

**FINANCIAL SERVICES ACTION PLAN:  
PROGRESS AND PROSPECTS**

**EXPERT GROUP ON BANKING**

**FINAL REPORT**

**MAY 2004**

## **EXECUTIVE SUMMARY**

### **STOCK-TAKING:**

The integration of the EU banking sector has increased, albeit mainly in the wholesale sector. The retail markets have remained essentially national/ local. Direct cross-border provision of retail banking services is still limited, although internet banking is gaining wider public acceptance.

Restructuring has continued, with the emergence of financial conglomerates, and of a few cross-border banking groups at regional level. National champions however remain the dominant model.

The financial performance of the EU banking sector has continuously improved in this dynamic environment, where competition between players has markedly increased.

### **IMPROVING THE PROCESS:**

The consistent implementation of the FSAP-acquis is a precondition to further integration and for level playing fields in the EU-25. Implementation and enforcement of existing FSAP measures should receive priority attention.

Future EU initiatives will need to be targeted at specific segments of the banking markets and must be justified by the net benefits they will bring to financial services providers and to their customers. The Commission should consult up-front and extensively with all interested parties, as was done for the review of capital adequacy rules.

The range of instruments to foster integration should be expanded, with a wider use of self regulation where appropriate and proportionate.

### **IMPROVING THE ENVIRONMENT:**

The future capital adequacy legislation involves an urgent need to improve and enhance coordination between the supervisors of cross-border banking groups. Legislation should establish a "lead supervisor" with wide ranging powers to ensure an effective and rational application of prudential requirements at each cross-border banking group.

Further integration depends on convergence in the interpretation and the daily application of the banking legislation. The Commission and the newly-established Committee of European Banking Supervisors will have a key role to play.

Competition is also a driving force for integration and needs to be encouraged by removing unjustified or unreasonable obstacles to market entry. This could be achieved by combining a variety of means, from pursuing targeted harmonisation to promoting mutual recognition more vigorously. This should however respect the diversity between the providers of banking services in the EU, which appears beneficial to consumers.

#### **A VALUE CHAIN APPROACH:**

Future EU-policy should consider the different elements of the “value-chain”, from back office functions to delivery to the end-user. Improvements in the infrastructure for payment and settlements, a rationalisation of reporting requirements, and a less punitive application of VAT on outsourcing are key conditions for a further integration of “upstream” functions in “centres of excellence” that will provide horizontal services to different parts of EU banking groups.

As regards “downstream” functions, the removal of policy-induced obstacles to integration –such as discriminatory tax treatments, different legal frameworks for collateral, would facilitate the cross-border delivery of competitive banking services.

The differences between the different rules for consumer protection across the EU also have a dampening effect on cross-border integration. Consumer confidence is paramount, and the integration strategy for retail markets should be supported by confidence building measures that ensure the protection of consumer in an open market.

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## 1. INTEGRATION: STATE OF PLAY

1. The expert group discussed the present state of integration of the EU banking sector in detail. The relevant key features – EU bank structure, competition and performance – that provide the backcloth for this report are highlighted below.

2. The term “bank” is used in the report in a broad, generic sense: it refers to the whole range of credit institutions that are licensed to provide the activities covered by an EU banking passport, as defined in the Codified Banking Directive 2000/12/EC.<sup>1</sup> Certain sections of the report also have a read across for other types of financial institutions which are subject to a similar prudential framework.<sup>2</sup> The term ‘cross border’ is used to cover both cases where services are provided either with or without a physical presence in the consumer’s country by a provider based in another country.

### 1.1. Structure

3. The structure of the EU banking sector has changed: consolidation has increased at national level; cross-border expansion has not matched the pace of national consolidation; in terms of market presence subsidiaries still co-exist with branches; there is limited cross-border offer of retail banking services. However, some cross-border ownership links have emerged resulting in some important financial groups with an EU-presence (see box 1).

#### ***Box 1: Structural changes in EU-banking sector<sup>3</sup>***

Bank lending remains the dominant source of private-sector financing in the EU. Bank assets were about 260% of GDP in 2000, having more than doubled since 1980.

The number of banks has fallen by 15% between 1997 (9,077) and 2002 (7,756), The number of bank establishments per inhabitant in the EU (0,51

<sup>1</sup> The list of activities subject to mutual recognition (“EU passport”) is in Annex 1 to Directive 2000/12/EC. The directive does not prescribe a specific legal form for credit institutions. In practice, banking activities may be provided by commercial banks, mutual societies, cooperatives, saving banks, credit unions, partnerships.

<sup>2</sup> In particular, investment firms are subject to similar prudential requirements for capital adequacy and large exposures.

<sup>3</sup> Sources: Commission, ECB, Deutsche Bank.

per 1000 inhabitants in 2002) remains however high compared to the US.

