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The Benefits of a Working European Retail Market for Financial Services

Report to European Financial Services Round Table

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Die Deutsche Bibliothek – CIP-Einheitsaufnahme

Heinemann, Friedrich:
The benefits of a working European retail market for financial services /
Friedrich Heinemann; Mathias Jopp. Ed.: Institut für Europäische Politik, Berlin
und Zentrum für Europäische Wirtschaftsforschung, Mannheim. –
Bonn: Europa Union Verlag, 2002
ISBN 3–7713–0607–8

© **Institut für Europäische Politik**, Berlin 2002
Publisher: Europa Union Verlag GmbH, Bonn

Layout: PAPYRUS – Schreib- und Büroservice, Bonn
Print: SDV Saarbrücker Druckerei und Verlag GmbH, Saarbrücken

ISBN 3–7713–0607–8

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EUROPA UNION VERLAG

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PREFACE

This report represents a continuation, in a much more sophisticated way, of the study of the "Cost of non Europe in financial services" in 1988, as part of the global analysis of the economic impact of a fully established EC Internal Market by 1992. At that time the European economic model used evaluated the potential benefit of the liberalisation of financial services as 1,5% of the EC 12 GDP out of a total of 4,5%, to be accrued after the completion of the Internal Market programme. Many commentators consider that this 4.5% evaluation was nothing more than a propaganda stunt as shown by the real evolution since then. This is however forgetting that the 1988 evaluation was clearly presented as a scenario of maximum success depending on the convergent behaviour of all the actors of the economy, business, trade unions and above all the member states' governments: unhappily this has not been the case, especially on the governmental side.

This said, the essential merit of this ZEW/IEP-report is to show that in spite of a number of legislative decisions already made, much remains to be done. This clearly requires not only the swift implementation of the Financial Services Action Plan, but also a number of other actions by the EU, its member states and the involved business actors. The list of the missing aspects is quite impressive and requires what, by the present operating standards of the EU, could well be considered an almost unreachable target in the light of the present mood of soft legislation and subsidiarity. Against this background and by taking two of the major obstacles to fully integrated financial markets as analysed in this report, the tax problem and the problem of consumer protection, the following approach might be considered:

In the cases of open tax discrimination against "EU-foreign" suppliers of financial services in an EU country, the procedures should be clear, as stressed in this report, since this would be an evident violation of the Treaty-based rule of non-discrimination. In all other cases, which relate either to national hidden protectionism or to differences in legislation aimed at the protection of legitimate interests, among others consumer protection, the major difficulty will lie in the complexity of making the appropriate EU-wide legislation in a rapidly changing environment. However, one method for taking more efficient action could be based on the concept as expressed by the Council in its conclusions on normalisation approved on the 16th July 1984. In this text the Council noted that "the objectives being pursued by the Member States to protect the safety and health of their people as well as the consumer are equally valid in principle, even if different techniques are used to achieve them".[1] This declaration opened the way to what was then called "the new approach to product legislation" which later has been largely applied to other areas like professions.

1 Council Resolution of 7 May 1985 on a new approach to technical harmonization and standards (85/C/136/01), Annex I Conclusions on Standardization, Approved by the Council on 16 July 1984.

For financial services also, it should be possible to express in a short and essential legislation the ruling principles which, in every area of proved public interest, would be common to all member states, including the candidate countries. This would create consistency across the EU's Single Market. The operational content of these ruling principles of a permanent nature would then be defined by one or a number of Committees. These should be funded by the EU budget and bring together – in presence of the Commission and without forgetting the prerogative of the European Parliament – high level representatives of both the interested branches of business and the control bodies of the member states. In fact, this concept would represent a merger of the operating system of the standard bodies in industry and of the "Lamfalussy" committees. In other words, such an approach would leave the protection of the essential public interest in the hand of the public authorities while entrusting jointly to the private and public technicians under control of the EU-Commission and the European Parliament the implementation of the common principles defined by the legislation.

Clearly such a suggestion goes well beyond the task entrusted to ZEW and IEP and so brilliantly executed. Given however the interest not only of the businesses involved but essentially of consumers and the entire economy in creating a real level playing field for financial services, I considered it useful, in view of my past experience in the legislative activity of the EU, to suggest a possible approach with the aim of completing finally the Internal Market in such a relevant area. That it is worth attempting energetically, this report on the "Benefits of a working European Retail Market for Financial Services" has carefully outlined.

Paolo Cecchini
Director General, ret., European Commission, Brussels

February, 2002

PREFACE

The vision of a single European market is central to the future of Europe, bringing real benefits to all who live in the member states of the European Union. Great progress has been made in completing the single market for goods and services. Completing the single market for financial services, however, has taken longer than we had hoped. This is partly because of the careful regulation of financial services by each member state. This and other factors are impeding the development of a single retail financial market in Europe.

This has a high cost for European consumers, in terms of reduced choice, higher costs and lower economic growth.

We cannot afford to continue to move at the slow pace of recent years. Indeed, the successful recent introduction of the Euro will increase consumers' interest in purchasing the best products available anywhere in Europe. Political leadership and commitment are now needed on all sides to deliver the current plans for financial services reform and to agree the further steps needed. I am quite sure that the European Commission, the European Parliament and the Governments of member states do recognise the importance of completing the single market for financial services. The forthcoming discussions at Barcelona will provide an ideal opportunity for renewed commitment to faster progress.

The European Financial Services Round Table funded the preparation of this independent report, by respected academic institutes, because we believed it was important that the current debate on priorities should benefit from an objective economic assessment of the benefits to be gained from completion of the single market. The report emphasises not only the benefits for consumers of greater product choice and competition between providers, but also the significant benefits for economic growth of a more efficient financial services sector in Europe. Ultimately, a single market for financial services will strengthen Europe's competitiveness.

Completion of the single market will require not only radical thinking, but also strong management of the extensive changes needed, both in the regulation of the industry and also in its operations. The transition, however, will also provide a much needed opportunity to simplify regulations and to build a clear and consistent regulatory framework for the forthcoming accession of new member states.

Given the considerable benefits which can be achieved and the costs of standing still, it seems clear that the initiatives required to complete the single market in financial services should be given high priority and increased urgency.

Pehr G. Gyllenhammar
Chairman, European Financial Services Round Table

February, 2002

EXECUTIVE SUMMARY

1. Introduction

In spite of considerable progress toward European capital market integration following the completion of the Single Market and the introduction of the Euro, national borders still constitute a considerable de facto barrier for retail financial markets. Direct cross-border business between financial service suppliers and end consumers is still the exception. Against this background this report addresses the following questions:

– *How powerful is the integrating effect of ongoing market trends like internet and cross-border mergers and acquisitions?*

– *Which benefits could be realised if a higher level of integration could be achieved?*

– *Which obstacles are mainly responsible for incomplete integration?*

2. Deficits of retail market integration

Although stringent legal impediments to cross-border activities in banking and insurance no longer exist different indicators show a relatively low openness of national markets. The market shares of foreign banks in individual EU countries are relatively small compared to other wealthy industrial countries. Entry into national banking markets is largely occurring through mergers and acquisitions (M&A). Case studies on multinational banks reveal that factors like high fixed costs of market entry make greenfield investment less attractive than M&A based access strategies.

The picture is not very different for the insurance sector where direct cross-border sales without physical presence in the target market play only a marginal role. Again, cross-border M&As are the predominant entry strategy. In addition, integration indicators show a markedly lower integration level for the life than for the non-life insurance market.

European fund market data on the number of registered foreign funds seems to indicate a larger degree of integration. However, since many of these "foreign" funds are of the Luxembourg or Dublin "round-trip" type, this indicator is misleading. Market shares of true foreign funds only reach significant levels in big markets like Germany while some small markets are effectively completely dominated by domestic fund suppliers.

The impact of the internet on the integration of retail markets for financial services does not meet optimistic expectations even in the case of the most developed e-finance market, the market for online brokerage. The analysis of price differences and direct cross-border activities dispells illusions: although the internet is increasingly becoming an alternative distribution channel it does not by itself overcome fragmentation of retail financial markets in the EU.

3. Potential integration benefits

The report advances the following arguments and quantified estimates on the beneficial consequences of further integration of financial services markets for consumers and the economy in the EU as a whole:

- *Product choice would increase*, in particular for consumers in small countries who today suffer most from incomplete retail market integration. In these countries, the supply of available funds for example could be augmented by a factor between 10 and 20.
- There is considerable scope for falling prices resulting from a higher integration level in financial retail markets. Economies of scale could be realised. Calculations for the fund industry indicate a large cost savings potential: on the assumption that integration would lead to an average fund size in Europe similar to that of the US, there would be a *cost saving potential of about 5 billion Euro annually* given the present size of the EU fund industry. These cost savings would be particularly helpful in the ongoing European reforms of pension systems since fund products will play an important role for funded old-age pensions.
- Private borrowers could benefit substantially through *lower interest rates*. A simulation for the period of falling interest rates in the second half of the nineties shows: if competitive pressure in a more closely integrated financial market forced banks to adjust mortgage interest rates more quickly to falling market rates private borrowers would benefit. In terms of a 100,000 Euro mortgage loan these integration savings in interest payments would have amounted in the period 1995–1999 to annually 2,550 Euro in Italy, 1,690 Euro in Spain, 1,580 Euro in Portugal and 790 Euro in Ireland.
- Retail market integration would probably also reduce the well-known home bias in private investors' portfolios. Performance calculations for national, European and world portfolios show that investors could significantly increase the Sharpe ratios of portfolios. Often the Europe-wide diversification is already sufficient to harvest all the *benefits of international diversification*.
- Furthermore, a larger degree of financial integration would be associated with *higher economic growth*. Theoretical considerations and insights from the relevant empirical literature back the assumption of a significant link between financial integration and growth. World-wide cross-country samples show that differences in financial integration between countries amounting to one standard deviation of the relevant integration indicators can explain annual growth differences of 0.5 – 0.7 per cent. Although these results do not cover all present EU member states they indicate roughly the potential for growth through financial integration: in terms of the EU GDP of the year 2000 the lower per cent figure of 0.5 would mean an additional growth effect of 43 billion Euro annually. A quantification of potential employment effects associated with more financial integration is difficult to make. They crucially depend on the flexibility of labour markets and the progress in labour market reforms.

- Finally, more financial integration is rewarded by a growing *international role of the Euro* because the efficiency of a currency's financial markets is among the determinants of its global acceptance. A greater acceptance of the Euro could in turn lead to additional benefits due to higher seigniorage, falling liquidity premiums and transaction costs.

4. Obstacles

A number of obstacles impedes the development of unified financial retail markets in Europe. There are policy-induced obstacles like different taxation, consumer protection or supervision arrangements that are capable of alteration, and there are natural obstacles like differences in language and culture that can not realistically be addressed by national or European policymakers. The impact of the different types of obstacles varies according to product type.

- For *insurance* products, a lack of confidence in the long-run reliability of unknown foreign suppliers is a particularly relevant obstacle. Furthermore, discriminatory tax practices and national differences in consumer protection due to different national policies and interpretations of the "general good" are important obstacles in the insurance business.
- The *internet-based* financial retail business is confronted with the following obstacles in cross-border activities: the need to design a variety of national marketing strategies, market peculiarities related to regulatory differences in consumer protection and supervision, the high costs of cross-border payments, the problems of cross-border identification of new customers, the heterogeneity of technical systems of stock exchanges and the consumer preference for "handshake", the physical meeting with the agent of a new supplier.
- Since successful management of asymmetric information problems is crucial for successful *credit business*, limited cross-border access to public credit registers and private credit bureaux is a particular integration obstacle for the credit market.
- For *funds* the outdated definition of UCITS in the directives limits cross-border marketing of innovative fund products. In addition, the burden of registration in a target market raises the costs for entering a national market. Furthermore, host country responsibility for supervision of advertising and marketing together with tax discriminations hamper the emergence of a unified fund market. The problems are aggravated by distribution channels that are still biased in favour of domestic fund companies.
- There is the danger that new obstacles are created as a consequence of national pension reforms. The German example shows that very specific national requirements on new *pension products* can constitute additional barriers to entry for foreign suppliers.

5. Some policy conclusions

A strategy based on an attitude of "wait and see" is not justified because ongoing market trends indicate that integration is unlikely to be completed without adjustments to the regulatory framework. The substantial potential benefits for consumers and economic growth clearly show that it is worthwhile to push hard for more integration of retail financial markets. Any integration strategy should aim to simplify direct cross-border contact between suppliers and consumers. This contact would speed up convergence of prices and promote a wider product choice everywhere in the EU. The need for political action also comes from the delicate fact that the "costs of non-Europe" are higher in smaller and poorer member countries than in the bigger and richer ones. While the Financial Services Action Plan and other legal initiatives properly address a number of integration obstacles, more needs to be done. Proposals for reforms are listed below. This is not an exhaustive list of recommendations. It briefly addresses the most burning issues; a detailed specification of the reform options would certainly need further analysis.

- It is important to devote more effort to ending *discriminatory tax practices* that currently shelter some national retail financial markets from foreign competition, and which do not conform with the EU Treaty. Examples concern the markets for life insurance and investment funds.
- Differences in *consumer protection* rules among the 15 EU countries render a pan-European marketing strategy and standardised products impossible. This issue is a critical policy-induced obstacle and could best be addressed by the creation of a consistent uniform level of protection with harmonisation on that basis. Three specific recommendations are:
  - The debate on derogation from the principle of home country control in the e-commerce directive should be reopened.
  - Furthermore, the interpretation of the "general good" provision should be harmonised and/or restricted.
  - There is a need to arrive at a unified definition of pension products in order to improve the conditions for developing a pan-European market for this high potential market segment.
- With FIN-NET the Commission has initiated an important infrastructure for creating *consumer confidence* in the legal safety of cross-border financial services. However, the existence of FIN-NET so far is not common knowledge. An information campaign is necessary to make this network of European ombudsmen better known and better understood, at least to the financial media and the staff of banks and insurers.
- With regard to *supervision*, there are short-, medium- and long-term options:
  - In the short-run it would be helpful if the supervisory committees devoted more effort to the consistency of rule-books, the standardisation

of reporting requirements and the harmonisation of supervisory practice.

