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Understanding Credit Markets for Europe

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EU Retail Financial Market Integration: Mirage or Reality?

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After the successful adoption of the Financial Services Action Plan (FSAP), the integration of retail financial markets is a next frontier for the EU. Several measures covering areas such as payments, retail credit and investment funds, and stretching across different policy areas are under discussion or are in the course of being implemented. In addition, the European Commission has started to look more closely at the sector from a competition policy standpoint.

But will the EU manage to create an integrated retail financial market? The single market has been on the agenda since 1992, and progress on the retail side has been extremely limited judging by certain indicators. It could even be argued that it has receded, as the EU's single market agenda has contributed to national consolidation of operators, which has reduced competition in many smaller and medium-sized member states.

This paper starts with a bird's eye view of retail financial markets in the EU today and their degree of integration. It reviews the EU measures affecting retail financial markets and how rule-making has evolved over the last 15 years. In a third section, we discuss issues raised by EU rule-making in retail financial markets and conclude with some recommendations for policy.

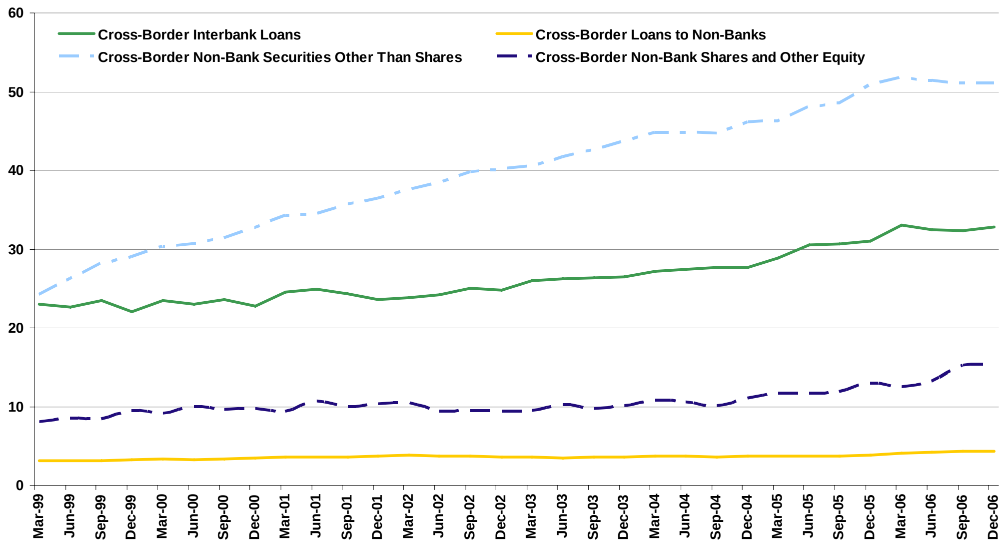
Retail financial markets are defined as services to consumers and small and medium enterprises (SMEs). In banking, the most important sub-sector of financial markets, retail represents over 50% of total EU activity in terms of gross income. According to European Commission estimates, retail banking represents a gross income of €250-275 billion per annum, which is equivalent to approximately 2% of total EU GDP (2004).

EU RETAIL FINANCIAL MARKETS TODAY

From a retail perspective, there is no such thing as an integrated financial market in the EU today. Market structures differ strongly; savings, credit and investment attitudes follow different patterns; consumer and investor protection measures vary; and language and habits diverge. Seen from a policy-maker's point of view, the non-existence of an integrated retail financial market is one of the biggest disappointments of European integration.

It suffices to mention a few figures to demonstrate that retail banking is national at best, even within the euro area: the share of loans granted in the euro area by cross-border monetary financial institutions (MFIs) to non-MFIs stood at 2.2% at the end of 1997 (1.5% for the rest of the EU); this figure had risen to no more than 4.2% in June 2007 (2.9% for the rest of the EU). Taking a price-based indicator, the cross-country standard deviation of interest rates on consumer credit had been rather high and constant, on average 1% over the period June 2003 – June 2007, with a slight increase over the last two years. And, to give another indicator for the level of retail banking integration, the cross-country dispersion of interest rates on lending for house purchases amounted to, on average, 0.3% over the same period, with no clear declining trend visible so far.[1] Meanwhile in wholesale banking, similar indicators such as data on cross-border interbank lending and securities issuance showed substantial progress over the same period (see Figure 1).

Figure 1. Cross-border provision of financial services in the euro area (assets, in %)



Note: Cross-border activity is expressed as a percentage of the total euro area provision of financial services.

