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# EU SINGLE FINANCIAL MARKET – PROSPECTS FOR CHANGES

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## Abstract

*The global financial crisis has revealed the weaknesses of the European financial market, which triggered the European Union (EU) work on further integration of this market. The aim of this article is to present the direction of changes concerning the integration of the EU financial market. These changes are mainly related to the issue of supervising the EU financial market, regulating the institutions operating in this market, protecting customers, improving the effectiveness of the market, its transparency and liquidity, as well as improving management in crisis situations.*

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## Introduction

For the past few years, the European Union (EU) has been undertaking some actions aiming at integrating the financial market of its member states and building the so-called single financial market. These actions, though they brought about a series of changes improving the functioning of this market, have not caused its full integration. Very little degree of integration can be observed mainly in the retail financial services sector. The sector of wholesale financial services presents a higher degree of integration.

The need for further integration of financial markets within the EU has gained considerable significance in recent years (2008-2011), due to the global financial crisis ignited by the mortgage loans market in the USA in 2007. The crisis laid bare the weakness of the European financial market, which could not resist its negative impact (European Commission, 2011, p. 5). Trying to streamline the functioning of the financial market and to increase its security, the EU developed a number of initiatives aiming at increasing the degree of the financial market integration. The aim of the article is to present the direction of changes concerning the integration of the EU financial market. These changes are mainly to do with the issues of supervising the EU financial market, regulating the institutions operating in this market, protecting customers, improving the effectiveness of the market, its transparency and liquidity, as well as improving management in crisis situations. A method of analysis and synthesis was used in the paper.

The article is based on a number of the European Commission (EC) documents related to the integration of the financial market, especially on those precisely determining the direction of this development, that is: Financial Services Action Plan (1999), White Paper - Financial Services Policy 2005-2010 (2005), Driving European Recovery (2009) and Regulating Financial Services for Sustainable Growth (2010).

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## The concept of the EU Single Financial Market

The EU countries aim at creating the so-called ‘single financial market’, that is the market with free flow of capital between member countries and freedom to offer financial services.

The concept of creating a single financial market appeared as early as in the Treaty of Rome (1957) establishing the European Economic Community – EEC (there was an entry in it recording the attempt of EEC member countries at creating a market with free flow of capital) and was strongly emphasized in the Treaty of Maastricht (1992) establishing the European Union. Creating the European Union, member countries obliged themselves to create an economic and monetary union (EMU). One of the conditions necessary for creating the EMU is the integration of the EU financial market. Its aim is to provide EU citizens with free access to all financial products offered in the EU market, as well as to create a situation in which all financial institutions enjoy freedom to operate in any EU country. This process is characterized by cross-border integration, that is an attempt at unifying financial markets of EU member states in order to create a single financial market<sup>2</sup>. The most important expected results of integration are: lower costs of financial intermediaries, providing investors with access to a number of differentiated financial instruments (which will allow them to diversify their investment portfolios more), increasing the effectiveness of capital use (EC, 2011, p. 5).

The work on creating a single financial market was especially intensified in 1999, when the European Commission (EC) presented a document called Financial Services Action Plan – FSAP (EC, 1999). This document outlined the direction of the integration of the EU financial market. FSAP stipulated creation of a single wholesale market of financial services and preparing appropriate regulations concerning supervision of the EU financial market. The implementation of the FSAP was through the development of a series of various documents dedicated for the financial market. These were directives, regulations, decisions, recommendations and announcements made by the EC. The most important directives for the functioning of the EU financial market are listed below (EC, 2009):

- 1) MIFID (Markets in Financial Instruments Directive) – directive concerning the trading of financial instruments in the European market,
- 2) Prospectus Directive – directive aiming at standardizing information contained in the issuing prospectuses,
- 3) Settlement Finality and the Financial Collateral Directives – directive determining the principles that must be adhered to by the securities market participants,
- 4) UCITS III Directive – directive concerning the operations of investment funds in the EU market,
- 5) CRD (Capital Requirements Directive) – directive determining capital requirements for banks,

IMD (Insurance Mediation Directive) – directive addressed at the insurance sector.

