

## CONTINUING THE INTEGRATION OF EUROPEAN FINANCIAL SERVICES MARKETS

Berlin, February 2007



## The arguments at a glance

- Legislative work on the Financial Services Action Plan of the European Union (EU) is now complete, but there can still be no question of a true single market for financial services. Further action is required to create an internal market for retail customers, optimise European supervisory structures and eliminate obstacles to mergers and acquisitions in the financial sector.
- It is vitally important for all the EU institutions to apply better regulation principles to future legislative projects. To reduce bureaucracy, the effectiveness of existing rules must also be reviewed.
- Both differences in national civil law regimes across Europe and the minimum harmonisation approach are increasingly proving to be obstacles to integration. Targeted full harmonisation and a more coherent (initially optional) European contract law would help to rectify the situation.
- The European Commission's present proposals for opening up mortgage credit markets and creating an internal market for consumer loans are on the wrong track. They would work to the detriment of supply diversity and the ability to tailor products to individual requirements.
- In the European Payments Council (EPC), the banking industry has laid the foundations for the start of the Single Euro Payments Area (SEPA) in January 2008. But urgent action still needs to be taken by policymakers on creating an appropriate European legal framework for payments in the internal market.
- The European directive implementing Basle II (CRD) must be applied consistently by national supervisors. Only stringent application of the rules without any effect on competition will avoid potential competitive distortions.
- Tax discrimination of companies operating across borders remains a serious obstacle to integration. It is to be hoped that those in charge at the EU institutions recognise the need for action in this field.
- When modernising company law and improving corporate governance, differences in member states' legal systems, funding traditions and company cultures should not be ignored.
- European financial market policy is quite rightly strengthening its focus on the representation of European interests at international level. The financial markets regulatory dialogue between EU institutions and major third countries is the correct approach to eliminating contradictory and discriminatory rules. EU trade policy should aim at eliminating discriminatory financial regulation also in emerging markets.

## Continuing the integration of European financial services markets

### The internal market for financial services is not yet fully integrated

The integration of Europe's financial markets remains one of the primary goals and also—compared to other sectors—one of the most successful areas of European policy-making. The Financial Services Action Plan (FSAP), adopted in 1999, has in recent years been the centrepiece of initiatives targeting the financial markets.

Almost all the FSAP's 42 individual measures were completed on schedule by 2005. Nevertheless, in its White Paper on Financial Services Policy (2005–2010), published in December 2005, the European Commission points out quite correctly that there can still be no question of a fully integrated single financial services market. It is therefore essential to press ahead vigorously with the integration strategy of the past few years and exploit the untapped potential in the EU for higher economic growth and more employment.

European financial integration has really moved forward in the last five years. The challenge now is to consolidate progress and work together on applying the better regulatory disciplines. Our aim should be to create the best financial framework in the world. It means creating real, tangible benefits for the citizens and businesses of Europe through lower capital costs, better pensions, and cheaper, safer retail financial products.<sup>1)</sup>

The FSAP has succeeded above all in enhancing the integration of the securities and wholesale markets. In these sectors, the focus must now shift to correct implementation at national level of the measures already adopted and to an analysis of their impact on the market.

This is not, however, to say that a phase of consolidation in the securities and wholesale markets should prompt a moratorium on regulation throughout the financial services market. There is a need for further measures designed to make cross-border activities easier for customers and suppliers and promote new European business models.

1) Charlie McCreevy, European Commissioner for the Internal Market and Services, in a press release of 5 December 2005 announcing publication of the White Paper on Financial Services Policy (2005–2010).

The most pressing issues are

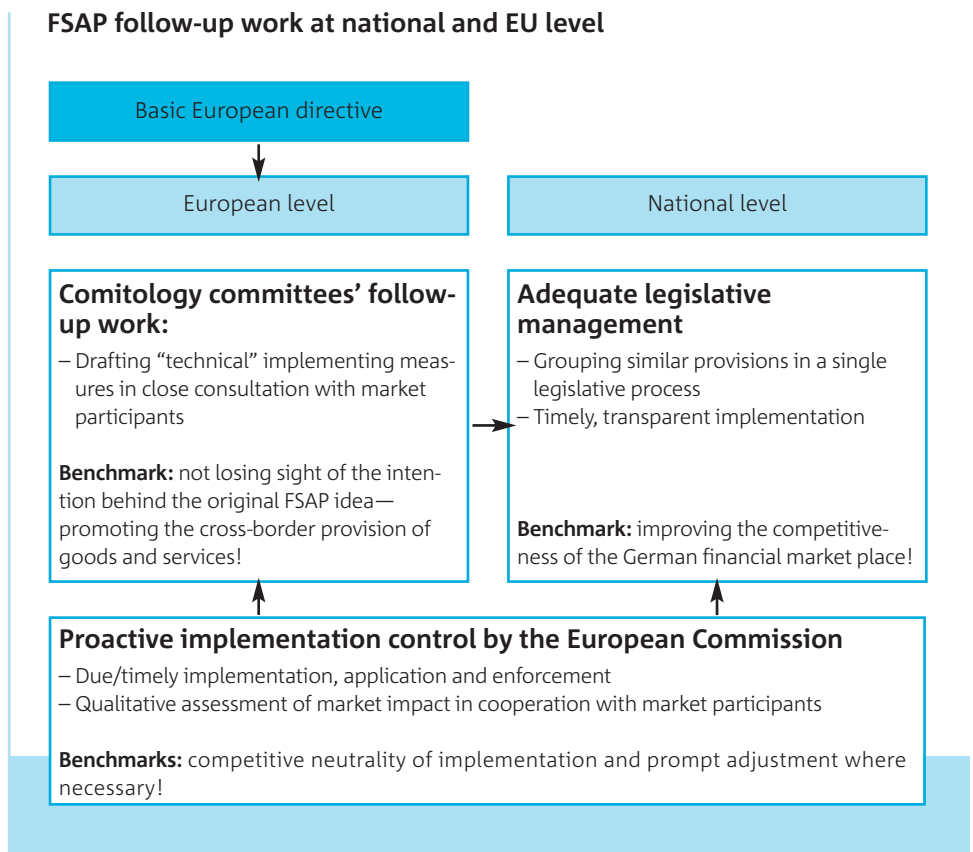
- dismantling barriers to cross-border retail banking;
- optimising supervisory structures for banks operating across borders and
- eliminating obstacles to mergers and acquisitions in the banking sector.

In its white paper, the European Commission rightly addresses these points, thus demonstrating its will to create a true single market for financial services.

