

Brussels, European Parliament, 6 and 7 June 2006

Europe's Retail Financial Services: On the road to integration, are we up to the challenges ?

Executive summary

The financial services sector of the European Union (EU), which comprises banking, insurance, securities and asset management, still has untapped potential for economic growth and jobs. And this despite the significant progress achieved through the forty or so directives implemented under the Financial Services Action Plan (FSAP).

As a result of European integration, consumers are not yet able to benefit from a broad range of pension and savings products or from cheaper, more reliable financial services. Europe's retail financial services markets remain fragmented; cross-border activities are still emerging; cross-border mergers are taking place, but in limited numbers; and pan-European products and services are being held back by regulatory complexity, among other things. Member States do not always apply directives uniformly, which limits their scope. Meanwhile, the need to update European laws and regulations to reflect market developments, and recurring discussions on the same topics, have given some market participants the feeling of regulatory fatigue.

Aside from the European institutions, the plan to integrate financial services in Europe is being carried forward only by large multinational groups, who often realise that it is nearly as hard to expand in another European country as it is elsewhere in the world. Despite the potential impact on growth and employment of a united European financial services market, politicians have so far failed to set priorities or translate their desire for integration into concrete action.

Financial integration, like market integration in general, is too often seen as a constraint rather than a dynamic force that will serve Europe's citizens.

1. Building an integrated European market in retail financial services must be a shared priority

In response to these difficulties, Eurofi has initiated an approach to achieve a more closely integrated financial services market in Europe, which will benefit both businesses and consumers as it advances. Integration should not be seen as an objective in itself or as a plan promoted solely by multinational financial groups. On the contrary, it should be considered as a priority goal shared by domestic and European market participants and by users, namely consumers and investors.

This will mean focusing on the activities or services most likely to generate value in the short term and communicating in a concrete fashion with consumers and investors about the practical benefits of a single market in financial services. It will also mean weighing up the problems encountered on the way to integration and inferring complementary approaches to harmonising or integrating those services.

That is why Eurofi has decided to address these issues at a two-day conference involving:

- users
- a broad range of financial institutions that vary in terms of size, nationality, business lines and structures (commercial firms, mutualist companies, cooperatives) and that operate in insurance, banking or asset management
- European and national members of Parliament, finance ministers, and representatives of Member States' Treasury departments as well as regulators and supervisors.

The aim is to identify priorities and avenues of progress that are likely to win the necessary political backing at European and domestic levels.

2. Eurofi has initiated in-depth cooperation and dialogue among key players to go beyond stereotypes

We have adopted an approach aimed at promoting mutual, constructive understanding of each key topic: consumer protection applied to consumer credit, UCITS, the single payments area (SEPA), European shareholding and corporate governance, regulation, and supervision, microcredit,. To develop a shared vision of an efficient Europe, it is necessary to acknowledge the constraints felt by all stakeholders, as well as the pace at which they evolve, and to concentrate mainly on integrating areas that can generate meaningful cross-border industrial synergies as well as potential benefits for consumers.

This approach has made it possible to go beyond fruitless preconceptions and stereotyped positions, such as conflicts of interest between national and international players, mismatches between consumers' and financial institutions' interests, and systematic defence of proprietary interests by domestic financial industries. With the 26th Regime, we can sidestep the current stumbling blocks and, in principle, build together an ambitious, realistic plan focused on the real needs of the various players.

Analyses have shown that no miracle products should be expected from an integrated financial services market, such as a pan-European payment card more attractive than the existing 25 Member States cards, or the savings product that will solve the pensions shortfall. Nor should we seek at all costs to harmonise or standardise all national frameworks: a process that has proved to be long, complex, costly and unsatisfactory in the past.

The real benefits will come from the emergence of European regulatory frameworks and working processes involving all stakeholders that will stimulate the creativity of financial institutions, foster their cross-border business, intensify competition between them, and unlock synergies in the context of a broader market. This will result in retail financial products and services, cheaper and better suited to consumers' diverse needs. Consequently a bigger dose of Europe will encourage more attractive pricing of financial services at the national level and drive the development of offerings more adapted to needs.

These European regulatory frameworks and working processes will mean greater flexibility for financial firms, but they will not weaken consumer protection. Advanced risk measurement and assessment techniques have allowed financial firms to offer products that have so far been prohibited, while providing consumers with appropriate information and charging attractive prices. And as consumers become better educated in financial matters, they should gradually be able to access more sophisticated products. Developing a common level of reasonable protection for consumers in Europe is not unfeasible provided that harmonisation efforts are focused on the key factors which allow the industry to generate cross-border synergies, leaving the other aspects of protection to the national authorities.

