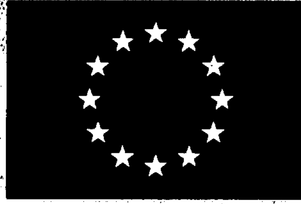

Towards a single market in financial services

COMMISSION
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The Treaty of Rome setting up the European Community aimed to create a single internal market encompassing a whole range of sectors, among them the services sector, including financial services such as banking, insurance and the markets in stocks, securities and related products. But although the years after 1958 saw considerable progress in this direction, the goals set out in the Treaty had still not been fully achieved by 1985.[1]

In that year the European Commission published a White Paper on completing the internal market, calling for a new impetus to integration. The aim was to weld together the 12 separate national economies into a single market, a single European economy, by the end of 1992. The 1985 White Paper programme was approved by the the 12 Heads of State or Government and incorporated into the Community legal order in 1986 by the Single European Act amending the EC Treaties, which defined the internal market as 'an area without internal frontiers in which the free movement of goods, services, persons and capital is ensured'.

The White Paper made the point that a common market for goods was already largely in place and that it was important to make similar progress in the area of services, particularly financial services, in view of their vital role in the European economy. This still holds good today.

A major sector

The financial services sector is an increasingly important part of the Community economy. In terms of output it accounts for about 7% of gross domestic product (GDP) for the Twelve as a whole, while in employment terms it provides over 3 million jobs — or about 2% of the EC total.

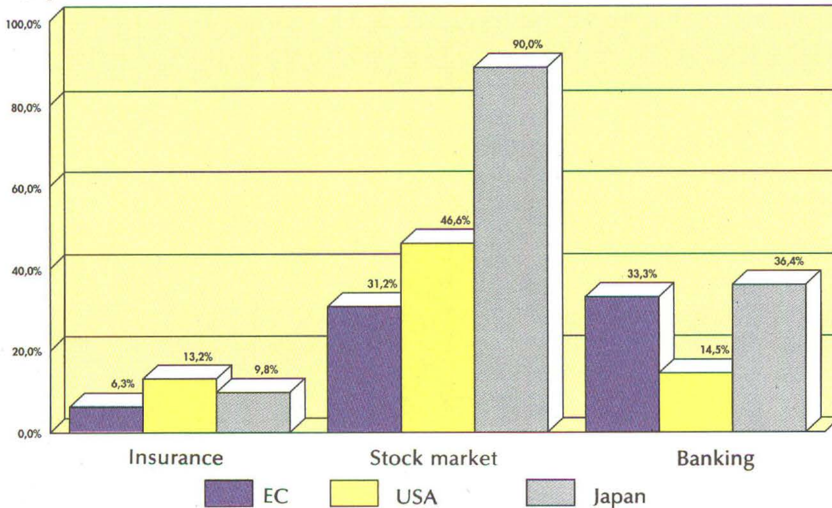
Financial services also provide a major input into the rest of the Community economy, with nearly half of the total profits earned by credit and insurance institutions being reinvested in other industries. Yet for many years they were unable to benefit to the same extent as manufacturing industry from the progress made towards dismantling trade barriers between the Member States.

Facing up to change

The completion of the single market in financial services marks the culmination of a process that has been under way for some time. Highly integrated markets already exist in reinsurance (insurance of insurers) and transport insurance, while many EC banks have branches in the Community's main financial centres, and a large number of securities are listed on the stock exchanges of more than one member country.

