The developing Single Market in financial services

Over recent months, the Bank has had discussions with a range of firms in the financial sector to gauge their views on the development of the Single Market in financial services. Although the sample was too small to be fully representative, most of their opinions were widely shared. This article[1] summarises those views, but it should not be taken to represent the Bank's own assessment.

Introduction

As the Edinburgh European Council declared in December 1992, the programme of European legislation proposed in the 1985 White Paper as necessary to underpin the Single Market was successfully completed according to timetable 'in all essential respects'.[2]

The process of bringing the Single Market into effect, however, still continues. As one part of this, over 500 European measures are having to be transposed into national law. This was acknowledged at the time of the Edinburgh European Council by the internal market ministers of the Member States, who invited the Commission 'during 1996, to provide an overall analysis of the effectiveness of measures taken in creating the Single Market, taking particular account of their impact on the aims of promoting throughout the European Union a harmonious and balanced development of economic activities . . .', and in addition to 'consider the impact on improving the competitiveness of European business in world markets'.

Over recent months, the Bank has canvassed the perceptions and concerns of financial sector participants on how the Single Market in that sector has developed so far. It has held informal discussions with some 25 firms—including banks, building societies, securities firms, insurance companies and brokers, fund managers, lawyers and accountants—as well as some of the trade and professional associations. These discussions have focused on the way in which the Single Market has affected the firms and sectors; the impact of the Single Market legislation, its benefits, drawbacks and identifiable gaps; and the remaining hurdles, either in the form of incomplete implementation or non-regulatory barriers.

In reporting these views, it is fully recognised that they derive from a small and no doubt not fully representative sample. A number of reactions were, however, widely shared; and there were in addition some interesting individual views. For that reason, they seem worth reporting; but this article seeks neither to make an overall assessment nor to express the Bank's views.

General reactions

Single Market legislation

There was general agreement among the practitioners that although the bulk of the financial services legislation had been agreed and was in the process of being implemented in most Member States, it was too early to reach firm conclusions on its impact. The 'passport' Directives for insurance, for example—which establish that an authorisation from the regulator in a firm's home state enables that firm to operate throughout the Union without further authorisation—had only just entered into force. For securities business, the Investment Services Directive (ISD) and Capital Adequacy Directive (CAD) were not due to be implemented for another 18 months. Only in banking had the Single Market legislation been in effect for a significant time—though even there for less than two years. The balance of opinion on its effects was mixed: some contacts noted, for example, that as yet there was little sign of a reduction in the influence of banks in their domestic markets.

Most contacts thought—perhaps not surprisingly—that it was impossible accurately to isolate the impact of the Single Market programme from other influences, such as technological developments, new service delivery mechanisms and market innovation, all of which were seen as important. In addition, the formal completion of the Single Market at the end of 1992 had broadly coincided with the low point of the economic cycle in Europe. This had almost certainly held back firms' European expansion plans and, in the view of some, had led to increased competition across the European Union's financial services sector. German unification had also had a marked impact on the sector, which was similarly difficult to isolate.

On the other hand, it was universally acknowledged that the '1992' concept, the intensive legislative negotiations and the expectations which these had generated had prompted most firms to consider their strategy towards Europe more actively. In some cases, this had led to retrenchment rather than expansion, but in others it had reinforced an existing focus on Europe as a single business area. This second

(1) Prepared by Gordon Thomson and Michael Taylor of the Regulatory Policy Division of the Bank's Financial Stability Wing, assisted by Nick Walsh in the Wing's Supervision and Surveillance area.
(2) Details of the main elements of the programme in financial services were given in the article, 'The EC Single Market in financial services', in the February 1993 *Bulletin*.

effect was perhaps most marked in the case of US institutions, which in many cases had been spurred on by 1992 to incorporate in at least one Member State or to reorganise their European activities so as to exploit an existing European-incorporated subsidiary, rather than to concentrate business in branches of the parent company. The evidence suggested that US firms had been particularly vigorous in their response to the opportunities in the Second Banking Co-ordination Directive (even if this was largely as a means of rationalisation); in the words of one contact, 1992 had created 'a climate for change'.

The measures (agreed in 1987) to abolish all remaining exchange controls in eight Member States by mid-1990 and in the other four states progressively thereafter were seen as by far the most significant feature of the whole programme. Without the liberalisation of capital movements, it was thought that much of the rest of the legislation would have been ineffective.

There was, though, less certainty about the effect of the other main feature in the financial services programme—the 'passport'. Most contacts thought the concept a good one; but there was thought to be a danger of firms seeking out the lowest regulatory requirements, and there was some scepticism about the passports' practical benefits.