- In the medium-term a serious reform debate should be initiated, reflecting the possible advantages of a two tier supervisory system where multinational companies could opt for supervision on a European level.
- With a long-term perspective, more thought could be given to the possibility of establishing a single European supervisory authority, especially if effective cooperation among 25 to 30 national agencies after enlargement proves to become too difficult.

- There is a huge gap between the *vision* of the EU as the most dynamic economy in the world and the *reality* of still fragmented EU-markets. In order to reduce this gap, the whole process of European regulation of financial services needs to be speeded up and member-states have to overcome their national policies of preserving market barriers or even re-establishing new ones. Otherwise it will be impossible to achieve the strategic objective of the Lisbon-process of a more deeply integrated European Union which will be able to match the challenges of globalization and to secure full employment by 2010.
- Finally, while the study has shed light on important aspects of the enduring "cost of non-Europe" further analysis is required. Two issues deserve to be looked at more closely given their enormous complexity: First, the implication of national pension reforms for integration and second, the adjustment of consumer protection regulation to the changing needs of the internal financial retail market.

1. INTRODUCTION

1.1 Focus and guiding questions

Looking back over the last decade it can be said with some justification that significant progress has been achieved on the way towards fully integrated financial markets in Europe. The 1993 Internal Market initiative and the Euro introduction in 1999/2002 constitute important milestones. The integration process has further been intensified by market developments like the surge in mergers and acquisitions and by technological innovations like internet based distribution. As a result, some market segments today do no longer have a national character. A prominent example is the Euro money market where high capital mobility together with the end of exchange rate risk have created a unified European market. Similarly, integration has made great progress in the securities markets and also in financial services markets for big industrial and financial players: today, these companies choose their products on a European or even a global scale.

Nevertheless, this success should not obscure the fact that integration of financial services markets is still a long way from the level of integration that exists within national markets. Particularly for *retail financial services* national borders still constitute a considerable de facto barrier. Even in the Euro age it is extremely rare for private individuals to compare domestic offers of, for example, life insurance or mortgages with offers from suppliers in other countries of the single currency area. Up to now, insurance companies or banks can only realistically expect to reach consumers in other EU countries if they establish some form of physical presence in the target country – be it through a greenfield investment, a cross-border merger or acquisition or some cooperative arrangement. The absence of frequent direct cross-border links between financial service providers and retail consumers holds true despite the fact that the Euro has made product comparisons easier and that the internet has reduced information costs to a considerable extent.

This situation poses challenging questions with high relevance for national and European legislators:

- *How powerful is the integrating effect of ongoing market trends like the establishment of the internet as a distribution channel or the increasing number of cross-border mergers and acquisitions?*
- *Which micro and macro benefits could be realised if a higher level of financial services integration can be achieved?*
- *What are the obstacles to cross border activities in retail financial services?*

These questions are closely interdependent and can only be addressed in a comprehensive analysis: the extent of achievable integration benefits depends very much on the nature of the most relevant obstacles. If natural factors like language differences are crucial there is not much that the European legislators can do. The case is different if policy-induced obstacles like tax discrimi-

nation or regulatory barriers have a major responsibility for the continuing importance of national borders.

This report addresses the above mentioned questions in a comprehensive way. The analysis starts in section 2 by giving an overview of the present level of integration. For different financial services markets and products the status quo and the main trends are described together with an assessment of the integrating role of the internet. Section 3 focuses on the potential benefits of a higher degree of market integration. This section presents new insights into macro- and microeconomic types of benefits from financial market integration. For some product types new information is presented that demonstrates that integration would significantly benefit consumers both in terms of product choice and cost efficiency of financial services. These benefits can only be realised if the causes of imperfect integration can be changed by politicalmeasures. Therefore, in section 4, an assessment of the most relevant obstacles is the logical next step. Finally (section 5), the report concludes by stressing some priorities for political actions.

1.2 Preparation of the report

This report summarises the results of a study that has been carried out by an independent research team consisting of ten experts headed by Friedrich Heinemann, Zentrum für Europäische Wirtschaftsforschung (ZEW, Mannheim), and Mathias Jopp, Institut für Europäische Politik (IEP, Berlin). The study was initiated and sponsored by the European Financial Services Round Table (EFR). The EFR represents leading European banks and insurers and is devoted to the completion of a single market in financial services (see appendix 2). The design of the study, the choice of methods, the ongoing work and the results were constantly discussed with an international advisory board consisting of well reputed academics from different European universities and experts from leading European banks and insurers. The advisory board was chaired by Paolo Cecchini, Brussels.

Dealing with the research questions as outlined above is an ambitious task. The starting point was even more difficult because of the very limited amount of literature on integration of European retail markets due to, not least, problems of data availability. The Cecchini Report of 1988 is one of the few examples dealing explicitly with retail products. Most academic work since then related to the measurement of financial market integration in Europe does not say much about the integration of retail markets but looks at links between the developments in various national capital markets e.g. in terms of interest rate or equity price interdependencies. While these studies, at least for the Euro period, regularly indicate a high level of market integration they do not say much about integration of financial services markets for end consumers.

Thus, this study tries to contribute to filling this gap and to learn more about the possible benefits of closer integration and the nature of obstacles to integration. The authors reckognise that this study will not be able to cover all aspects of the questions outlined above and that more research needs to be done

to fully understand all aspects of the integration problems of the retail financial services markets in Europe. Nevertheless, the results of this work might be helpful for the European legislator and others to define priorities for the further integration strategy that could bring massive benefits to consumers and the EU economy as a whole.

The financial services sector consists of a multitude of different markets. The level of integration, the impact of different integration obstacles and the extent of benefits in the event of their partial or full removal might differ widely between these individual markets. In order to take care of this diversity the analytical work was structured into modules with each one addressing a different market and/or a different aspect of the guiding questions described above. Modules focussed on specific markets or products were complemented by research with a more holistic approach. In addition to the wide use of existing data bases, further data were collected through questionnaires addressed to leading banks and insurers in Europe (see section 4.1) and to leading European online brokers (see section 4.2.2).

This report summarises the main insights of all these analyses and attempts to present these results in a non-technical style although in some analytical modules extensive use of up to date econometric methods was made.

Readers interested in the details of the work, the methods used and the full documentation of all results are referred to the background papers listed in Appendix 1 which are all downloadable in full text from www.zew.de/erfstudyresults/ or www.iep-berlin.de/forschung/eu-market/.

2. STATUS QUO OF INTEGRATION: DEFICITS ON RETAIL MARKETS

2.1 Towards integrated financial markets

The 1990s have considerably improved the regulatory preconditions for closer integration of European financial services markets. For the banking markets, the final lifting of capital controls and interest rate deregulation and the implementation of the second banking directive (see Table 1) were important steps towards the opening of national markets. For insurance, the third generation of insurance directives from 1992 was expected to put in place the desired quantum leap for completing a single market in the insurance sector too. Since 1999, the single currency has overcome a further major obstacle to an easier cross-border marketing of financial services.

Table 1:
Liberalisation of Banking Activities in EU Member States

	Lifting of capital controls	Interest rate deregulation	First Banking Directive	Second Banking Directive
Belgium	1991	1990	1993	1994
Denmark	1982	1988	1980	1991
France	1990	1990	1980	1992
Germany	1967	1981	1978	1992
Greece	1994	1993	1981	1992
Ireland	1985	1993	1989	1992
Italy	1983	1990	1985	1992
Luxembourg	1990	1990	1981	1993
Netherlands	1980	1981	1978	1992
Portugal	1992	1992	1992	1992
Spain	1992	1992	1987	1994
UK	1979	1979	1979	1993

Source: European Commission (1997)

These major changes have clearly transformed European capital markets. A single monetary market was born as a consequence of the introduction of the Euro involving the twelve member states of the Euro area. Furthermore, a corporate bond market has emerged providing larger companies with a new source of finance. On an unprecedented scale, mergers and acquisitions have led to the creation of multinational banks, insurers and conglomerates. In addition, cross-border mergers of stock exchanges have created truly European platforms for equity and derivative trading (DANTHINE ET AL., 2000).

Retail Markets – the special case

In spite of these successes, it is less clear whether integration reached a similar level in retail markets. Of course, to a certain extent private households also benefit from the general level of achieved integration in as far as they can now invest directly into the whole Euro universe of securities without exchange rate risks. In theory, they would also have the choice between all kinds of financial services like insurance polices, bank credits, payments services of a large number of suppliers in the Euro area from Finland to Greece. De facto, however, every day experience indicates that cross-border sales of retail financial services are still the exception. So, the analysis starts with some short diagnosis of the status quo in financial services market integration.

2.2 Methodological considerations

In order to assess market integration methodological approaches exist that are either price or quantity related. Price related measures make use of the fact that integration should lead to a price convergence for homogeneous products across markets ("law of one price"). Quantity related measures rely on the fact that integration should boost cross-border transactions. Both approaches are being frequently applied in integration studies dealing with wholesale financial markets (for a survey, see background paper SCHÜLER AND HEINEMANN, 2002).

For retail markets in Europe, hardly any up to date analysis for either approach exists. The CECCHINI REPORT of 1988 is one of the rare examples presenting price comparisons for retail financial services across European countries. This kind of approach has not been updated since on a pan-European scale. This is obviously due to the fact that it is hard to find products for different countries that are indeed fully homogeneous. Life insurance contracts in Britain and in Germany are very different when taking into account all product characteristics. Interest rates for bank loans across countries are only fully comparable if the currency, the borrowers' characteristics and all details of the loan contract are identical.

To cope with these problems, our study applied a mixture of quantity and price related integration measures depending on data availability. The study considered how certain indicators of foreign suppliers' presence in domestic markets have changed during the nineties. Some price related integration measures could be obtained for the market for online brokerage (see section 2.6) and from an ECB database on retail interest rates (see box 1).

A further methodological comment is necessary concerning the analytical separation between banking and insurance. In the future, this separation could become increasingly artificial given the recent trend towards bancassurance. Links between life insurance companies and retail banks are becoming more common through cooperation, joint venture or acquisitions in most European countries. For the time being, however, this trend towards integrated financial retail companies is only in the beginning so that it still seems legitimate to stick to the separation for analytical purposes.

Box 1: Long-run interest links ("cointegration") as a measure of integration

With the ECB data base on national retail interest rates an interesting data source exists that can be used for measuring the degree of retail market integration in Europe. Close ties between retail rates across countries can be taken as a sign of high integration. Unfortunately, national rates in this data base are not fully harmonised and might differ in important but non-observable characteristics such as the creditors' average default risk or size of credit. This problem precludes simple tests for the "law of one price" in fully integrated markets.

Here, a well established econometric tool of time series analysis is helpful – cointegration analysis. Cointegration tests look for a long-run link between time series without requiring a mechanical close tie between these series. Between integrated national markets this kind of long-run tie should be detectable. Thus, the existence of cointegration can be taken as an indicator of financial market integration.

This analytical strategy has been applied in our project and is documented fully in the background paper SCHÜLER AND HEINEMANN, 2002. In order to allow for the existence of exchange rate risk as a major determinant of interest rate differences until the introduction of the Euro in 1999, the analysis is not based on interest rate levels but on the spread between retail and market interest rates. The results show a different degree of integration across various markets. Little cointegration is found in the market for *mortgage loans* to households. So far there is not a single European mortgage loans market although there is some evidence for integration in Belgium, Germany, the Netherlands and, perhaps, Spain. The market for *consumer loans* does not show any sign of integration. The European markets for short-term and for medium and long-term *loans to corporate enterprises* seem to be more integrated. This might be explained by the fact that enterprises may have easier access to alternative sources of finances be it through a credit from abroad or through the issue of a corporate bond. For the *time deposits market* the estimations provide some evidence that this market is integrated to a large extent. This seems to be plausible since, traditionally, time deposits are strongly linked to the money market. With the introduction of a single currency a single European money market emerged which in the case of time deposits may have enforced integration. A possible explanation for the lack of integration in the *savings deposit market* may be that savings deposits are usually made by savers that attach much importance to a personal customer-bank-relationship. Hence, cross-border competition is probably relatively low, hindering integration in this market.

2.3 Integration trends in banking

By the seventies and eighties the share of foreign assets and liabilities of EU banks had increased and this process accelerated in the nineties (for details on these statistics see the background paper BUCH AND HEINRICH, 2002). In contrast to that, market shares of foreign banks in EU countries remain relatively small. Exceptional cases are Ireland, Luxembourg and the UK, i.e. countries which host international financial centres and/or have a long tradition of a very liberal regime towards foreign banks. On average, the fraction of banking assets being held by foreign-owned banks in 1999 was 16 per cent for EU countries which is significantly below the average for high income countries world-wide (34 per cent). A further indicator of relatively low integration are low correlations among the return to bank equity across European countries: for the period 1979 to 1996 the average correlation coefficient is 0.05. Average

return correlations for profits of banks across US regions, for instance, are substantially higher with 0.44 (background paper BUCH AND HEINRICH, 2002).

Aggregate data reveal that the entry into national EU banking markets occurs mainly through mergers and acquisitions (M&A), even though the majority of M&A activity between 1985 and 2000 (84 per cent) involved domestic financial institutions only. Of the cross-border M&As, 5 percentage points involved two European institutions and 11 percentage points involved mergers between European and non-European institutions (ECB, 2000).

In order to complement the information obtained from aggregate data, case studies of market access strategies in the EU banking sector have been conducted within the framework of our research (for details see background paper EPPENDORFER ET AL., 2002). The analysis focused on the cross-border strategies of *Banco Santander Central Hispano* (Spain), *Nordea Group* (Sweden), *BNP Paribas* (France) and *HSBC* (United Kingdom). Table 2 (p. 23) presents as an example a summary of the strategies of the Nordea group.