### Implementation, enforcement and evaluation of the Financial Services Action Plan

Now that the FSAP has been completed at EU level, attention is turning to full and timely implementation of the measures at national level. Unfortunately, FSAP implementation and enforcement is not taking place in all member states on schedule and in a manner designed to promote integration.

Both the EU institutions and national lawmakers thus face the task of identifying why this is happening and taking concrete action to ensure that rules are implemented properly



and on schedule. The publication of tables and charts on transposition<sup>2)</sup> and the European Commission's transposition workshops for member states represent useful first steps. It will become necessary to introduce further measures when Level 4 of the Lamfalussy process examines the extent to which EU rules have been complied with.

The problem of gold plating, that is to say the addition of supplementary and more stringent rules by member states when transposing EU legislation, is sometimes encountered when FSAP directives are implemented at national level. This practice is totally at odds with the aim of establishing a single financial market with a level playing field for all market players.

If the benefits of a single market for customers and suppliers are not to be cancelled out, all member states should desist from gold plating.

The commitment to refrain from gold plating and create competitive market structures should also be examined when the European Commission conducts its in-depth FSAP evaluation, which is scheduled to last until 2009. It will be important, too, to analyse the reasons for the excessive degree of detail in the rules finalised so far since this threatens to deprive market participants of the room to manoeuvre

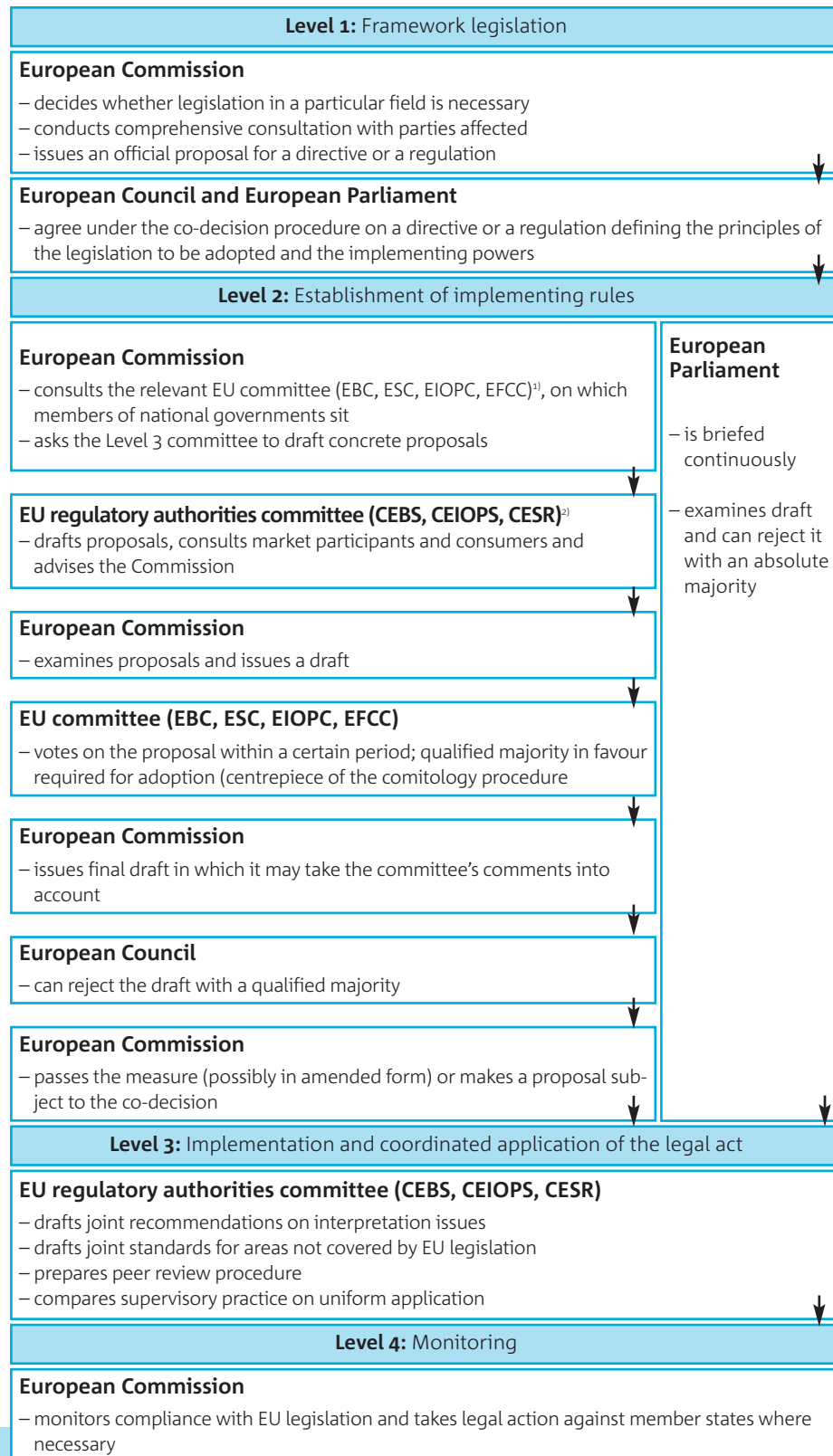
which is so vital to progress towards a single financial market.

One of those reasons is that the Lamfalussy process, which was introduced to make the EU legislative process swifter and more flexible, does not yet draw a sufficiently clear distinction between core issues, which should be decided by the Council and the European Parliament, and technical implementing measures, which can be dealt with by the European Commission at the subsequent Level 2. Distinguishing between the two often requires lengthy case-by-case analysis, which ultimately undermines the efficiency the process was designed to achieve. These problems need to be solved without delay so that the Lamfalussy process can deliver its potential to make legislation more flexible and workable in the field. The experience gathered by market participants with the new legislative model should be part of the debate, in line with a better regulation approach.

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2) The Commission's regularly updated tables and charts on the transposition of FSAP directives can be viewed by going to: [http://europa.eu.int/comm/internal\\_market/finances/actionplan/index\\_en.htm](http://europa.eu.int/comm/internal_market/finances/actionplan/index_en.htm).

## The Lamfalussy process



1) EBC: European Banking Committee; ESC: European Securities Committee; EIOPC: European Insurance and Occupational Pensions Committee; EFCC: European Financial Conglomerates Committee.

2) CEBS: Committee of European Banking Supervisors; CEIOPS: Committee of European Insurance and Occupational Pension Supervisors; CESR: Committee of European Supervisory Regulators.