For retail (private customer) business, in the view of many it was often not viable to offer services either cross-border or through a branch, because consumers favoured familiar domestic products and institutions. As a result, many firms inclined towards acquisition or to cross-border alliance giving reciprocal access to each party's customer base. The latter strategy has been particularly evident in the banking sector.(1)

As for wholesale (interprofessional) business, where the markets have become increasingly global over the past decade, there was some concern that the effect of the rules associated with each passport—in particular, the new notification requirements—might be to constrain, rather than liberalise, market access. This concern was not confined to new business but also extended to the treatment of existing activities. In addition, some firms that had sought to make use of the passport—for example to allocate the group's capital more efficiently—had encountered significant practical difficulties: it often proved costly to unravel existing group structures, especially in terms of tax; some had also met pressure to maintain their local incorporation.

Concern was also expressed that some Directives might be being more strictly implemented in some Member States than in others. A number of contacts suggested that there had been cases of countries acting, if not against the letter of the Single Market legislation, against its spirit; and they stressed the importance of effective enforcement arrangements.

Contacts contrasted the approach to implementation in some Member States—where Directives were transposed into national law on the basis of broad principles—with that elsewhere, including in the United Kingdom. In their view, the former approach often allowed greater leeway and this increased the importance, when transposing European legislation into national law, of ensuring that the delicate compromises reflected in the Directives were fully safeguarded.

On the question of whether there were any obvious gaps in the Single Market programme that could be filled by future EU legislation, the areas most frequently mentioned were:

- pensions liberalisation (especially in the light of the stalemate over the proposed Pension Funds Directive, which itself was seen as only a limited first measure);
- minimum harmonisation of insolvency law (against the background of the continued lack of agreement on the EU Bankruptcy Convention and on the draft Directives on the winding-up of credit institutions and insurance companies;
- a further extension of the passport for collective investment schemes in transferable securities (UCITS), beyond the amendment Directive currently under negotiation;
- a passport for legal services;
- some minimum harmonisation of auditors' liability; and
- a minimum mutual recognition of borrowing and lending techniques in the real estate sector.

Some also mentioned taxation, but there was almost unanimous opposition to the idea of an EU withholding tax on savings, which was considered distortionary and potentially damaging to the competitiveness of EU financial services companies.

Of the legislation still being negotiated, most concern was expressed about the so-called 'horizontal' Directives (those applying to more than one sector)—particularly in the consumer field—which threatened to undermine financial services proposals already agreed. The draft Directives on data protection and distance selling were the examples most often cited.

Remaining barriers

The Bank's contacts saw four main types of remaining barriers to the Single Market—regulatory; fiscal; cultural and structural; and legal and technical.

(1) The question was explored more fully in the article on cross-border alliances in banking and financial services in the Single Market in the August 1993 *Bulletin*.

Although *regulatory* barriers were not considered in themselves an insuperable obstacle to the operation of the Single Market (in many cases firms had chosen local incorporation in individual Member States prior to 1992 as a simple solution), contacts offered a number of examples of rules which disadvantaged non-residents. These included restrictions on lawyers practising in other Member States (despite the Mutual Recognition of Diplomas Directive), on the sale of certain financial products in particular Member States and on foreign participation in various local business arrangements (such as mortgage refinancing). Contacts also mentioned more general differences in legislation governing certain activities (eg mutual funds) or—on what were considered public interest grounds—in relation to conduct of business rules. This last feature of the passport Directives was widely seen as a weakness which could become increasingly important as Member States continued to implement the Directives, because it could undermine the basic division of responsibilities between home and host states.

On *fiscal* matters, in the view of some the lack of harmonisation constituted an important barrier; for some others, it was a 'background aggravation'. Several instances were cited of firms' operations being inhibited by the complexities or differences of tax systems in different Member States. Multinational companies who wished to move their employees between Member States or to create more efficient centralised pension arrangements seemed to face particular problems. Another common complaint was that certain Member States were slow to reimburse tax to non-residents.

Whereas regulatory and tax problems were seen as soluble in time, *cultural and structural* barriers were thought more difficult to overcome. A number of examples were cited: customers' preference for domestic firms and products (this included Member State governments' preferences when tendering for privatisation business); a perception that foreign institutional forms and products (for example, UK building societies and unit trusts) were little understood; various 'traditional' practices, such as the close links—often cemented by cross-shareholdings—between industry and domestic financial services firms; differences of attitude among shareholders to the importance of dividends; differences in the form of pension provision (which it was thought would change slowly and only in response to domestic demographic pressures); a cultural bias in continental Europe towards a banking rather than a trading approach; and, in some markets, the level of state involvement. All these created obstacles to the provision of services by foreign firms, whether cross-border or through local establishment.