Table 2:
Market Access Strategy of Nordea Group

General Company Data	• MeritaNordbanken, Unidanmark and Christania Bank form the nordic financial group Nordea (almost € 20 bn market capitalisation per August 2001); • Nordea Group has a strong distribution network throughout the Nordic and Baltic Sea region which comprises 1,481 branch offices or Internet-service centres with 37,630 employees; • Nordea is present in 22 countries including 14 countries outside the Nordic and Baltic Sea region;			
Pan-European strategy	• "One-bank-shopping-concept": to provide a single point of entry for customers to enable them to get access to the entire supply of services of all integrated banks; single brand Nordea for all banks from December 2001; • Branches network in the Nordic region, representative offices and cooperation with local banks in the most important European cities and countries; • Integrated Internet-banking: Solo as a full-service Internet bank;			
Recent expansion activities				
• Target countries	Finland and Sweden	Denmark	Norway	Sweden
• Date of new market entry initiative	1998	2000	2000	2001
• Entry method	• Merger between Merita (Fin) and Nordbanken (S) into MeritaNord-banken with Nor-dic Baltic Holding as the bank's holding company;	• Acquisition of Unidanmark by MeritaNord-banken;	• Acquisition of Christiania Bank og Kredtkasse to form Nordea Group;	• Acquisition of Postgirot (Swe) by Nordea;
	2000: Integration of Christiania Bank og Kreditkasse (K-Bank) (Nor), Merita Bank (Fin), Nordbanken (Swe) and Unidanmark (DK) into Nordea Group;			
• Products offered	• Allfinance (incl. life insurance products in all nordic countries and non life insur-ance products in Norway, Denmark and Finland) • Cross-selling potential due to the integration into Nordea			
• Distribution channel	Multi-channel (branches, telephone, internet)			

Source: DATAMONITOR (2000) and NORDEA (2001), for details and further case studies see background paper EPPENDORFER ET AL. (2002).

These case studies confirm the macroeconomic observation on the relative importance of different market access strategies. Greenfield investments through the establishment of new branches or subsidiaries is of no importance today due to high fixed costs and the importance of well known brand names. Instead, cross-border market shares are acquired either through M&A or cooperations and strategic alliances. Of increasing importance for market entry is also the establishment of telephone and internet banks. Each of the examined strate-

gies, however, still has to deal with considerable barriers to market access. The case studies underline the importance of the following obstacles: different national tax legislation, different national consumer protection rules, different national accounting standards and bankruptcy principles, different solvency control, different take-over directives and different national supervision. The predominance of M&A based strategies can be interpreted as the companies' reaction to bypass many of these obstacles by acquiring the specific know-how about the peculiarities of the national market. In addition, an acquisition is often the only way to reach the critical market size within the available time period.

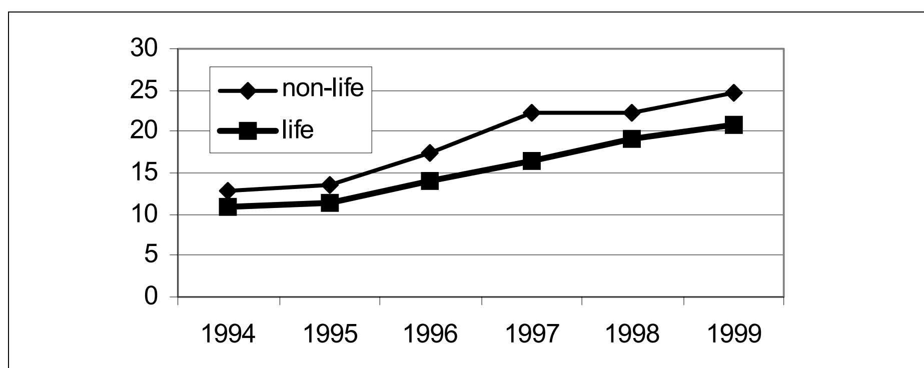
2.4 Integration trends in insurance

For EU insurance markets, in qualitative terms, a similar message concerning dominant cross-border strategies emerges: by far the most important strategy is cross-border M&A. Figure 1 reveals that the market share of foreign controlled insurers in national EU markets has been constantly increasing during the second half of the nineties although the respective market share of 20 to 25 per cent is still rather low. In addition, the indicator shows a lower integration level for the life insurance market.

Although some big companies are consequently pursuing pan-European strategies, they all still have a significantly stronger presence in their home markets than in Europe as a whole. Several national market leaders do not even have any presence at all outside their home markets (CREAN ET AL., 2001).

The lower degree of integration of the life insurance sector (compared to non-life) is particularly problematic given the booming development of this sector and its great importance for old age pension savings. In 1999 life insurance premiums paid in the EU amounted to 59 per cent of all insurance premiums, compared to a share of only 45 per cent in 1993.

Figure 1:
Market share (premium based, in per cent, weighted averages)
of foreign controlled insurers in domestic EU markets

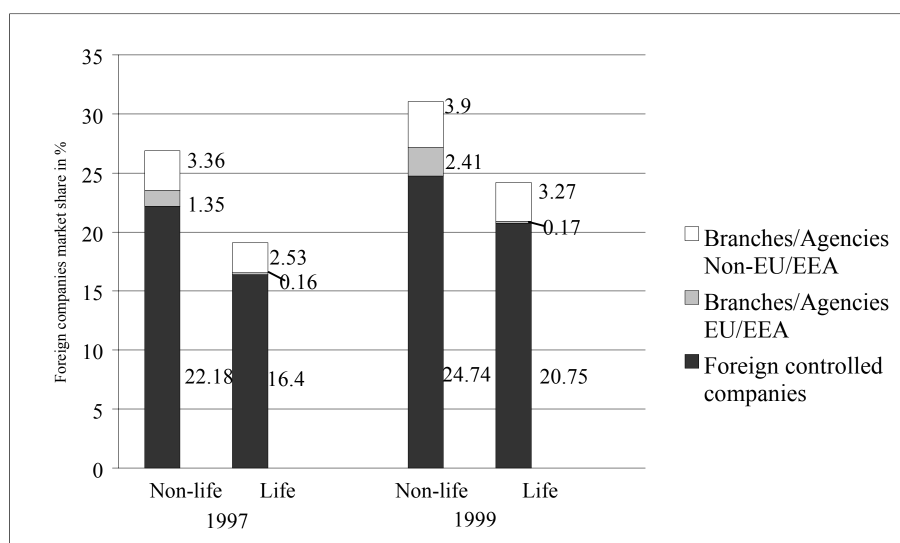


Source: Background paper BECKMANN ET AL. (2002), calculations based on data of the OECD Insurance Statistics Yearbook 2001. A company is regarded as foreign controlled if foreign share in capital is at least 50 per cent.

Direct cross-border sales without the use of a physical presence play only a marginal role: in 1999, only 1.9 per cent of total non-life insurance premiums were written directly cross-border, for life insurance this number is even lower at 0.6 per cent (SWISS RE, 2000).

Figure 2 combines the foreign market shares through foreign controlled companies and through foreign branches and subsidiaries. For the latter, a distinction is made between branches and subsidiaries from EU/EEA countries on the one hand and Non-EU/EEA countries on the other hand. This broader data supports the finding that M&A is the dominant form of entry into a foreign market and that integration in the insurance sector is generally increasing, slowly but steadily, with life insurances lagging behind the non-life sector.

Figure 2:
Foreign market shares in life and non-life EU insurance markets (premium based)



Source: Background paper Beckmann et al. (2002), calculations based on data of the OECD Insurance Statistics Yearbook 2001.

2.5 A retail product example: the EU fund market

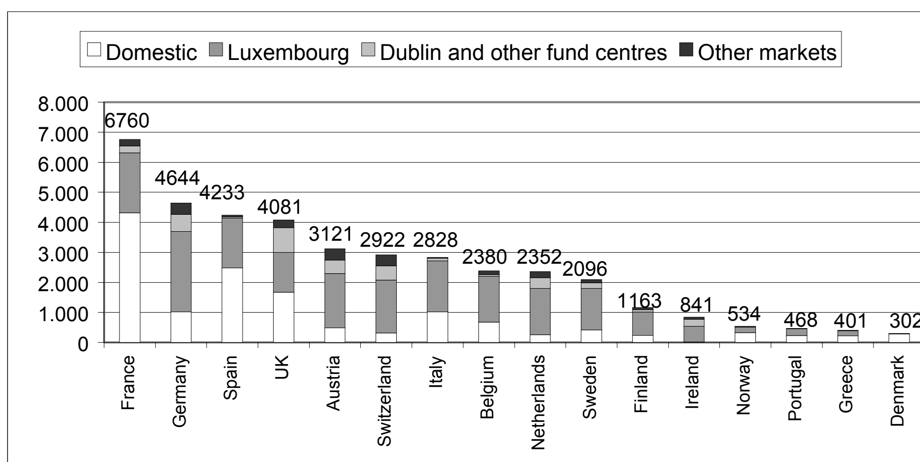
Judged solely on the basis of foreign banks' and insurers' market shares in domestic markets, it is hard to tell the extent to which retail consumers already benefit from integration in terms of a larger product choice, increasing quality and cost savings. Here, the weak data situation does not allow a full answer.

Nevertheless, in order to shed some light on the very limited progress in integration from the retail consumer's perspective, our study focused on the case of the market for investment funds (for details and further data see background paper HEINEMANN, 2002). Apart from sufficient data availability there are further reasons to look at this specific product:

- First, fund products play a rapidly increasing role in private portfolios. On a per capita basis fund investment of European households increased from 4,000 Euro in 1995 to 11,600 Euro in 2000.
- Second, it is to be assumed that this role of funds in private portfolios is going to grow given recent developments in European pension policy. Many countries are reflecting on or already implementing reforms that create a funded pillar for retirement pensions. These reforms are indispensable given the *"pay as you go"* schemes are unsustainable due to an ageing population. Independently of the details of national legislation investment funds will play an important role in these privatised retirement schemes.
- Third, the European fund industry looks back at a long history of liberalisation since the legal precondition for opening national markets were created in 1985 when the UCITS ("undertakings for the common investment in transferable securities") directive took effect.
- Fourth, problems with respect to consumers' access to information should not play such a prominent role as for other financial services. Today, fund rankings provided by companies like Standard & Poor's are easily accessible and provide comparisons in regard to the quality of domestic and foreign products. Thus, the low degree of integration of the fund market probably hints at an even lower degree for other retail product markets where information problems are more widespread.

Figure 3 (p. 27) shows the number of funds notified in each country and the domicile of these funds. At a first glance, the data seems to indicate that integration of European fund markets is high since in most countries (with the exception of Denmark, France and Spain) there are more foreign than domestic funds available. However, this is an incomplete picture. Foreign funds are by far dominated by funds domiciled in Luxemburg, Dublin and other tax favoured locations. These funds are often of the "round trip" type: although being cross-border in a formal sense they are designed for a particular national market and the choice of the domicile is driven by tax reasons.

Figure 3:
Number of funds available in national markets (31 March 2001)



Source: European Fund Information Service, London, derived from Lipper data. The category 'Dublin and other fund centres' includes the Channel Islands, Bermuda, Liechtenstein and the Netherland Antilles. Luxemburg is not included on the horizontal axis since here categories "domestic" and "Luxemburg" coincide.

Data on foreign fund market shares as published in different research material are not consistent. In an unpublished paper of summer 2001, European Fund Services estimates the market share of pure foreign funds (round-trippers are excluded) in Germany for mid 2000 to be around 13% in terms of assets. Foreign market shares in France, Italy and Spain are estimated by the same source to be no higher than 5%. In Sweden, the market share of foreign funds is reported to be even less than 1%. MOODY'S INVESTORS SERVICE (2000) estimates the market share of foreign funds in Germany to be much lower at 2.4% of assets and somewhat higher in Italy at 7.6%. Thus, all available asset based data show that true foreign funds still play nothing but a minor role – even in a market with a long history of liberalisation, a common currency since 1999 and less burdened by information problems than other financial services markets.

2.6 Removing barriers? The impact of e-finance

Even with highly imperfect integration, political action is only required if ongoing market trends are not powerful enough to overcome the remaining obstacles. The increasing use of the internet as a distribution channel is one of the trends that could possibly help to overcome national borders. The internet revolution has sometimes fuelled high expectations of overcoming national borders. This euphoric view can be summarised in the following way: due to the technical advances, consumers are no longer bound to national or regional firms, they are able to shop around at all companies world-wide that provide services online. On the supply side, the internet eliminates a number of processing steps and labour costs, and it avoids or at least reduces the fixed costs

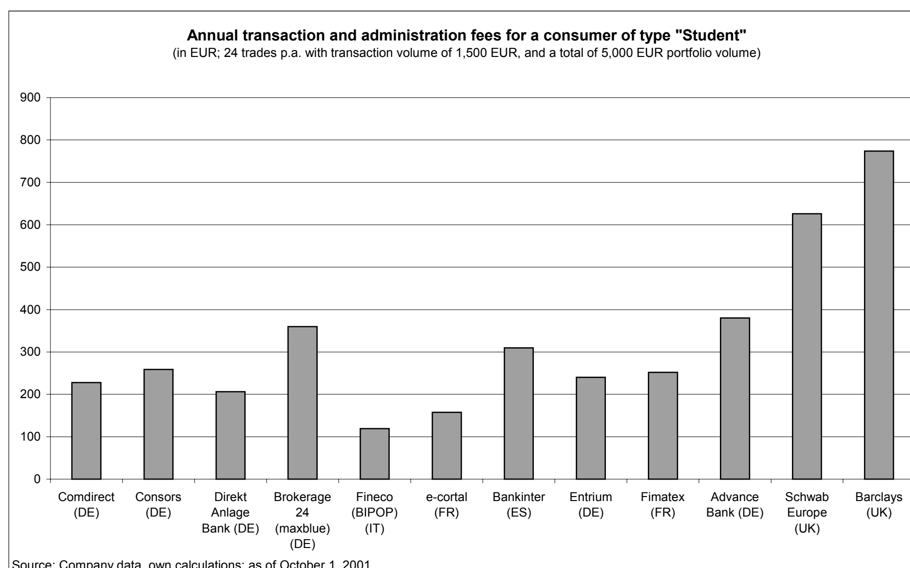
of branches and related maintenance. However, this euphoric view might be erroneous or at least premature. It overlooks the fact that the internet does not necessarily overcome all of the existing barriers to cross-border marketing of financial services such as regulatory problems related to consumer protection or the preference of consumers for domestic suppliers.