3. Eurofi has highlighted five tangible benefits that should result from the construction of a European market in retail financial services

- The plan for a single euro payments area (SEPA) will shortly provide citizens with Europe-wide payment instruments. At present, domestic payment instruments cannot be used elsewhere in Europe with the same execution time standards and pricing structures. By 2008, Europe will provide its consumers with a direct debit that can be used domestically or across borders and will standardise execution times for cross-border credit transfers. By the same deadline, it will be possible to use payment cards anywhere in the Euro zone.
- In addition, if Europe allows financial firms to reap the full benefits of using internal models for risk assessment and management, the construction of an integrated market will make it possible to develop insurance and savings products that are not available at present in some countries. For example, savings products that pay a guaranteed annuity following a vesting period are unavailable in certain countries because of high regulatory capital requirements. Another example is the recognition of a special status for microfinance institutions, a move that would encourage the development of microcredit in Member States thanks to easier access to refinancing facilities.
- European integration of retail financial services should also result in a larger number of firms doing business in each market, thereby fostering competition and providing consumers with cheaper and more attractive products and services.
- A genuine retail financial services European market will generate economies of scale for firms in their processing operations as well as in trading and clearing systems (securities, payments). These savings, which hinge on the harmonisation of legal and tax rules and market standards, will impact the prices of consumer services, since competitive forces will be at work.

For example, an increase in the average size of investment funds – currently five times smaller in Europe than in the USA – resulting from the possibility of cross-border mergers of funds will help reduce management expenses and the volatility of risks. In addition, a bank that operates in several EU countries will no longer have to develop an interface for each payment and securities settlement system in those countries. And it will be able to market similar products (consumer credit,

pension savings products) throughout the EU on the basis of a single industrial tool.

- Most EU countries must cope with new common challenges. It is better to address these collectively rather than wait for different solutions to emerge at the national level and then harmonise them. Several examples can be mentioned: developing employee shareholding and Pillar 2 pension schemes, which are becoming increasingly necessary as industrial and commercial firms expand across Europe; taking measures to encourage shareholder stability; defining jointly the split of responsibilities between investment funds producers and distributors; standardising settlement procedures for investment funds in the context of a development of open architecture models (third-party distribution of funds); and dematerialising retail payments to reduce the use of cash and cheques, which expose retailers and consumers to the risk of crime (fraud, assault) and are exceedingly expensive to process.

4. Main integration drivers identified

Stable, common economic and technical rules

To reap these tangible benefits, it is first necessary to develop genuine European passports for savings vehicles such as UCITS. In addition, standards and technical procedures for settling trades in securities and UCITS shares and for processing payment transactions must converge; access to national infrastructures for securities and retail payments must be made easier (affordable entry fees, governance rules that take account of users' needs); cross-border mergers and acquisitions should be governed by the same rules as domestic deals; and the rules on fees and charges need to be stabilised, particularly in areas that depend on system-based processing (payment instruments and securities trading and post-trading).

To enable banks to see the economic and commercial potential of Europe-wide markets for payments and securities trading, it is vitally important to stabilise the rules on payment system fees (i.e. payment for interbank services), which form the basis for making and sharing investments and for developing the use of payment instruments. For the same reason, it is important to assign stable roles to the various players in the investment funds post-trade value chain.

The technical and financial developments needed to build these European markets are being delayed by the prevailing mood of uncertainty which is illustrated by a certain number of pending issues: the Commission's sector survey on payment cards, the interchange fee procedures in various EU countries, the lack of economic groundrules to support the mandatory roll-out of payment instruments due by 2010, the lack of decisions about the scope of activities and governance of securities post-trading central providers...

A uniform regulatory environment for legal and tax issues is needed to ensure effective freedom to provide services and to encourage economies of scale

Subsidiaries and branches of financial institutions must have effective freedom to provide services throughout Europe. This will require a uniform regulatory and

supervisory environment as well as consumer protection and tax measures that emphasise industrial synergies but that can be adapted at national level to allow for specifically local cultural and historical factors.

A series of common mechanisms covering consumer protection, taxation of financial products, and the solvency and liquidity of financial firms must be developed at European level. These mechanisms, which include for example methods for establishing tax bases, right of withdrawal for borrowers, the calculation of insurers' technical reserves, ... must be detailed enough to be used directly by the financial industry.

In particular, to ensure an effective freedom to provide services across Europe, the local arms of cross-border financial firms should not be subject to additional regulatory and administrative constraints and capital requirements, besides those applicable at group level. In other words, such firms must be considered as single entities doing business in a single EU market; they must be regulated and supervised accordingly and must not incur additional costs for having to comply with 25 sets of national regulations. At present, they are forced to develop a new offering from scratch in each market because of these heterogeneous constraints.