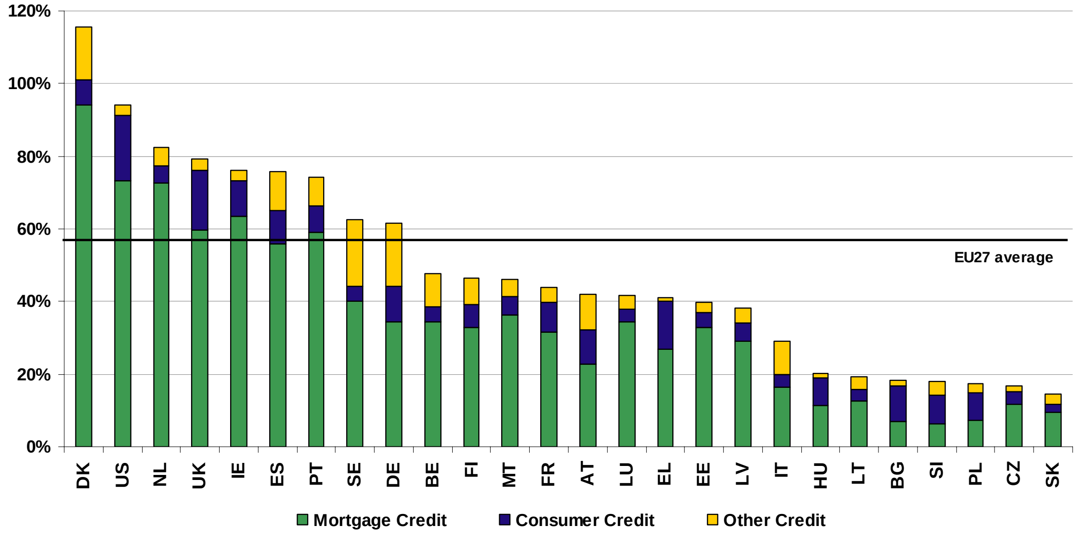
Source: ECB (2007).

Comparing different segments of retail financial markets indicates how much lending habits differ in the EU. The total indebtedness of households in the EU differs from well over 100% of GDP in Denmark to about 20% of GDP in most of the new member states, with an EU average of 59% in the EU-15, and 56%

[1] Data taken from the European Central Bank's indicators of financial integration in the euro area, and based on a speech by Jean-Claude Trichet on "The state of European financial integration" at the Third Euro Fixed Income Forum, Euromoney Conferences, Paris, 28 November 2005. As regards mortgage lending, it could be argued that risks are region-specific, and that hence there will be no convergence.

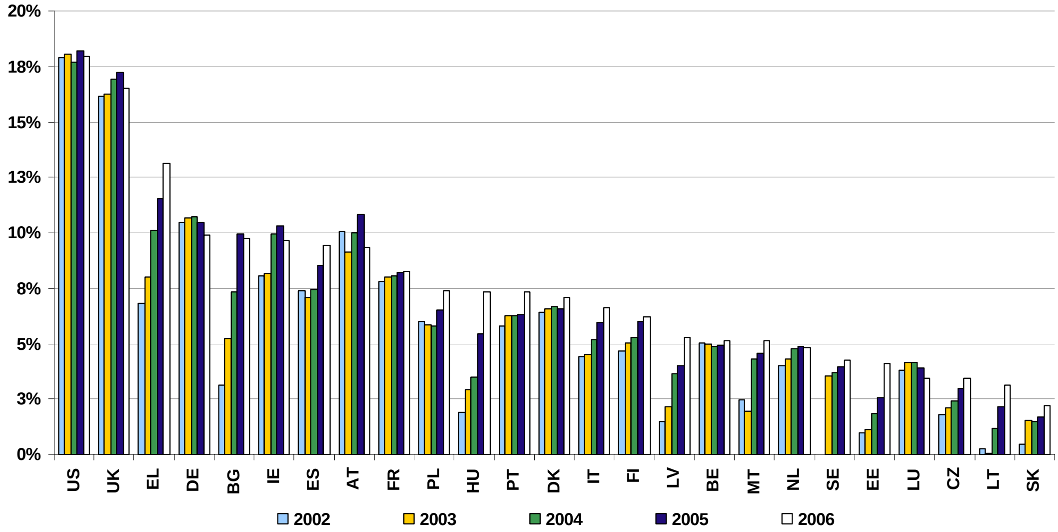
for the EU-27 in 2006 (see Figure 2). Comparing the composition of household debt shows that, while mortgage credit is by far the most important component, the share of short-term consumer credit differs importantly, varying from 16.5% in the UK to 3.4% in Italy (see Figure 2). Interesting to note is that it is difficult to generalise about differences in patterns of consumer lending in Anglo-Saxon vs. continental European countries, with Germany having a share of 10% of GDP, Spain 9.5% and Greece 13% (see Figure 3). Growth of consumer credit has also been more pronounced in the Southern European countries over the last few years, with growth rates in most standing at well above 10%.[2]

Figure 2. Composition of household debt in EU-25 member states and the US, 2006 (as % of GDP)



Source: ECRI (2007).