In order to understand more about the integrating potential of the internet in financial services a thorough analysis of the market for online brokerage was necessary (see background paper SCHÜLER, 2002). Online brokerage represents the services of internet based retail banks that provide all services centred around the purchasing and selling of securities to the private consumer. This particular type of e-finance activity offers two analytical advantages compared with other emerging forms of retail e-finance. First, in some EU countries this market is already highly developed: at the end of 2000 there were already 3.74 million online brokerage accounts in Europe (JP MORGAN, 2001). Second, price comparisons within and across countries are facilitated by the fact that there is a largely homogeneous service, the purchase or sale of stocks for a given amount of money.

The analysis proceeded in the following way: prices (transactions costs and other administrative charges) of the leading 12 European online brokers representing a market share of 70 per cent were compared for five different customer groups. Figure 4 (p. 29) depicts the resulting pricing differences for the investor type "student" (for the other price comparisons and details see background paper SCHÜLER, 2002).

The comparisons reveal substantial price differences for all investor groups. An important result in the integration context is that "between" variance of prices across countries is larger than "within" variance in a country. Even this internet based market is thus characterised by national price levels. In addition, the comparison with the US benchmark shows that price differences between EU markets are substantially larger than price differences within the US market for online brokerage.

Figure 4:
Annual costs of online brokerage for consumer type "student"



Source: Background paper SCHÜLER (2002).

The national character of the market also becomes obvious by looking at prices charged by direct brokers and their foreign subsidiaries. Here, a pattern of "following the market leader" can be detected. Online brokers do not export their home prices to the target market but adjust to the conditions in the target market.

Finally, direct information of cross-border marketing strategies of online brokers in the EU underlines the continuing relevance of national borders on this most developed e-finance retail market: interviews among leading European online brokers showed that with few exceptions these companies do not presently serve clients with residence outside the national borders. Clients in other EU markets are mainly addressed through newly established or acquired subsidiaries in these target markets.

The message of this assessment of the e-finance channel stresses the need for an active integration policy: although the internet is increasingly becoming an alternative distribution channel for the marketing of financial services, it does not by itself overcome fragmentation of EU retail markets. Although it would offer the technological possibility for supplier-consumer-contacts independent from distance and country of residence, this opportunity is not currently exploited – even in the most developed e-finance sector in existence.

3. POTENTIAL INTEGRATION BENEFITS

The preceding section backs the view that financial services markets are still far from fully integrated. While security markets in the Euro area are already closely integrated and the financial industry is slowly transforming towards a globalised sector, retail markets in EU countries still appear to have a rather national character with substantial price discrepancies and also significant differences in product availability between national markets.

Further integration of retail markets would be associated with not only different kinds of benefits for consumers but also for the economy as a whole. It is the purpose of this section to assess these advantages in qualitative terms and also to illustrate the benefits in quantitative terms. These considerations demonstrate that any political action fostering financial services integration is highly consistent with other official objectives of EU policies such as boosting growth and employment or supporting the global role of the Euro. Calculations demonstrate that the advantages of retail financial market integration are non-trivial in monetary terms.

Table 3 summarises the potential benefits that are included in this study's analysis. It must be stressed that the analysis of this chapter is closely linked with the next chapter's focus on the nature of existing obstacles to integration. Only to the extent that important obstacles to integration can be removed by policy makers can these benefits be realised through appropriate action by those responsible.

Table 3:
Benefits of integration on EU markets for financial services

Consumer benefits	Macroeconomic benefits
– product choice – pricing, economies of scale argument (including quantifying examples for investment funds) – pricing, competition of suppliers argument (including quantifying examples for credit interest rates) – improvement in portfolio allocation (including quantification of diversification advantages through European portfolios)	– stimulation of capital accumulation – stimulation of financial market development – improving efficiency of capital allocation – positive growth and employment effect (including estimation of growth equation) – impact on the global role of the Euro

3.1 Consumer benefits

3.1.1 Choice

The argument is simple: if national borders ceased to constitute limits to retail markets in the EU, a European citizen would have the de facto choice among financial services supplied anywhere in the Community. However, quantifying this advantage is difficult. The central problem is that *de jure*, due to the provision of the common market, citizens have access to financial services everywhere in the EU. Even if *de facto* this access does not often exist, the resulting limited availability of product alternatives is hard to measure.

The data on registered funds in European markets presented in figure 3 above (section 2.5) allow a quantification of the potential increase in product choice. Although a consumer is not prohibited from buying investment funds that are not registered with his domestic authorities this is de facto precluded by severe tax disadvantages of non-registered funds. Thus the number of registered funds in each country immediately reveals a particular type of "cost of non-Europe" carried by consumers in small European countries. These investors suffer from a lack of choice among financial products. While investors in big markets can choose among thousands of funds, availability is restricted to a few hundred in countries like Denmark, Greece or Portugal. Full integration would therefore multiply the number of available fund products from the perspective of small countries' consumers by a factor 10 to 20.[2]

One characteristic of the results of the funds analysis can most likely be generalised: consumers in small EU countries would tend to benefit even more from further integration than consumers in large countries. The reason is that the commercially attractive large economies already attract more foreign suppliers. Due to the market potential of countries like the UK, France or Germany suppliers are willing to invest heavily in order to cope with specific entrance barriers in these countries. At the same time smaller countries are often ignored in internationalisation strategies because their minor market potential cannot pay back the access costs in a limited time frame. If it were possible to establish easy cross-border contacts between suppliers and consumers everywhere in the EU this would particularly widen the product choice for consumers in small countries.

3.1.2 Pricing

The stronger competition resulting from more integration should increase the pressure on prices for financial services of a given quality. Price differences that can not be explained by differences in quality indicate potential consumer benefits through more integration. This is why the above findings on price differences in the market for online brokerage alone already indicate substantial scope for price reductions in some countries.

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2 Of course, integration of fund markets would most likely lead to a consolidation in the number of funds so that on the basis of today's fragmented market data the increasing choice can not be precisely quantified.

Generally, however, the evaluation of benefits based on price differences is difficult due to data problems and the heterogeneity of products – both problems are particularly severe for financial services. Therefore, this study followed different pricing related strategies. For fund products, the benefit calculations are based on the cost function of running investment funds. For credit products, the analysis looks into the link between market and retail interest rates ("interest rate pass-through") and asks how integration would affect this link.

Economies of scale in the management of funds

On average, funds domiciled in the EU are much smaller than US funds: while in the end of the first quarter 2001 a typical EU fund had assets of 176 million Euro, the average US fund with 910 million Euro was more than five times larger. Fund size differs considerably between EU countries – the extremes are Italy with 417 million Euro and Finland with only 56 million Euro (for details and full data sources see background paper HEINEMANN, 2002).

The smaller European size has different reasons. The long history of funds and the large weight of private savings for retirement pensions in the US have fostered the development of these products. But the smaller average fund size in Europe is also a consequence of market fragmentation. If borders did not play a role in selling funds, average fund size and country size would not be correlated as they obviously are. In the case of a separation of markets, a national product is largely restricted to national consumers, implying the correlation between country and fund size.

Fund size is a significant driving force for average costs. This intuitively appealing hypothesis was supported by a thorough study of the US Securities Exchange Commission in 2000 (SEC, 2000). Based on 1999 data for almost 9000 funds the study explores the determinants of fund costs. Included in these expenses are management fees, but no sales loads and no transaction costs of a fund for the selling and buying of securities.[3]

While the descriptive view already reveals a negative correlation between the volume of assets and expenses (see figure 5, p. 33), this finding alone would not provide a robust basis for the analysis since a multitude of determinants explain the costs of running a fund and could bias the results: equity funds are more expensive than bond funds. Funds investing in domestic assets are cheaper than internationally investing funds etc. Hence, a multivariate regression is more reliable than a simple descriptive view.

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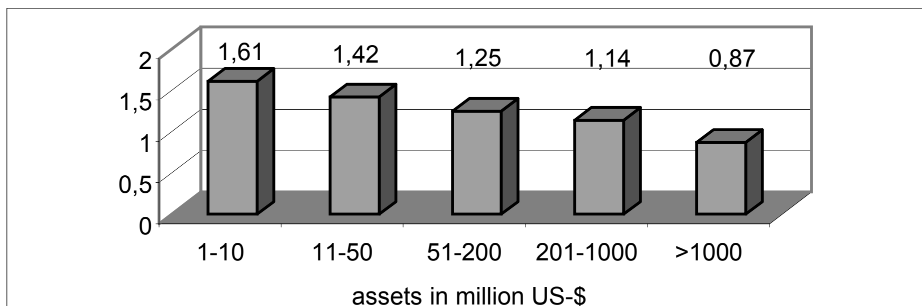
3 The reason for excluding sales loads results from data problems: for a sensible integration of these costs on an annual basis one would need to know average holding periods for each fund. Apart from that, data on effectively paid sales loads are not obtainable. The exclusion of sales loads should not bias the SEC analysis' results too much since the basic regression includes a dummy for load/ no-load funds.

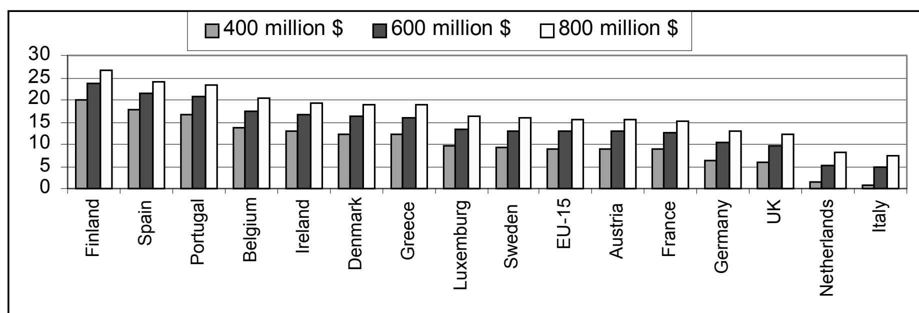
Figure 5:
Fund expense ratio in % depending on size of assets



Source: Background paper Heinemann (2002), data from SEC (2000), data base: 9000 open-ended US funds, without money market funds. Expense ratio does not include sales loads.

Such a cross section regression is included in SEC (2000). Among others the following control variables are included in the specification: volume of fund assets, portfolio turnover, fund age and several dummies for fund category (equity, bond, speciality, international), index and no-load funds. A crucial result for the purpose of this report is: the volume of a fund's assets turn out to have a highly significant negative impact on fund expenses. Since a study of a comparable data base and quality does not exist for the European fund industry, these US findings are the best available basis for a quantification of the potential benefits from larger European fund sizes. Of course, the cost structures of US and EU fund sectors are not completely identical due to differences in regulation, competition and investors' preferences. Nevertheless, the assumption that basic features of the cost structure are comparable between the two markets seems well justified.

Figure 6:
Cost savings under different fund size scenarios (in basis points)



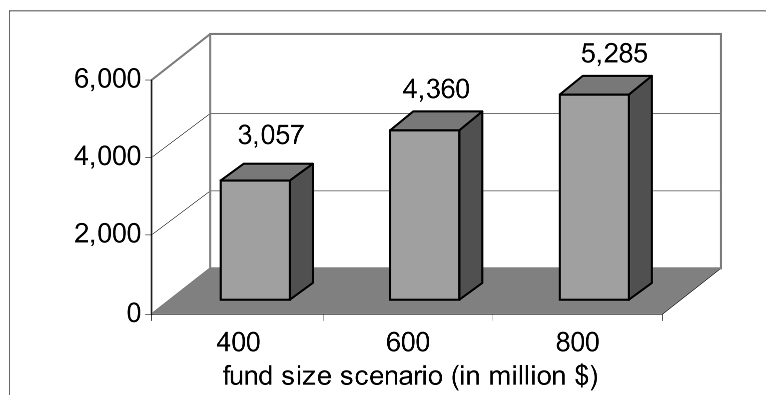
Source: Background paper HEINEMANN (2002), calculations based on regression results from SEC (2000). Country assignment refers to domicile of funds. Particularly in the cases of Ireland and Luxembourg this is not equivalent to target market of funds.

The assessment of the cost savings potential through pooling of funds in a unified EU fund market produces interesting results. Following the economies of scale argument, consumers in countries with the smallest funds could expect the largest benefits from European fund pooling. Figure 6 shows the potential savings in basis points on different EU markets of different scenarios on average fund size. The 400/600/800 million $ scenario assumes that the average EU fund size reaches half/three quarters/total of the present US level.

The cost savings associated with these scenarios are not trivial in absolute numbers. Figure 7 gives an indication based on the present size of the EU fund sector and the above quantified economies of scale: annual costs of managing European funds could be cut by around five billion Euro if the average US fund size could be achieved (which is about 800 million $). Of course, these numbers can only be regarded as a rough indication of benefits. One major shortcoming is the static perspective of this analysis, based on the present size of European fund markets. Even under the present fragmentation and inefficient cost structure this financial segment is growing. If efficiency gains through pooling could be realised this should lead to a further acceleration of growth of the funds market. In this sense these benefit estimates can be regarded as conservative.