Better regulation

Most of the measures in the FSAP, such as the directives on UCITS, life insurance, Pillar 2 pension funds, and distance marketing of consumer financial services, were adopted before the Lamfalussy Process came into effect. When transposed into national law, they created differences in national legislative frameworks, which continue to hinder the Europe-wide development of financial products and firms. Despite European-level political agreements to achieve the harmonisation needed to integrate markets, firms are still unable to take advantage of that integration. In this regard, targeted full harmonisation and the 26th Regime are additional factors of progress.

Furthermore, European institutions should operate in such a way as to allow EU-wide measures to emerge before Member States address similar issues with no prior consultation. For example, the development of new types of investment funds, such as real estate funds, private equity funds and hedge funds, is being handled differently from country to country. This will require a harmonisation process that ought to have been in place beforehand.

The Lamfalussy Process allows the Commission to focus its legislative initiatives after consulting systematically with stakeholders. Nevertheless, its consultation methods can be improved. Instead of asking the market to react bilaterally and sequentially to its proposals, as is often the case at present, the Commission could adopt more systematically a participative and consultative approach at the earliest possible stage of the process – as it has already done for example by setting up expert groups on investment funds.

In addition, methods must be put in place to coordinate market initiatives. While it is up to the market to handle technical standardisation issues in particular in areas such as the processing of payment instruments, investment funds and securities, steps

must be taken to ensure firstly that the resulting solutions reflect the needs and constraints of the main players and secondly that they are implemented on schedule.

5. Progress areas proposed

- **Single Euro Payments Area (SEPA): A new focus on dematerialised payment instruments, underpinned by stable economic ground rules**

Banks must continue to make profits from the payment instruments business. Therefore, in light of the 2010 deadline, the legal rules governing fees for services rendered by banks, both to each other and to customers, must be stabilised as soon as possible. These fees and the arrangements for charging them must be set in relation to banks' investments and the services they provide to each other, as well as the maturity of their systems. Market participants must be closely involved in setting the economic rules on this subject.

For 2010, Eurofi believes that the real benefits for consumers, companies and government departments will come mainly from greater use of electronic payment instruments rather than from efforts to seek unified European payment instruments. It is the first step towards infrastructure consolidation, made possible by the implementation of technical standards that will deliver economic benefits to users in the form of lower prices.

- **Investment funds: To create an efficient European fund market, the policy guidelines of the Green Paper must be implemented quickly and uniformly and additional action must be taken at market level**

The European fund market is growing strongly and looks set to rival its US counterpart in the near future. To ensure that it remains competitive and appealing to investors over the long term, it must be integrated so that costs can be gradually reduced and investors gain access to top-performing products.

The market regularly acknowledges the potential for significant progress contained in the Green Paper guidelines, namely passports for funds, management companies and depositaries, fund mergers, pooling techniques (eg virtual pooling or master-feeder), cross-border development of non-UCITS products such as hedge funds, real estate and private equity funds. This summer, the two expert groups set up by the Commission are due to determine what action to take and how to implement the guidelines.

This will naturally entail targeted adjustments to the UCITS Directives, allowing them to evolve in line with market innovations. This is not possible at present since the two existing directives are very detailed as they were adopted before the implementation of the Lamfalussy process.

Recasting the directives would take too long, making it impossible to meet the industry's needs. A solution must therefore be found as quickly as possible so that the Lamfalussy principles can be applied to the new measures. The solution

recommended by the European Parliament (based on the recommendations of the Klinz report) would be to apply the Lamfalussy principles to the modified dispositions without modifying the complete contents of the directive.

Further thinking is needed on three additional regulatory developments in order to build a European fund market: clarifying the split of responsibilities between asset managers and fund distributors, establishing procedures to ensure equivalent treatment of UCITS and competing investment vehicles, and specifying any changes in tax treatment that may be necessary to support the necessary evolutions.

Alongside these regulatory issues, initiatives must be taken at market level to determine how asset managers and distributors will share activities and evaluate more precisely the related legal and economic impacts and how to improve the processing of funds across Europe in the context of developing open architecture models.

It is necessary to build an optimised, target vision of distribution and processing based on existing solutions, the interests and competitive advantages of market participants, and the potential benefits for final investors. The aim is to establish an overall roadmap for optimising the European fund industry in the years ahead. These market-led actions need to be further coordinated at the EU level to favour their implementation and should be put in the perspective of a common medium term target for EU funds distribution and processing that is lacking at present.