Figure 3. Consumer credit in EU member states and the US, 2006 (as a % of GDP)

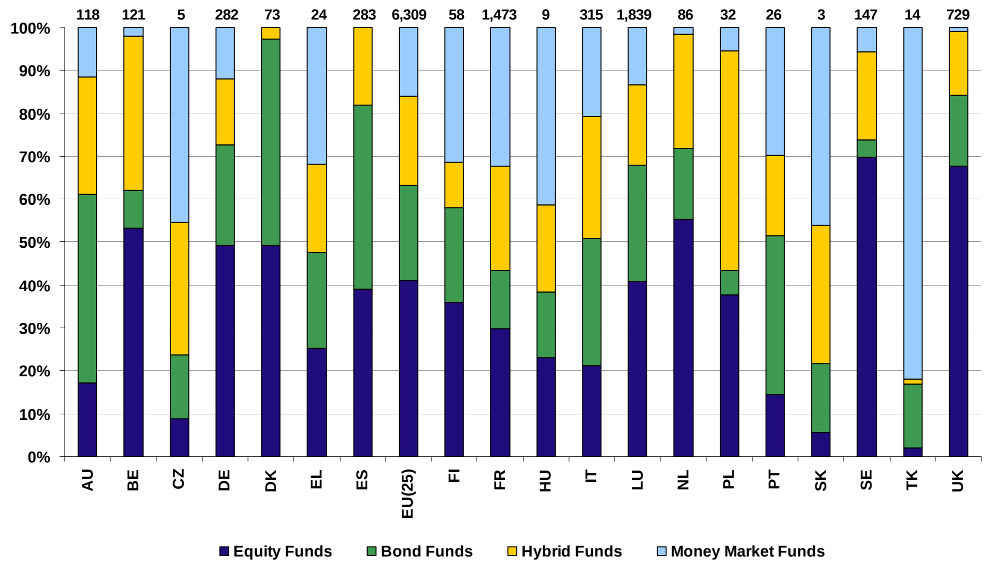


Source: ECRI (2007).

[2] Data from the European Credit Research Institute (ECRI) Statistical Package 2007 (www.ecri.eu).

Moving to another segment of retail financial markets, investment funds, one finds large differences in long-term savings behaviour of households. Assuming that investment funds are essentially used by non-professional investors, these differences reflect different attitudes towards savings and investment. Although the share of equity funds has increased from 26% in 1996 to 43% in 2006 at EU level, bond and money market funds have remained important (see Figure 4). In certain member states, such as France, Greece and Portugal, short-term money market funds continue to account for 30% of the investment fund markets, while in other member states, such as Denmark, the UK and Belgium/Netherlands, they are almost non-existent. Bond funds also continue to be the most popular investment funds in several member states, such as Austria, Denmark and Spain, with shares close to half of the local investment fund market. Equity funds are the most popular investment funds in the UK, with 68% of the fund market, but also in Sweden, with 70%, and the Netherlands, with 55%.

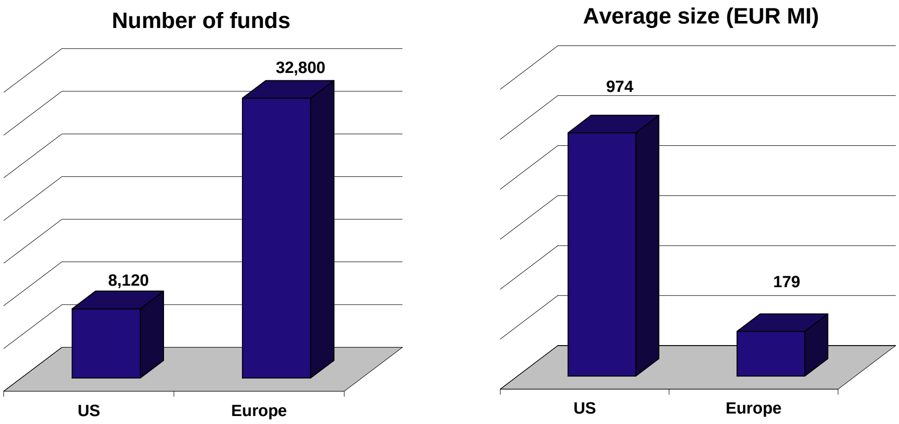
Figure 4. Investment funds asset spread in EU member states, Switzerland and Turkey (€ billion)



Source: European Fund and Asset Management Association (EFAMA).