## Better regulation

If the action plan's primary goal of promoting cross-border business is not to be frustrated by additional bureaucracy, it is essential to seek ways of improving regulation. A key role in this respect will be played by thorough impact assessments of all policy proposals.

But better regulation also means that legislation is not the answer to everything. It should always be asked whether market solutions or self-regulation by market participants might prove to be equally effective. Such options should be examined at an early stage in the consultation process.

If it is not necessary to pass a legislative measure, then it is necessary to pass no legislative measure.<sup>3)</sup>

It is no less important to scrutinise existing legislation with the aim of getting rid of unnecessary bureaucracy. If this is to be achieved, it must be possible to revoke or simplify rules. The pilot project launched by the European Commission in 2005 for this purpose should be extended to the area of financial services as soon as the FSAP's economic impact begins to make itself felt on the market.

The announcement by the European Commission on publication of its White Paper on Financial Services Policy that it intends to apply the better regulation approach to all future legislative proposals is thus an import-

ant step towards improving the quality of EU legislation.

It should nevertheless be borne in mind that this is a joint responsibility, which must also be shared by the Council and the European Parliament. Legislative impact assessment is not the province of the European Commission alone. If far-reaching amendments to a Commission proposal are adopted during discussions in the Council or Parliament, these should be examined just as rigorously as the original proposal itself. The assessment should be conducted within a framework which guarantees political neutrality and the best possible quality while keeping delays to the legislative process to an absolute minimum.

## Retail banking without frontiers

With the conclusion of the FSAP, the spotlight is turning increasingly to the retail markets, which still remain far too fragmented. It is therefore to be warmly welcomed that all EU institutions have made a firm commitment to eliminate obstacles to supplying cross-border financial services to retail customers. An integrated retail market will promote the competitiveness and growth perspectives of the EU.

As things stand, however, national borders represent virtually insurmountable barriers for consumers and the banks alike. "Natural" obstacles, such as differences in language and mentality, can be overcome with time as economic and social integration continues. Far more serious are the "artificial" obstacles arising from the fact that rules and regulations, especially

3) Attributed to Charles de Montesquieu (1689–1755), French political philosopher and writer.

those governing consumer and investor protection, vary widely from one member state to another.

These differences in European civil law regimes and the associated legal uncertainty impede the cross-border supply of financial services. As a result, a major segment of the financial market lacks a set of consistent and reliable rules for cross-border business.

The current fragmentation of retail financial services is unsatisfactory. There are huge latent benefits waiting to be exploited: a wider range of products and lower prices for customers; economies of scale for pan-European institutions; better synergies between companies merging together.<sup>4)</sup>

Common to these three projects is the key role assigned to a shared approach to consumer protection. This is to be welcomed, since legislators' focus on uniform and reliable consumer and investor protection standards will clearly promote the convergence of individual legal measures. The EU institutions have long preached the concept of the "responsible consumer", who is reasonably well-informed, vigilant and knowledgeable. This concept should be at the heart of future consumer policy relating to financial services. The consumer should be given access to thorough and objective information. Without responsible consumers, competition will be unable to flourish through the mechanisms of price and performance.

Against this backdrop, the European Commission has launched the following three initiatives:

- the White Paper on Financial Services Policy (2005–2010), which maps out its strategy for the next five years;
- the Green Paper on Mortgage Credit in the EU, whose objective is to establish a European market for mortgage loans and
- the revised proposal for a new Consumer Credit Directive, which aims at creating an internal market for consumer loans.

<sup>4)</sup> Charlie McCreevy, European Commissioner for Internal Market and Services, in "Banking regulation: next steps", a speech to the conference held by the French Banking Federation on 21 March 2006 in Paris.

The minimum harmonisation approach currently applied to directives concerned with consumer and investor protection is increasingly proving to have serious limitations: national implementing laws differ too widely for Europe's consumers and suppliers to benefit from them as they should. Furthermore, these directives often contain exemptions allowing member states to retain or introduce diverging rules "in the interests of the common good". This option is not infrequently misused to insulate domestic markets from competition.

The aim should be instead to establish pan-European definitions and rules for cross-border transactions. Future EU regulation on consumer protection should therefore be based on the following set of common principles:

- "quality, not quantity", meaning that suppliers should provide appropriate information;
- time to reflect (in the form of a cooling-off or right of withdrawal period);
- option of "individual" advice on request, but no mandatory requirement;
- straightforward customer complaint procedure;
- no product harmonisation through legal provisions.

The establishment of a fully integrated retail market would give a major boost to growth: consumers would be able to enjoy the benefits of the internal market. The banks, meanwhile, would have easier access to new market segments. The result would be increased efficiency and more prosperity.

The standardisation of rules for individual financial products, in contrast, would reduce product diversity and competition. Instead of overregulating financial services, which would ultimately disadvantage the customer, European lawmakers should confine themselves to establishing a level playing field for all market participants.

It is to be welcomed that the EU institutions want to create common, more straightforward rules in order to strengthen consumer confidence in the internal market. Nevertheless, given the complexity of regulation in the area of European consumer protection, the question should be asked whether "less can sometimes be more". What is needed are not new rules, but consolidation and streamlining. The European Commission's ongoing revision of the *acquis communautaire* on consumer protection offers an excellent opportunity to achieve these objectives. The oft cited "responsible consumer" should not fall victim to overregulation: it should be remembered that too high a level of protection ultimately has its price.

## ELIMINATING OBSTACLES IN RETAIL BANKING

The following measures, which could be taken in the short to medium term, would facilitate cross-border electronic access to retail banking products for bank customers in Europe:

- Allowing cross-border bank accounts to be opened over the Internet without the cumbersome need to furnish proof of identity by non-electronic means, such as Germany's Postident system, would make life considerably easier for both consumers and banks. This would require a legal basis permitting bank accounts to be opened throughout the EU with an advanced electronic signature.
- With regard to lending operations, many member states do not allow guarantee or consumer loan agreements to be concluded over the Internet. In Germany, for example, sentence 2 of Section 492 (1) of the Civil Code (Bürgerliches Gesetzbuch, BGB) explicitly prohibits the conclusion of such contracts "in electronic form". This restriction on online banking should be lifted throughout the EU without delay since the right of withdrawal in the Distance Selling Directive already gives consumers an adequate period for reflection. Furthermore, German law already allows customers a right of withdrawal from consumer loan agreements "irrespective of the medium involved" (BGB Section 495).
- Concerning e-commerce in general and Internet banking in particular, there is an urgent need for the European Commission to clarify the relationship between the country-of-origin principle enshrined in the E-Commerce Directive and general conflict-of-laws rules (private international law). Given the virtual nature of Internet processes, it would be worth considering giving preference to the country-of-origin principle, either as a general rule or special connecting factor.
- To increase legal certainty with respect to cross-border transactions, civil-law formalities should be standardised in consumer protection laws across the EU (e.g. obligations to furnish information, advise of right of withdrawal). This would dispense with the time-consuming and costly need to examine the requirements of each national jurisdiction.
- German lawmakers are called upon to make cross-border investments easier for customers and banks. Electronic signatures should be allowed when making, renewing and cancelling applications for exemption from capital gains tax, for example.