Consolidation in the number of banks has taken place mainly at national level. Cross-border mergers and acquisitions have been relatively limited, though in some cases they have led to the emergence of regional banking groups, such as in the Benelux and Nordic countries. Despite progress in cross-border integration in wholesale markets, domestic consolidation has prevailed in the retail sector where no pan-European bank has yet emerged. However, cross-sector institutions have emerged, with around 25% of EU-bank deposits and 30% of life assurance premiums held by financial conglomerates.

Banks have shown a slight preference to develop their cross-border activities via subsidiaries rather than branches, in spite of the existence of an EU passport. Nevertheless, many of the larger financial groups maintain a presence in other countries using both branches and subsidiaries. All in all, the total market share of branches and subsidiaries of foreign institutions amounted to 15,2% in 2002.

Direct cross-border provision of traditional banking has increased in recent years but remains relatively small in terms of overall banking activity. Cross-border activity is relevant essentially for large customers, with the provision of traditional lending/deposit products still marginal.

Direct, 'physical' contact remains the predominant means of delivery in the majority of the Member States. Alternative delivery channels are generally complements rather than substitutes to more traditional methods. Internet banking is gaining wider public acceptance, but bricks-and-mortar establishments remain important as a means to maintain consumer confidence and to attract new customers.

Banking activities have also changed, with an increased reliance on non-interest income (from 28.3% of gross income in 1992 to 42.5% in 2001) reflecting a diversification in revenue streams and activities of banks in most of the Member States. In addition, banks continue to expand the range of products and services offered to customers.

*Consolidation has taken place mainly at national level; regional groups have emerged.; financial conglomerates play an increasingly important role*

*Branches coexist with subsidiaries in expansion strategies*

*Physical presence remains key to attract consumers*

## 1.2. Competition

4. Competition between market players has nevertheless increased, particularly in the wholesale sector (see box 2). There are however different views on whether this increased competition has resulted in actual benefits for the consumer.

### ***Box 2: Competition in EU-banking sector***

Consolidation in the banking sector has resulted in relatively high concentration ratios in several of the Member States (in Belgium, the Netherlands and Finland, the 5 largest credit institutions account for more than 75% of total assets). Nevertheless, there is no evidence to suggest that higher market concentration has reduced overall competition among banks in the Member States concerned, though this might have occurred occasionally in specific market segments.

Indeed, EU banks operate in an increasingly competitive environment due to the emergence of alternative providers of banking services. Among the non-bank institutions offering banking services are mutual funds for the collection of deposits, large retailers in the provision of consumer credit and credit cards and specialised intermediaries in selling retail insurance and investment products and mortgages in some countries.

Competition in the provision of bank lending has been intensified by improved access (typically among large corporate clients) to direct financing via domestic and international capital markets. There have also been positive experiences in the certain areas of retail banking (e.g. consumer credit).

Banks also face stiff competition in generating their non-interest income, as the provision of investment banking and capital-market oriented services (e.g. underwriting/M&A) has become an international business.<sup>4</sup>

*Competition pressure has increased on banks, partly due to competition from other categories of service providers*

### **1.3. Financial performance**

5. Bank financial performance and efficiency have improved, partly because of increased efforts towards effective risk management and measurement, but still lags behind the US.

### ***Box 3: EU-bank financial performance***

Average profitability among EU banks has been on a rising trend in the last decade, although it has been persistently lower than in the United States. The return on equity of EU banks increased from 9,3% in 1992 to 12,3% in 2001, with a peak of 15,2% in 1999, while US figures rose from 12,6% to 18,6% over the same period,<sup>5</sup> Interestingly, and consistent with evidence for

*Profitability has improved, but remains well below US levels.*

<sup>4</sup> Since EMU, euro area issuers have chosen less often bankers from their home country to issue in EUR (40% against 50% with the legacy currencies). There has been a decline in the percentage of issues where the banker nationality matches the currency dropping from 90% pre-EMU (1994-98) to 70% post-EMU (1999-2nd quarter 2001).

<sup>5</sup> Source: OECD, Bank profitability, 2003.

the United States, very large EU banks do not seem to systematically outperform smaller institution. Medium size banks display the highest profitability, while small banks the lowest.

Restructuring and the spread of new technologies have led to an improvement in cost-efficiency in EU banking, which is visible in declining cost-to-income ratios, from 63,7% in 1992 to 61,6% in 2001.<sup>6</sup> In this respect, banks in several of the Member States have outperformed their counterparts in the United States.

EU bank solvency indicators have improved in the last decade and remained, on average, well above the minimum regulatory requirements even during the recent economic downturn (e.g. the total regulatory capital ratio for the EU banking sector was 12.3% in 2002).

6. It is however not clear from the available indicators to what extent that integration can be attributed to the FSAP or to other factors such as globalisation, advances in technology, introduction of the euro.... It is nevertheless felt that the full potential of integration, in particular in the field of cross-border retail activities still remains far from achieved. This may also have adverse consequences in relation to price and product competition. It must however be noted that an increase in the number of products does not automatically result in a benefit for the consumer: the distribution channels and the level of consumer influence play a crucial role in more effective competition.