Finally a number of *legal and technical* barriers were identified—again often arising from different traditions. Examples included: differences in labour legislation (which often made it difficult to recruit teams of staff locally or, after an acquisition, to change existing staff contracts); in insolvency law (where in one country, for example, contracts made less than a year before a bankruptcy are automatically declared invalid); in property law and the law on netting; and in national consumer protection legislation.

It was also noted that legal concepts often had widely-differing applications across the European Union. Differences between Member States' definitions of 'public liability', for example, meant that contracts or insurance policies needed to be designed for each individual market. Similarly, contacts cited claims-made policies (where the insurer is liable only for claims first made during the period of cover, regardless of when the injury or damage occurred) and exclusion clauses as examples which could be voidable either on public policy grounds or where a master policy is in a different language.

In summary, many contacts considered that the practical benefits of the Single Market's legislative programme *so far* had been relatively limited. It was felt, however, that this should not deter the Commission either from giving implementation, monitoring and enforcement of the legislation high priority or—selectively—from extending the programme. On the second issue, some viewed the subsidiarity test which, following agreement at the Edinburgh European Council, is now obligatory on the Commission when it considers any new legislative proposal, with mixed feelings. Though it was designed to prevent action being taken unnecessarily at EU level, they were concerned that it might be used by Member States to thwart the proper functioning of the Single Market.

Turning to wider issues, and in particular the impact of the Single Market legislation on London's position as a financial centre, the general view was that the 1992 programme should, and probably did, represent more of an opportunity than a threat. London continued to enjoy advantages of language and—particularly for US institutions—a broadly familiar regulatory framework; the main trend so far among third-country institutions wishing to benefit from the Second Banking Co-ordination Directive's passport was for them to centre their EU operations in UK-incorporated subsidiaries. However, there was a warning that there was no room for complacency: several contacts noted the government-sponsored campaigns in Germany and France to attract new business to their own financial centres. London needed to remain a free and open market, and to keep abreast of or in advance of other centres in such things as clearing and settlement systems; and financial regulation needed to be implemented in a way that did not impose unnecessary burdens on financial practitioners.

As for a strategy on economic and monetary union, the overwhelming response was that although this had earlier been a subject for careful consideration and forward planning among financial services firms, there now seemed less likelihood of an early move to Stage 3. There was, however, considerably less agreement about the prospective impact on London if the United Kingdom were not to be in the first wave of countries moving to a single currency.

Views of specific sectors

Banking

The primary piece of Single Market legislation affecting the banking sector is the Second Banking Co-ordination Directive (2BCD). It is the 2BCD which confers a passport on credit institutions, ie the right to establish branches or to provide services cross-border throughout the European Union once authorised by their home supervisory authority. There are a number of accompanying Directives which set minimum standards in respect of capital adequacy, large exposures and consolidated supervision.

Although the 2BCD has been in force in the majority of Member States since January 1993 and its geographical scope was extended to cover most EFTA countries from January this year by the European Economic Area (EEA) agreement, banks considered that its impact had been limited. Some pointed to increased competition, but this was generally either from existing players in the domestic market or, particularly in the credit card and payments area, from affiliates of companies traditionally operating outside the financial sector.

Wholesale banking business has in any case long been international in orientation; in the retail sector cultural barriers remain strong, with customers often reluctant to deal with foreign institutions even for basic banking services. So banks have not seen the passport as an opportunity to create new pan-European branch networks, and future expansion was thought more likely to be by acquisition, which would permit a local identity to be preserved. Despite the costs and effort involved, the most common use of the passport to date has been to convert existing subsidiaries into branches of a single European operation, so permitting a more efficient allocation of capital. Third-country (most notably US) banks, as well as securities firms with an existing banking subsidiary in the European Union, have been at the forefront of this trend.

Contacts perceived a number of difficulties with the 2BCD. The requirements on an institution that is taking advantage of the passport to notify the host state's supervisory authority of the services it is already providing in that state was seen as excessive or unnecessary; there were suggestions that some Member States were questioning banks' claims and demanding fresh notifications. There was a further problem surrounding the definition of a cross-border service: Member States were applying different interpretations of when a service qualified and therefore required notification; the resulting uncertainty was seen as a significant barrier to trade.