There is no reliable way to quantify how these cost savings would be distributed between the industry (profit margin increase) and the private investors (increase in net returns). Since integration of fund markets would lead to an intensification of competition among fund companies investors should reasonably expect to gain a significant part of these cost savings.

Figure 7:
Potential annual savings of fund expenses in EU (in million Euro)



Source: Background paper HEINEMANN (2002), calculation based on FEFSI data on the size of EU fund markets end of March 2001, assumption is that economies to scale correspond to the findings of SEC (2000).

Speeding up interest rate pass-through

The pass-through from capital market interest rates to retail interest rates has been extensively studied in the literature on monetary policy transmission (for a survey and detail of the analysis see background paper HEINEMANN AND SCHÜLER, 2002). It is now an established empirical fact that generally this pass-through process is sluggish and asymmetric: banks adjust credit rates faster in times of increasing market rates than in times of falling rates. Adjustments are accelerated by increasing competitive pressure. Therefore, further progress in retail market integration would benefit private borrowers in periods of falling market rates through a faster fall in retail credit rates. If private households had access to credit everywhere in the EU banks adjusting rates more slowly would immediately be punished by a loss in market share as former customers would now take credits from banks adjusting rates more quickly in other EU countries.

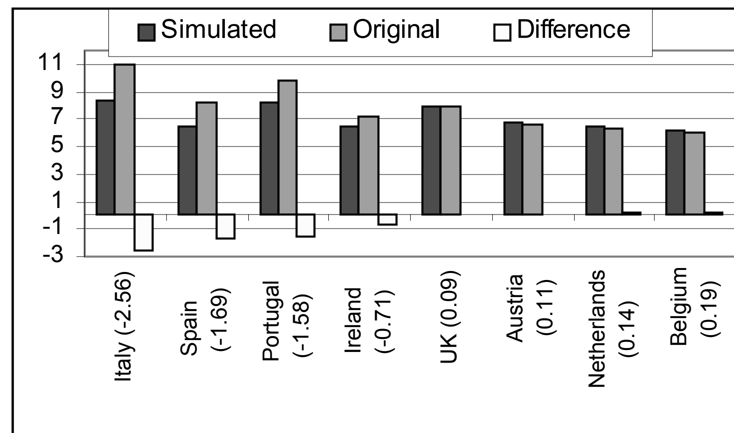
This link between pass-through speed and stronger competition through closer integration is used to quantify integration benefits from the point of view of private borrowers. The empirical analysis is based on the ECB data base "National Retail Interest Rates" which among others includes national retail interest rates for mortgage loans to households, consumer loans to households and short term loans to corporate enterprises. The quantification refers to the period 1995–1999 which was characterised by a more or less constant fall in interest rates. The benefit calculation – although refined in detail (see box 2) – follows straightforward considerations: It asks how much private borrowers in slow adjusting markets would have saved in this period if their banks had shown the adjustment speed of the country with the fastest pass-through. It assumes that integration would lead to a convergence of adjustment speed on the level of today's fastest adjuster.

Figure 8 (p. 36) presents the results for the mortgage credit market where the fast adjusting German market serves as a benchmark for the integration scenario. For the reference period March 1995 to January 1999 the figure includes for each country: the mean of the original interest rate series, the mean of the simulated series assuming adjustment speed of the benchmark case and the difference between both means. It indicates that borrowers in Italy, Spain, Portugal and Ireland would have benefited substantially from more integration in this period of falling interest rates: on average Italian consumers taking out a mortgage loan would have paid 256 basis points less for their credit, but also for Spanish (169 basis points), Portuguese (158) and Irish (79) consumers integration benefits are substantial. In terms of a 100,000 Euro mortgage loan these integration savings in interest payments would have amounted in the second half of the nineties to annually 2,550 Euro in Italy, 1,690 Euro in Spain, 1,580 Euro in Portugal and 790 Euro in Ireland. For the other markets with a pass-through equally fast to the German benchmark no significant savings would have been realised.

Of course, one could argue that these quantifications may to a certain extent overstate integration benefits. The analysed period was heavily influenced by

the EMU driven process of interest rate convergence and it could be argued that in the future there will be no similar periods of falling interest rates. However, it is also true that the approach of taking the fastest adjusting market as the integration benchmark leads to a rather conservative assessment of integration benefits since integration would probably lead to an even further degree of competition and a higher pass-through speed.

Figure 8:
Average mortgage credit interest rate March 1995 – January 1999 (in per cent)



Simulation is based on characteristics of market with fastest interest rate pass-through. In brackets behind country name: value of difference between mean original and simulated series. This difference can be regarded as indicator of potential integration benefits for mortgage borrowers. The lower its value, the higher the benefits of integration. For details see background paper HEINEMANN AND SCHÜLER (2002).

It must also be stressed that consumer savings in times of falling interest rates are only one side of the medal. In times of rising credit rates a faster pass-through is to the disadvantage of borrowers. Due to the typically asymmetric adjustment – faster pass-through to credit rates with increasing market rates than with falling rates – this disadvantage would, however, not outbalance the advantages over a whole interest rate cycle.

Insights into the drivers of pass-through speed show the way for reducing these customer disadvantages. The Euro and the resulting convergence of money markets and financial structure will work towards convergence of pass-through speed. An important message from the whole study is the following conclusion: a more reliable and probably faster mechanism would apply if direct cross-border retail credits become more important. This kind of cross-border activity could set in motion an arbitrage mechanism that should force banks to speed up interest rate adjustments for the benefit of borrowers and savers.

Box 2: Calculation of integration benefits through faster interest rate pass-through

The measurement of pass-through speed is based on the estimation of a flexible specification of the adjustment process between market and retail interest rates (technical detail and formulas in the background paper HEINEMANN AND SCHÜLER, 2002). The specification allows for the presence of a long-run "cointegration" link between both interest rates and, therefore, includes an error correction term. This error correction term takes account of the fact that large deviations from long-run equilibria should speed up adjustment of retail rates. Preparatory diagnostics (Johansen cointegration tests) are used to check for each product country combination whether the inclusion of this error correction specification is appropriate. Based on this estimation strategy 24 regressions for each available combination between EU countries and three product types (mortgage loans, consumer credit, short-term enterprise credit) were executed. In order to simplify the comparison, results are standardised in terms of the implied three month adjustment of retail rates following a fall in the market rate of one percentage point (see table 4).

Table 4:
3-months-decrease of retail rates after a one percentage point fall in market rates
(in basis points)

Country	mortgage loans	consumer loans (short-term)	enterprise loans (short-term)
Austria	-14	-60	-44
Belgium	-107	-98	-83
France	-	-	-45
Germany	-99	23	-13
Ireland	-56	-	3
Italy	-47	-	-167
Netherlands	-97	-	-62
Portugal	-11	-32	-53
Spain	-35	-46	-75
UK	-62	-73	-

Source: Background paper HEINEMANN AND SCHÜLER (2002), simulated effect on retail interest rate of a 1 percentage decrease in market rates (=government bond yields for most mortgage credit series and 3 month money market rate for all other series) given the estimation of the pass-through process. Estimation is based on the period of decreasing market rates 1995–1999.Gaps: no estimation and simulation possible due to data availability.

Generally, the different quality of regressions in terms of explanatory power and stability of implied adjustment processes indicate that the link between market and retail rates is much closer for mortgages than for consumer and enterprise credits. The results of the three month adjustment allow to identify the benchmark countries used in the simulation of the integration scenario – although not in a mechanical way. A benchmark country should not only show a fast speed of adjustment, the relevant underlying regression should also show a satisfying explanatory power and should represent a stable pass-through process. This led to the choice of Germany as the benchmark country for mortgages and Belgium for consumer and enterprise credits.

3.1.3 Portfolio performance

It is well known from portfolio theory that pure domestically invested asset portfolios are usually sub-optimal. If for example a private investor in France invests only in French equities he will have a lower return-to-risk ratio than compared with a world-wide investment. As this is true in general for all types of investors, countries and assets, a better diversification should improve the performance of investments.

Integration of capital markets in the EU implies a free access to “foreign” financial markets. Theoretically, all Europeans have full access to all other European and most of the non-European capital markets. But nevertheless only a small part of total assets of private households is invested in marketable assets such as equities and bonds. And there is also the well-known tendency to invest a very large proportion in the home country. One part of this so-called home bias is that private as well as institutional investors prefer investments in equities and bonds denominated in the own currency. Since the introduction of the Euro this obstacle to foreign investments is abolished. Increasing integration of EU retail markets should further tend to reduce this bias for European investors. If consumers have more frequent contact with financial services providers of other EU markets this would also make them more aware of the attractive characteristics of foreign assets.

This link between retail market integration and portfolio diversification was used for a calculation of integration benefits in terms of an improved portfolio performance (full details and further results including fully hedged portfolios in background paper SCHRÖDER, 2002). Table 5 presents the results from the perspectives of investors from France, Germany and the UK.

Table 5:
Sharpe Ratio depending on nationality of investor and degree of diversification

	equity portfolio			bond portfolio		
	national	European	World	national	European	World
German investor	0.085	0.149	0.139	0.063	0.150	0.113
French investor	0.112	0.127	0.119	0.042	0.067	0.064
British investor	0.091	0.101	0.095	0.051	–0.012	0.001

Source: Background paper SCHRÖDER (2002), calculated for period January 1978 – June 2001 on the basis of monthly returns, no currency hedging. Market capitalisation weights and country indices from Morgan Stanley (equity) and Salomon (bonds).

The results show for a German investor that world-wide and European-wide diversified equity and bond portfolios performed much better than portfolios restricted to only German assets. This can be seen from the so called Sharpe ratios that are much higher when foreign assets are included in the portfolio. The Sharpe ratio is defined as the portfolio return minus a risk-free interest rate, divided by the standard deviation, which serves as the measure of risk.

The Sharpe ratio therefore measures the reward or premium which the investor earns for one unit of risk. The higher the Sharpe ratio the better the performance of the portfolio. The best performing stock and bond portfolios are those with a diversification amongst Europe-wide assets. The inclusion of other international assets is somewhat less profitable than using only European assets, which can be seen from the lower Sharpe ratios of the World Portfolios. The results for French investors are very similar to those for German investors: the best performing portfolios consist of Europe-wide diversified stocks or bonds. The World Portfolio is again only second best, although it has a significantly higher Sharpe ratio than a portfolio that consists only of domestic assets. Only for a British bond investor does the local portfolio perform better than an internationally diversified asset structure.

Calculations have also been performed on different subperiods to check for the stability of results, see table 6 for equity portfolios: benefits of diversification change considerably over time but are always there. The result where French and German investors gain more by European than by world wide diversification is stable for different calculation periods including the most recent period from January 1995 to June 2001.

Table 6:
Stability of diversification benefits over time, difference of Sharpe ratios of world and Europe portfolios relative to a local portfolio (unhedged currency returns)

	Jan. 78 – June 01	Jan. 89 – June 01	Jan. 95 – June 01
Equities World			
British Investor	0.004	0.009	0.012
French Investor	0.007	0.014	0.012
German Investor	0.054	0.031	0.071
Equities Europe			
British Investor	0.011	0.008	0.003
French Investor	0.015	0.015	0.018
German Investor	0.064	0.032	0.078

Source: Background paper SCHRÖDER (2002).

In sum, there are large differences between the performance of asset portfolios of the investors analysed. However, there is a clear answer to the question whether international diversification matters: holding only domestic assets is an inferior solution. The performance of the portfolios could be significantly improved by investing in international stocks and bonds. It is also interesting to note, that often the Europe-wide diversification for stock and bond portfolios leads to the best results. A world-wide diversified stock portfolio could cause lower risk-adjusted returns to the investor than a Europe portfolio. This is a very promising result concerning the integration of European retail financial markets: if this integration encourages diversification of private portfolios

at a European level the most important step towards an optimal asset allocation would have been achieved.

3.2 Growth effects

Since the publication of the Cecchini Report it has become a well known fact that financial market integration tends to foster growth and employment in a significant way even if some of this Report's results are often not fully understood: explaining the growth path of a country or a continent is always a multidimensional exercise, many different factors are relevant and it is hardly possible to ascribe a failure or success of reaching a desired growth path unambiguously to one certain factor.

However, the fact that financial markets are one of these relevant growth factors, is increasingly supported in a growing strand of literature following the paper by KING AND LEVINE (1993) (see also WORLD BANK, 2001). This literature is not directly dealing with *financial integration between countries* but rather with the *financial development within a country*. Nevertheless, since integration of financial markets and financial development obviously are interdependent, this literature is also helpful for a better understanding of the link between financial integration and growth.

There are two main effects explaining a possible positive impact of financial market development on macro economic growth.

First, deep and developed financial markets can foster *capital accumulation*. Higher efficiency of financial markets reduce the fraction of savings that is lost in the intermediation process. Thus, more capital can be channelled into investment and thus induce growth. This argument becomes even stronger if one extends the traditional focus on physical capital allocation to human capital allocation and innovation. All these factors today are regarded as crucial for the growth prospect of the EU economy and all these factors should be positively influenced if financial intermediation becomes less costly. Furthermore, the savings ratio could be stimulated due to more attractive investment opportunities. At the same time, countervailing forces could even reduce the savings ratio since easier access to credits and better insurance could induce households to consume more. Therefore, the capital accumulation impact of financial market development is not certain.

Second and unambiguously, financial market development fosters growth through *a more efficient allocation of a given supply of savings*. Improved risk sharing and a more efficient information process concerning investment alternatives allows the financing of investment projects with a higher marginal productivity of capital.

Empirical analysis supports the relevance of these theoretical considerations. Studies like KING AND LEVINE (1993) and PAGANO (1993) support the view that financial market development fosters growth and also demonstrate that this link is no statistical conclusion resulting from a reversed causation of growth fostering financial development.