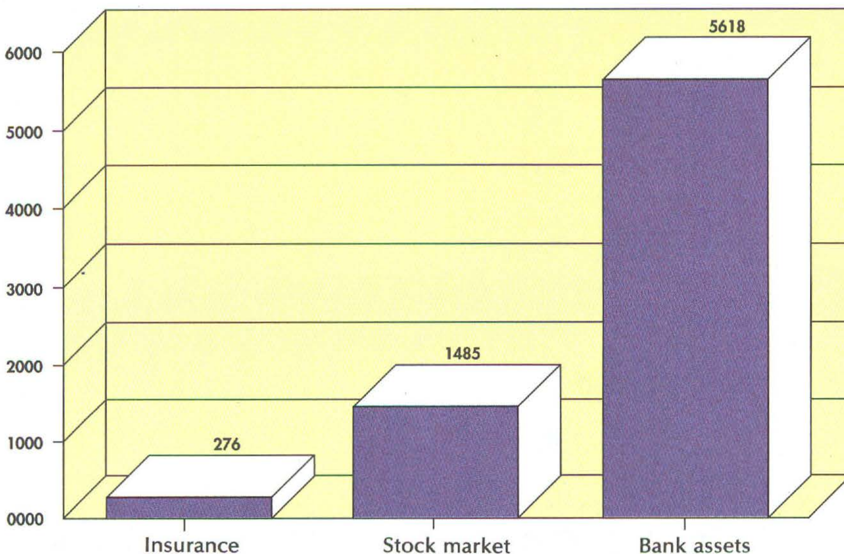
[1] *This brochure replaces No 17/88. Manuscript completed in March 1992.*

Financial markets in the European Community, the United States and Japan (in %)



Insurance: total premiums as % of GDP. Stock market: capitalization as % of GDP (USA: New York; Japan: Tokyo). Banking: bank assets as % of GDP.

Breakdown of the financial sector in the Community (billion ECU)



Insurance: total premiums *Stock market: capitalization*

Sources: Insurance: OECD, Insurance statistics, (1989). Stock market: International Federation of Stock Exchanges, (1990). Banking: Eurostat, (1988).

In the past, however, national regulations imposed for prudential reasons have hampered financial institutions wanting to set up in other Member States or offer services there. Open markets, free competition and cost efficiency have not always proved attainable.

For some time, too, changes have been taking place in the environment in which European financial institutions operate:

- The market has become a global one, increasingly integrated across the world. Financial services companies can now transfer capital very quickly from one continent to another.
- The development of new telecommunications and information technologies has reinforced the globalization process and ensured the rapid spread of innovation and new financial products.
- Wider competition between different kinds of financial institutions is tending to blur the distinctions between banking, insurance and securities firms.
- Competition between European financial institutions and their American and Japanese counterparts has also increased.

With world financial markets rapidly moving to continuous 24-hour trading centred on three principal time zones in the USA, Europe and the Far East, the European market needs to gear itself up to compete on the world stage.

The case for a single European financial services market

A single Community-wide market in financial services offers many advantages:

- National laws on their own no longer offer an adequate framework for the future development of the sector, especially in view of the pace at which globalization is moving. If Europe is not to lose its share of the business and of the employment that goes with it, the Community has to develop an efficient and open market in financial services.
- From the consumer's point of view, there are great benefits to be reaped from having access to a wide range of competing financial products irrespective of nationality.
- For the competitiveness of manufacturing industry too, it is vital for the financial sector to be as competitive as possible.
- The financial services industry itself needs to get in shape to face the challenge from the USA and Japan.

A report prepared for the Commission in 1988 on the cost of 'non-Europe' in financial services showed significant potential gains to be made from completing the internal market. It estimated that the overall benefit to the consumer could amount to anything between ECU 11 billion and ECU 33 billion.[1] Assuming it

[1] *ECU 1 (European currency unit) = about UKL 0.70, IRL 0.77 and USD 1.24 (at exchange rates current on 31 May 1992).*

actually turns out somewhere in the middle of this range it would give a figure of ECU 22 billion, with further gains likely to result from more closely aligned interest rates.

The report also pointed out that the benefits of the internal market were expected to extend beyond simply eliminating the extra costs due to trade barriers affecting financial services, since there would also be an added boost to trade itself. This would mean more competition, generating wider opportunities for the financial services industry and lower costs for the consumer. It would also mean greater freedom of choice for consumers, allowing them to go to service suppliers from other Member States to obtain the best terms and conditions on offer.

The foundations of the single financial services market

The single market in financial services rests on three major freedoms:

- Freedom for all financial institutions to base their head offices and to set up branches anywhere inside the Community.

- Freedom for them to offer their own particular products across frontiers in other Member States without having to set up offices there.

- Freedom of capital movements throughout the Community.

The programme of legislation drawn up by the European Commission (and now largely adopted by the EC Council of Ministers) was designed to remove all restrictions and obstacles that interfere with these freedoms.

- **Freedom of capital movements.** This is the backcloth against which the Community's whole approach to the liberalization of financial services is set.