## 2. IMPROVING THE PROCESS

### 2.1. MEASURING THE IMPACT OF FSAP

7. The expert group considers it difficult to measure the full impact of the FSAP, since a number of important measures remain to be proposed or adopted (Basel2/CAD3) or have not yet entered into force (Conglomerates).

8. Implementation and enforcement of existing legislation should have overall priority. In addition to this, convergence of implementation measures across the Member States must be more in focus than now: differences between national interpretations and applications of EU-rules can be a major obstacle to cross-border development. Furthermore, incoherencies between existing EU legislative provisions should be eliminated (e.g. divergences between the e-commerce directive and the distance marketing of financial services directive). This removal of

*Consistent  
implementation  
of EU legislation  
is key*

<sup>6</sup> Source: OECD, Bank profitability, 2003.

inconsistencies in the implementation and application of existing legislation is a crucial step before new legislation is developed.

*Box 4: Differences between the E-commerce directive, the Distance marketing and other directives.*

**Unsolicited commercial communication:** The e-commerce Directive establishes a system of consultation of opt-out registers), while the Directive on the distance marketing of financial services provides for an optional system allowing Member States to choose between an opt-in (requirement of consumer's prior consent) or an opt-out system (consumer has not expressed his manifest objection). A third Directive (2002/58/EC) on privacy and electronic communications creates an additional divergence, since it requires the prior consent of the customer before sending electronic mails for the purposes of direct marketing).

**Starting point of the right of withdrawal:** in the Directive on the distance marketing of financial services, the starting point of the right of withdrawal is the date of the conclusion of the contract, while in the proposal for a directive on credit for consumers, the starting point could be the day on which a copy of the credit agreement is transmitted to the consumer.

**Cumulative effect:** in the case of consumer credit (or a mortgage credit subject to the Code of conduct sold via the internet), three sets of pre-contractual information requirements might need to be disclosed to the borrower, arising from the directives on e-commerce, distance marketing of financial services directive and the Proposal for a consumer credit directive or code of conduct for mortgage loans. This overlap would result in around 40 kinds of information to be disclosed to borrowers.

## 2.2. ADOPTING CLEAR AND REALISTIC PRIORITIES

9. Against this backdrop the Group urges the Commission and other EU institutions to adopt a realistic and pragmatic vision to create an integrated and competitive EU banking sector. This involves the use of all means and measures at its disposal, including those in the context of competition policy.

10. The focus needs to be on ensuring that fragmented market places are truly open to competitive forces. The creation of open competitive market places will help the creation of a single market foreseen in the EU Treaty.<sup>7</sup> This should take account of the fact that, as described above, the present state of integration reflects different business models, different demands,

*Market entry  
should be  
facilitated*

<sup>7</sup> Article 3.1. c. of the Treaty (consolidated version of EC and UE Treaties).

different solutions according to cultures and socio-economic starting points.

11. Barriers to cross-border activity have hitherto been seen mostly as differences in national requirements relating to authorisation or conduct of business and have been met with almost automatic regulatory responses. Stripping away barriers to cross-border establishment by institutions (single license mechanism for branches in the Second Banking Co-ordination Directive) has proved successful (even though subsidiaries appear to be the preferred means of cross-border expansion – one major cross-border group is however adopting European Company status and converting its subsidiaries into branches). In addition, the business models of the European company or the European Cooperative Society will provide possibilities to operate under an EU regime.

12. Obstacles to cross-border banking activities and market entry remain. This concerns less the wholesale trading area than retail banking. This seems to be mainly due to the inclination of consumers to turn to their local and more familiar institutions. In the retail segment, remaining barriers often relate both to market structures and to the national legal requirements determining the features of those financial products.

13. The Group considers that, in the medium-term, the EU-legislator should address any barriers in a more focused – and restrained - manner. Removing obstacles is justified if the benefits arising from action (regulatory or otherwise) can deliver public interest objectives and are significantly higher than the costs of implementation for both banks and their customers. Additionally, more emphasis should be put on ensuring that Member State markets are indeed open to competitive entry.

*Targeted actions will be needed, and should be prioritised after cost-benefit analysis.*

14. Setting realistic objectives is an important first step. The EU-institutions should prioritise their actions even more than at present. Resources should also be made available to monitor more closely the enforcement of EU legislation.

15. Transparency of policy implementation from beginning to end is essential to gather support and understanding from stakeholders and to ensure common application of that policy in practice. The Commission's services have set high standards over the past years (e.g. on the future capital adequacy regime) and are encouraged to continue their policy of openness and continuous engagement with industry and consumer representatives. In addition to open consultations with all stakeholders, new structures have emerged that can play a valuable role, such as the new European Banking Industry Committee (EBIC), FIN-USE and the Committee of European Banking Supervisors (CEBS).

*Expectations are high on transparency and involvement of industry*

### **2.3. USING THE MOST APPROPRIATE INSTRUMENT**

16. The EU-institutions and, importantly, industry itself should be more open to the use of a wider range of instruments to reach policy objectives. In

particular non-legislative measures can play an important part. They may encompass, for example, guidance for Member States on the implementation of legislation; recommendations on the application of the existing directives (e.g. scope of E-money directive); enforcement measures and pre-infringement procedures.