A side-effect of the diversity in fund markets is the lack of scale economies; less competition (as fund managers have to adapt supply of products to local demand), and limited synergies and cost savings on the operational side. The fund market is probably the clearest example of the non-integration of retail financial markets in the EU, the cost of which is passed on to the user. The number of European funds is four times higher than in the US, but the average size is less than one-fifth that of US-based funds (see Figure 5). The sub-optimal average size brings about higher operational costs for fund managers, a higher cost ratio for funds, and duplication of infrastructure.

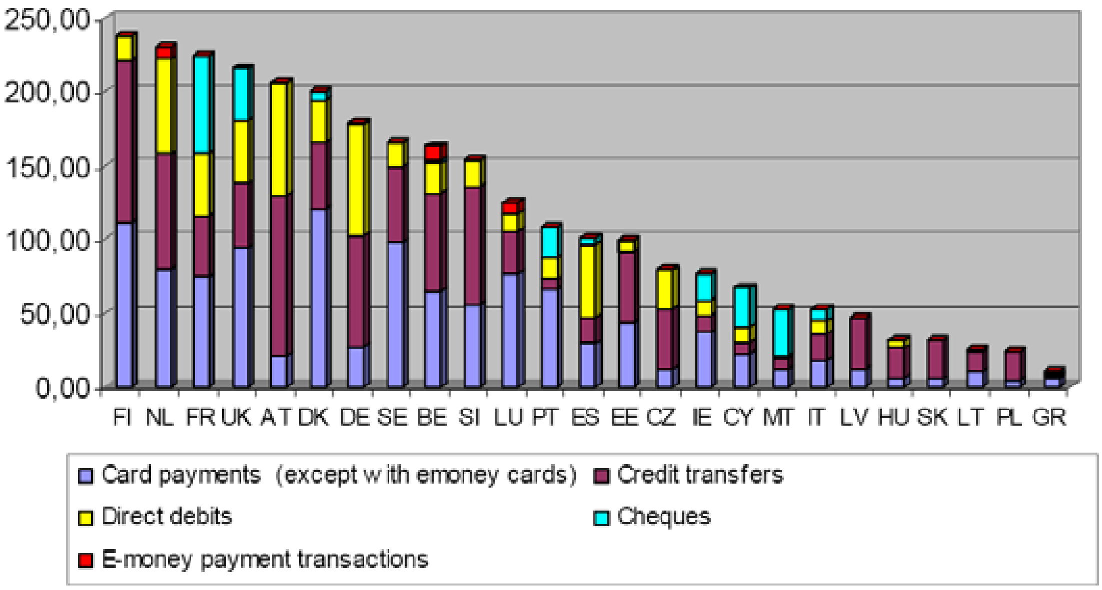
Figure 5. Comparison of average investment fund size in Europe and the US, 2006



Source: ICI.

A third segment of retail financial markets, payments, also shows large structural differences. Even today, payment habits differ widely throughout the EU. There are large variations in the use of means of payment: cash, pre-paid cards, debit cards, credit cards, cheque-based payments and electronic transfers. In some member states, cheques have entirely disappeared in the retail sector, whereas in others, their use is still widespread (see Figure 6). An indication of the differences in availability of means of payment is the density of ATMs in the EU, which varies from 1 per 663 inhabitants in Portugal or 1 per 762 in Spain to 1 per 3,235 in Sweden and 1 per 3,837 inhabitants in Poland, for an EU-25 average of 1 per 1,355 inhabitants (ECB, 2007, p. 17). This is not only a matter of new versus old member states, as the eurozone average is 1,249, or only slightly below the EU-25 average.

Figure 6. Number of cashless payments per capita in the EU-25



Source: European Commission (2007b).

EU MEASURES AFFECTING RETAIL FINANCIAL MARKETS

The above overview suggests that a single EU retail financial market hardly exists, and gives the impression that the EU has not done much in this area so far. This is not the case, however; the EU has been active as well in the harmonisation of conditions for financial products and services providers. But unlike wholesale financial markets, the main factor determining strength in retail financial markets is distribution networks, and its is only very recently that the EU has started to act from this perspective on the basis of its powers to ensure free competition in the single market. A number of indicators such as market fragmentation, price rigidity and customer immobility suggest that competition in the EU retail banking market may not be working effectively, preventing users from getting the full benefits of the single market.

EU action in the domain of retail financial market harmonisation has mainly focused on products as well as on the conditions for the services providers. This distinction is still relevant, as the question remains how to best integrate markets, through product or further services providers' harmonisation. The debate regarding an optional 28th regime (see below), which has been ongoing for some time, is an example of the former, whereas the recent MiFID directive is an example of the latter.

The first product harmonising directives date back to the mid-1980s, and some can be considered to be truly successful. The UCITS (Undertakings for Collective Investment in Transferable Securities) Directive introduced a single format for the open-ended funds that invest in transferable debt or equity securities to be sold with a single authorisation throughout the EU. Today, there are around 32,000 UCITS products, representing over €6 trillion of assets under management. UCITS licensed products thereby represent about 79% of the total assets of European investment funds.[3] These facts point to the success of the UCITS brand as one that is operational and reliable, all the while securing a high degree of investor protection.