The implementation of the FSAP was finished in 2004. The document contributed significantly to the creation of legal framework of the EU single financial market and is considered to be the most important EU document on EU financial market integration.

In 2005 the next stage of integration was started, consisting in implementing solutions developed within the FSAP to the legislature of particular EU countries. Moreover, in December 2005 a document called White Paper. Financial Services Policy 2005-2010 (EC, 2005) was

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<sup>2</sup> Apart from the term of cross-border integration, there is a term of cross-sector integration, consisting in creating ties between different sectors of the financial market (for example between the bank sector and the insurance sector).

issued, which stipulated the continuation of the financial market integration initiated within the FSAP. It emphasized mainly the necessity of increasing the transparency of legal regulations, widening cooperation between organs supervising financial markets of particular EU member states as well as creating the single retail market.

Apart from the documents assuming undertaking complex actions towards integration of the financial market, the EU took up a number of independent initiatives which significantly contributed to the integration of this market. The most important of them are:

- 1) introducing a single euro currency in EMU member countries – which eliminated the exchange rate risk and ensured full transparency of prices and costs in the EMU countries,
- 2) running a common monetary policy in the EMU countries – the European System of Central Banks (ESCB) is responsible for the implementation of this policy. The main aim of the policy run by the ESCB is to maintain a stable level of prices in the EMU area. This undoubtedly is conducive to the financial market integration,
- 3) introducing the system of making gross settlements, called - TARGET 2 (Trans-European Automated Real Time Gross Settlement Express Transfer System). The system allows us to make settlements between banks and major clients on-line,
- 4) establishing a single euro payment area – SEPA (Single Euro Payment Area). All payments realized within SEPA are treated as home payments and realized with the use of single payment instruments.

Despite a number of actions taken by the EU in order to create a single financial market, this process has not been finished yet. The integration is hindered by large discrepancies between countries concerning internal regulations of financial markets as well as various development level of particular EU countries. The factor that greatly influenced the slowing down of the financial market integration within the EU was the global financial crisis which started in the mortgage loans market in the USA in 2007 and then spread to nearly all countries all over the world, including the European ones (EC, 2009, p. 4) (particularly large negative impact of the crisis was observed in the banking and investment funds markets). EU countries focused on fighting off the consequences of the crisis than on the financial market integration within the EU. Moreover, the crisis revealed the weakness of the EU financial market. It turned out that many solutions adopted by the EU in order to integrate the financial market is not conducive to the efficient development of this market. In the report on integration and stability of the European financial market developed in 2011 by the European Commission, the authors emphasize the fact that the crisis clearly demonstrated that the degree of the EU financial market integration is much lower than commonly assumed before the crisis (this particularly refers to the monetary market, which had been perceived as a market with high degree of integration) (EC, 2010, p. 6).

One could pose then a number of questions – whether the direction of the integration adopted by the EU is correct, and – what new regulations should be introduced on the EU level to improve the functioning of the EU financial market. Some actions have already been taken. Others are still subject to discussion at the EU level. Below we present the directions of changes proposed by the EU.

## **EU financial market – changes**

The European Commission (after the crisis) published two documents in which it precisely determines the direction of the development of the single financial market. The first one is called Driving European Recovery from 4<sup>th</sup> March 2009 (EC, 2009), the other one Regulating financial services for sustainable growth from 2 June 2010 (EC, 2010).

These documents have indicated a number of necessary reforms for improvement of the way the EU financial market operates. They concern the issues of supervising the EU financial market as well as the issue of regulating this market, improving the effectiveness of its functioning, transparency, liquidity and integration. Moreover, a number of regulations aiming at consumer protection have been specified there. Finally, an attempt at developing some guidelines concerning management in crisis situations has been made.

As far as supervision of the EU financial market is concerned, the EU stipulated creation of the European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS). The new system was implemented on 1<sup>st</sup> January 2010 (EC, 2011).