*A wider policy-mix should be used...*

17. Self regulation by industry could bring added-value in areas that are not already subject to extensive and detailed regulation. Self regulation can be a flexible and powerful instrument taking various forms such as codes of conduct (bi- or multilateral agreements between different parties such as banks and their customers), market conventions between industry participants on standards or infrastructures (e.g. mortgages or clearing and settlement), guidelines on good practices and industry sponsored accreditation. To be effective self regulation must be endorsed by all parties concerned and be enforceable against all participants. The boundaries between self regulation and statutory regulation will have to be defined in the light of different criteria, such as intensity of public policy objectives (financial stability, fair competition, protection of consumers...) or the extent of conflicts of interest between market practitioners and public policy objectives.

*...with self-regulation playing an active role.*

#### ***Box 5: The European code of conduct on home loans***

The European Code of Conduct on Home Loans was signed on 5 March 2001 by all major European financial services trade associations. It was backed by a Commission Recommendation (Brussels, 1 March 2001, C (2001) 477 final). The aim of the code is to allow borrowers to understand mortgage products to make an informed choice. It allows borrowers to compare products on a standardised and personal basis by introducing the European Standardised Information Sheet (ESIS) which includes 15 items of information focused on cost elements and is presented in the same way throughout the EU. It creates price transparency on a cross-border basis. It responds to the specificity of the complex environment of the mortgage industry. It is also more flexible than regulation. In 2003, more than 3800 credit institutions had notified their adherence to the Code and a first of its implementation assessment was carried out by a consultant. The report is available on the website of the Commission (DG SANCO and DG MARKT). Consumer groups (BEUC) have also made public their own assessment of the implementation of the Code.

*More than 3800 credit institutions have notified their adherence to the Code.*

### **3. IMPROVING THE ENVIRONMENT**

18. Prudential oversight over institutions' business and competition are the most encompassing issues at stake. Targeted measures in these areas are desirable. They have the potential to increase domestic and cross-border efficiency and are a concrete step towards further integration. Prudential supervision and competition have increasingly a cross-sector dimension, as similar services may be provided by different types of institutions (credit

institutions, investment firms, insurance undertakings, UCITS...).

### 3.1. IMPROVED SUPERVISORY CO-OPERATION IN THE EU

19. Supervisory standards should be effective and proportionate. Crucially they protect creditors, ensure confidence and stability in the financial system, thus contributing to a healthy economic environment. Inefficient supervision with duplication of efforts or unfocused practices costs: it is a drag on banks' internal structures, profits and optimal business strategies. In an internal market the lack of supervisory co-operation and fragmented/diverging practices deter cross-border business. This also contrasts with the increasing industry practice of integrating and centralising business functions ("centres of excellence") such as risk management.

20. Great strides have been made over the last 15 years, with the introduction of minimum bank capital requirements, a single passport and home country control over branches in other EU-states. There are four compelling reasons to improve and further develop these foundations:

*Banking supervision needs to cope with new challenges...*

- 1) The forthcoming new capital adequacy rules which will be more risk-sensitive, but also more complex to implement by firms and to supervise by authorities;
- 2) The enlargement of the Union with 10 new member countries will increase the number of authorities involved and thus the potential for further inefficiencies;
- 3) The recent adaptation in banking of certain principles proposed by the Group of Wise Men chaired by Baron Lamfalussy;
- 4) The growing integration of EU-financial markets.

21. The Group has identified three crucial areas that require the attention of the European Commission, regulators and industry. They are: legislation, supervisory arrangements and convergence of supervisory practices.

#### 3.1.1. Legislation

22. The way in which the EU implements the new Basel Agreement in a European directive is the most immediate example of how EU-legislation will have a direct impact on regulated institutions.<sup>8</sup> The directive will need to combine flexibility with technical details; to reflect the risks of very different types of institutions; and to reconcile national particularities with a level playing field in Europe's financial sector and beyond.

*...such as a new ambitious capital adequacy framework*

<sup>8</sup> The EU capital adequacy framework will apply to both credit institutions and investment firms.

### ***Box 6: Examples of potential fragmentation***

*National options:* The Basel Committee's 3rd Consultation Paper and the European Commission's parallel draft proposal for a directive contain more than 70 implementation options for Member States. Banks with cross-border subsidiaries may be required to meet different requirements in each Member State.

*Supervisory discretion:* the future capital adequacy framework will enhance the powers of supervisors to fine tune the capital requirements applicable to each individual bank following a Pillar 2/ Supervisory Review Process. The supervisors will also have the responsibility to authorize the use of internal systems for credit risk (internal ratings based approaches) and for operational risk (advanced measurement approaches. Financial groups that develop group-wide risk management and measurement systems will have to have them recognised by different supervisors in their home- and host-countries.