Another example of a product-harmonising measure is the consumer credit Directive (CCD) (87/102 EEC) of 1987, which essentially harmonised the calculation of the annual percentage rate of charge (APR) for short-term consumer loans in the EU, and required all banks to apply it. Although the APR is largely followed in the EU – there were some loopholes in the directive such as for mail order companies – consumer credit is rarely sold on a cross-border basis, as indicated by the data above.[4]

A third group of product-harmonising measures concern those in the field of retail payments. The best known is the 2001 EU regulation on cross-border payments, a directly applicable measure that mandates that charges have to be the same whether the payment is national or cross-border. It applies to credit transfers, cash withdrawals at cash dispensers and payments by means of debit and credit cards. Although the regulation was heavily contested by the banks, it was preceded by years of empty promises by the banking industry to bring down costs for cross-border transfers and cash withdrawals abroad. Two further important developments in this domain, the first being a new payment services providers' directive, which allows payment transmitters to have a single licence at a regulatory capital cost that is far below what is required for traditional banks. Payments and related services are currently treated differently in the EU. The second development is SEPA (Single European Payments Area), an initiative by the European banking industry, but at the insistence of the European Commission and the ECB, to

[3] Data based upon a recent CEPS report on the UCITS review (see Lannoo & Casey, 2008). It should be added that truly cross-border funds represent only 17% of total UCITS funds, and that the instrument is thus only partially used on a cross-border basis. However, this is determined by the control of distribution networks, discussed in more detail below.

[4] The consumer credit Directive was recently amended (April 2008) to increase the level of harmonisation, and has become a full harmonisation type of directive for those provisions that are harmonised by the measure.

standardise the processing of retail payments in the EU. The effect for users is that value dates for transfers are harmonised and time limits are set for settlement at EU-wide level.

To the group of services providers' directives belong the well-known second banking, investment services (ISD) and insurance Directives. The basic approach of these directives was minimum harmonisation of basic prudential rules and standards and mutual recognition, i.e. subject to compliance with EU-wide harmonised rules, financial institutions could provide services throughout the EU. This approach has been successful in wholesale finance, but much less so in the retail domain. The directives allowed member states to impose additional barriers based upon the 'general good' clause, which was invoked to maintain host country consumer protection rules, as these were not, or insufficiently, harmonised by the directives.

Table 1. EU retail financial product and services harmonising measures

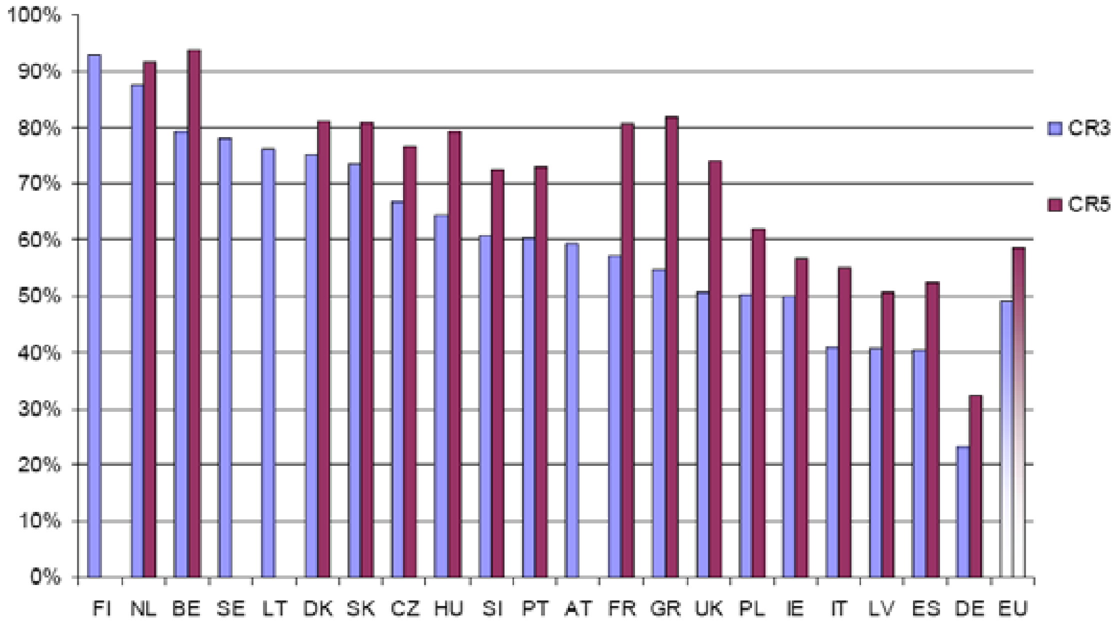
Domain	Measures	Scope	Implementation
Product harmonisation			
Payments	Cross-border payments regulation	Cash withdrawals and credit transfers	2003
	E-money institutions directive	E-money issuance and administration	2002
	Payment services providers directive	Money transfer institutions	2009
	Single European Payments Area (SEPA)		2009
Retail credit	Consumer credit directive	Short term low value retail credit	1990 – 1992 –2000 – 2010
	Mortgage credit white paper		
Investment funds	UCITS I – II – III – (IV)	Single format for equity, bond, money market and funds of funds	1987– 2003 – …
Free provision of services			
Banking	2nd banking directive, capital requirements directive (CRD)	Basic banking and investment services activities	1992 – 2007
Investment services	Investment services directive (ISD), Market in financial instruments directive (MiFID)	Investment services (covering also structured products, hedge funds, etc.)	1996 – 2007
Insurance	Insurance directives	Life and non-life insurance services	1990 – 1994
Deposit (and investor) guarantee schemes	EU-wide minimum level of depositor protection	Minimum level of protection per depositor of €20,000, not applicable to foreign currencies	1995