This target should take into account the current solutions developed by EU market players, the competitive positioning and interests of the different market players and the potential benefits for investors and should enable to develop a pan-European roadmap for the optimisation of funds distribution and processing.

- **Microcredit is a tool for promoting growth and social cohesion in the EU. It must be encouraged by European institutions**

According to the European Microfinance Network, the potential microcredit market in Europe is estimated at at least 11 million potential. It is profitable, and market participants create sustainable financial institutions that are efficient and effective, both financially and socially. Developing microcredit will mean supporting microfinance institutions (MFIs) in the start-up phase and lifting a number of institutional barriers, such as rules that prevent MFIs in some countries from borrowing in order to lend, interest rate caps that make it impossible to cover the excess costs inherent in distributing small loans, and Basel Committee regulations that are not entirely suitable to microcredit.

A Commission initiative to draw up an inventory of European best practices in terms of the legal and regulatory environment for microcredit would help this technique to develop in the EU. The inventory would also specify the status that should be given to European MFIs. Five points are essential: MFIs should be allowed to borrow in order to lend; the Basel Committee's regulatory capital requirements should be adapted to microcredit portfolios; MFIs should have an appropriate supervisory

regime; interest rate caps should be removed so that MFIs can recoup their costs; and legal measures should be defined to encourage securitisation.

In addition, the Commission and the European Investment Fund should launch an intensive communication initiative focusing on Joint European Resources for Micro to Medium Enterprises (JEREMIE) so that member states may take it into account when preparing the next generation of ERDF funding.

In sum, the Commission should prepare an action plan to foster the expansion of microcredit across the EU.

European shareholders rights: Priorities for action must be defined at European level, alongside the Commission's current proposals, to make our capital markets more attractive to investors

The proposal for a European directive on shareholder rights, together with the Transparency Directive, should enable shareholders to play a more active role in key decisions affecting the companies they invest in. Among other things, it would make it easier for them to attend general meetings, ensure they have adequate information, and help them exercise their voting rights across borders.

Consideration should be given to two other questions. The first is how to build a stable base of shareholders that are involved in the development of their company and how the regulatory framework can be adjusted, if necessary, to take into account the specific characteristics of each category of shareholder. Discussions under way at present have shown that the traditional categories – individual, institutional, domestic, foreign, etc. – make it difficult to identify those shareholders that remain with the company over time. Accordingly, new rules are needed to attract stable shareholders who play a part in the long-term growth of European firms. The second question is what possible evolutions are needed in particular to corporate governance rules to enable unlisted or small and mid-sized companies to gain easier access to capital markets in the EU.

Consumer protection (consumer credit): Finalise an agreement on the precise measures to be included in the draft directive for the seven priority areas identified for harmonisation

Pursuant to the concept of targeted maximum harmonisation, the market has identified seven priority topics that can ensure adequate and uniform protection for European consumers while allowing the industry to generate sufficient economies of scale. These topics are advertising, pre-contractual and contractual information, definition and calculation of interest rates, right of withdrawal, linked credits, early repayment.

Although the draft directive does address these issues, precise measures have yet to be finalised for all seven topics. This needs to be done in order to find the best trade-off between country-specific situations and the constraints of financial services suppliers and distributors, without giving rise to undue complexity or unnecessary detail. The common proposals of the market were published in May 2005 by the European Banking Industry Committee (EBIC).

Once these additional precisions have been specified, Member States should not be allowed to introduce specific domestic consumer protection requirements regarding these topics as they would hinder the potential for financial institutions to develop industrial synergies.

More generally, targeted full harmonisation (ie full harmonisation of the main dispositions that are necessary to guarantee an adequate level of consumer protection adapted to the average needs of EU consumers while enabling the industry to develop synergies and cross-border business) appears to be an adequate solution for many industry players and observers in particular for consumer credit as detailed above but also for mortgages and savings products.

Full harmonisation indeed enables financial institutions to offer their products under the same key legal requirements in all Member States (enabling them to develop economies of scale in product development, marketing and processing) and prevents consumers from being confronted with different legal regimes for the same product without losing protection.

However the scope of topics selected for harmonisation and the degree of precision required for harmonising dispositions on these topics needs to be determined on a case-by-case basis (depending in particular on the product / service considered) to avoid creating unnecessary complexity.

If it proves impossible to agree on targeted full harmonisation measures or to guarantee uniform transposition of the directive, a 26th Regime with an adequate level of consumer protection could be a possible alternative.