#### *3.1.2. Supervisory arrangements*

23. The (necessary) complexity of the capital requirements requires a rethink of the way in which cross border supervision is organised today. This is exacerbated by the emergence of cross-sector financial conglomerate type groups. There are a range of options available. Maintaining the status quo is unacceptable in view of the inefficiencies it generates. There was unanimity that there should be no delay in addressing the considerable challenges that both industry and supervisors alike will face in the immediate future. EU-banking legislation should require the appointment of a lead supervisor with clearly defined tasks and powers in a wide range of areas. These should include at least the necessary powers to take decisions on prudential reporting, internal models, group-wide diversification effects, 'pillar 2' requirements.<sup>9</sup> It should also co-ordinate on-site inspections in a financial group's cross-border entities<sup>10</sup>.

24. Of crucial importance will be the definition of the respective powers of the lead supervisor and of the other supervisory authorities in a banking group, in particular as regards the supervisory process and the validation of group-wide internal models for credit risk and operational risk. As regards

*A lead supervisor is urgently needed for cross-border groups*

<sup>9</sup> The future capital adequacy framework will be based on three pillars: harmonised minimum capital requirements (Pillar 1), individually-adjusted capital requirements that may be imposed by the supervisor (Pillar 2) following a review process (e.g. to take into account specific risk factored not captured under Pillar 1); enhanced disclosure requirements (Pillar 3).

<sup>10</sup> This approach already exists in the EU financial Conglomerates Directive (2002/87/EC)

further integration of the supervisory functions, there are different schools of thought on the desirability of establishing a pan-European authority with supervisory powers. This would in any case not be a short-term solution.

### 3.1.3. Convergence

25. The capital adequacy provisions need to be transposed and implemented in 15 - soon 25- Member States and applied by at least 25 supervisory authorities. The potential for diverging and even conflicting application is evident. An increase in the number of Member States and complexity of legislation must go hand-in-hand with an increase in convergence of supervisory standards. "Convergence" does not mean more legislation. Nor does it imply that authorities should be forced to adopt identical solutions at all times. Convergence of legislative interpretation of EU-Directives is clearly the Commission's responsibility, under the control of the ECJ. It should continue to resolve interpretation issues in a transparent manner ahead of national transposition, e.g. by organising meetings with the industry and with the competent authorities of Member States.

*Commission must encourage a consistent implementation*

26. Convergence of practices means that supervisory authorities must be encouraged to adopt similar solutions to similar issues. The Commission has a particular role to play in integrating the new Member States fully in the enlarged Union. The new Committee of European Banking Supervisors (CEBS)<sup>11</sup> is expected to focus on convergence of supervisory practices and also has an important role to play in supervisory assistance and training in the new Member States. This should be translated into more consistent rulebooks across the EU. Increased supervisory disclosure will be important: national approaches and procedures should be published, so that they can be more easily compared across Europe. National regulators should publish their rules, together with a regular and detailed commentary on implementation activity, including the reasons underlying their approach. Supervisory disclosure should also include some impact assessment.

*Convergence of practices will be a key task for European supervisors*

27. The Commission is encouraged to work together with the CEBS and the industry, including the EBIC and other representative industry bodies, to identify any needs to adopt legislation at EU-level. Building upon CESR's experience, CEBS will need to consult the industry in a timely and transparent manner. CEBS's outputs will have no legally binding force but will enjoy moral force. The CEBS would provide benchmarks for the application of EU banking legislation and could review complaints from

<sup>11</sup> The CEBS was established by Commission Decision 2004/5/EC to serve the following objectives: advising the Commission (in particular on draft implementing measures), contribute to the consistent application of legislation and to the convergence of supervisory practices, enhance supervisory cooperation.

individual regulated institutions that consider they are subject to unfair supervisory treatment with respect to level playing fields. A “review” mechanism could be developed to ensure that CEBS operates in full transparency and openness with all stakeholders.

#### *3.1.4. International regulatory dialogue*

28. Finally, international developments and global financial market integration reinforce the need for closer cooperation between EU-authorities and those of our major trading partners. Global banking markets often require global solutions. Supervisory rules and accounting standards are good examples. There may be sensitive extra-territorial considerations. The Commission’s ‘regulatory dialogues’ with the US authorities in particular are supported and should be continued to identify potential problems and solutions early-on and to converge broad views on future policy directions. The Commission should involve the industry in the dialogue process, and should make public details of its on-going dialogue as soon as reasonably practicable.

*Dialogue with extra-EU regulators is of crucial importance*

### **3.2. COMPETITION AS A DRIVER OF INTEGRATION**

29. The integrated single market in financial services can be achieved through a number of business models, such as:

- a multi-national approach with a presence in a number of Member States using subsidiaries, branches, other forms of distribution such as joint ventures or through independent third parties
- a true cross border model where there is no presence in the consumer’s Member State as could be achieved, for example, by postal or internet services.