Finally, the passport relates to services rather than products. It was suggested that since there is no express provision in the Directive obliging Member States to allow banks to sell a particular financial product in their jurisdictions, some countries were continuing to restrict competition by prohibiting certain types of product—sometimes, it was thought, on the grounds of the 'general good'. Bans on the provision of interest-bearing current accounts and on collective investment schemes transacting foreign exchange business with banks incorporated in another Member State were cited frequently as examples.

Building societies

A common perception emerging from the discussions with building societies was that the Single Market had had little impact so far, and that cross-border business was negligible. Although they were classed as credit institutions and eligible for the passport, and although house finance was one of the activities included in the passport, building societies generally considered that they operated at a disadvantage in continental Europe compared with their UK bank competitors. The concept of a building society and its mutual status was not well understood. Prospective house-buyers were reluctant to do business with foreign institutions, still less those of an unfamiliar type. And unlike most banking activities, the housing finance market was characterised by significant differences among Member States in property and insolvency law, and in tax treatment. In at least one Member State, for example, tax relief on mortgage payments applied only to customers of domestic institutions, whereas in another a higher rate of mortgage registration tax was applied to borrowing from a finance house than from a bank.

Building societies also perceived some constraints on expansion into Europe from their domestic building society legislation. At European level, there was widespread agreement—despite the inclusion of housing finance in the 2BCD—about the need for a measure which brought full mutual recognition of funding and lending techniques. This, it was recognised, would have to be a long-term aim, as national property law would be difficult to change.

Securities houses

With the Investment Services Directive (ISD)—the counterpart to the 2BCD in the securities field—not due to come into force until 1 January 1996, securities firms had little to say on the effects of the Single Market to date. Since the major firms already deal cross-border, particularly for wholesale business, few were expecting major changes to the environment even after ISD implementation. But as with banks, some might take the opportunity to convert their existing European subsidiaries into the branches of a single entity (US institutions were thought likely to be at the forefront of any such moves).

On the other hand, a number of the ISD's provisions caused concern. Contacts viewed the notification requirements, which mirror those in the 2BCD, with apprehension. The Directive was also seen as leaving a number of barriers in place. In addition, the delay before implementation was thought to risk a slowing-down in the process of liberalisation by some Member States.

An additional concern was that the ISD would allow Member States to continue to require their investors to deal in securities only on a regulated market. This so-called 'concentration' rule was considered a potentially significant barrier to the provision of cross-border services, for example in over-the-counter instruments (even though the Directive requires Member States that apply the rule to allow investors to 'opt out'—by electing to have transactions executed away from a regulated market). Finally, firms were concerned about how conduct of business rules would operate when they sought to use the passport. Although there are general guidelines on the rules that can be imposed, these allow a good deal of flexibility in interpretation. Some firms thought that the example of 2BCD implementation suggested some Member States might simply apply all their existing conduct of business rules, so reducing the ISD's market-opening potential.

Fund managers

Fund managers have in principle had slightly longer than other sectors to reap benefits from the Single Market legislation: the UCITS Directive, which provided the 'passport' for marketing certain collective investment schemes, came into force in most Member States in 1989. Contacts, however, judged the freedoms reflected in this Directive to be quite limited, and hoped that an amendment currently under negotiation would liberalise the area further. This amendment is designed to extend the marketing freedoms to money-market and cash funds, funds of funds(1) and 'feeder funds';(2) and to allow third-country branches to administer funds in the Member State in which they are located and EU-incorporated institutions to provide cross-border administration of funds. From January 1996, the ISD will also provide non-bank fund managers with a passport for this business equivalent to that available to banks (under the 2BCD) since the beginning of 1993.

On balance, therefore, fund managers shared the perception that the Single Market had not so far had a significant impact. Their expansion into Europe had been motivated more by client requirements and by tax considerations (some double-taxation treaties between EU countries facilitate the sale of offshore funds) than by the Single Market programme. Moreover, locally-incorporated subsidiaries had to date often been viewed as the only practical route for this business.

Although some fund managers had seen significant growth in sales of investment services in Europe in recent years, they felt that it was not easy to operate efficiently on a pan-European scale. The preference of customers in some Member States for bond rather than equity-based products had not assisted UK firms, with their equity management skills; but the privatisation programmes under way in some Member States should provide increased opportunities. The complexities of custody regulations in some countries, and of tax systems in others, instances of tax disadvantages for those investing in foreign UCITS and the widely-differing structures of pension funds were all seen as barriers to business. Most expressed disappointment that the proposed Pension Funds Directive (viewed as a limited first measure towards full liberalisation) had created such difficulties during negotiation. They now hoped that pensions reform—particularly in some of the larger Member States—would open up the market.