In a second phase of regulation, the consumer or investor protection barriers to the single market gave rise to a higher level of harmonisation. In certain cases, the EU went for maximum harmonisation, and in others for 'targeted full harmonisation'. Examples of the former are the 2003 prospectus directive, whereas MiFID or the 2005 amendments to the 1987 consumer credit directive exemplify the latter. Under the maximum harmonisation approach, the same standards apply throughout the EU, member states cannot impose additional standards for firms under their jurisdiction and mutual recognition does not apply. Under targeted full harmonisation, full harmonisation applies to a limited set of issues covered by certain measures, whereas the rest remains subject to mutual recognition. As a result of differing investor protection rules, the MiFID, for example, went for an extensive harmonisation of conduct of business requirements for investment firms in the EU, making the new directive five times as long as the directive it replaced, the ISD. Since the directive has only recently come into force, it is too early to make any judgements whether it is working.

An issue that affects retail financial markets directly but was not given much attention until very recently is depositor protection schemes. A 1994 directive harmonised the minimum level of deposit protection in the EU at €20,000, but left the method of funding and the degree of co-funding to the member states. In addition, there are provisions to make sure that competition between systems, and thus the single market, does not emerge (non-export and topping-up provisions with local schemes for branches). In view of the failure of Northern Rock, this directive is up for urgent review, as deposit holders of European-wide banks would be treated differently in case of a bank failure.

Given the limited progress in retail financial markets integration, the European Commission started to look deeper, and it is only recently that it started to investigate whether competition was functioning effectively. In 2005, an inquiry was launched into retail banking, whose conclusions were published in January 2007 (European Commission, 2007a). In general, the inquiry found that European retail banking markets were not excessively concentrated at national level, but only ‘moderately’. On the basis of a special examination of retail banking data only, it found an average concentration ratio of the three and five largest retail banks across all EU25 countries (weighted by member state population) of around 50% and 60%, respectively (see Figure 7). However, the most concentrated countries, such as Finland, the Netherlands, Belgium and Sweden, stand well above this level, and one may wonder whether, with almost no cross-border competition, these levels are sound.

Figure 7. Concentration ratios in banking: CR3 and CR5 (2004)



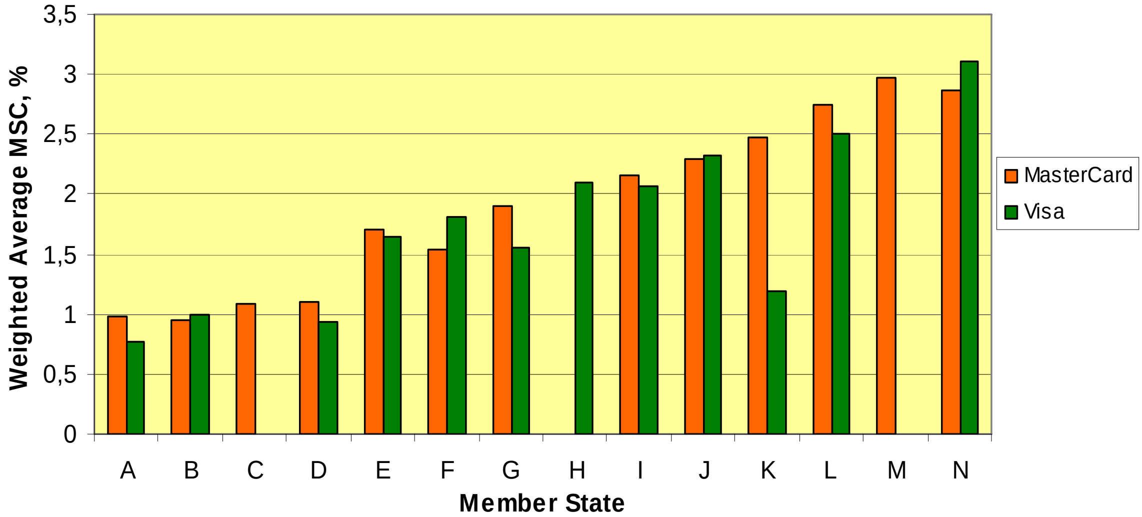
Note: Intra-sample share (retail income) extrapolated with deposits

Source: European Commission (2007b).

