Creating a Single Financial Market in Europe: What Do We Mean?

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European heads of government committed themselves at the Lisbon Summit in March 2000 to the objective of making the European Union the most competitive economy in the world by 2010. One crucial policy-strand, which is supposed to contribute to that objective, is the creation of a capital market in Europe, which can rival the North American capital market in terms of its depth, liquidity and flexibility. The aim is to develop a market which allows European companies to raise finance on competitive terms, to promote investment and growth, and which provides investment opportunities across the continent, which better match the needs of all European investors.

In general, we would have to acknowledge that progress towards the headline objective of making Europe the world's most competitive economy has been – to put it politely – slow. Productivity growth in Europe has continued to lag the US. Rates of business formation are still slower and unemployment remains stubbornly high. Perhaps we are making progress but, if so, it looks to be a case of, as we say in English, *reculer pour mieux sauter.*

That is not to say that the Lisbon agenda itself has stalled. And in the case of the building blocks of the single financial market, many of them have been put in place.

I suspect, however, that the heads of government in Lisbon would be somewhat surprised by the way in which their initiative had been taken forward. At the outset, the single financial market initiative was seen as a flagship project for the UK, and for market liberals more generally. It was intended as an initiative to remove barriers to financial market activity across the continent, and to create freedom for investment banks in the City of London to spread happiness and joy across the continent.

But, as is the way in the construction of Europe, the process of defining what was meant in practice by the single financial market was handed over to the European Commission, which devised the Financial Services Action Plan. The FSAP consists of 42 directives or regulations, many of them of impenetrable detail. Taken together they introduce a significantly more intrusive and costly regulatory regime for many financial firms across the EU. Just one example will suffice. The insurance mediation directive, which was intended to allow cross-border insurance-broking throughout the EU, introduces a regime of regulation of all insurance brokers, even if purely domestic in their business,

in order to create a level playing field for cross-border activity. The result is that some twenty thousand new firms will be brought into the FSA's regulatory regime, with doubtful benefits from the point of view of the policyholder. Costs will rise, and the consumer detriment in general insurance is not sufficiently large, in my view, to justify those costs. Consumers can easily check the costs of house or motor insurance policies very quickly, secure competing quotes and press on. The regulatory regime already provides some assurance about the prudential soundness of firms allowed to offer this business. The added value of a conduct of business regime is low.

As a result of this detailed articulation of the action plan, the line-up of support for the FSAP has shifted and it is now quite common for the UK government to find itself in a small minority of states resisting the terms of new financial market directives. That is currently true, for example, in relation to the investment service directive where the UK was voted down last October on some crucial points.

So the first major question I would like to address this evening is – how has this happened? How has a liberalising initiative become bogged down in detailed negotiations, and how is it that the country that was most supportive of the initiative at the outset is now far less enthusiastic.

A good part of the reason derives from a lack of clarity about the objectives of the single financial market programme, right at the outset. And, indeed, in a lack of understanding of the different positions of the different member states. We all understand why agreements on reform of the common agricultural policy are so difficult to achieve. For some countries, the agricultural sector is a far more significant part of the economy than it is for others. The same is true of financial services. The UK is in a particularly strong position and is a natural exporter of financial services to the rest of the Union. It therefore has an understandable interest in lowering barriers to exports, and indeed in lowering barriers to takeovers. We are quite used to hostile takeovers, and to the creation of large multinational conglomerates. We also tend to think that, if genuinely free trade in financial services across the Union is allowed, the City of London will be a major beneficiary.

Those countries which are sizeable importers of financial services, and which fear that their financial sector might be wholly taken over by foreign companies, have quite a different set of interests. They are likely to look for rules which, in practice, make it difficult for overseas institutions to establish a dominant participation in their market.

There are also significant differences in the character of financial regulation from one country to another. In many continental European countries, for example, financial regulation focuses on the product. There are tight definitions of the type of investments that may be sold, including detailed rules about their risk characteristics. Process regulation, by contrast, is far less well developed. In the UK, the opposite is true. We have typically

eschewed product regulation, on the grounds that consumer interests are best served by flexibility and innovation. But we recognise that some of the imaginative products that will thereby be promoted will be quite unsuitable to unsophisticated investors. So there are serious disciplines on advice and on the selling process. (This regime has not prevented serious mis-selling, of course, a point which advocates of product regulation often make).