So far this literature has only rarely included the integration aspect. On theoretical grounds there is a clear case for a positive impact of integration on development of financial markets. Integration means access of savers and investors to other countries' financial services, investment opportunities and savings supply. Integration will boost competition and innovation in the financial sector and thus speed up financial development.

DE GREGORIO (1999) has found support for the positive growth impact of financial market integration based on estimates of growth equations for the period 1976–1993 and a sample of industrial and developing countries. According to this study integration affects growth mainly through financial development: highly integrated countries show a high degree of financial development and, as a consequence, high growth rates. Realistic integration advances (amounting to one standard deviation of the integration indicators) give rise thus to an increasing annual growth of 0.5–0.7 per cent. Although it is not possible to derive from this study immediately precise estimates of possible growth bonuses in the Europe of today, the study supports the case that not unimportant growth effects would be achieved through better integration of financial markets (see also box 3, p. 42). When taking alone the lower percent figure of 0.5 of DE GREGORIO'S estimations it would translate into an annual growth of 43 billion Euro on the basis of the EU GDP of 2000.

Box 3: A three-step estimation procedure to identify the growth and employment bonus of integration

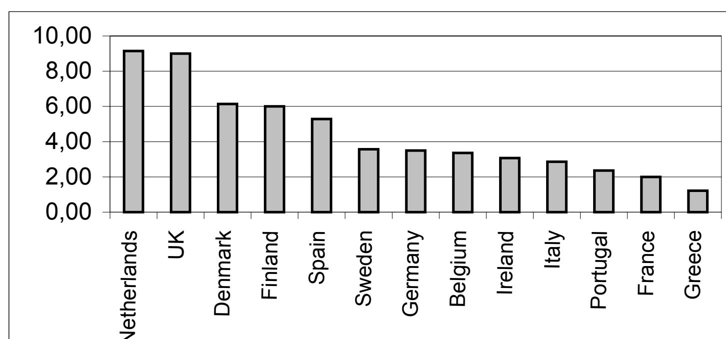
Since the empirical literature on the nexus between financial integration and growth is rather scarce, the research team has devoted some effort to these issues (fully documented in background paper NEIMKE ET AL., 2002). For the EU countries the relationship between financial development, financial integration, growth and employment has been analysed using a three-step econometric approach.

In the first step a panel analysis of a growth equation including bank and insurance related financial development indicators among traditional explanatory variables was carried out. The panel consisted of 14 EU countries for the period 1960–1999. The panel estimation produced country individual regression constants ("random effects") that can be interpreted as part of total factor productivity growth.

These constants were the starting point for the second step: a cross section regression to explain differences in total factor productivity growth by financial market integration. Integration indicators used refer to the presence of foreign banks and insurers in terms of number and market share. This estimation reveals a significant impact of foreign banks' market share on growth differentials. A one percentage increase in foreign banks' market share is associated with an annual total factor productivity growth bonus of 1.7 per cent. Since different integration indicators are highly correlated the foreign bank market share must be interpreted as jointly representing a multitude of factors associated with more integration and can not be simply ascribed to the presence of foreign banks. Also the exact size of the coefficient must be treated with extreme caution due to the limited explanatory power of the whole regression (adjusted $R^2 = 0.37$) and the small number of observations (13) in the cross-section. Nevertheless, the coefficient's sign and significance are in line with the findings in the empirical literature that financial integration is among the relevant determinants of economic growth.

In the third step, country specific growth unemployment relationships ("Okun" coefficients) were estimated in order to relate financial market integration growth bonuses to potential employment effects. Here, it can be shown that the same growth effect would be translated into very different national employment effects depending on the employment elasticity of growth (see figure 9, p. 43). Countries with flexible labour markets and highly growth-elastic employment can generate higher employment effects through pushing financial market integration. This is a helpful reminder that the long-run success of financial integration in reducing unemployment crucially depends on the progress of labour market reforms and reforms in other policy fields like taxation and social security.

Figure 9:
Relative employment effects of financial market integration



Employment effect of a uniform increase in financial market integration relative to the reference case Austria which shows the lowest long-run "Okun coefficient" (reaction of unemployment rate to growth). Figure can only be interpreted in relative terms, for example: the positive employment effect of financial market integration is in Finland six times larger than in Austria. Details: Background paper NEIMKE ET AL. (2002).

3.3 The international role of the Euro

Following the introduction of Euro notes and coins the changeover to the Euro has been completed. The race between the Euro and the Dollar has only just begun. This race is not merely a matter of prestige. The wider international use of a currency offers a number of hard economic advantages (see BECKMANN ET AL., 2002, for a survey):

- Seignorage: the more foreigners are willing to hold the domestic currency the larger the seigniorage gain for the issuing central bank.
- Liquidity premium: interest bearing assets denominated in a widely used international currency can benefit from a liquidity premium.
- Savings in transaction costs: transaction costs in foreign exchange and securities markets tend to be lower for a global currency than for a currency with only minor international relevance.

PORTES AND REY (1998) and PORTES (2000) expect that these benefits could add up to as much as 0.4% of the Euro area's annual GDP if the Euro reaches its full potential as a global currency.

Whether these potential benefits can fully be realised depends also on the competitiveness and efficiency of Europe's financial services industry. The global role of a currency as medium of exchange, unit of account and store of value is depending on many factors. An economy's size and its share of world trade are important determinants but are not sufficient to determine the international role of a currency (BECKMANN ET AL., 2002): of the most important factors explaining the continuous global dominance of the Dollar are the superior efficiency and liquidity of US financial markets.

With this background, the link between financial integration and growth depicted in the preceding section is reinforced in terms of currency economics: pushing integration of EU financial retail markets will also support the future role of the Euro as a global currency. The more competitive the financial services industry in Europe, the greater the speed of innovation. The better the value for money of its financial products, the more attractive Europe's currency becomes for global investors.

4. OBSTACLES TO CLOSER INTEGRATION OF RETAIL FINANCIAL MARKETS

4.1 Survey on natural and policy-induced obstacles

The benefits of more integration as assessed above will only materialise if existing barriers between financial markets are dismantled. The success depends not only on the political willingness to act but also on the nature of the obstacles: if these are not capable of being changed, at least in the medium-term, European legislators would have to accept the fact that the existing fragmentation is a given fact. Before coming to policy conclusions it is therefore of crucial importance to identify those factors that bear the main responsibility for the continuing relevance of national borders for financial services in Europe.

Table 7 (p. 46) offers an overview and systematisation of integration obstacles. In general, national fragmentation of markets for financial services along national borders are either a result of policy-induced or natural factors.

Policy-induced are those obstacles that could in principle be addressed by national or EU legislators with a realistic prospect for successfully speeding up integration. The clearest example for a policy-induced obstacle is the continuing existence of national currencies in Denmark, Sweden and the UK. With the decision to introduce the Euro in these countries a considerable contribution to a higher integration with European markets would be made. Further examples for policy-induced obstacles are tax discriminations against foreign financial suppliers, e.g. in the cases of registered funds and life insurance policies, or obstacles resulting from an uneven regulatory playing field in Europe.

Natural obstacles can not be directly addressed by the legislator because they are rather a consequence of preferences, technology and the inherent characteristics of a market. Natural obstacles might nevertheless undergo considerable changes in the course of time – for example due to improving technology (internet) or changing consumer preferences or the long-term development of a European Polity. Language differences are the most obvious natural barrier to full integration of EU markets on the demand side: most European consumers want to communicate with their bank or insurer in their mother tongue. A further demand side example of a natural obstacle is the high importance which trust plays when the consumer makes his choice between financial service providers. Here domestic suppliers with a good business record and an established brand name have a natural advantage over foreign newcomers.

Table 7:
Obstacles to full integration of EU financial retail markets

	"natural"	"policy-induced"
demand side	– differences in language, culture – consumer trust in established national suppliers – distance and the desire for "handshake" (personal contacts)	– discriminatory tax treatment of foreign financial services/products – existence of a national currency (Denmark, Sweden and UK) – insufficient knowledge about cross-border redress procedures
supply side	– information costs caused by natural factors (e.g. cultural differences, differences in general legal tradition) – sunk costs of market incumbents – bias for home products in established distribution channels – some smaller national EU markets commercially not attractive	– information and adjustment costs caused by national differences in regulation (e.g. supervision, consumer protection, accounting standards) – obstacles to cross-border information flows (e.g. due to limited access to foreign credit registers) – competitive privileges of domestic suppliers (e.g. through government ownership) – shortcomings of Internal Market rules (e.g. through slow EU legislative adjustments to new developments) – particular costs of cross-border operations (e.g. money transfers, identification procedures)

The brand name consideration already hints to natural barriers on the supply side: these barriers largely have to do with the fixed costs of each market entry – for established domestic consumers these expenses have a sunk cost character. This can explain why foreign suppliers do not enter a national market even if this market yields above-normal profits for domestic suppliers.

Often the borders between natural and policy-induced obstacles are not clear cut. On the supply side, the costs to obtain information about the specificities of a national market act as a natural barrier. A company considering whether to enter a new national market has to pay the entry ticket in form of expenses for information about this market and the costs for adopting its products to the market's specific needs. However, the extent of these information and adjustment costs are only "natural" as long as they are not pushed up by excessive national provisions for consumer protection, or specific provisions in supervision and accounting rules – factors that could in principle be harmonised on a European level.

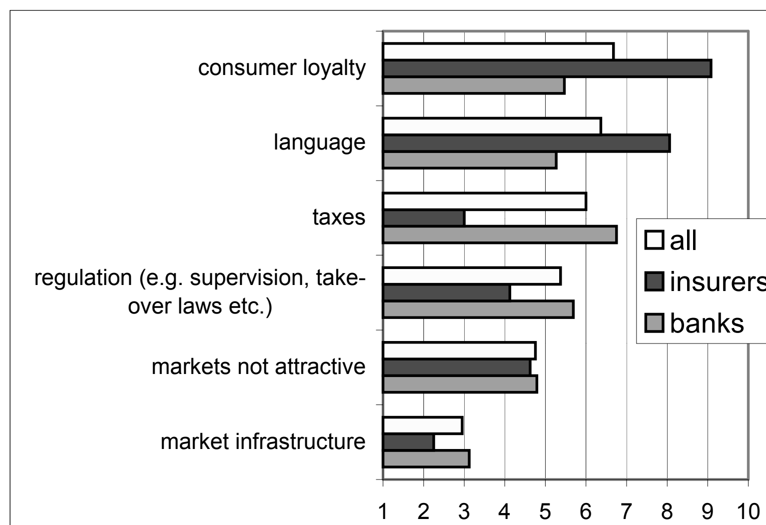
It is no easy task to identify within this list of obstacles the most important ones – also because their relevance differs across segments of retail markets. Therefore, the obstacles will be assessed for some specific product groups in the next section. On a general level, however the following statements can be made:

– Information costs – both of the natural and policy-induced type – play a major role as an integration obstacle. The empirical fact (see sections 2.3 – 2.4) that M&A strategies are so dominant in crossing national borders in the EU financial market can be interpreted in the following way: a merger

with or an acquisition of a company in the target market has the crucial advantage to acquire the necessary know-how on national conditions. If these information problems were less widespread greenfield investment would be more important.

- Natural obstacles matter to a considerable extent in Europe. Econometric evidence presented in BUCH (2000) on the factors driving the international expansion of banks shows that variables like distance, language differences and differences in the legal system tend to hinder foreign presence. In a questionnaire distributed to leading European financial service providers, obstacles like consumer loyalty and language receive the highest weighting (see figure 10, p. 48). Therefore it is unrealistic to expect in the foreseeable future that financial integration will reach the level that exists within national markets.
- At the same time the variables that can be influenced by policy makers also have an impact on integration. This means that policy is indeed able to foster integration by appropriate measures – even if it is not able to achieve a level of integration existing for example within the USA. The leeway for policy can be recognised from the fact that projects like the Single Market Program and the Basel Capital Accord have prompted more cross-border activity in a significant way (BUCH, 2000). Written interviews with representatives of leading banks and insurers have shown that policy-induced obstacles related to taxes and regulation do not rank far behind the language obstacle (figure 10). For bank products these obstacles seem even to be more important than the natural ones.
- Existing obstacles are more relevant for small and poor than for big and rich countries: fixed costs of market entry resulting from all kinds of information costs are more effective in deterring potential entrants the lower the market potential in the particular target country is. In countries with considerable market potential, however, it seems to be worth investing into efforts for crossing the existing hurdles.
- Policy measures, even if successful in the medium term, need time to have effects: the character of many obstacles implies a certain inflexibility of existing customer supplier links – leading to a kind of hysteresis of incomplete integration. It often takes years for new suppliers to establish trust and brand names and to proceed with the learning process in regard to the characteristics of a new target market. The consequence is that even political breakthroughs like the introduction of the Euro take their time to affect retail oriented integration indicators.

Figure 10:
Average relevance of obstacles in EU retail financial markets
(10 “highly relevant” to 1 “no relevance”)



Source: Research Team Questionnaire answered by 7 leading European banks and insurers.

4.2 Obstacles for specific financial products

Without claiming completeness, the following section assesses the obstacles more specifically with respect to certain financial product and service examples.

4.2.1 Insurance

Since insurance is essentially based on *trust*, the natural obstacles related to consumer preferences for companies with a good reputation and an established brand name is particularly important (for details see background paper BECKMANN ET AL., 2002). This is also backed by the survey’s results where *consumer loyalty* and *language* are identified to be particular relevant integration obstacles in insurance (see figure 10). The fact that there is a lower degree of openness in the life sector compared to the non-life sector also fits into this context: trust is more relevant for a long-term product like life insurance than e.g. for a car insurance contract.

Conventions regarding the terms of insurance contracts also have an influence on the readiness of policyholders to switch to a rival product. Price sensitive behaviour is favoured in the UK where customers must actively take steps to renew their policies each year. In continental Europe, however, the *renewal of contracts* for the most part is automatic unless a contract is cancelled in the three months before the date of renewal.