## Harmonisation of civil and contract law

In its 2003 action plan on European contract law, the European Commission identified numerous obstacles and hindrances to doing business across borders in the internal market. The need for alignment of the laws regulating cross-border business at European and national level was evident. Against this background, the European Commission's reaffirmation in its October 2004 communication "European Contract Law and the revision of the acquis: the way forward" of its intention to create a more coherent European contract law is to be welcomed.

Even in areas where EU harmonisation has already taken place, nationally implementing legislation differs too widely for consumers and suppliers to benefit. Above all, differences in substantive law between national civil law regimes continue to make it difficult to supply financial services across borders, especially in retail banking.

Economic realities will ultimately lead to a kind of 'EU Civil Code'. For this, we will need a common set of principles.<sup>5)</sup>

The European Commission has assigned a key role in improving the coherence of European contract law to the Common Frame of Reference (CFR), which is due to be approved in 2009. The CFR, which also enjoys the support of the European Parliament, is to contain basic principles of contract law, definitions of legal terms and model rules. It is being drafted for the European Commission by a group of legal academics drawn from all over Europe. The Association of German Banks is involved in a network of experts known as CFR-net, which was set up by the European Commission to ensure that the frame of reference will properly reflect the needs of its future users.

It is open to question, however, whether the ambitious timetable for preparing the framework and the tight deadlines for comment will allow CFR-net members sufficient time to deal with all the material involved. The CFR must be designed in such a way as to meet user needs in practice if it is to gain widespread acceptance and later form the basis for an optional European contract law code. It is vital, above all, for the project to focus more strongly on contractual freedom as a key component of a private law geared towards a free market economy. Furthermore, there is a need for an open discussion of the central issues with the involvement of all parties, including academics, who have been responsible for national contract law regimes up to now. The European Commission is called upon to lay the necessary groundwork.

5) Klaus-Heiner Lehne, Member of the European Parliament, on the adoption in Brussels on 23 March 2006 of the report on "European Contract Law and the revision of the acquis: the way forward".

## The integration of European mortgage markets

The European Commission sees action aimed at improving consumer information and protection as crucial to integrating Europe's mortgage credit markets.

It is true that a high level of consumer confidence is particularly important in this business segment. Product transparency and consistent information standards are major prerequisites here. As early as 2001, the European banking industry created its Code of Conduct for Home Loans with exactly this in mind.

But the statutory regulation of mortgage loans proposed in the European Commission's July 2005 Green Paper on Mortgage Credit in the EU would go far beyond this and be tantamount to product harmonisation. Neither mandatory information and advice requirements nor the introduction of standardised repayment arrangements could accommodate differences in national consumer profiles. Furthermore, it should not be overlooked that the quality of advice and product design are criteria that allow customers to differentiate between rival suppliers and therefore do not lend themselves to standardisation. As the European Parliament acknowledged in its report on the European Commission's green paper, such an approach would not be conducive to more competition or a market-driven approach to the integration of mortgage markets.

A capital market-based approach would achieve these objectives more readily. Better international diversification of credit risk, improved refinancing conditions and better capital allocation could together increase efficiency and result in more favourable interest rates in the mortgage loan sector.

This would require the following measures to be put in place:

- a legal framework for efficient portfolio trading that would allow the development of a liquid secondary mortgage market;
- easier transfer of real-estate security interests, and last but not least;
- the introduction of a euro-mortgage.

## **Revision of the European Consumer Credit Directive**

In October 2005 the European Commission published a new proposal for revising the Consumer Credit Directive. The proposal represents a step towards improving the legal environment for consumer credit in the internal market. Compared to the original September 2002 proposal it takes a more differentiated approach and somewhat more account of the banking industry's needs. It is to be welcomed, for example, that mortgage loans are now to be excluded from the scope of the directive.

Negotiations in the European Council were initially slow before gaining momentum at the end of 2006. The harmonisation approach which is being pursued continues to lack balance, however. More minimum harmonisation of the rules governing consumer credit will not deliver a consistent or reliable legal basis. Reservations on the part of both suppliers and customers about cross-border loans will only be overcome by an appropriate level of full harmonisation of the areas of law which have particular relevance to doing business across borders.

Despite some improvements compared to the European Commission's original proposal, particularly the planned rules on "responsible lending" remain problematic. These would enable consumers to shift responsibility for the economic consequences of their actions on to the lender. This would be an inappropriate signal. It cannot be the task of lawmakers to protect responsible consumers from themselves to the detriment of the supplier.

Naturally, consumers must have access to the information they need to make a responsible decision. The creation of new circumstances under which the banks may be held liable, however, risks causing the banks to cut down their lending in future. This would make access to credit unnecessarily difficult, especially for consumers with a low credit score.

When debating the revised proposal, therefore, the primary objective of both the Council and the European Parliament should be to give consumers more options, not less product diversity.

## The road to the Single Euro Payments Area (SEPA)

The European banking industry established the European Payments Council (EPC) to offer the European Commission, Parliament and Council and the European Central Bank a central interlocutor on payment-related issues.

In December 2004 the EPC published a detailed road map for the creation of a Single Euro Payments Area (SEPA). Under this road map, the European banking industry will offer consumers SEPA instruments for direct debits, credit transfers and card payments from 2008 onwards. Customers will then be able to make euro payments within the EU just as simply, swiftly and securely as they carry out national payments today. For corporate customers that do cross-border business and for German SME exporters, SEPA has the additional benefit that all payments can be carried out using the same conventions and standards. These customers will thus be able to unify their processing of all payments in euros.