*Legislation should be neutral on models for business integration*

These channels will of course co-exist with domestic providers of financial services. Businesses and consumers need to be free to choose which model to use. Legislation should therefore not seek to prefer one model above another.

30. To date, a large part of the Commission’s work has been aimed at harmonising requirements at what might be described as either:

- the authorisation level (what a firm needs to do to gain permission to transact business in a certain sphere), or
- the supplier/customer interface (how a firm must interact with its customers).

These are important steps. However, of themselves, they are not sufficient to promote the creation of a single market in financial services. The other

area which needs to be addressed more fully is the opportunity to compete:

- ensuring that the EU market place as a whole and Member State markets within it are as open as possible to new providers
- promoting an attractive business regime in Member States and across the EU
- leave open to business the choice of what to supply and at what cost and to whom
- ensuring that wherever possible preference is given to promoting competition between providers rather than protecting any particular type of provider.

This should of course take account of other policy objectives, such as consumer protection.

***Box 7: specific examples of barriers to competition:***

In some Member States cross-border acquisitions are perceived as hampered by a takeover legislation and administrative practices generally protective of domestic interests.

Competition between credit providers can be promoted by enabling access to not only negative data (e.g. on defaults) but positive data too (e.g. on exposure).

Registration of security and related taxes, where this is very expensive it inhibits new entrants to a market and protects long standing incumbents (e.g. for mortgages, stamp duty varies from 1% to as much as 12,5%).

*Specific obstacles to market entry have been identified*

31. Competition also forces firms to strive for competitiveness and economic efficiency. In order to be effective, competition assumes that the market is made up of suppliers who are independent of each other, each subject to the competitive pressure exerted by the others. Therefore, a perfectly competitive banking market is not structured in such a way as to be dominated by one or a few key players, i.e. the relevant market does not face monopolistic or oligopolistic structures.

32. A pluralistic banking market is necessary so that the consumer can choose from among a large number of products and services from a variety of providers.<sup>12</sup> There has been no evidence that a specific business model, corporate structure or legal form would provide more benefits to the consumer. Consequently, EU initiatives should take account of the potential implications of action for the full range of institutions and providers of

*EU legislation should respect the "biodiversity" of players*

<sup>12</sup> See paragraph 2 and footnote 1.

market services that might be affected.

33. The group recommends that the Commission should take action to ensure that domestic practices or legislation which have the effect of limiting competitive entry to markets are highlighted and where appropriate proposals or actions should be forthcoming from the Commission to address them.

#### **4. THE 'VALUE-CHAIN' APPROACH: (FROM BACK OFFICE TO DELIVERY TO THE END-CONSUMER)**

34. In developing its policy the Commission is furthermore encouraged to assess the different elements of the value chain of business in order to determine its priority areas of attention. This encompasses:

*The value-chain is a valuable reference for targeting EU action*

- the 'back-office' production phase and support (including risk management, structural organisation, payments, clearing and settlement and general prudential supervisory features relating to business operation)– local, international or even global
- delivery and distribution channels through the Treaty freedoms of establishment and services' provision, and
- the consumer of the financial service itself.

##### **4.1. BACK-OFFICE**

35. The 'back-office' stage of the value chain will support and generate trades and sales. Operations will frequently encounter obstacles to cross-border business that relate to infrastructure questions. Even if, as far as retail banking is concerned, delivery is still essentially local, there are examples where steps in the business chain have been integrated on a pan-European basis. Measuring only the volume of cross-border delivery would therefore be misleading and inadequately reflect integration.

36. Certain obstacles in the 'back-office' functions persist and do require attention. The Group has identified five specific areas that need to be improved.

*Steps need to be taken to facilitate the integration of back-office functions.*

- 1) **Clearing and settlement:** The Group shared the conclusions of the Giovannini report on EU Clearing & settlement arrangements.
- 2) **Payments:** The European Payments Council is seen as valuable process to promote efficiency and integration in payment systems.

<sup>13</sup> The report is available on the web site of the Commission (DG Internal market).

- 3) **Wholesale cash circulation:** The need for an easier cross-border circulation of wholesale has increased with the introduction of the euro. The Group supports the efforts of the European Payments Council to create a Single Euro Cash Area. A close cooperation with the ECB (Banknote Committee) is encouraged.
- 4) **Reporting requirements:** At present, financial industry's reporting requirements are mainly decided at the national level, by individual authorities. There is little cross-border/cross-sector harmonisation in this field and external requirements are seldom based upon or coordinated with the data that is generated by existing corporate reporting systems. The result is a costly, decentralised corporate reporting structure and sub-optimal reporting quality. The Group shared the conclusions of the Forum Group on reporting requirements<sup>13</sup> e.g. enhancing the role of the coordinating supervisor for groups' reporting and taking advantage of the new committees of supervisors to promote the convergence of requirements across the EU.
- 5) **Value-added tax on outsourcing:** The application of VAT tax on intra-group transactions is an obstacle to the creation of "centres of excellence" with a vocation to provide horizontal services to the different entities of the group.