These naturally different positions were little appreciated at the beginning of the programme. But, beyond that, there was also a crucial lack of clarity about the objectives. UK policy makers typically thought of the programme as one designed to facilitate capital raising across the Union. It was, as I have suggested, part of the competitiveness and liberalisation agenda of Lisbon. Elsewhere in the Union the programme was seen as one which focused just as much on retail investment. With the introduction of the Euro that was a natural focus for policy makers. They were quite reasonably concerned about the growth of cross-border trade in financial services, even in the retail sector. For the "out" countries, retail rule-making seemed a lower priority, indeed one which could bring considerable cost, with few observable benefits.

And at the same time there was no clear understanding about the nature of the regulatory regime that would be necessary in a single financial market. To simplify somewhat, there are two generic approaches to regulation in a single market: mutual recognition, or harmonisation. Mutual recognition means broadly what it says. We accept broadly equivalent regimes in different countries, recognise the validity of our respective regulatory structures and, so to speak, take in each other's washing. This is, broadly speaking, the approach taken in many other areas of European regulation. The Commission sets general rules, and relies on member states to police them in their own countries. We assume that they are policed in a comparable way.

Harmonisation is different. It implies that we should be looking to establish one single rulebook for the whole of the Union. Of course a certain degree of harmonisation can be compatible with mutual recognition. Indeed the UK government's line has typically been to argue for mutual recognition based on a set of harmonised core principles.

But many other countries go much further. And the harmonisers can be subdivided into two categories: maximum harmonisers and minimum harmonisers.

I recognise that at this point we may seem to be getting into a "big ender, little ender" dispute. (For those not familiar with Swift, those who believe it appropriate a boiled egg from the big end, go to war against those who believe it right to start from the little end.)

The difference between maximum and minimum harmonisation is rather more significant. Minimum harmonisers tend to argue that there are certain rules, which ought to be common across the Union, but that we can allow some local flexibility to reflect the nature of the different financial markets in different member states. The maximum harmonisers take a different view. They believe that we should harmonise everything, to prevent member states from engaging in strategies of competitive deregulation, or indeed to prevent the addition of super-equivalent measures domestically which might have the effect of protecting home companies from cross-border competition. Increasingly, the Commission has been putting forward maximum harmonisation proposals recently, which are inevitably more detailed and more constraining, and usually more costly, especially for those countries, like the UK, which already have well-developed regulatory regimes which need to be significantly changed following the passage of a maximum harmonisation directive.

The third area in which there was a crucial lack of clarity at the outset concerned the way the regulation of a single financial market would be carried out in practice. At its simplest, would there be a single central regulator, or would member states themselves be responsible? Here again, the UK position is straightforward. We see no reason to depart from the usual arrangements in Europe, whereby rules may be set centrally, but are policed locally. Others, however, have argued that we will not see a fully functioning single financial market unless there is a single regulator, or perhaps a set of sectorally based regulators in Brussels or a continental financial centre.

It is perhaps not surprising, then, that as these uncertainties were left unresolved at the outset, the process of articulating a single financial market has been fraught with difficulty. Versions of these arguments have arisen on many of the individual directives, and ad hoc solutions have been reached in each case, leaving a complicated patchwork of rules and regulations, which lack clarity and consistency.

However, it is fair to acknowledge that the Commission have nonetheless made considerable progress with the FSAP. Many of the 42 measures have now been enacted, or are close to completion. They have overcome inertia and some political obstacles, so that it will be possible for the Commission to declare a sort of victory in 2005, which was the target end date for the completion of the market. But as we approach that date it is reasonable to ask ourselves just what has been achieved and what the practical effects will be.

My assessment can be only cursory tonight. But now that I have moved to an academic institution I feel less embarrassed about offering a partial assessment. Because the flipside of that coin is that more research work is necessary to produce a clear and comprehensive assessment of the FSAP. I

am sure that the LSE would be happy to perform such an assessment, for a suitable consideration.

But it is possible, as I suggest, to draw up a preliminary balance sheet. To do so we can usefully consider five linked tests. I seem to recall the "five test" framework being used elsewhere, but the precise reference escapes me for the moment.

The first test is whether we are making adequate progress with the legal and regulatory framework.

The second is whether that framework is actually being implemented and enforced evenly across the EU.

The third and obviously linked question is whether we have adequate and compatible regulatory structures across the Union to promote enforcement and broadly comparable application of the rules.

The fourth is whether our financial markets and financial institutions are in practice operating in a way which will mean that the opportunities created by the single financial market are taken up in practice.