The SEPA project is—in ambition and size—comparable with the changeover to the euro banknotes and coins, although the logistics are quite different. SEPA could be seen as an important historical step in the unification of Europe after the introduction of the euro banknotes and coins.<sup>6)</sup>

Last but not least, SEPA will make it possible to centralise account maintenance and improve liquidity management. This is highly important for companies that operate across Europe.

The timetable is on track for the introduction of SEPA instruments—SEPA implementation—by 2008. Subsequent migration, that is to say the complete replacement of existing systems, will depend on market developments. Such complex developments with far-reaching economic implications cannot be prescribed by law. The speed of migration must be determined by market realities.

### SEPA IMPLEMENTATION:

With the adoption of the EPC rulebooks in March 2006, the most important prerequisites for creating SEPA were met. Efforts are now focusing on preparing for technical implementation of the products by 2008. Customers will then be able to use the SEPA payment instruments.

### SEPA MIGRATION:

“SEPA migration” is the process of replacing today’s national payment systems with SEPA instruments. Migration will be market-driven and continue beyond 2010.

6) Jean-Claude Trichet, President of the European Central Bank, in a speech at the Euro Finance Week on 13 November 2006 in Frankfurt am Main.

## **The single legal framework for payments in the internal market**

The European banking industry, working under the umbrella of the EPC, has done what was necessary to make SEPA a reality. The integration of Europe's payment systems cannot be achieved by the banks alone, however. The SEPA direct debit, in particular, will require a single legal framework to bridge the differences in national legal regimes. With this in mind, the European Commission issued a proposal for a directive to create this framework for payments in the internal market. The directive is intended to establish uniform rules on, among other things, the authorisation of payments, the applicability of account identifier standards, the revocation of payment orders and on refunding direct debits.

But the proposal published by the European Commission in December 2005 went far beyond that which is required. Establishing a legal basis for SEPA does not make it necessary to define payment institutions without a banking licence or impose extensive information requirements, for example. While the revision of the Commission proposal by the European Parliament's Economic and Monetary Affairs Committee in September 2006 did not bring any breakthrough, it produced a number of positive changes.

On this basis, the EU institutions were, however, unable to agree on adoption of the directive by the end of 2006 as originally planned. This delay affects the SEPA direct debit in particular, as uniform law is a condition

for the use of this product within the European Union. The final talks on adoption of the directive must now focus on really facilitating payments in the internal market and not creating new obstacles in the interests of would-be consumer protection. Moreover, it would not be acceptable for the legal framework to interfere with the freedom of suppliers to make their own business policy decisions. In particular, there must be no restrictions on product design and pricing freedom.

## **Capital adequacy requirements for banks (Basle II)**

The Basle Committee on Banking Supervision's June 2004 reform of its capital adequacy rules is a major contribution to the stability of the global financial system. While the new capital adequacy framework (Basle II) was designed primarily for internationally active institutions, the Capital Requirements Directive (CRD), which came into force on 1 January 2007 to implement Basle II in the EU, covers all European banks. A number of adjustments were made to the Basle framework when drawing up the directive to take account of specific European needs.

Compared to its predecessor, Basle II makes lending conditions more closely reflect the creditworthiness of the borrower. Fears that switching to Basle II would have an adverse effect on borrowing conditions for German companies have proved unfounded. True, the introduction of rating systems has made it necessary for companies to disclose more information about their situation to the

banks. But the internal rating systems now used throughout the industry have not made it more difficult for companies, even small ones, to access credit<sup>7)</sup>.

It is vitally important that Basle II should be applied consistently in member states. National supervisors are therefore called upon to ensure uniform legal implementation and practical application of the CRD. The large number of national options currently enshrined in the directive need to be gradually reduced. Furthermore, the broad scope for discretion which the rules allow must be dealt with as consistently as possible in practice.

A key issue when the CRD is implemented in Germany is to ensure that the treatment of intra-group exposures does not distort competition across the industry.

If exposures between members of a joint liability scheme are exempted from capital requirements, all the essential requirements that apply to banking groups must be satisfied in full by joint liability schemes, too. These requirements include central risk management and central monitoring of large exposures. There must be no watering down of the directive's rules in this area.

While Basle II took effect in the EU on 1 January 2007 (simple approaches), with the more sophisticated approaches becoming applicable from 1 January 2008, implementation in the United States is not anticipated until 2009 at the earliest. On top of this delay, the US version of the rules differs from the Basle framework in a number of serious

## INTRA-GROUP EXPOSURES (IGE)

One of the CRD's most contentious options is the exemption from capital requirements of all exposures between public-sector banks and between cooperative banks in Germany on the strength of these banks' membership of their sector's joint liability scheme. This would result in around two-thirds of German banks no longer needing to set aside capital against interbank transactions with other institutions in their sector.

There is a risk of substantial systemic risk and competitive distortions compared to the situation under Basle I. For this reason, the directive ties the use of this option to the fulfilment of strict criteria. It is up to German supervisors to monitor rigorously that these criteria are met.

respects. These two factors will together make it enormously difficult for internationally active banks to implement Basle II on both sides of the Atlantic. EU banking supervisors and their US counterparts are therefore called upon to jointly negotiate a mutually acceptable solution which will avoid the duplication of work and competitive distortions for banks operating on both continents.

7) 2006 corporate survey by the Kreditanstalt für Wiederaufbau (KfW), "Unternehmensfinanzierung: Immer noch schwierig, aber erste Anzeichen einer Besserung. Rating erreicht zunehmend die kleineren Unternehmen." Frankfurt am Main, September 2006, page 6.

## Integration of European supervisory structures

The borders between banking, insurance and investment business are becoming increasingly blurred and the number of European financial conglomerates is increasing. At the same time, the progress in information and communications technology is accelerating the globalisation of financial transactions and facilitating market entry as well as the development of new markets and lines of business. As a result, handling such increasingly international and cross-sectoral transactions is becoming more and more complex. Financial institutions are responding to this by centralising their risk management. Only centralised risk management allows an assessment of a group's overall risk exposure and prompt cross-border intervention.

These developments have produced a two-fold response from supervisors in the EU. On the one hand, there is a trend towards integrated financial market supervision across sectoral borders: in Germany, for example, the Federal Financial Supervisory Authority, BaFin, was set up on 1 May 2002, while the UK combined the different national supervisory authorities into the Financial Services Authority (FSA).

On the other hand, there is also a trend towards much closer cooperation between national supervisors. This cooperation promises, in particular, more consistent implementation of EU rules. At the same time, codes of best practice are emerging and national supervisors' joint response to cross-border developments is being improved. This process can be

described as the creation of a "European supervisory culture", a target also pursued by the European Commission<sup>8)</sup>. It is a major step on the road to a European System of Financial Supervisory Authorities (ESFSA).