## 4.2. DELIVERY AND DISTRIBUTION CHANNELS

37. As noted before, there has been a preference for subsidiaries over branches in the strategy for cross-border European expansion. The European banking legislation has effectively removed overlapping and ineffective national requirements for bank branch establishment. Direct cross-border provision of traditional banking services has increased in recent years, but remains relatively small in absolute size and relevant only for large customers. Internet banking is gaining wider public acceptance, but bricks-and-mortar establishments remain important as a means to attract new customers.

38. The freedom to provide cross-border services is fully established in EU law. Nevertheless, banks opting for this mode of delivery are confronted with two types of obstacles: structural barriers relating to the intrinsic nature of retail financial services or to the attitudes of companies and consumers; and policy induced barriers.

*The freedom to provide banking services without local presence...*

39. *Structural* reasons for a lack of integration are related to the complexity and to the long term perspective of certain products which lead consumers to favour locally established entities with whom they can develop a 'relationship'. Trust in the reliability of the supplier is essential. Consumer confidence and awareness of regulation and redress mechanisms also play an important role. This is the case for most retail banking services such as credit (consumer credit, mortgage credit, leasing). When operating abroad banks may prefer - at least initially - to establish a local presence as it is the best way to dovetail into local legislation and the enforcement of such

*...is still hampered by structural obstacles...*

legislation by local regulators. These factors limit the ability of new entrants to break into the home market through remote delivery. This is however not always the case: there are examples of banking groups that started with on-line services and afterwards established a physical presence. There are also idiosyncratic barriers such as the specificities of local or regional demand and needs, as well as cultural and language barriers which naturally limit the extent of integration.

40. The choice of distribution channels for banks is also driven by *policy-induced* obstacles. The Group has identified tax-driven obstacles and legal and administrative obstacles. The Group accepts the political difficulty of seeking harmonization at EU-level in the area of taxation. It nevertheless considers that the examples it has identified (see box 7) are unjustifiable obstacles for business and customers. As a first step the Commission is requested to carry out a study identifying precise areas of, and the cost of, tax discrimination. In addition the Commission should publish and maintain 'scoreboards' naming and shaming those Member States which maintain tax discriminations.

*...as well as by policy and administrative barriers.*

***Box 7: Examples of tax obstacles:***

- The non-taxation of interest may only be available for accounts with a bank established in the Member State in question;
- Foreign lenders may have to pay a high amount of withholding tax on interest received and cannot offset this fully against national tax charges;
- Member States may require companies to appoint a local tax representative;
- Member States may unduly delay refunds of taxes such as VAT to non-domiciled entities.

41. Legal and administrative obstacles add complications and costs to cross-border business. The Group has identified the most obtrusive obstacles to cross-border banking (see box 8).

***Box 8: Examples of legal/administrative obstacles:***

- Differences between bankruptcy laws which make cross-border lending and the preferential/non-preferential position of bankrupts difficult
- Differences in collateral requirements, transferability of loans, forced sales procedures, debt recovery process
- Lack of availability of personal data for responsible consumer lending
- Prohibition of certain banking products and control of product design

making differentiation impossible. Under certain circumstances, this may be perceived as a barrier to efficient competition. A case is pending in the European Court of Justice as regards the prohibition of interest bearing current accounts in France.

- Differences in contract law and in consumer protection rules are perceived by the industry as dampening factors for cross-border development.

42. The examples that have been identified vary in nature. Bankruptcy laws and collateral requirements are rooted in civil and contract law. Others lie in administrative law and practices (forex trading) or national market practices (data bases). The Group is of the view that the Commission should come forward with concrete proposals on the most appropriate instruments to address these obstacles. Relevant initiatives include the Action plan on single EU contract law and the Green paper on the conversion of the Rome Convention on the law applicable to contractual obligation into a Community instrument. The Forum Group on mortgage credit is also currently looking at some of these issues.

43. In particular the impact of the host country “general good rules” based on contract and consumer protection laws play a significant role in determining bank strategies and choices for foreign expansions. The impossibility to apply “home country” legislation increases legal costs and obviously is a source of uncertainty, which may deter market entry. This particular issue is related to the final stage of the value chain – the consumer – and is considered in the following section.

*General good rules may be (mis)used to deter market entry*

### 4.3. THE RETAIL CONSUMER

44. As noted above, the Group strongly agrees that removing obstacles remains a valid aim, albeit it should not become an over-riding aim in itself. This applies also to national requirements with consumer protection motives (e.g. contractual law and consumer protection, requirements for SMEs).

45. Any EU-driven action for further integration of retail markets should be subject to ex-ante costs/benefits analysis:

- Which single market freedoms for which retail products can be realistically undertaken on a pan-European basis?
- What business functions can be usefully facilitated by removal of legal barriers? Is an obstacle likely to be removed by harmonization?
- Will its removal lead to increased supply? Is supply likely to be met by

*EU action in the retail sector needs to focus on services that best qualify for integration*

demand?