The fifth and last is, in a sense, the overall assessment. Are there signs that the programme is in practice delivering more cross-border financial activity, more competition and keener prices?

Test One: The Rules

More than three quarters of the measures in the FSAP have been implemented, though not all quite in the form envisaged. Some, for example the takeover directive, have left a lot to be desired. Others such as the investment services directive remain embroiled in difficult negotiations. One major piece of the jigsaw, the risk-based capital directive, awaits the conclusion of the Basel Two Exercise, which is rather like waiting for Godot.

But, overall, we would have to acknowledge that in its basic rule-making task the Commission has done reasonably well, against a very tight deadline. This, of course, says nothing about the content of the directives agreed.

It is too soon to produce a definitive verdict of this first of my five tests, but "so far so good" might be a reasonable summary of the position at present. I suspect there will be some slippage in the original timetable but I doubt whether that will be crucial.

There is, of course, another question which the Commission will need shortly to address. What happens beyond the FSAP? Is there a need for an FSAP2, another raft of harmonising legislation?

My own view is that the Commission should be very cautious in proposing more legislation in the short term. There are some areas where further progress is needed, particularly in the insurance and reinsurance markets. But the Commission needs to take account of the digestive capacity of the market. That would suggest to me that any further activity should be very carefully considered and very tightly focused. Indeed, my view is that the Commission should adjust its focus away from legislative productivity and towards implementation and enforcement, the subject of my second test.

Test Two: Are the Single Financial Market Rules Being Enforced?

It is much harder to give a definitive answer to this question. But my judgement would be that we are still a long way from consistent enforcement.

In part, that is because of the wholly unrealistic timetables for implementation of the directives which have been set. Some of the changes required are extremely complex and require a major overhaul of domestic regimes. It is highly unlikely that all the directives that have recently been passed will be implemented on their planned timetable. My successor at the FSA has made the point that a huge amount of change is emerging all at the same time and that firms are finding great difficulty in coping.

There is also, frankly, evidence that in some countries companies continue to stumble on obstacles which stand in the way of cross-border activity. In some cases they are required to establish local presences where that should not be necessary. They are required to seek local approvals where they ought not to be required, and there are sometimes tax and other reasons which create domestic preference.

To some extent, the remedies for this lie in the hands of the market itself. Companies need to be ready to bring complaints to the Commission and so far relatively few have done so. The pan-European networks of regulators also have a role to play. One of the aims of the Lamfalussy reforms (on which a little more later) is to forge a consistent approach to regulatory action across the EU. So far not a lot has been done, but there are plans afoot.

On a second test, therefore, the verdict can at present only be "must try harder".

The third test leads on from this point. It is:

Test Three: Are the Regulatory Structures in Place

There are those who argue that we will never see a proper single financial market unless there is a single regulator and that the regulatory structures in Europe are simply not compatible with the kind of financial integration which heads of government say they seek.

I do not agree. In other parts of economic life in the European Union we typically agree law and rules at the centre, which are then implemented in member states. We agree rules on cleanliness of beaches, but we do not see inspectors from Brussels in Blackpool – something for which they are grateful, no doubt. It is also crucially relevant that enforcement takes place in the court systems of individual member states and, until we have a single legal system – which looks some way off – enforcement is bound to be local. So I am not a supporter of a Euro-FSA – and certainly not of a Euro-SEC.

On the other hand we need to recognise that financial services are in some ways different from other forms of economic activity. That is why we have agreed a framework of mutual recognition and regulation so that if a UK resident places a deposit in a French bank, she must look to the French banking commission for reassurance and protection, not to the FSA.

If that mutual recognition system is to work effectively we need to have confidence in each other's work. That, in turn, requires a greater degree of commonality of approach in regulation than is necessary in some other areas, though it does not amount to the case for a single financial regulator. There needs to be more joint working and more collaboration on rule making and enforcement than is typically necessary in other areas of economic life. That is the case for the new Lamfalussy committees of regulators, which ministers at last, a couple of weeks ago, agreed to establish. (I might say in parenthesis that it took ministers eighteen months to agree the location of the tiny secretariat of these three committees. The chances of them being able to agree on the location of a single regulator in less than a couple of decades must be remote.)

But if we are to have greater collaboration between regulators, it would certainly help if those regulators were similarly structured in different member states. Indeed that is a point which the Lamfalussy committee made in its report on securities regulation, which has been given less prominence subsequently.