  - Already in the early 1960s, direct investment and portfolio investment in quoted shares and bonds were liberalized.

  - In 1986 the Council adopted a Directive extending the list of liberalized transactions to include long-term loans, unquoted securities and the issuing of foreign securities on domestic markets.

  - In 1988 the Council approved a Directive to liberalize all other transactions: short-term monetary instruments, current and deposit account operations, financial loans and credits.

  These Directives are now in force (with some exceptions until 1993 in Spain, Portugal, Greece and Ireland), which means that all Member States are obliged to ensure that:

- ☐ their residents have access to the financial systems in the other Member States and to all the financial products available there;
- ☐ there are no restrictions on capital transfers;
- ☐ there are no other discriminatory measures that will hinder or distort the free movement of capital.

■ **Freedom of establishment and freedom of services.** The liberalization of capital movements is not sufficient by itself to secure effective freedom of financial services.

- ☐ Even after the lifting of all restrictions on capital movements, differing national regulations could pose barriers, restricting freedom of establishment and hampering free trade in financial services.
- ☐ Without common rules for the supervision of financial institutions, business would tend to migrate to centres where supervision is most lax.
- ☐ There have to be broadly equivalent standards for protection of investors.

Building on the basic principles of the Treaty and on the legislation already in place, the White Paper set out a general strategy for achieving the Community's objectives, involving:

- ■ the harmonization of basic standards for supervising financial institutions and protecting investors, depositors and consumers;
- ■ mutual recognition by the supervisory authorities in the Member States of the way in which they each apply those standards; and
- ■ based on these first two elements, 'home country control and supervision' of financial institutions (i.e. by the country where they are based) covering all their operations throughout the Community, whether through branches or in direct services across frontiers.

As far as banking operations and dealings in securities are concerned, the key element of the system is a single licence issued by the Member State where an institution is based, allowing it to market services in other member countries either through branches or directly across frontiers, provided it is allowed to market those same services in its home country.

In the insurance sector, on the other hand, supervisory control will be divided for a time between the Member State where a company is based and those where it has agencies or branches, before the system eventually switches over to the same pattern as for other financial institutions shortly after 1993.

Community legislation, sector by sector

1. BANKING

- The first banking coordination Directive was adopted in 1977, achieving three main goals.

  - It cleared away most of the obstacles to freedom of establishment for banks and other credit institutions.
  - It laid down common standards for granting banking licences.
  - It introduced the basic principle of home country control.

  But a number of obstacles still needed to be removed before a genuinely unified Community banking market could come into being.

  - Banks or credit institutions still had to obtain authorization from 11 different supervisory authorities to set up branches in all the other Member States.
  - It was still impossible to offer banking services across the frontiers in some Member States.
  - Banking activities had not been precisely defined.

- The second banking coordination Directive, adopted in 1989, did away with all these barriers.

  - It consolidated the principle of a single banking licence valid throughout the EC, authorizing a bank or credit institution to operate anywhere in the Community either through branches or directly.
  - National supervisory authorities were obliged to recognize licences issued in other Member States.
  - It set out a list of banking activities, including not only the main traditional services but also some that were new for certain Member States, such as trading in securities.
  - It laid down a minimum capital requirement of ECU 5 million in order to found a new bank.
  - Supervisory rules were introduced covering, among other things, internal management and audit systems.

- Further legislation was needed to ensure equal competition between banks and other credit institutions within the Twelve and to forestall a migration of banks to countries with less strict supervision. This included:

  - ☐ A Directive for a harmonized solvency ratio, also adopted in 1989, setting out high common standards.

  - ☐ Rules to protect depositors' interests and limit the size of risks taken on by credit institutions. The Commission produced draft Directives addressing these two issues in 1992 and 1991.

  - ☐ Rules on the annual accounts of banks and rules to harmonize the definition of a bank's 'own funds'. These were adopted in 1986 and 1989 respectively.

It is worth noting that freedom of establishment and the freedom to provide services across frontiers also extends to mortgage credit. EC legislation will allow the various forms of credit available from national institutions that specialize in this area to be marketed throughout the Community.

Another initiative in the banking sector concerns ground rules for consumer credit operations. Here too a Directive has already been adopted.