Such a system, headed by a supranational supervisory authority, should be directly responsible for supervising large, cross-border financial institutions. Institutions operating only domestically would continue to be overseen by national supervisors. The ESFSA concept is similar to the European System of Central Banks (ESCB) or the two-tier procedure under EU competition law. It would thus comply with the subsidiarity principle enshrined in the EU Treaty.

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8) European Commission White Paper on Financial Services Policy (2005–2010), page 12.

An ESFSA has a number of advantages. For example, duplicate reporting to different supervisory authorities, inconsistencies due to national rules or supervisory practices, and competitive inequalities would all be avoided in future. In addition, an ESFSA would have clout commensurate with Europe's economic weight in international negotiations.

However, besides the political will among member states and supervisors, the establishment of an ESFSA with the power to supervise individual institutions calls for a wide-ranging basis in European law. This is because, despite harmonisation of numerous supervisory rules, the EU does not yet have a common supervisory law framework. On the way to supervisory convergence in Europe, the Level 3 committees in the Lamfalussy process therefore play a key role.

Another key issue is supervisory convergence. We need to build a true European supervisory culture with mutual trust and confidence. [...] I want to see enhanced cooperation, so supervision in all the member states is done to top-class standards. We will help the supervisory committees wherever we can, but the main task of making the system work will be with them. I won't hesitate to suggest reforming the system if I see that it doesn't do the job.<sup>9)</sup>

What is more, the authority heading the ESFSA needs to have the power to impose effective, uniform sanctions. These do not yet exist either at European level, as there is no European administrative or enforcement law. National differences in the legal remedy granted to supervised institutions also have to be taken into account. Since supervisory rules, which may go as far as stipulating the closure of an institution, have potentially serious civil-law implications, harmonisation of civil law particularly with regard to the way claims for compensation are regulated would also be required.

Supervisory standards should not be allowed to create any new inconsistencies in the *acquis communautaire*. It is therefore important to prevent any clash between European supervisory law and contract law or data protection law from the outset.

The EU institutions are on the right track in the integration of European supervisory structures. Yet, the adjustment of supervisory structures threatens to fail to keep pace with the globalisation of banking business. This is why the European law issues mentioned above now need to be tackled firmly.

9) Charlie McCreevy, European Commissioner for the Internal Market and Services, in "Building an EU Integrated Market in a Globalised World", a speech to the World Congress of Financial Executives on 9 October 2006 in Berlin.

## Obstacles to cross-border mergers and acquisitions

The single European financial market will only unfold its full prosperity-boosting impact once financial services can—wherever it is economically profitable—also actually be provided across borders. Merging with a foreign bank or acquiring a foreign bank are merely two, albeit important, ways of expanding operations beyond home-country borders. As such, mergers and acquisitions complement other means of providing financial services across borders like, for example, direct marketing abroad by mail, by telephone or over the Internet, plus the establishment of branches or legally independent foreign subsidiaries.

From an internal market policy standpoint, mergers and acquisitions are not an end in themselves. So allowing them cannot be an objective per se either. What matters is the benefit that can be created for customers and suppliers.

Consolidation in European financial markets is picking up but is still lagging behind other sectors. This is unfortunate because, whilst consolidation is not an end in itself, it remains a means to achieving greater efficiency. Consolidation allows institutions to reach their full potential and to compete internationally. Markets are dynamic and we have to provide the appropriate framework to avoid any obstacles to their dynamism.<sup>10)</sup>

The number of direct legal obstacles to mergers and acquisitions in the EU is relatively small, and the European Commission's proposal to review the rights and obligations of EU supervisors when assessing intended cross-border holdings (Article 16 of the Codified Banking Directive) is a further step in the right direction. Now it is up to the Council to support this new arrangement proposed by the European Commission as an appropriate approach.

Much more serious than the direct obstacles are the indirect ones. While they do not actually block mergers and acquisitions, they make them unprofitable. These obstacles have to be eliminated at national and European level in order to ultimately generate more growth momentum for Europe's economy as a whole.

10) Charlie McCreevy, European Commissioner for the Internal Market and Services, in "Improving the supervisory approval process for mergers and acquisitions", a speech on 12 September 2006 in Brussels.

## OBSTACLES TO CROSS-BORDER MERGERS AND ACQUISITIONS

- Although there is the danger that Article 16 of the Codified Banking Directive, which deals with the approval/prohibition of the acquisition of qualifying holdings, may be used for protectionist purposes, it plays an important role in maintaining the integrity of the financial system. It would be advisable to add a negative clause to Article 16 explicitly stipulating that it serves prudential purposes only. Supervisors should be required to assess intended holdings in a clearly structured notification procedure and, when issuing a negative decision, to explain in detail the reasons for their decision to applicants.
- A serious obstacle to consolidation in the European banking sector is the ban on selling off a large part of the German banking industry. The public ownership of Landesbanken (central savings banks) and Sparkassen (local savings banks) enshrined in the savings bank laws in force at federal state level means that much of the German banking industry is excluded from the outset from mergers with and acquisitions by German or foreign banks. German federal state legislation should be amended accordingly so that basically any (foreign) investor can invest in any bank in Germany on a non-discriminatory basis.
- The protection of the name “Sparkasse” under Section 40 of the German Banking Act, which stipulates that the name “Sparkasse” can only be used by public-sector banks, should be abolished. The agreement reached between the European Commission and the German government for Berlin, stating that any potential private buyer of Berliner Sparkasse may freely use the name “Sparkasse” in the future, must also cover all future privatisations of savings banks. Only if a buyer can carry on a bank under its familiar, well-established market-place name will real investor interest, which is a condition for consolidation, be able to develop.
- Banking supervisory rules are inadequately harmonised in the EU. Particularly the European directives implementing Basle II contain a number of national options that can be designed differently by each member state. It is also to be feared that qualitative supervisory rules—even if they apply uniformly EU-wide—will be interpreted and applied differently by individual supervisors. In the event of a cross-border merger, this sometimes means wide-ranging—and extremely costly—adaptation of business processes to the banking supervisory regime of the future country of domicile.
- A serious economic obstacle is the still outstanding harmonisation of civil law and contract law. In the retail banking sector in particular, there are different civil-law formalities to protect consumers in member states (e.g. obligations to furnish information, advise of right

of withdrawal). Costly and time-consuming examinations of different national legal regimes prevent harmonisation of business processes, with the result that economies of scale and fixed-cost savings cannot be achieved to a large extent.