The responsibility for tax policy mainly lies with the EU Member States. With respect to insurance one has to differentiate between the taxation of insurance companies and the taxation of an individual policyholder. A major integration obstacle for the life-insurance market results from taxation of individual policyholders. Here, *discriminatory taxation* has been present concerning tax deduction of life insurance premiums when deduction is limited to contracts that are effected with an insurer being authorised in the country of the policyholder. Still in 1999, a couple of EU/EEA countries granted fiscal advantages of that form (OECD, 1999).

A further major obstacle results from extensive *consumer protection* with respect to *the general good principle*. Although consumer protection is important for the individual customer, often it also turns out to be an instrument of protectionism against "foreign" competition to the detriment of the consumer's interests. In carrying out insurance activities in a host country, insurers must comply with national conditions in order to respect the general good principle (AMATI, 2000). Companies that want to be present in the whole EU have to adapt to the rules of 15 different countries. These rules differ widely since what is regarded as general good depends strongly on specific national traditions. This implies an immense barrier to market entry for SME insurers. Furthermore, due to the described asymmetries between high and low market potential countries, the general good problem tends to limit for the customer the availability of choice between insurers particularly in small countries.

4.2.2 E-finance

It is of particular importance to understand the obstacles that are relevant for cross-border e-finance business. As the analysis of section 2.6 has clarified the "internet revolution" so far has not yet succeeded in creating European retail markets for financial services without national borders. The new distribution channel offers the technological possibility for easy contacts between suppliers and customers independent of geographical distance. However, even in the most developed e-finance market, the market for online brokerage, this possibility is hardly used for direct cross-border business.

This experience allows us to draw important conclusions with respect to the fixed cost entry problem in accessing a national market. The internet is obviously able to reduce some components of a market entry's fixed costs: it seems no longer necessary to invest heavily in a physical presence through setting up or acquiring a branch network. The same holds true for up-front investment in technology. In principle, the existing domestic technological infrastructure could be used to do business with customers in different countries.

At the same time, the availability of the internet distribution channel does not alleviate fixed cost entry barriers resulting for example from:

- the need to design for each national market a *specific marketing strategy* taking account of the language, the culture and other specific preferences of potential customers;

- the need for large up-front *advertising* in order to establish a brand name;
- information costs in regard to *market peculiarities related to regulation* (consumer protection, supervision);
- adaptation of IT systems to local requirements and particularities.

That these remaining fixed costs are important can also be seen from the results of a survey among leading European direct brokers.[4] Almost all of them state that reaching the critical size for entering the market is very relevant as a barrier to entry: this answer is only plausible under the assumption that relevant fixed costs for a market entry in an internet based market remain. Obviously, even in electronic markets the established suppliers are protected through sunk costs from foreign competition. Therefore, similar to conventional distribution channels also online brokers regard it as necessary to set up a physical presence in a target market by establishing a subsidiary or by merging with a local company in order to get the necessary know-how from local managers.

Further obstacles that could directly be addressed by policy makers turn out to hamper the border crossing function of the internet in financial retail markets: according to the above mentioned survey the structural problems in the *European payment system* impair online brokers in addressing foreign customers directly through the domestic homepage. This is evident from investors who frequently transfer money between the online account at the direct broker and the domestic current account. Therefore, the high cost of cross-border transfers plays a role as an integration obstacle in e-finance (for policy measures on cross-border transfers see 5.1).

Another obstacle mentioned by the online brokers was *identification of clients across borders*. Unless a customer visits a branch in person, identification is frequently provided by local post offices, which, according to one broker interviewed, often causes problems. An alternative is to require the customer to visit an embassy or a notary. Such complicated procedures may discourage consumers in choosing a foreign online broker.

Furthermore, the *heterogeneity of the technical systems of stock exchanges* was mentioned as an obstacle. Concerning the trading industry, increased integration between stock exchanges has taken place in the form of cross-border cooperation and mergers. However, the clearing and settlement infrastructure has remained relatively fragmented (ECB, 2001). As a consequence, some online brokers charge additional fees for purchasing and selling stocks listed on foreign exchanges or do not even offer this service. This may also defer customers from choosing a supplier abroad.

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4 The online brokers were asked for their assessment on the importance of various barriers to market entry in various European countries. Since the answers did not significantly differ from country to country, the identified obstacles are regarded as barriers to entry for all European markets. For details see background paper SCHÜLER (2002).

Of course, the online brokers survey identifies obstacles only from the suppliers' point of view. From a consumer perspective the question of *trust* is of crucial importance when choosing a foreign supplier. When it comes to investing, borrowing money or buying an insurance contract, the *"handshake"* is a very important prerequisite (LEAMER AND STORPER, 2001). Since the internet does not allow for this "handshake", the knowledge of the company to which one is giving money becomes essential. This is probably the main reason why consumers do not naturally switch to a foreign online broker even if they could save a lot of commission and administration fees. Additional consumer problems relate to uncertainties in cases of legal disputes with the supplier. Here, cost-efficient *cross-border redress procedures* are important preconditions for overcoming consumer reluctance to contract with a foreign supplier.

4.2.3 Cross-border credits

Credit suppliers have to cope with the problem of *asymmetric information*: The potential borrower has an incentive to conceal factors associated with a low creditworthiness. The lender can only be profitable in the long run if he is able to arrive at a more or less accurate assessment of the individual ability to honour credit obligations. In the course of financial market development, institutions have emerged helping to overcome these information problems in the credit business based on the principle of information exchange among lenders (JAPELLI AND PAGANO 2000). Private credit bureaux and public credit registers (often run by central banks) allow for information sharing on the creditworthiness of individual borrowers and of groups. Furthermore these information sources offer valuable input for running effective credit risk management tools in banks.

This credit information infrastructure has been developed on a national basis. Some of its features, however, may serve as an obstacle to cross border credits insofar as foreign market entrants do not get the same *access to credit registers and private credit bureaux* as their domestic competitors. For example, it is a usual characteristic of public credit registers at national central banks in Europe that access is only granted to the domestic reporting financial institutions. This means that foreign suppliers are lacking precise information for assessing credit risks.

Although there have been initiatives to establish a closer cooperation among European credit registers these efforts have so far not met with success. On the long run it may well be possible that this integration obstacle will be removed by the growth of private transnational credit bureaux (JAPELLI AND PAGANO, 2000).

For certain types of credit there have been specific *tax obstacles* for cross-border business in the past but these have been successfully overcome. An example concerns cross-border mortgages. In Belgium, tax relief for capital repayments of mortgage loans was previously limited to Belgian lenders. In the meantime, this discrimination was brought into line with the principle of the free provision of services. However, other subtle practices related to the treatment of

mortgages with regard to taxes and subsidies still discriminate against cross-border business which has moved the European Commission to pursue infringement cases against the Greek, Italian and Portuguese governments (EUROPEAN MORTGAGE FEDERATION, 2000).

4.2.4 Funds

The fund industry itself as represented by the European association FEFSI and its US counterpart ICI stresses very much the importance of the policy-induced obstacles. This analysis can be summarised in the following way:[5]

Although the UCITS Directive in 1985 intended to provide a convenient passport for pan-European sales of funds its success has so far been limited. The reasons for this are:

- *Innovations leaving UCITS definition outdated:* the European fund passport is limited to those products fulfilling the Directive's definition of UCITS. Here the national and European legislator always lags behind the market development. The present legislative activities promise some progress in this regard: the UCITS directive is in the process of modernisation [COM (2000) 329 and COM (2000) 331]. If these changes are implemented problems with the restricted UCITS definition in regard to money market funds, "funds of funds" and index funds will be overcome. If the Lamfalussy approach is successful, future adjustments of the legal framework would be accelerated.
- *The burden of registration in the target market*: the UCITS Directive is interpreted and implemented differently in the member states. According to the Directive a fund must be authorised for sale by local authorities in the target market. Registration procedures are nationally different. ICI (2000) reports for example that in Italy registration typically takes up to six months. Further examples highlight the burden of the diffuse registration procedures (MOODY'S INVESTORS SERVICE, 2000): in Spain an official translation of the fund prospectus is obligatory. The Netherlands require a detailed tax history of a fund. The modernised UCITS directive will bring some progress: the adjustments will introduce a fully harmonised, simplified prospectus alleviating the fixed cost problem of entering another EU market.
- *Host country responsibility for advertisement and marketing:* Article 44 (2) of Council Directive 85/611/EEC of 20 December 1985 (last amendment from November 2000) states: "Any UCITS may advertise its units in the Member State in which they are marketed. It must comply the provisions governing advertising in that State." Thus one single pan-European marketing strategy for a fund is impossible due to different national restrictions for this strategy.

Tax discrimination of foreign funds: in a multitude of ways national tax laws discriminate against foreign funds (see for details: FEFSI AND PRICEWATERHOUSE COOPERS, 2001). An extreme example is Denmark where a discriminatory

5 For a recent summary of these associations' views see FEFSI (2001) and ICI (2000)

taxation of capital gains of foreign funds in practice precludes the market entry of foreign funds.

From a fund company's perspective, the registration and advertising related obstacles lead to a fixed cost problem for entering a new EU target market. These fixed costs will only make an entry profitable if there is sufficient potential in the target country.

It is, however, questionable whether even the best regulatory changes could really produce a quick integration of fund markets. The experience of markets like Germany or France poses some challenging questions: here the significant presence of foreign funds prove that the fixed cost problem is of less relevance for these markets. Thousands of foreign funds have overcome the registration and advertisement hurdles but their market success is limited. Attempts at explanation must therefore also look at the natural barriers. MOODY'S INVESTORS SERVICE (2000) convincingly assigns large importance to a further natural obstacle resulting from the *existing distribution channels*. The major proportion of funds is still sold over the bank counter. Banks still often advise their customers with a bias towards fund products of the own group. Therefore, foreign funds still lack distributive capacities preventing a breakthrough even after overcoming the regulatory hurdles of the registration procedure.

The *distribution obstacle* is natural in the sense that legislators do not have direct instruments to overcome it. However, ongoing market trends can be expected to alleviate the problem in the future. First, the expected restructuring of distribution channels towards direct internet sales and independent fund shops ("fund supermarkets") will work towards structures less biased towards domestic products. Second, a by-product of cross-border M&As in banking is the reduction of the domestic bias in this sector. Third, the bias for domestic funds might also decline within domestic banks. Consumer sophistication is increasingly pushing the demand for third party products. Banks have to react and to offer a more neutral assistance in fund selection or otherwise risk to lose market shares.

4.2.5 Obstacles related to pension products

While so far the analysis has identified long existing obstacles there is the danger that ongoing national policy processes could create new obstacles to a unified retail financial services market. This danger is clearly relevant for pension products. It is undeniable that the traditional systems for retirement pensions have largely become unsustainable. Without reforms, the demographic development would unduly increase the financial burden on active workers in the traditional "pay as you go" pension systems. There is no doubt that recent efforts to complement these traditional systems through funded pillars point in the right direction.

From an integration point of view, however, it is highly desirable that these reforms do not result in an even stronger fragmentation of pension product markets along national borders in the EU because of the highly specific na-

tional regulation of the privatised pensions. The example of the German "Riester products" (see table 8) shows that this problem is now increasingly becoming relevant. The requirements for pension products to be eligible for government subsidies under the new German system are very specific. No conventional UCITS-fund or life insurance policy would qualify without major adjustments. This means that each pan-European supplier of pension products is forced to set up a particular variant for the German market. Therefore, this national regulation creates new de facto barriers for a highly promising part of the retail financial services market. With this kind of extensive and specific national regulation a true internal market for pension products will not have any chance.

Table 8

Some of the requirements for Riester products according to the German Pension Act
– no proceeds may be taken from the policy before the age of 60 (other than for disability and limited scope for loanbacks against real estate),
– the accumulated fund at retirement must guarantee at least the premiums paid,
– all proceeds must be taken as an annuity (there is no cash option), the annuity must be either level or increasing from age 60 to 85,
– providers must fully disclose all costs and charges and provide annual account statements,
– all expenses must be spread over the first 10 years of the policy rather than charged as incurred,
– products must be certified by the Federal Insurance Supervisory Office.

5. SOME POLICY CONCLUSIONS

5.1 General insights

Even a decade after the completion of the single market and three years after the arrival of the Euro the integration of financial retail markets in Europe is far from complete. The benefit analysis has demonstrated that closer financial integration is linked to substantial consumer advantages, higher growth and an increasing global importance of the Euro. These benefits justify further efforts in favour of truly unified financial markets.

The analysis shows that doing nothing is unacceptable. Though there are important market trends that tend to foster integration these alone are not powerful enough to create unified retail markets in the medium term. The internet based distribution channel is overcoming some natural integration hurdles but so far it is hardly used for direct cross-border financial retail business. Consumers of financial products become increasingly educated and open to the international product supply, but as long as considerable uncertainty remains – e.g. in regard to cross-border legal disputes – these consumers will stick to domestic suppliers. The increasing number of cross-border M&As in the financial industry is working in favour of integration but does not directly give European consumers access to financial services and conditions in other EU markets. Finally, there is a delicate political problem associated with today's imperfect integration: The "costs of non-Europe" are particularly high in the smaller and poorer member states. In these countries market forces resulting from profit opportunities are often not strong enough to overcome existing barriers.

Summing up, there is a need for further political action. What is important is the fact that there is indeed considerable political scope. Of course, part of the incomplete integration is a consequence of natural factors like language and culture. The analysis of obstacles above has, however, stressed the importance of factors that can be altered by appropriate decisions by European and national legislators.

Any integration strategy should pay particular attention to opening *direct cross-border contacts* between suppliers and consumers. Foreign direct investment in financial retail services is helpful and necessary to link national markets, but activating direct contacts between foreign suppliers and private consumers could shortcut some developments: it would immediately speed up convergence of prices and ensure a larger product choice everywhere in the EU.