Finally, action was needed to prevent shady operators from taking advantage of the opening up of the banking and financial markets to exploit potential loopholes in the supervisory arrangements. The outcome was the adoption in 1991 of a Directive aimed at preventing the use of financial institutions to launder the proceeds of criminal activities.

2. PAYMENT SYSTEMS

Making a payment within any Member State is now a rapid and simple process. It can be done by electronic transfer between banks, by cheque or by payment card. Yet individuals and businesses attempting to transfer relatively small sums from one Member State to another find it complicated, expensive and slow. The work which has gone into creating a single market needs to be backed up by improvements to Europe's payment systems.

The Commission has already taken some steps in this direction:

- A 1987 recommendation incorporating a code of conduct for relations between banks and retailers with regard to electronic fund transfer at point of sale (Eftpos).

- A 1988 recommendation setting out minimum terms and conditions for the protection of the holders of payment cards.

- A 1990 recommendation dealing with bank transfers, in particular with the information to be given to the customer, the time transfers should take and the possibilities of redress in the event of complaint.

In 1990 the Commission published a discussion paper on possible improvements, which has been looked into by two advisory groups set up in 1991 (one

representing banks and central banks, the other bringing together various users). Most of the suggested improvements can be achieved through self-regulation or other voluntary action by the banking industry, although a few areas remain where legislation may be necessary or more effective.

Firstly, improvements should produce benefits for users of payment systems, for instance:

- Customers should be given clear information on the various ways of making a payment in or to another Member State and the costs involved (including exchange costs).

- There should be no hidden or surprise charges for individuals when exchanging cash at banks or 'bureaux de change' for foreign currency.

Secondly, the Commission will encourage moves by banks and payment system providers to make payment instruments increasingly interoperable and to link the payment systems of different Member States. In particular:

- Studies should be carried out on the feasibility of linking electronic clearing centres across frontiers and of improving the electronic networks in countries where they are currently less well developed.

- Encouragement will be given to banks to propose common EC standards for payments, in order to increase efficiency and reduce costs. A new European banking standards committee is due to be officially recognized as soon as it is fully operational.

- Certain legal aspects of payment systems should be harmonized where differences make cross-border payments more costly and difficult.

A communication published by the Commission in 1992 identifies the areas where the need for action is most pressing. The signature in February 1992 of the Treaty on European Union reinforces the need to lose no time in creating the conditions for rapid, reliable and economically priced payment services serving the whole of the Community.

3. INSURANCE

Freedom of establishment for insurance companies was introduced in the 1970s by the first EC Directives on non-life insurance and life assurance. Motor insurance Directives were also adopted, abolishing frontier checks on international insurance cards ('green cards') and reducing differences in compulsory third-party insurance cover. Progress towards securing full freedom to provide services, on the other hand, has been slower.

- In 1988, following a number of major rulings by the European Court of Justice in 1986, the Council adopted a second Directive on non-life insurance to secure:

  - some harmonization of national laws in this area;

  - a wide measure of freedom to provide services in connection with major risks in the industrial, commercial and transport sectors;

  - free access to the Community market for large policyholders.

- The same principle of freedom to provide services (implying free access for policyholders to the whole Community market) also applies to life assurance and motor insurance, and in 1990 the Council adopted Directives on them as well.

  - The life-assurance Directive provided for a broad measure of freedom to provide services and hence easy access to the whole Community market for customers to take out policies in other Community countries either directly or through an intermediary. Protection for the man in the street was guaranteed by a rule under which the law of the policyholder's home country would normally apply.

  - The motor insurance Directive set out to secure wide freedom for major policyholders. But in the interests of insured parties and accident victims, insurers providing services outside their home country must designate representatives responsible for settling claims in the country or countries where they operate.

- In a slightly different field, in 1991 the Council adopted a Directive on the harmonization of the annual accounts of insurance companies to make it easier to compare and monitor the accounts of insurers in different countries.

- In its 1986 rulings the Court of Justice held that mass consumers of insurance (i.e. the man in the street) needed a greater degree of protection than large policyholders and that more detailed harmonization was required here. The Commission has therefore proposed two further Directives on non-life insurance and life assurance, envisaging:

  - a single licence issued in the country where the insurance company is based, along the lines of the system already adopted for banking;

  - greater freedom for the insurer in drawing up new contracts;

  - common rules on the assets which insurers are required to set aside to meet their commitments;

  - provisions to ensure that inspectors from the country of a policyholder will be able to secure adequate protection for him and to monitor compliance with any rules of general interest in force in his country;

  - full information for the policyholder about his insurer and the content of his policy.