- **The 26th Regime: A complementary regulatory approach that mitigates local transposition differences**

The 26th regime is a complementary regulatory approach that will help to overcome the difficulties arising from differences in local transposition. New directives will be needed to overcome these disparities, a process that will take at least five years (based on the time between the inception and national-level implementation of the Markets in Financial Instruments Directive, now being applied) even with the benefits of the Lamfalussy Process. The 26th regime avoids having to harmonise domestic legal frameworks and allows local firms to adapt to these measures at their own pace.

This approach should be tried out in the field of retirement savings, for example. In practice, this would mean amalgamating the political agreements arrived at through various directives (occupational retirement provision, distance marketing, Third Directive on life insurance, etc.) in a single European Regulation. At the same time, care would be taken to closely involve national parliaments in the approach: the aim is certainly not to circumvent them but, on the contrary, to ensure that vital national interests do not take second place to the demands of harmonisation.

To that end, and to demonstrate the regime's benefits to European and national authorities, it would be useful to summarise the differences between pension products that can be attributed to the transposition of EU directives. The Commission White Paper on Financial Services Policy (2005-2010) provides for "a full economic

and legal assessment of all FSAP measures". This summary of transposition differences should be reviewed at that occasion.

It would also be helpful to describe differences in tax practices, to assess their negative impact on the integration process – regardless of the method chosen to reach that end – and to show that Member States can maintain fiscal autonomy while harmonising their tax practices.

Having done this, the feasibility of the new approach can be shown by preparing a draft regulation. Based on that document, which the EFR is due to release in the near future, representatives of consumers and investors must be mobilised and brought together. It will then be necessary to approach the members of the Economic and Financial Committee and the main representatives of the finance commissions of National Parliaments in order to take account of reactions and get them on board. This is a vital precondition for initiating political momentum and reaching agreement at European level.

6. A political initiative on supervision is urgently needed

In the field of supervision, Eurofi has identified a pressing need for a shared vision of the economic and prudential benefits to be reaped from centralising the functions and business lines of financial firms and on the advantages of basing supervisory assessments on their internal risk-measurement models.

In particular, it is necessary to launch a European initiative based on adopting a common approach to and appraisal of modelling techniques, mustering the resulting skills and resources, and deciding jointly on group-level and local-level supervisory functions. It is also necessary to check the quality of the legal framework for intra-group agreements guaranteeing the solvency and liquidity of subsidiaries and branches. Last but not least, it is vital to build a coordinated framework for management and responsibility-sharing in crisis situations.

The only way to address the true issues underlying the current work on supervision is through a political initiative – in the form of a Mission – from the council of EU finance ministers, ECOFIN. This does not mean creating new organisations from scratch; it will be possible to rely on the members of the European regulatory and supervisory committees set up under the Lamfalussy arrangements (CEBS, CEIOPS), on the European System of Central Banks, on the Financial Services Committee, and on a small number of senior managers of domestic and multinational financial groups.

The chief priorities in this Mission are to identify opportunities for using internal models for regulators and supervisors, to identify the benefits of an integrated approach, and then to work out the conditions for an effective pan-European approach. The presence of managers of insurance and bancassurance companies is absolutely vital in this respect.

Another area of concern is the case of multinational banking groups that could create systemic risks if they were to run into difficulty, thus demanding a swift response (unlike insurance groups, where the only danger is a solvency risk). On this point, the

Mission must develop a consistent pan-European approach for preventing and managing crises. This involves defining the key priorities and the arrangements for coordinated management (i.e. ensuring that supervisors provide national central banks and the ECB with relevant information as quickly as possible, given their various links with Member States), identifying the consequences in terms of responsibility-sharing between stakeholders, establishing principles and procedures for sharing financial support and restructuring costs, and establishing legal procedures for formalising countries' commitments to national central banks.

Retail financial services play an important role in the everyday lives of European citizens. Building an integrated market in retail products would provide them with numerous benefits and help reconcile them with Europe.

Eurofi's proposals can be achieved in a realistic timeframe. We believe that illustrating and communicating the concrete benefits of European financial integration for citizens and fostering a constructive dialogue among stakeholders with appropriate institutional processes are key conditions to enable these proposals to be implemented.

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Axa, Aviva, BNP Paribas, Crédit Agricole, Citigroup, Deutsche Bank, European Investment Bank (EIB), Euronext, JPMorgan Chase, Goldman Sachs, Groupe Banque Populaire, La Banque Postale, Sanpaolo IMI, Société Générale, Unicredit Group ;

wish to thank particularly the financial institutions who supported and help to organise the event:

l'Association pour le Droit à l'Initiative Economique (ADIE), Dexia, Deutscher Sparkassen und Giroverband (DSGB), Forum of European Asset Managers (FEAM), Fortis, ING Group, Visa Europe.