The inquiry, however, identified behavioural entry barriers and cooperation problems that might lead to collusion in the sector. Competition concerns were identified in the following areas: 1) payment systems, including card payment systems; 2) credit registers; 3) cooperation between banks; and 4) setting of prices and policies. Therefore, it was concluded that action by competition authorities could be needed.

The background study to the sector inquiry provides rich evidence of these problems and is required reading for those who want to understand European retail banking better (European Commission, 2007b). Some of its findings are really staggering, above all in the field of payment cards, and require a policy response. It identified a high variation in *cardholder*, *merchant and inter-bank fees* (multilateral interchange fees) across the member states, which highlights market fragmentation. In two cases, cardholder fees are double that of the EU average, which is €24. Inter-bank fees on credit cards in Visa and MasterCard networks in Portugal were more than twice the level of those in Slovakia. Meanwhile merchant fees for the same type of cards in Portugal and the Czech Republic were more than three times the level of fees in Finland and Italy (see Figure 8). In addition, small business merchant fees are easily more than 70% higher than larger ones, which, according to the European Commission, cannot be explained by transaction volumes alone. These differences allow the European Commission to exercise its powers of enforcement under Articles 81, 82 and 86 EC, to ensure that the competition rules are respected in retail banking. In the meantime, the European Commission has started action against MasterCard's multilateral interchange fees (MIF) for cross-border payment card transactions under Article 81 of the Treaty.[5]

Figure 8. Credit card merchant services charges (MSC) in the EU (2004)



Note: Weighted Average MSC Rates Charged per Country for MasterCard and Visa Credit Cards, %
Source: European Commission (2007b).

One of the reasons why integration in retail markets is so limited is that taxation differs widely across the EU, a situation that can be expected to remain for some time to come. In the area of direct taxation, very few EU harmonising measures have been adopted so far, limited to a few measures eliminating double taxation between enterprises and the taxation of savings directive. According to the latter, the exchange of information between member states concerning interest income obtained from savings by EU citizens becomes automatic. This measure is seen as a way to reduce the reasons why EU citizens place their savings in other European jurisdictions, as tax avoidance is tackled, also as far as neighbouring off-shore jurisdictions are concerned. The situation is even more dissuasive for equity holders, as foreign dividend income is often taxed twice, once in the home country of the company, and once again in the home member state of the taxpayer. This situation is a complete anathema to the single market, but has not even appeared on the radar screen of European policy-makers. In addition, there are other elements of national personal income tax schemes that distort the comparison of European retail financial markets. For

[5] European Commission decision of 19/12/2007 (see http://ec.europa.eu/comm/competition/antitrust/news.html).

example, the extent to which interest payments on home loans may be deducted from taxable income varies from one member state to another. These deductions often do not apply to mortgage loans provided by foreign banks under the free provision of services.

ISSUES RAISED BY EU ACTION IN THIS DOMAIN

The huge diversity in retail financial markets and the resulting EU policy measures discussed above raise several important questions, which are outlined below.

1. Is targeted full harmonisation, or maximum harmonisation the way forward?

The increasing reliance on maximum harmonisation to advance market integration is unsound for several reasons. First, as the body of EU single market law is based on the principle of minimum harmonisation, the practical application of legislation to areas where member states cannot impose additional rules is a recipe for problems. It will only work in distinctly defined areas with limited or no overlap with other areas of law-making. In the area of consumer credit, for example, a directive harmonising the conditions for the cross-border provision of consumer credit using the maximum harmonisation approach directly affects EU or national legislation regarding personal data protection or contract law. Second, it excludes regulatory competition and market-driven adjustments. In the area of disclosure regulation, for example, mandating a maximum level of harmonisation in the prospectus directive seems like a contradiction in terms, as an optimal level of disclosure can never be mandated, and room must therefore be built in for market-led improvements. More generally, maximum harmonisation also opens the way towards a single supervisory authority. If standards are the same all over the EU, it is of less use to continue to apply the home-country control principle, which is a cornerstone of the single financial market. Under maximum harmonisation, member states only compete in supervisory performance, not on regulatory standards. It would thus ease the way towards a single authority.