From the perspective of constraining systemic risk, the ESRB is of vital importance. Its main goal is to supervise the whole EU financial market (the so-called macro-prudential supervision). The activities of the Board focus around observing the financial market in the context of possibilities of systemic risk appearing. Apart from monitoring the market, the Board issues recommendations concerning corrective actions in situations of increased threat of systemic risk. The Board cooperates with the International Monetary Fund (IMF), the Financial Stability Board (FSB) and ESFS (European Central Bank, 2010). Although the Board does not have any binding powers, its role as an institution of early warning against systemic risk may considerably decrease the risk of its appearance (IMF, 2010, pp. 35-36).

ESFS is a network of institutions. Its participants are organs supervising financial markets in particular EU member states and three newly-created cross-national organs, namely:

- 1) European Banking Authority (EBA),
- 2) European Securities and Markets Authority (ESMA),
- 3) European Insurance and Occupational Pensions Authority (EIOPA).

These organs conduct activities whose main objective is to develop common regulatory and supervisory standards for the European financial market.

The European Banking Authority was established in place of the Committee of European Banking Supervisors. Its job is to develop binding technical standards for banks (on the basis of the Community law) as well as issuing interpretation guidelines for supervisory bodies in particular EU countries. These actions are to limit the discrepancies in the interpretation of the EU legislature. A significant feature of the European Banking Authority is the possibility of directly influencing home financial institutions as far as the EU prudential requirements are concerned (such actions, though, are limited only to the situation in which domestic supervisory organs do not take appropriate action against the institution which does not comply with the EU guidelines). Moreover, the European Banking Authority is to supervise some pan-European financial entities, such as rating agencies or EU clearing houses (Zaleska, 2010).

Apart from the new supervision over the financial market, the EU stipulated introduction of a number of regulatory changes which are binding for EU financial institutions. They concern mostly prudential requirements, internal risk management and availability of financial information. Among these regulations one could mention (EC, 2010):

- 1) The Capital Requirements Directive (CRD) – directive specifying new principles concerning capital requirements for banks and investment funds (the EU plans to adjust EU regulations to the guidelines presented under “Basel III”. The changes are to deal with tightening capital requirements),
- 2) Solvency II Directive – directive determining new principles of capital requirements for insurance companies. The regulations of this directive will come into force in 2013,



- 3) Omnibus 2-Directive – directive addressed at insurance companies. It is to be valid until the Solvency II Directive comes into effect. Its aim is to ensure fluent transition of insurance companies to the requirements imposed in the Solvency II directive,
- 4) New principles concerning remuneration and bonuses in financial institutions – their aim is to increase the effectiveness of risk management,
- 5) Green Paper on Corporate Governance in Financial Institutions its aim is to improve the supervision of risk taken by financial institutions and to increase the effectiveness of risk management,
- 6) Regulation on Credit Rating Agencies – CRAs – these regulations introduce new principles governing the establishment and supervision of rating agencies,
- 7) AIFM Directive (Alternative Investment Fund Manager Directive) – directive addressed at managers of alternative investment funds. It aims to allow supervisors of financial markets to early detect systemic risk originating in alternative investment funds. The EC proposed the introduction of a rule stipulating that only the funds which receive the so-called European Passport will be able to offer their services. Also, a number of requirements concerning the principles of investment funds' operations and reporting systems have been introduced (Athanassiou, 2010, p. 8),
- 8) New Accounting Standards (published by International Accounting Standards Board - IASB) – they specify new requirements concerning the disclosure of information about risk associated with various financial instruments.

Another type of regulations developed at the EU level are regulations aiming at improving the effectiveness of the financial market operations as well as increasing its liquidity, transparency and integrity. An example of such planned regulations can be (EU, 2010, p. 6):

- 1) expanding the scope of MIFID (Markets in Financial Instruments Directive) to incorporate new financial instruments (not only shares) and new trading platforms,
- 2) changes in the scope of the directive concerning market abuse (Market Abuse Directive – MAD) so as to ensure more effective detection, prevention and penalization of market abuse,
- 3) new requirements concerning derivative transactions (OTC derivative transactions). Some guidelines have already been outlined in this respect. They stipulate the necessity of settling the transaction with the help of central units (central counterparties – CCPs). This will give the authorities supervising the EU financial market better access to information and as a result, better chances of identifying potential conflicts which may appear in the market.

