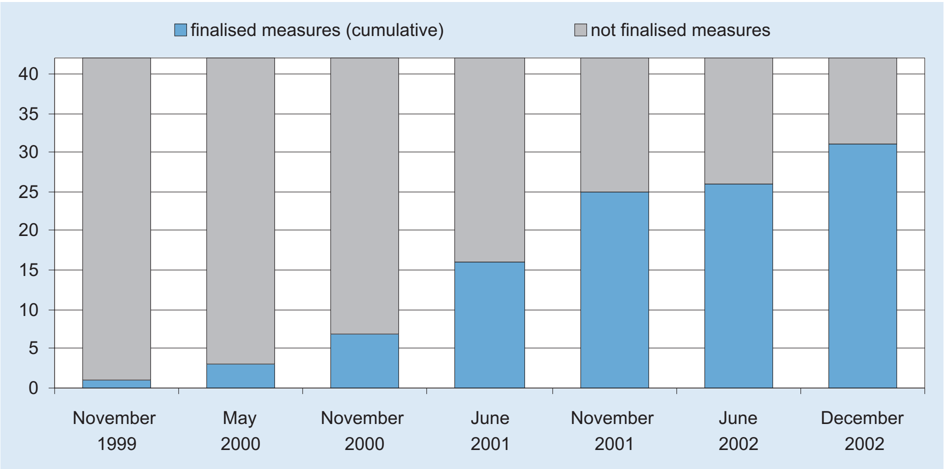

Figure 2. Implementation of the Financial Services Action Plan

The completion of FSAP will quite likely be supported by **the decision taken at the end of 2002 to extend the Lamfalussy[8] process from the securities field to the entire financial**

[7] J. Dermine. European Banking: Past, Present and Future. 2002. www.ecb.inte/home/conf/cbc2/dermine_comp.pdf
[8] Alexandre Lamfalussy chaired the committee, which proposed the above reform – to speed up the processing of securities market legislation.

sector. The regulatory procedures of the Lamfalussy process allow faster adoption of legislation – the Council and European Parliament co-decision procedure has been relatively cumbersome and slow. According to the Lamfalussy process the drafting and continued monitoring would be the responsibility of the committees, which can be more flexible in their work. The co-decision procedures should be used for framework directives whereas drafting, approval and implementation of more detailed regulation would be within the competence of the committees. In securities market legislation the Lamfalussy process was applied in early 2002 and the positive experience encouraged expanding the process to all financial sectors. In an ideal case, the committee system will be introduced at the beginning of 2004.

Although the fear to lag behind the FSAP timetable has inspired the Lamfalussy process and its expansion, it is appropriate also due to rapidly developing financial services. Quite often the regulatory environment cannot adjust itself to rapid changes but the Lamfalussy process allows a more fast response.

EU Financial Sector *Acquis* and Estonia

The EU accession negotiations assessed the compliance of Estonian legislation, including the financial sector legislation, with the EU *acquis.* Also, implementation possibilities were assessed. **In financial services Estonia considered it appropriate to transpose the entire EU *acquis* by the accession date, with the exception of two transitional arrangements** – Estonia was granted a transitional period until 31 December 2007 for the deposit and investor guarantee schemes in order to reach the minimum compensation amount for 20,000 euros (about 313,000 kroons) required by the EU legislation.

Upon completion of the negotiations on the free movement of services, Estonia started to observe the adoption of new EU legislation and assess their potential implementation in Estonia. Since 16 April 2003 Estonia has been an observer in the EU and is allowed to voice its opinion already during law-making process. After accession to the EU, presumably on 1 May 2004, Estonia will have a full voting right on all issues.

Conclusion

Europe without internal frontiers has been a leading idea ever since the early days of the European Union. Over the years the idea has expanded from the customs union to an internal market. Parallel to the internal market also financial services have developed along the same lines.

In the first decades, the pan-European integration of the financial sector spread primarily in the banking and rigid restrictions existed between Member States in other parts of the sector. The completion of the internal market programme in 1993 introduced a significant change. The elimination of frontiers in four fields allowed harmonisation of licences, regulations and supervision practices.

Theoretical and empirical research has reaffirmed the positive impact of the institutional-framework-sustained financial markets integration on economy. Similarly, further harmonisation of the EU financial services sector has taken place in recent years: regulations are amended pursuant to economic and legislative progress in order to enhance integration of the single market.

The Financial Services Action Plan approved in 1999 encompasses similar principles. The FSAP provides 42 measures to be implemented by 2005, which will facilitate financial sector integration in order to make the sector more effective. These steps are an integral part of the goal set by the Lisbon European Council that the European Union should become the most competitive economy in the world by 2010. According to various estimates, the measures could result in potential gains of about 1.4%…1.6% of GDP over the next ten years. The FSAP implementation has been successful. Also simplified processing of legislation in the securities market sector and expansion of these principles to other parts of the financial sector will facilitate the implementation progress.

Estonia will transpose the EU financial services *acquis* upon accession to the EU with the exception of two transitional arrangements. Thus, Estonia will also benefit from the single market. Besides, our full membership will allow us to influence the EU law-making process, also in financial services.