There was also general concern about the potential burden of host country conduct of business rules, which it was felt were likely to differ considerably between Member States, even when all the securities markets legislation was in place.

Insurance companies and brokers

As the so-called 'Third-Generation Directives' providing a passport to life and non-life insurers were due to come into force on 1 July 1994, insurers and brokers were inclined to suspend judgment on the Single Market's legislative programme in insurance as a whole. General views on the previous generation of Directives—intended to liberalise large-risk business on the non-life side and own-initiative life business—were that the former had had some effect, but the latter virtually no influence on cross-border activity.

There was general agreement that a local presence was essential in markets where companies had an interest—particularly for mass (ie consumer and small business) risks—and that to avoid potential practical problems local incorporation was the best route. Even then, however, barriers were seen to remain: idiosyncrasies in national contract law and in legal concepts—as well as widely-differing tax arrangements—meant that products needed to be tailored to each market. In addition, differences in the way insurance was sold and solvency margins were calculated and—particularly in life insurance—conservatism on the part of customers made it difficult for new firms to enter the market.

Contacts viewed the UK insurance market as open. Although US, Japanese and Scandinavian insurers had for various reasons concentrated on competing in their home territories, the large French, German and Swiss insurers had proved particularly active in the United Kingdom, in some cases benefiting from what were perceived to be more favourable tax regimes at home and dividend policies which enabled a faster accumulation of reserves.

Some thought that the Single Market had come at an unfortunate time for UK insurers, coinciding with problems and major internal restructuring at Lloyd's, and with losses in areas such as mortgage indemnity insurance. These factors, combined with UK insurers' relatively modest capital compared with their major continental competitors, continued to inhibit expansion into Europe.

Product innovation and other technological changes were considered potentially important for the future. Indeed, though some thought that there would be no significant

(1) Funds which invest solely in the units of other funds.
(2) Funds which invest solely in one other (master) fund.

benefits from the passport in the short term, others considered that the approach taken, for example, by direct insurance companies (which transact business with their clients directly, rather than through an intermediary, with attendant savings on infrastructure and other overheads) could be successful as the benefits of the passport Directives fed through.

Brokers noted that their position was still uncertain and that there were no common EU rules on, for example, establishment. Some countries had traditionally banned brokers. There were, however, opportunities for 'niche' business, for example in risk management and captive insurance.(1)

The legal profession

Contacts pointed to the rapid increase in the number of multinational law firms operating in continental Europe since the late 1980s—prompted by general, if not universal, liberalisation. But despite hopes following the agreement of the Mutual Recognition of Diplomas Directive in 1988, liberalisation had in practice been disappointing. Implementation of the Directive was held to have been either slow or incomplete, particularly concerning the arrangements for tests before lawyers can practise elsewhere. As a result, the main effect of the Directive had been to ease the transfer between legal professions of Member States with similar legal systems.

But the Diplomas Directive was aimed only at establishing the freedom to practise of individual lawyers. There was general support for a further measure to ease the more extensive export of legal services. To this end, the Council of Bars and Law Societies of the European Community had produced a draft text for Commission consideration to allow law firms from one Member State to set up branches freely in another without having to integrate fully into its legal profession. Some Member States' preference for compulsory integration after a transitional period was considered unnecessary and inappropriate for cross-border legal services.

Summary

The firms whose views are reported in this article, although drawn widely from within the financial services sector and closely-related activities, by no means covered the whole range. In addition, any conclusions on the Single Market's development at such an early stage in the programme—and given its implementation initially against the background of Europe-wide recession—can only be tentative.

The frequency with which similar opinions and assessments were expressed was notable, however. Although those contacted expressed widespread support for the aims of the Single Market and for its principal features, such as the passport, this was qualified by misgivings about some of the procedures proposed. Contacts also often referred to remaining barriers—regulatory, fiscal, legal and structural/cultural.

Many practitioners were confident that the regulatory and fiscal concerns would either be surmounted over time or would diminish. Structural and cultural barriers were seen, however, as more deep-seated, with limits on the extent to which policy actions could overcome them.

Yet there was a clear feeling that there was plenty of scope to improve the Single Market programme now. The key areas were seen as implementation and enforcement; repeated emphasis was given to Member States' differing approaches to implementation as a cause of competitive inequalities. Not surprisingly, therefore, effective policing of the legislation by the Commission was seen as a necessity, despite doubts about the Commission's resources. The need for adequate enforcement emphasised that the Single Market programme was not completed at the end of 1992; rather, it was seen as a continuing process the full effects of which could take many years to work through.

(1) Captive insurance companies are set up to insure or re-insure all or part of the risks of their parent company.