The EU is also considering the introduction of new regulations concerning short sales<sup>3</sup> and swap transactions (Credit Default Swaps). New regulations are to contribute to better transparency of such transactions and to allow the supervisors the detection of situations threatening stability of the financial market. “Short sales” is considered by many economists as a factor destabilizing the market. Its criticism has intensified especially after the outbreak of the global financial crisis<sup>4</sup>. Many countries have introduced the ban on using “short sales” (Avgouleas, 2010, p. 24). Another type of regulations developed on the EU level are regulations aiming at protecting consumers. We could list here a new system of guaranteeing deposits (Deposit Guarantee Schemes - DGS) and a system of compensation for investors (Investor Compensation Schemes – ICS) (EC,

<sup>3</sup> “Short sales” is a financial operation consisting in selling company assets (securities) which we do not possess. Usually in such operations, an investor borrows assets, although there are also operations in which an investor neither owns nor borrows the assets that they are selling (naked short sales).

<sup>4</sup> Some economists are of the opinion that the prohibition of “short sale” is not the best solution. They emphasize that it doesn't result in less price volatility, but only in a negative impact on financial market liquidity.

2010, p. 8). Since the beginning of 2011, the minimum value of deposit coverage was increased to € 100,000 within DSG and to € 50,000 within ICS. At the same time, the time when resources are unavailable has been shortened to 20 working days (the EU plans to shorten this time to 7 working days). The EU also plans to introduce the principle stating that the institution responsible for payment of guaranteed resources of deposit holders is always the country in which a given institution operates, which means that in case of credit institution branches, the responsible country would from now on be the country in which a branch operates, not the home country of a branch of a credit institution (after payment of resources, the guarantee system operating in the country where a particular branch operates would apply to the system of guaranteeing resources from the home country of the branch of a credit institution for reimbursement).

Another idea that originated at the EU level was that of establishing the Insurance Guarantee Schemes – IGS, covering all member states. Moreover, the European parliament Economic and Monetary Affairs Committee (ECON) proposed to establish the European Fund of Guaranteeing Deposits. The fund would deal with protection of deposit-owners' interests in cases of financial institutions' insolvencies. ECON proposes that the newly-established institution was financed from fees paid by cross-border financial institutions of systemic importance. The amount of fees would be differentiated and would depend on the level of deposits in a particular institution and its exposure to risk (IMF, 2010, p. 40).

The EU also stipulates the introduction of some changes in the directive on Units for Collective Investment in Transferable Securities – UCITS. The aim of these changes is to improve the protection of investors in cases when the depositary loses assets or is guilty of any financial abuse.

Another step planned by the EU is the introduction of new guidelines concerning offering mortgage loans. The aim of these regulations is to provide appropriate level of regulation and supervision of the entities offering this type of credit.

Moreover, retail investors are to be given better access to information concerning the investment opportunities offered by financial intermediaries. The information will cover especially indication of risk and costs associated with a given investment. To achieve this, the EU plans to introduce appropriate guidelines addressed at financial intermediaries.

Apart from new guidelines which are to streamline the operations of the financial sector, the EU is trying to develop a risk management system in crisis situations. It is considering the introduction of a model based on cooperation of financial institutions with financial market supervisors. Moreover, the possibility of the so-called 'freezing' bank assets by supervisors in times of crisis is being analyzed. In 2010, the European Financial Stabilization Mechanism (EFSM) and European Financial Stability Facility (EFSF) were established, their aims being the support in stabilizing the European debt market (the sum of € 50 billion was allocated for this). Moreover, the European Council gave its consent for establishing the European Stability Mechanism – ESM, which would supplement supervision of the EU market (ESM is to be set up in the middle of 2013) (EC, 2010, p. 7).