Are there any signs of convergence in Europe on a common model? Until recently it would have been hard to answer that question in the affirmative. But there are now signs that regulatory integration is finding favour in more and more member states, albeit not always exactly on the same model. There are now single regulators in Sweden, Denmark, the UK of course, Germany, Austria, Ireland and Belgium. Considerable integration has been achieved in the Netherlands, Finland and in Luxembourg and is under discussion elsewhere. One outcome of the Parmalat affair in Italy looks likely to be some regulatory consolidation there also.

Unfortunately, we are still some way short of consensus and a number of countries, notably France, remain attached to a three-pillar structure, with banking supervision still in the Central Bank. Indeed, the European Central Bank has set back the cause of regulatory consolidation in Europe with its

claims for a central role in banking supervision. In my view it is inconceivable that ministers should wish to give the ECB, with its deliberately high degree of independence in monetary policy, responsibility for major areas of financial regulation. And I think that under Jean-Claude Trichet, it is unlikely that the ECB will continue to press for regulatory powers.

My own view, which I know remains controversial in some parts of Europe, is that the case for integrated regulation has now been so strongly made out that other countries should move quickly towards it, both on the grounds of domestic effectiveness, and in order to facilitate the European collaboration we need to make the single financial market work well. Unfortunately, a number of central banks remain to be convinced of that.

So, for the time being, we have to say that we do not have regulatory systems in place, which gives the best chance of completing the single financial market and there is considerable work still to be done.

Test Four: Are Markets and Institutional Structures in the Private Sector Developing on a Pan-European Basis?

But more important than this assessment of regulatory structures is the question of how the market itself is developing. Are there signs that financial institutions themselves are operating on a pan-European basis?

For the moment, I think we would have to say that there is relatively little sign that financial services firms themselves are gearing up to exploit the potential of the single market.

If we look solely at the banking sector, a recent study has shown that of nineteen major banking mergers in the last five years, only seven were cross-border within the European Union, and most of those were relatively smaller deals. The most obvious trend has remained continued consolidation within member states, instanced by the BNP/Paribas deal in France and the Royal Bank of Scotland's acquisition of National Westminster in the UK. A number of other potential cross-border mergers in Europe, which might well make economic sense, have foundered either on the unwillingness of the authorities to sanction such deals (not the case in the UK, I should add) or national sensitivities about head offices and cost-cutting. Several banks have attempted to pursue the goal of a pan-European retail bank, but have so far been thwarted in those ambitions. It has not proved possible, for example, to buy a sizeable bank in Italy, given the Bank of Italy's resistance.

As a result, I have met many bank chairmen who would like to establish a pan-European institution, but who would like to be the second chairman to try it, not the first.

There has been some cross-border activity in the insurance market, but again not on a scale which is likely to revolutionise the provision of financial services in the Union.

In the securities area, we are all aware of the high profile failure of the proposed Frankfurt and London merger. Euronext has, by contrast, made considerable progress in bringing a number of European exchanges closer together, albeit the business model remains somewhat short of a single multi-country platform. The tortoise, rather than the hare approach to exchange consolidation seems to be more successful at the moment.

I remain of the view that further consolidation of trading platforms in Europe is likely to occur in the next few years. There are something like 25 equity markets still in the current EU, compared to three or four in the US, for a much larger overall market.

My conclusion here cannot, therefore, be particularly favourable. There is still a long way to go, and the market is certainly not telling us that conditions for pan-European provision of financial services are in place.

Which brings me to my fifth and final test.

Test Five: How Much Cross-Border Activity is There?

This is the ultimate test – whether the market is responding in terms of cross-border activity, and whether that is producing the supposed benefits of a deeper and more liquid financial market, both for investors and capital-raisers.

It is frustrating to note that there is relatively little hard evidence on this question, which one might reasonably think was the most significant issue. Some attempts have been made to assess the potential impact of a single financial market, but I do not find them wholly persuasive or adequately rigorous. One is left, therefore, with an impressionistic response to the question.

I believe there are very different answers for the wholesale and retail markets respectively.

In the wholesale markets there is evidence of growing consolidation of activity in a small number of centres, notably in London. Most of the investment banks operating in the European Union have centred their activities here, and that applies both to American-owned and continental European-owned institutions. Most sizeable cross-border M and A activity in the EU is handled in London, one way or another, as are most major capital-raisings. The potential investor base which can be accessed here is very large. But there is also some evidence of consolidation of business elsewhere

in the community. German and Eastern European business has tended to move towards Frankfurt, for example.