In 1991 the Commission also adopted a recommendation on insurance intermediaries (brokers, agents, and other newer channels), with the twofold aim of setting a minimum level of qualifications for them all and of clarifying the distinction between dependent and independent intermediaries.

Finally, also in 1991, the Commission sent the Council a proposal for a Directive on the freedom of pension funds to manage and invest their assets.

4. STOCK EXCHANGES AND SECURITIES MARKETS

The Commission's overall objective is to create a unified securities market enabling issuers to raise capital on a Community-wide basis, allowing intermediaries to offer services and create branches in other Member States as easily as in their own, and offering investors a wide range of competing investment products to choose from. A number of Directives have been adopted towards this end.

- The three stock exchange Directives, although adopted at different times, made up a single package with the same implementation deadline for all three.
  - The first, dating from 1979, coordinated the conditions for the admission of securities to official stock exchange listing (e.g. minimum size, minimum period of existence, distribution of securities among the public, etc.) and imposed permanent obligations on issuers. In particular they must publish information on any new developments likely to have a substantial effect on the price of their securities.
  - The second, dating from 1980, dealt with stock exchange admission prospectuses and coordinated the information to be disclosed so as to enable investors to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching to the securities.
  - The third, dating from 1982, required listed companies to publish half-yearly reports giving turnover and profit-and-loss figures for the first six months of the financial year.
- A 1985 Directive on open-ended undertakings for collective investment in transferable securities ('Ucits'; these include unit trusts, investment funds, etc.) laid down common rules, with provision for home country control. Once such an undertaking has been licensed in its home country, it is able to market its units in other Member States without having to reapply for a licence each time, since all the Member States recognize the rules and controls of the home country.
- A 1987 Directive amended the 1980 Directive on stock exchange listing prospectuses so as to provide mutual recognition here as well. A prospectus approved in the home country no longer needs separate approval in others and can be issued without any change in content (except, of course, that it may have to be translated).

- A 1989 Directive allows issuers to use the prospectus approved in their home country when securities are offered for the first time to investors for a simultaneous public offer in other Member States. The standard of disclosure must be at least the same as that required by the 1980 Directive.

- A 1990 Directive further amended the 1980 legislation to allow issuers to use a single prospectus approved in their home country both for public offers and for admission to stock exchange listing anywhere in the Community.

- A 1989 Directive on insider trading required all the Member States to introduce similar rules, so as to safeguard the smooth operation of the unified market and ensure investor confidence in it.

- A 1988 Directive dealt with the information to be published when major holdings in listed companies are acquired or disposed of. Anyone buying or selling a major shareholding must notify the company in question of their new number of voting rights if any of the thresholds laid down in the Directive are exceeded. The company must then publish the information in compliance with its obligations under the 1979 Directive.

Two further Directives are due to be adopted shortly:

- A draft investment services Directive aims to bring in a 'European passport' for anyone wishing to carry out investment business in securities and related instruments, subject to home country authorization, regulation and supervision. It will extend the right to provide such services (already enjoyed by banks under the second banking Directive) to non-bank firms and will allow all investment firms, banks and non-bank companies, to have access to stock exchange membership in all the Member States and to set up branches or subsidiaries there.

- A draft Directive on capital adequacy will require investment firms to meet certain conditions designed to ensure that they have sufficient capital to cover a range of risks, although it does not set a binding minimum level of financial resources. The intention is to ensure adequate investor protection and rough equivalence between bank and non-bank investment firms, while enabling the Community's financial centres to remain competitive compared to rival financial markets outside the Community.

The Community is aiming to establish a single market in financial services as part of the wider single European market due to be in place by 1993, allowing banks to offer the full range of their services throughout the entire Community and to set

up branches in other Member States as easily as in their own, enabling customers to buy insurance providing cover throughout the Twelve on the most reasonable terms, and ensuring that the market for securities and capital is of a size sufficient to meet the financing needs of European industry and to attract investors from all over the world.

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