In the context of the EU's Financial Services Action Plan and other ongoing legal initiatives many problems have already been identified and are being properly addressed (for the progress in the implementation of the FSAP, see EUROPEAN COMMISSION, 2001). An important example is the regulation of cross-border payments. Though it is debatable whether the chosen instrument of price regulation really complies with market principles it is indisputable that an obstacle that is highly relevant in cross-border financial retail business is being addressed. However, there are areas where more needs to be done. In

the following section some particular policy recommendations are made which by far do not cover all aspects of European and national policies. They should be read as examples of promising measures to develop financial market integration. Apart from this it is obvious that more work has to be done to specify the details of future policy reforms given the complexity of issues like pension reforms or consumer protection. Nevertheless, the following suggestions might be helpful to clarify the necessary direction of required actions.

5.2 Fighting tax discrimination against 'foreign' suppliers

In regard to discriminatory tax practices there is only slow progress. The Code of Conduct for Business Taxation is not helpful in overcoming the problems of tax discrimination against foreign financial services. The Code of Conduct addresses tax practices aimed at attracting foreign business to a Member State rather than measures which keep 'foreign' business from another EU country out of a market – which is the problem for example in the fund market and also to a certain extent in the life insurance market.

At least for some products and national markets integration has only a chance if discriminatory tax practices are abolished. The fund market in Denmark is an example: all other attempts to open the country for 'foreign' EU-funds will be in vain as long as the existing tax discrimination continues.

The European Commission should play an active role and challenge tax practices in member countries that are against the competition rules and the principles of the Treaty more often. In cooperation with the official European organisations of the particular financial service industries the tax discriminations should be identified. On that basis the Commission could start infringement cases against the concerned governments for the sake of implementing the Treaty provisions. If an agreement can not be reached these cases should be brought to the European Court of Justice. The chances of success of this strategy should be high: it is established EU case law that member states shall avoid any overt or covert discrimination on grounds of nationality (FEFSI and PRICEWATERHOUSE COOPERS, 2001).

5.3 Reducing national differences in consumer protection

In the field of consumer protection, any integration strategy has to take account both of demand side and supply side aspects. On the demand side, a sufficient level of protection is necessary to create the degree of trust that is essential from the consumers' perspective. On the supply side, national differences in consumer protection is a burden for a profitable market entry. Both kinds of interests can be reconciled by the definition of a consistent level of protection and a harmonisation on that basis.

Progress along these lines is being made but more needs to be done. In the European Commission's proposal for a Distance Marketing Directive a part of these problems is addressed with the harmonisation of key marketing rules aimed at encouraging consumer confidence in retail financial services provided

for example on the internet. Initially, the adoption was planned for end 2000, now it is hoped for June 2002 (EUROPEAN COMMISSION, 2001). The Directive on a legal framework for electronic commerce (2000/31/EC) adopted on 8 June 2000 had to be transposed into national law by January 2002. The e-commerce Directive is based on a country of origin approach in consumer protection. An internet based financial service provider will in principle only have to fulfil the legal requirements of his country and could on this basis do business with customers in other EU countries. However, the directive includes a number of possible derogations for important financial services such as UCITS and insurance. Thus in these sectors, the host country control in consumer protection continues to render a unified pan-European marketing strategy of suppliers impossible. Fund and insurance companies still have to deal with 15 different sets of consumer protection rules. It is highly desirable to reopen the debate on the full application of the origin approach with the objective of reducing or eliminating exemptions.

In this context it is also necessary to limit in the future the applicability of the general good principle: the general good issue today provides a clause for implementing all kinds of individual host country regulations. It thus can be abused for purposes of protecting domestic suppliers. Here it is necessary to come up with a common and restrictive definition of the general good. The European Commission should consider which legislative measures would best serve this objective.

The integration obstacles resulting from the national approaches to pension reforms (see section 4.2.5) require a policy with the same logic. On grounds of consumer protection some national legislators have defined very specific requirements for pension funds. This leads to the establishment of new barriers for a unified European market – a problem which must be addressed. From an integration perspective, the ideal solution is a unified European standard for pension products without leeway for national legislators to set up further specific requirements.

5.4 Enhancing Consumer Trust

Alternative dispute resolution (ADR) systems can be a helpful instrument to foster *consumer trust*. Since the cost of bringing a legal dispute to court is often without proportion to the value of the service provided, ADR schemes can be a cost efficient device creating consumer confidence in their protection in legal disputes with the supplier. As argued above, the trust issue is one of the important demand side obstacles for cross-border financial services business. Therefore, an ADR system for cross-border business would be a big step on the way toward European retail markets for financial services. Thus it merits special attention that the Commission launched FIN-NET in February 2001, an EU-wide network of financial services complaints bodies.[6]

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6 for details see: http://europa.eu.int/comm/internal_market/en/finances/consumer/adr.htm.

FIN-NET links more than 35 different national complaint bodies – the national ombudsmen – into an EU-wide complaint network. Thus the existing national infrastructure is used. The objective is to make out-of-court settlement of cross-border dispute accessible to the consumer when the consumer and the provider of the financial service do not come from the same Member State. This is achieved by mutual recognition of the national redress bodies and exchange of information. In case of a dispute the consumer will be able to complain to a third party even if the supplier does not adhere to the complaint scheme in the consumer's country of residence. The complainant is put in touch with the redress body in the supplier's country of operation through the redress body in his own country of residence.

There is no doubt, that FIN-NET can be a big step forward to the creation of consumer confidence in the legal safety of cross border contracts in financial services. A precondition for FIN-NET's success, however, is that the ordinary consumer and the staff of financial services providers know of its existence. This is not the case today. So far the existence of FIN-NET is not common knowledge, and the media have not yet taken any notice of it. It seems that the parties involved have not yet devoted enough effort to the marketing of the network. If FIN-NET is to be of any use, much more needs to be done to make it known. This is a joint responsibility of the Commission, the national complaint bodies and the financial industry. An information campaign should be designed addressing at least staff in banks and insurance companies and the financial media in Europe.

5.5 Harmonising supervision

National differences in supervision both in terms of implementation and administration of EU law are a major source of high country specific information costs. These country specific information costs are at the heart of many suppliers' reluctance to develop pan-European marketing strategies. A more level playing field in supervision would therefore not only reduce competitive distortions it would also have a positive integration impact on retail markets. A consistent EU wide supervision system will become even more necessary after the enlargement of the EU when national supervisors of accession countries might otherwise add to the supervisory heterogeneity.

Today, the preconditions for the creation of a single European financial supervisory authority are not yet established and it is far from clear whether such a unified system would really be the optimal solution (see background paper LANNOO, 2002): One disadvantage of a single European authority is that it would set an end to inter-agency competition. This competition, however, is beneficial since it fosters efficiency and innovation. Furthermore, the single authority could increase problems of moral hazard by creating a perception that the whole financial system is more secure.

The establishment of a single authority would not be the only way for reducing the fragmentation resulting from the present regulatory approach. Cooperation can achieve much not only in optimising supervisory efficiency but

also in aligning administrative practices. There are highly successful examples like FESCO (the Forum of Securities Commissions) where within few years a trustful cooperation has developed. Nevertheless, more needs to be done to use this cooperative structure for overcoming integration hurdles: the different supervisory committees who constitute the cooperative link between national supervisors should in the future devote more efforts to:

- the consistency of rule-books,
- the standardisation of reporting requirements,
- the standardisation and harmonisation of supervisory practice.

While these measures could help already in the short-run, a more fundamental *medium-term reform option* should also be considered: Similar to the two-tier US system of state and federally chartered banks, large European banks could be allowed to opt for a supervision by a newly established European supervisory agency (this proposition was already made by SCHOENMAKER, 1995). The European agency would not replace the national supervisors but complement them. For the companies opting voluntarily for supervision by the European agency, Europe would become the "home" country. This two-tier system has two advantages: Pan-European banks and insurers would no longer have to deal with different sets of supervisory rules. At the same time, the beneficial competition between national supervisory agencies could be preserved together with the advantages of supervisors being well informed about the characteristics of national markets and national companies.

A single European supervisory agency is only imaginable as a *long run option* but it seems worthy of a more thorough consideration. Experiences after enlargement could strengthen the case for a European supervisor if effective coordination among 25 to 30 autonomous agencies proves to be impossible. Furthermore, with increasing integration the requirement for a level supervisory playing field could become increasingly important in order to avoid serious distortion of competition. Nevertheless, any development towards a European system would have to respect the subsidiarity principle. Thus a European System of Supervisory Agencies could one day become a solution – analogous to the European System of Central Banks.

5.6 Strengthening Europe

The proposals made above should not be seen only in the narrow context of financial market policies. They have to be seen in the broader picture of European integration and the vision of a more deeply integrated and enlarged European Union with a single currency and a truly single market. The desire is for a Europe which would be able to match the challenges of globalisation and a new knowledge-based economy, challenges which are "affecting every aspect of people's lifes and require a radical transformation of the European economy" (European Council 2000). According to the European heads of state and government such a transformation strategy should result in the EU "becoming the most dynamic … economy in the world, with full employment

and increased levels of social cohesion, by 2010" (European Council 2001). In order to achieve this strategic goal, the European Council at its Lisbon meeting declared that an important element would be the creation of "efficient and integrated financial markets" that could "foster growth and employment by better allocation of capital and reducing its cost" (European Council 2000).

Today however, the reality in financial markets, and retail markets in particular, is still far from this vision. The single currency is there but not a single market. Fragmentation is the dominant feature in financial retail markets, impeding economies of scale for the financial industries, excluding consumers from cheaper products and greater choice, and preventing additional growth of the whole EU-economy.

It is true that a lot has been done in recent years within the framework of the Financial Services Action Plan. This report has shown however, that this is not enough. The whole process needs to be speeded up and member states, notably the bigger ones, have to overcome their policies of maintaining market barriers or even re-establishing new ones because of a lack of a European perspective, old fashioned national standards and protectionist ambitions. In view of the potential growth effects and consumer benefits it would be worth for European decision-makers and legislators addressing the difficult task of removing the obstacles to a fully developed financial services market and, hence, to invest in the vision of a more closely integrated Europe with a true single market in which the possibilities presented by the single currency, the Euro, can be fully exploited.

The direction for the way ahead seems to be clear at least. But there are still important aspects of the link between financial integration and growth, notably in the retail markets, which deserve more careful analysis. More research is required with respect to particular market elements such as pensions and pension reforms and consumer protection. Also further work has to be done on the model of a vision for a true pan-European market, how it would function and through which institutions and mechanisms it could best be governed.

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APPENDIX 1: LIST OF BACKGROUND PAPERS

These background papers fully document the research on which this report is based. The papers are downloadable in full text from www.zew.de/erfstudyresults/ or www.iep-berlin.de/forschung/eu-market/.

RAINER BECKMANN, CARSTEN EPPENDORFER AND MARKUS NEIMKE (2002): Financial integration within the European Union: Towards a single market for insurance

CLAUDIA M. BUCH AND RALPH P. HEINRICH (2002): Financial Integration in Europe and Banking Sector Performance

Carsten Eppendorfer, Rainer Beckmann and Markus Neimke (2002): Market Access Strategies in the EU Banking Sector

FRIEDRICH HEINEMANN (2002): Benefits of Creating a Real EU Market for Investment Funds

FRIEDRICH HEINEMANN AND MARTIN SCHÜLER (2002): Integration Benefits on EU Retail Credit Markets: Evidence from Interest Rate Pass-through

KAREL LANNOO (2002): The Structure of Financial Market Supervision in the EU and the Required Adaptations in View of Market Integration

MARKUS NEIMKE, CARSTEN EPPENDORFER AND RAINER BECKMANN (2002): Deepening European Financial Integration – Theoretical Considerations and Empirical Evaluation of Growth and Employment Benefits

MICHAEL SCHRÖDER (2002): A Note on Benefits of Diversification and Integration for International Equity and Bond Portfolios.

MARTIN SCHÜLER (2002): Integration of the European Market for E-Finance – Evidence from Online Brokerage

MARTIN SCHÜLER AND FRIEDRICH HEINEMANN (2002): How Integrated are European Retail Financial Markets? A Co-integration Analysis

APPENDIX 2: MEMBERS AND MISSION OF THE EFR

Mission of the EFR

A group of leading European banks and insurers formed the European Financial Services Round Table (EFR). The members of EFR are Chairman or Chief Executives.

The purpose of EFR is to provide a strong industry voice on European policy issues relating to financial services. The initial objective is to support the completion of the single market in financial services. Members of the EFR believe that creating free competition on a level playing field with harmonised regulations and a single capital market will bring substantial benefits to customers including increased competition and greater innovation. These benefits will help to drive down prices and deliver a wider and better choice of financial products to customers.

EFR Members

Pehr G. Gyllenhammar, Chairman EFR and CGNU plc

Claude Bébéar, Président Directeur Général, AXA

Dr. Rolf E. Breuer, Spokesman of the Board of Managing Directors, Deutsche Bank AG

Hans Dalborg, President and CEO, Nordea AB

Gianfranco Gutty, Chairman, Assicurazioni Generali SpA

Rijkman Groenink, Chairman of the Managing Board, ABN-Amro Bank N.V.

Ewald Kist, Chairman of the Executive Board, ING Group

Sir George Mathewson, Chairman, Royal Bank of Scotland

Michel Pébereau, Président du Conseil d'Administration, BNP Paribas

Alessandro Profumo, Chief Executive, UniCredito Italiano S.p.A.

Dr. Henning Schulte-Noelle, Chairman of the Board of Management, Allianz AG

Francisco Gonzalez Rodriguez, Chairman, BBVA

Anton van Rossum, Chief Executive Officer, Fortis

Dr. Hans-Jürgen Schinzler, Chairman, Munich Re

K.J. Storm, Chairman of the Executive Board, AEGON N.V.