These trends have, however, been under way for some time and it would be hard to attribute them directly to the Financial Services Action Plan. The FSAP does simplify legal and regulatory processes to some degree, but my suspicion is that it would be hard to see any discontinuity in the general trend of consolidation in wholesale market business caused by the action plan itself, or any particular directive within it.

If we look at cross-border banking, the picture is very patchy. One interesting measure is the total assets of branches of banks from European Economic Area countries in each individual European country. So, for example, in the UK, the total assets of European, non-UK banks in London in 2001 was around 1.4 trillion Euros, some 25% of the assets of the UK banking system as a whole. That seems to show quite a highly developed degree of European integration.

But the total assets of all other European banks in all other European countries (excluding their own) in which they operate was only 650 billion Euros. So fully two-thirds of the cross-border activity in bank branches is taking place in the UK. The picture is slightly different if you look at subsidiaries, where the numbers are larger in other countries, but that partially shows the banks have been obliged to operate through domestically capitalised institutions, rather than on a straightforward cross-border basis. And that means a less efficient use of capital.

In the retail market, we have to acknowledge that the amount of genuine cross-border business is relatively small, in spite of the introduction of the Euro – though it may reasonably be said that we are looking at an early snapshot, and that cross-border Euro-business may well begin to grow. The picture does vary from sub-sector to sub-sector. The UCITS directives have stimulated some cross-border selling of mutual funds, but there is very little cross-border retail-banking so far, in spite of the initial promise of Internet banking. And there has been relatively little in the way of cross-border life insurance or pensions business. That may be partly attributable to regulatory obstacles, but also to different tax regimes and to different structures of long-term saving. In many cases they have cultural roots, and are not likely to be altered in the short-run by regulatory change.

It remains the case that the retail markets are very different across the Union. In some countries almost all retail transactions are handled by the customers' "home bank". In the UK, of course, few people look for long-term savings products to their banks. Also the UK's dual system of tied and independent advice is not widely operated elsewhere in the Union. And the coverage of private sector pensions products differs hugely from place to place, by a factor of five or six from the largest to the smallest penetration.

So we are a long way from a single financial market for European consumers, and my suspicion is that regulatory harmonisation in itself is unlikely to deliver that single market. There will be a need for more pan-European firms, and for changes in tax and social security systems which are probably more significant obstacles.

Conclusion

This may seem a somewhat downbeat assessment of progress, and in a sense it is. I believe that some of the aspirations of politicians in this area will take a considerable time to be achieved. Furthermore, a lot of effort is under way to reconcile the details of regulatory regimes, particularly in the retail markets, which I suspect will have little impact on consumer behaviour, yet will impose significant costs on financial services firms. The FSAP has focused far too much attention on the retail sector, where in the short-run the scope for beneficial integration is relatively small.

I also believe that in some cases the wholesale market initiatives have been misconceived. There is not time this evening to look in detail at any individual measures. But in its current state the investment services directive may hinder the development of efficient capital markets in Europe, rather than encourage them, by placing restrictions on the extent to which investment banks can internalise customer orders, and indeed restrictions on the provision of execution-only broking services.

But what my assessment shows most strongly, I believe, is that the next phase of activity in Europe needs to have a different focus. We need less new legislation, and more effort on practical implementation. The Commission needs to spend more time on enforcement, crucially with the help of the industry itself. There needs to be more analysis of just what the barriers to cross-border mergers and acquisitions and to cross-border selling really are. Many of them are nothing to do with the detail of conduct of business regulation. Some of them are barriers imposed for straightforwardly protectionist reasons in some member states.

And in individual countries they need to tidy up their domestic regulatory systems, before making grand plans at the European level.

The arrival of a new Commission later this year would be a good moment for reflection. The frenetic regulatory activity of the last two or three years has been driven by a perceived need to meet a political timetable and one ordained – in my view – without heads of government having a good understanding of what it was they wished for. The new Commission would do well to pause for breath, to allow the directives already agreed to settle down, and perhaps to ask again the question of what elements of financial market convergence will genuinely promote economic growth and prosperity. If they asked themselves the question in that form, then I doubt whether the insurance mediation directive, or indeed the proposed consumer credit

directive, which would impose quite an unsuitable structure of harmonised regulation across the Union, would score highly.