46. The potential benefits of further integration of European retail markets lie broadly in two main areas: efficiency (costs and price reduction) and completeness (expansion of the range of products offered and the types of customers served). Although the benefits are difficult to quantify with precision, there is no reason to doubt that integration can bring about increased efficiency and an extension in the range of products at the domestic level. For example, a foreign entrant may have a small impact on the industry in terms of market share, but may introduce new practices, products or concepts which make the domestic market more efficient. (In the mortgage credit area, for example, benefits could be gained from developing the national markets into broader European markets operating across borders).

47. The EU strategy for further integration in retail banking must maintain consumer confidence, which is a pre-requisite for the development of cross-border activities. The risk that the pure application of 'country of origin' rules could lead to regulatory arbitrage and a move towards the lowest common denominator of regulation and consumer protection should be avoided by sensible regulation. This would avoid consumer resistance to new entrants. In the event that cost/benefit analysis produces evidence that EU-action has merit, the focus of attention should first be on the general principles governing the operation of institutions or the provision of services rather than an outright harmonization of products. Good examples are confidence building measures such as out-of-court redress mechanisms.

*Any initiative should maintain a high degree of consumer protection*

48. It is difficult to gauge whether harmonization of retail financial markets will unleash real demand-driven benefits for consumers. The Commission is therefore urged to focus efforts only on those products that are objectively suitable (possible candidates include consumer credit, leasing, saving products). The Group is aware of the work currently conducted by the Forum group on mortgage credit. Harmonisation should apply only to items deemed important for integration (e.g. information requirements, Annual Percentage Rate of Charge, early repayment, removal of legal caps of usury, access to databases, cross-border accounts, custodian services or cash pooling). Here the Commission, together with industry should consider the appropriate mix of policy instruments, from full harmonisation to alternative policy instruments.

49. Any efforts to legislate retail services must focus on harmonisation that is necessary and sufficient to support each internal market objective in question, including fair competition and consumer protection. This should in particular ensure that providers complying with the set of harmonised requirements will not be subject to additional requirements when they provide services in other EEA countries. This may involve more, or less prescriptive harmonisation, depending on the assessment of risks associated with the cross-border activity or function at issue. In general, it is desirable that the principle of mutual recognition should be applied vigorously.

## 5. RECOMMENDATIONS FOR ACTION

In the course of its discussions the expert Group has been able to reach agreement on a number of concrete and pragmatic recommendations which would further integration of the EU-banking sector listed below.

### **Recommended actions to further integration of the EU-banking sector:**

- The EU-institutions should conduct a full and public impact study on the results of the Financial Services Action Plan within four years after its completion and publish policy conclusions
- Implementation and enforcement of existing legislation should have overall priority. Convergence of implementation measures across the Member States should receive more attention already before the transposition of directives. Incoherencies between existing EU legislative provisions should be eliminated.
- Further integration efforts should be subject to ex-ante analysis as to the costs and benefits of intervention. This should be supported by a comprehensive study of the patterns of retail markets. Removing obstacles should be pursued if the benefits are higher than the costs of implementation for both banks and if integration delivers net benefits to the end-customer.
- The Commission should define clear medium and long term goals to reach a single Market. A realistic step-by-step approach with timeframe should be adopted to achieve further integration towards the end-goal of a competitive single market.
- The Commission is encouraged to follow the value chain of business in order to determine its priority areas of attention. A pragmatic case-by-case approach is needed, considering particular obstacles relating to the cross-border supply of each specific product and the required and tailored solutions. Efforts should focus only on products that are objectively suitable and tradable and on those issues that are deemed important for integration.
- Work should be set in hand to improve the clearing & settlement of transactions, wholesale cash circulation, and to streamline reporting requirements.
- The Commission and the Council should work towards the abolition of unjustified tax obstacles in four areas: non-taxation of interests, offsetting received interests, appointment of local tax representatives, VAT treatment for intra-group outsourcing.
- The Commission should present proposals to reduce differences between national bankruptcy laws, forced sales procedures, collateral requirements and transferability of loans.
- Together with industry the Commission should examine the possibilities improve the availability of personal data for responsible consumer lending, consistent with the Data Protection Directive

- Commission proposals for prudential legislation (Basel 2/CAD3 in particular) must be balanced, receptive to rapid change and avoid too many national discretions which will hinder a level playing field in the EU. The principle of a lead supervisor should be adopted.
- The Commission and CEBS must work systematically to converge practices. Disclosure of supervisory requirements should be mandatory. Formal consultation mechanisms with industry should be established.
- The Commission should continue and deepen its regulatory dialogue with major trading partners to identify problems upstream, seek early solutions and converge policy views. There should be appropriate mechanisms to involve industry and provide feedback.
- The Commission should take action to ensure that domestic practices or legislation which have the effect of limiting cross-border access to markets are addressed
- Further integration in the retail sector should be accompanied by confidence building measures. Consumer awareness should be promoted.
- The Commission is encouraged to continue its contacts with the industry and with end-users on the implementation of the FSAP.

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