The new system of management in crisis situations is to limit direct aid of the state for financial institutions in crisis cases (state aid for endangered banks during the last global crisis consumed nearly 13% of the EU GDP (EU, 2010, p. 11). According to the European Commission, crisis-related costs should be borne mostly by shareholders and creditors (EC, 2010, p. 11).

## Conclusions

The process of integrating financial markets of EU countries has been taking place for many years. It has not been completed yet, though. Financial markets of EU countries are not fully

integrated, although, as indicated in the report on financial integration in Europe presented in May 2011 by the European Central Bank, the integration process is deepening. The intensity of this process varies in different segments of financial markets. 2010 brought increased intensity of integrations in the shares market. However, we cannot observe a similar situation in the monetary or bond markets. The process of integrating these markets has been significantly slowed down due to deteriorating fiscal situation in many EU countries (ECB, 2011, p. 7-8).

The global financial crisis has revealed the weaknesses of the European financial market, which intensified the work of the European Commission on integrating this market. The changes proposed by the EC concern mostly the issues of supervising the EU financial market, regulating institutions operating in this market, protecting consumers, improving the effectiveness of its functioning, its transparency and liquidity and management in crisis situations. The EU is aiming at developing regulations which would prevent new financial crises, and not only easing its effects. It is a really daunting task, as it requires developing clear and effective principles of cooperation among numerous institutions operating in the EU market.

There is no doubt that the EU financial market requires introduction of some changes which will ensure its effective operations. Therefore the EU initiative in this area must be valued positively. However, the issue which may raise some doubts is the direction in which the financial sector is reformed.

We should consider whether the regulations in financial markets should go towards determining fixed rules of operating in the financial market or rather towards attempts at eliminating unwanted actions. Undoubtedly, the introduction of strict rules of operations could result in a rapid increase in the degree of financial integration in the EU countries, but in the case of countries with large variation in the degree of development of financial markets, it is difficult to administer and very time consuming. What's more, it creates a risk of overshooting the market. Therefore, a better solution in the case of the EU seems to be attempts at eliminating unwanted actions.

Another problem concerns systemic risk. A question could be raised – whether increasing the degree of financial integration within the EU does not result in greater likelihood of systemic crisis appearance. Systemic risk is the risk of collapse of the financial system of a country (or group of countries) due to some external shocks. The source of shocks can be both macroeconomic factors, as well as microeconomic factors. The financial integration leads to the strong links among EU countries, which seems to be a negative factor in terms of systemic risk. It causes the increase of systemic risk.

We may also wonder to what extent these regulations concerning financial markets should be regional, that is valid in the area of the EU, and to what extent global. We should also analyze whether creation of regulations that bind EU financial institutions does not lower their competitiveness in the global market? Will the attempt at increasing security of the European financial system bring about lower economic development rate in Poland? It should be noted that in most European countries the dominant role performed in income redistribution is that of banks (not capital market). We may also ask a question – will the introduction of ever rigorous regulations concerning bank operation not limit their activities concerning financing small and medium enterprises (SME), which, as we commonly know, are the driving force of each economy. So far, the EU hasn't estimated the impact of the new regulations on the SME sector. However, we can try to make some observations in this direction. It can be expected that the new regulations concerning the bank capital will increase the cost of banks' operations. There is the concern that banks will seek to "flip" the increased costs to borrowers. According to the Institute of International Finance (IIF), credit costs can increase by 1.3 %. Higher cost of credits will undoubtedly



affect the decrease of interest in taking bank credit by SMEs, which in turn may result in reducing their investments. The new regulations on the quality of capital can additionally contribute to the reduction of banks activity in granting credits. Banks will be forced to tighten the procedures of granting loans.

Reforming and integrating the EU financial sector is to bring about improved effectiveness of its operations, increased liquidity, better level of protecting consumers operating in the EU market as well as greater security of this market. We should remember, though, that the effects of reforms will be felt not only by the financial market, but by the whole EU economy. Apart from positive effects, there may also appear some unwanted effects, which at the present stage of reforming the financial system are difficult to indicate yet.

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