- With regard to company law, the supranational legal form of the European Company (Societas Europea, SE) allows companies to merge across borders and transfer their seat in a manner enabling them to retain their identity. The 10th Company Directive on the merger of companies from different member states is also a step in the right direction. However, the new European Mergers Directive is not sufficient to prevent the current discrimination against German companies, e.g. on the controversial issue of the German system of employee participation (“co-determination”).
- If hidden reserves are disclosed in cross-border mergers, there is the danger of (once-only) double taxation in both countries concerned. At the same time, current taxation of earnings poses permanent obstacles to cross-border groups and thus to corporate takeovers. Loss offsetting for tax purposes between parent companies and subsidiaries should therefore be possible across borders as well in future.
- Due to the lack of VAT neutrality in the financial services sector, attempts to achieve cost synergies by centralising services are all too often thwarted by a heavy additional VAT burden. A uniform EU-wide definition of financial services and products is also missing. The present revision of the 6th VAT Directive should help in this respect.

## Tax issues

Particularly the treatment of cross-border activities makes clear that the different tax regimes in place in the EU member states are one of the toughest remaining obstacles to the single financial market.

Diverging tax rules, e.g. for determining taxable income and calculating tax bases, hamper cross-border business and investment in the EU, increase the cost of capital and diminish both returns on investment and international investors' interest in the eurozone.

It is not a question of different tax rates, which should certainly be subject to competition between tax systems, but of unacceptable tax discrimination that is an obstacle to cross-border offerings, the sale of investment products and cross-border investment. Numerous national tax laws are, moreover, still incompatible with the fundamental freedoms enshrined in the EU Treaty (freedom of establishment and freedom of capital movements).

Bringing national tax laws into line with Community law and filling the gaps in tax harmonisation that still exist are therefore priority tasks in the further development of the internal market.

The aim is thus clear: creating more legal certainty Europe-wide and dismantling tax barriers. To accomplish this, the following measures are required in particular:

- harmonising determination of taxable income for companies which invest in more than one EU member state;
- introducing the possibility to expand loss offsetting for tax purposes within a group to foreign subsidiaries and branches (“permanent establishments”) in other EU member states;
- ensuring VAT neutrality for the banking industry;
- removing tax obstacles to cross-border restructuring measures;
- resolving important issues which the EU Savings Tax Directive leaves open (e.g. the definition of “innovative financial instruments” and “other institutions” excluded from the Directive).

## Company law

Alongside the FSAP, the European Commission's action plan for Modernising Company Law and Enhancing Corporate Governance in the European Union, which was unveiled in 2003, has evolved into one of the most important internal market projects.

When it comes to transferring their seat across borders, companies in the EU still face numerous legal and administrative obstacles. It is to be welcomed that the European Commission now intends to present the Directive on cross-border transfer of seat (14th Company Law Directive) that is endorsed by a large part of the business sector<sup>11</sup> and the European Parliament<sup>12</sup>.

At the same time, it became clear in the various consultations that lean, unbureaucratic and efficient legislation should be the target vision for future EU policy on company law and corporate governance. The better regulation rules could be a major contribution to intensive competition and economic growth in this area as well.

If new rules are issued, these must make allowance for the differences between the legal systems, ownership structures, funding traditions and company cultures in the member states. The European Commission should therefore focus on establishing uniform principles for key aspects of company law and corporate governance.

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11) Results of consultation, presented on 7 July 2006, on the future priorities of the action plan on Modernising Company Law and Enhancing Corporate Governance in the European Union, page 17.

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12) European Parliament resolution of 4 July 2006 on recent developments and prospects in relation to company law, paragraphs 32 and 33; European Parliament resolution of 12 December 2005 on the Commission legislative and work programme for 2006 (COM (2005) 531), paragraph 12.

## **OVERVIEW OF THE MEDIUM-TERM MEASURES (2005–2008) ANNOUNCED IN THE EU ACTION PLAN ON MODERNISING COMPANY LAW AND ENHANCING CORPORATE GOVERNANCE IN THE EUROPEAN UNION<sup>1)</sup>**

### **Corporate Governance**

- Increased disclosure of institutional investors' investment policy and policy with respect to the exercise of voting rights
- Option of a two-tier or a one-tier system for all listed companies
- Strengthening directors' responsibilities (special investigation right, liability for wrongful trading, imposition of directors' disqualification)
- Study of the consequences of an approach aimed at establishing a real shareholder democracy (one share/one vote), at least for listed companies

### **Capital maintenance**

- Considering an alternative capital maintenance regime

### **Groups**

- Presenting a framework rule for groups that allows subsidiaries to adopt and implement a coordinated group policy

### **Pyramids**

- Banning the listing of companies belonging to abusive pyramids, where appropriate, after carrying out further examination and obtaining an expert opinion

### **Restructuring**

- Simplifying the 3rd Company Directive (Merger of public limited liability companies) and the 6th Company Directive (Division of public limited liability companies)

### **EU legal forms**

- Examining the need for other EU legal forms of enterprises (e.g. European Mutual Society)

### **Transparency of national legal forms**

- Introducing basic disclosure requirements for all legal entities with limited liability after further examination

<sup>1)</sup> European Commission action plan of 21 May 2003 on Modernising and Enhancing Company Law and Corporate Governance in the European Union, Annex I, page 2.

## Clearing and settlement

An integrated European financial market can only be achieved if the market, too, is involved in securities processing (clearing and settlement/post-trading). The European Commission has therefore rightly taken up this issue. The approach it has chosen—removing market weaknesses with regard to competition through voluntary self-regulation (in the form of a code of conduct) by the central trading, clearing and settlement service providers, is expressly welcomed.

The most important points in the code of conduct signed by the industry in November 2006 are, for example, price transparency by the end of 2006, unhindered mutual access by system providers by 30 June 2007 and separation of core and ancillary services, including separate accounting, by the end of 2007. This package of measures is ambitious timewise but covers the right points as far as users are concerned.

There is also agreement on the need to remove the barriers to cross-border clearing and settlement identified in the reports submitted by the so-called Giovannini Group (2001/2003). The expert groups set up by the European Commission, i.e. CESAME (technical/organisational barriers), the Legal Certainty Group (legal barriers) and FISCO (tax barriers), are exploring ways to eliminate these obstacles and coordinating market-driven measures. In the technical/organisational sector, first results have already been presented by market participants. However, because of the interdependencies with legal and tax barriers, the synergies

that can be achieved are limited. Driving forward work in this area is a priority issue.