2. Is an optional or 28th regime feasible?

Pressure groups have been arguing for some time that a solution to market integration is the adoption of an optional 28th regime, which would be accessible to all market participants, and would allow them to choose to follow either their home country regime or the optional 28th regime. Rather than bothering to agree on minimum standards or finding agreement on the elements that would form the basis of targeted full harmonisation, a new European-wide regime that would co-exist alongside the national regimes (thus becoming a 28th regime) would in the long run be an easier way to integrate markets. An example of an optional regime in financial regulation is the UCITS directive, which has proven to be very successful, although a more recent example in another field, the European Company Statute, which offers an optional way to incorporate a business, has so far proven unsuccessful (see Arbak, 2008). The problem is that an optional regime needs to be fully adopted and promoted by all the member states, if not, it will not take off. The reference to national law should also be limited, as it reduces the attractiveness of the regime. Specifically in the area of retail financial markets, given the difficulty encountered so far in finding agreement on basic consumer protection measures amongst EU member states, it could prove to be an almost impossible exercise.

3. Does the levelling-up process in harmonisation reduce market contestability, and thus competition?

The tendency towards more detailed harmonisation, as embodied in several more recent pieces of financial market legislation, and most pronounced in the MiFID directive, are proportionally more cumbersome to implement for smaller firms than for large firms, and thus contribute to further consolidation and increased scale in the sector.[6] This could further reduce competition, above all in retail financial markets, which already face an excessive degree of market concentration at local level.

This reveals an inherent contradiction within the single market programme, at least as far as retail financial markets is concerned. The EU's work stimulated increased consolidation in the private sector, and in the financial sector in particular, but this process has reduced competition in markets that are local in orientation.

4. From a competition policy perspective, there is not much the European Commission can do, apart from acting ex-post on clear and specific violations of antitrust rules.

The high levels of concentration in certain member states are essentially an issue for the member state authorities to act upon, not the EU. If the EU wants a more integrated retail financial market, it would have to use other means than competition policy, such as a deliberate enterprise policy, or instigate class actions by user groups against banks. Policy initiatives in either field is seen to be unlikely.

5. There is a need to harmonise the objectives of supervision and to promote financial education.

A buzzword in the post-FSAP context is supervisory convergence, by which is meant that supervisory instruments and procedures should be more closely aligned in the EU. However, this is putting the cart before the horse, in the sense that the EU should first formally harmonise the objectives of supervision. Although the broad objectives are the same – safeguarding the stability of the financial system and protecting consumers/investors – important differences may exist in other objectives. One of the objectives of the UK Financial Services Authority (FSA) is "the promotion of public understanding of the financial system", which means that it needs to help consumers understand the financial products they buy. To our knowledge, this is not necessarily an objective of other supervisory authorities in the EU. Acceptance of this objective would come to meet a growing need for financial literacy in a world with increasingly complex financial products, and at the same time clarify that the consumer is in first instance liable for her/his financial decisions.

Harmonising the objectives of supervision, and promoting financial education could also clarify the role of the EU in this domain, on which the European Commission has recently launched some initiatives.

6. What is the impact of the 2007-08 financial market turmoil?

The financial market turmoil has highlighted the need to urgently address some important issues on the supervisory side that also affect consumers, most notably the 1994 deposit guarantee schemes directive. In the event of a European-wide bank failure, the realisation by European citizens that deposit guarantee levels differ substantially across the EU would rapidly backfire against the single financial market.

CONCLUSION

Notwithstanding over 15 years of the single market and almost 10 years of monetary union, retail financial markets in the EU remain diverse, and signs of more integration and increasing convergence are limited. Markets are national at best, and behave according to local patterns.

Not much change can be expected in the coming years in the structure of retail financial markets. The main instrument left at EU level to create a more integrated retail financial market is competition policy, but the problem of high concentration is mainly at a national level, meaning that it is up to national

[6] See for more on this subject Casey & Lannoo (2006, p. 4).

authorities to react, and EU action under antitrust policy is by nature ad-hoc and ex-post. Hence structural change can only be expected to happen slowly over time.

The main issue is to make users aware of the increased possibilities offered by the single market, and of their rights under EU law. In this sense, the EU has missed a golden opportunity to advertise its retail financial market agenda more broadly among European citizens. The 1999 Financial Services Action Plan, which was essentially about wholesale financial markets, was widely advertised and publicised by the EU. This contributed to public awareness of the issues at stake, the support for the programme and its success. The retail agenda has been advertised much less or not at all. EU work on SEPA, UCITS and consumer credit are not known beyond a limited circle of specialists.

The EU should also formally align the objectives of financial supervision and propose to make financial education a task for the authorities in all the member states. This would at the same time raise the awareness amongst consumers of the benefits of the single market.

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