The European Commission plays a key role when it comes to coordinating and pressing ahead with the various legal measures and self-regulation approaches. At the same time, it will also be interesting to see to what extent the common securities settlement platform (TARGET2-Securities) project announced by the European Central Bank can also help in this respect.

## Accounting

The mandatory application of the International Financial Reporting Standards (IFRS) by all listed companies in the EU from 2005 was a key milestone on the way to an integrated European financial market, as the adoption of common international standards ensures transparency and comparability of company accounts. The mutual recognition of IFRS and United States Generally Accepted Accounting Principles (US GAAP), which is extremely important for internationally active companies, should now also be seen against this background.

The European Commission has made a firm commitment to mutual and simultaneous recognition of these accounting standards over the past few months. It should continue its efforts to achieve convergence, as comparable, internationally accepted accounting standards are crucial to efficient capital markets.

However, convergence should not be seen as a one-way street leading toward US GAAP. The main aim must be creating high-

quality standards. But this also means that due account must be taken of the European market situation in the standard-setting and convergence process. To ensure this, every effort should be made to strengthen Europe's influence in the international standard-setting process at the level of the International Accounting Standards Board (IASB).

Underlining the importance of the European Financial Reporting Advisory Group (EFRAG), which advises the European Commission on IFRS issues, is a first step in this direction. Against this background, the working arrangement concluded between the European Commission and the EFRAG in March 2006 is to be welcomed: it defines the tasks and responsibilities of the EFRAG, as well as the working relationship between the EFRAG and the Commission departments.

What is also important for the acceptance of the IFRS and for their recognition in the US is that they are applied uniformly in Europe. To this end, the "European Roundtable for consistent application of IFRS in the EU" was set up. It allows the major players in the accounting sector to exchange views on controversial IFRS application issues. Interpreting individual IFRS is not the Roundtable's job, however. This is the task solely of the IASB's International Financial Interpretations Committee, to which the Roundtable forwards inquiries where necessary.

## **Optimising international representation of European interests**

The activities of European companies and banks do not end at the borders of the EU or even of the eurozone. This is why optimal representation of the EU in non-European and international bodies is right at the top of the EU financial market policy agenda.

The aim must be agreements reached directly within these bodies that meet the requirements of European market players from the outset. This requires a strong, coordinated European voice. Reviewing rules that have already been negotiated at international level to possibly amend them substantially for the EU remains a wrong approach. The consequence is incompatibilities that ultimately lead to costly obstacles to operation for European suppliers and to a less than optimal supply of goods and services for European customers.

Legal rules that are developed in financial market places outside Europe, particularly in the US, and that affect the activity of European companies and banks may also be a problem. This makes the informal EU/US Financial Markets Regulatory Dialogue, which has been held regularly since 2002, all the more important.

To avoid continuous ex post repair of conflicting rules on both sides of the Atlantic, this dialogue is increasingly moving towards deliberate integration of the transatlantic financial markets. This is to be welcomed. A good example is the progress made in the mutual recognition of IFRS and US GAAP.

The way forward is clear: the transatlantic regulatory dialogue is also an area where the principle of mutual recognition of different financial market standards is able to prevent dual or even conflicting regulation of banks and issuers. This is evident particularly where the standards that are to be mutually recognised are based on international rules—take, for example, the capital requirements for banks agreed by the Basle Committee.

The “mutual recognition” approach should be pursued more seriously and more determinedly. The resulting international deregulation would provide a boost to growth in the EU, the US and in all other industrialised countries involved (e.g. Australia, Canada, Japan, Switzerland).

Even where banking and capital markets are less advanced, integration can still be driven forward to the mutual benefit of all concerned. But before this can happen, the discriminatory restrictions on market access by foreign financial institutions in many emerging countries have to be removed. The WTO’s Doha Round provided a multilateral forum comprising 150 member countries for this purpose. Following the recent suspension of the Doha Round, the EU will turn its attention more to bilateral free trade agreements with the leading markets. However, numerous issues that remained unsolvable in the course of the Doha Round, will have to be addressed again even in negotiations on bilateral free trade agreements. In the medium term, reverting to multilateral negotiations therefore remains the most sensible way forward. The newly established regulatory dialogues with China, Russia and India are to be welcomed.

## Conclusion and outlook

Further developing the internal market must remain the EU's key strategy for more growth and economic vigour. There are good reasons for this strategy: competition in Europe means cost advantages and synergies that bring benefits for consumers in the form of lower prices and a better supply of goods and services, while the cost advantages in the internal market make European companies stronger and improve their international competitiveness.

This goes particularly for the financial services markets. These play a vital role on the road to more growth and prosperity in the EU. Yet, the EU is still a long way from a true single financial market. Although much has been achieved under the Financial Services Action Plan, by no means all market sectors have actually been integrated. This not only adversely affects banks' flexibility and efficiency, but also deprives consumers and corporate customers of the chance to positively experience what economic integration can mean. The FSAP was a—successful—first step towards opening up the financial markets. Its completion is not enough, however. This is why there is no place for “euro fatigue” in financial market policy. If financial market integration is to be carried on successfully, calls for protectionism and safeguards against competition should go unheeded in the future, too.

The European Commission has recognised this and, with “dynamic consolidation” as its guiding principle, is showing the right way forward, if “dynamic” is really taken seriously. Besides implementation of the FSAP and an assessment of its market impact, integration of the remaining market segments and institutional structures must be tackled firmly. That goes, first and foremost, for the retail and SME sectors, but also for the establishment of a European supervisory culture<sup>13</sup>.

It is greatly welcomed that both the German parliament<sup>14</sup> and the European Parliament<sup>15</sup> have made a commitment to these objectives. Integration of the financial services markets is now being accorded the political importance it deserves. This raises hopes that setbacks at the overarching political level—such as the failure so far to adopt the European Constitution—will not have any lasting negative repercussions for integration of the EU markets for financial products.

13) European Commission White Paper on Financial Services Policy (2005–2010), Annex II, page 20.

14) Bundestag Resolution of 15 March 2006 entitled “Besser regulieren, dynamisch konsolidieren – Leitlinien für die künftige EU-Finanzmarktintegration” (Printed Paper 16/933, page 1).

15) Own-Initiative Report of the European Parliament on the “Current state of integration of EU financial markets” (2005/2026 (INI)), 28 April 2005.

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CONTINUING THE INTEGRATION OF  
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