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Article — Digitized Version

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Intereconomics

Suggested Citation: Randzio-Plath, Christa (2000) : Challenges and perspectives for a single market for financial services in Europe, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 35, Iss. 4, pp. 192-197

This Version is available at:

<https://hdl.handle.net/10419/40775>

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Challenges and Perspectives for a Single Market for Financial Services in Europe

The introduction of the euro has highlighted the fact that Europe's financial markets are still characterised by a high degree of fragmentation. This threatens to impede the process of structural reform which is hoped to increase the competitiveness of the European economy. The modernisation of the European economy should therefore start with the modernisation of its financial services markets.

The single market for financial services began to be established as long ago as the 1970s (with the adoption, for example, of the First Banking Directive). Community minimum prudential standards and the mutual recognition of financial supervision by the individual Member States created the preconditions at an early stage for a "European passport", which allows financial services providers (banks, insurance companies and securities firms) to exercise the right of establishment and freedom to provide services across borders. In practice, this means that financial institutions which have been granted authorisation to conduct their business by the supervisory authorities of a Member State may also pursue their business in all other Member States without requiring further authorisation. This principle of mutual recognition is not confined to EU Member States, but also applies to financial institutions from third countries which have been granted authorisation in an EU Member State.

However, the legal framework for financial services established at community level has failed so far to overcome existing obstacles to cross-order business for companies and individual citizens. The introduction of the euro has highlighted that there is still a high degree of fragmentation in financial services markets. Continued discretionary powers of national supervisory authorities and the possibility accorded to the Member States of prohibiting cross-border provision of services on general interest grounds prevent companies and individual investors from drawing full benefit from the single currency and the single market for financial services.

The inefficiency and fragmentation of financial markets in Europe risk turning into a serious obstacle

for the structural reforms launched by the Cardiff European Council with a view to promoting the competitiveness of the European economy. In order to ensure the cost-effective financing of this process, we need a transparent and efficient financial services infrastructure. The modernisation of the European economy must therefore start with the modernisation of its financial services markets: reducing the cost of capital by facilitating cross-border financing for big companies and SME's, enabling high-tech and start-up companies to raise capital at a pan-European level and offering better returns on investment to institutional and private investors will be an essential precondition for making the structural reforms a success story. Reducing the cost of borrowing and channelling capital into the most profitable enterprises means in practical terms increasing the productivity of capital, which is equivalent to an increase in economic productivity as a whole. At the same time, the improvement of cross-border investment opportunities for private and institutional investors means higher returns and a trend towards higher income from capital. In addition to the positive impact on private demand, this creates greater scope for private pension provision, which in turn may help secure state pay-as-you-go pension schemes in the long term.

The establishment of a single currency area represented a quantum leap for European financial markets and, at the same time, was the trigger for a process of restructuring on a scale not experienced hitherto. However, this process must be accompanied by an appropriate regulatory and supervisory framework, which at the same time allows markets to integrate and to ensure financial stability by addressing new systemic risks (spill-over effects) resulting from market integration and liberalisation. The Heads of State and Government, who at the recent European Councils in Lisbon and Feira renewed their commit-

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ment to economic reform and the modernisation of financial markets in Europe have taken up this challenge. With a view to fully exploiting the growth and job-creation potential of integrated and efficient financial markets, the Commission was asked to speed up the measures of the Financial Services Action Plan.

Financial Services Action Plan – Main Objectives

The Financial Services Action Plan essentially reflects the conclusions of a high-level policy group composed of personal representatives of ECOFIN ministers, which was set up by the Vienna European Council in December 1998. It contains priority actions as well as a timetable for individual measures, starting in 2000 in the following areas:

Establishment of an integrated wholesale market. This includes improving access to capital markets within the EU, establishing a common legal framework for integrated securities and derivatives markets, containing systemic risk in securities settlement, and establishing a secure and transparent environment for cross-border restructuring of companies in the financial services sector. Particular importance will be attached to the harmonisation of requirements for financial statements of listed companies in order to offer European companies an alternative to the use of US GAAP (Generally Accepted Accounting Principles) if they want to get their shares listed in the United States.

Establishment of open and secure retail markets. The key elements are improving the provision of information to consumers, establishing judicial and extra-judicial procedures for redress in the event of default in performance or defective performance in cross-border trading, eliminating unjustified national rules governing retail business where they represent a barrier to cross-border provision of services, and reducing the cost of cross-border payments.

Establishment of state-of-the-art prudential rules and supervisory structures. This includes adopting a uniform legal framework for the issuing of electronic money, stepping up the fight against money laundering and fraud in the financial system, improving rules for the prudential treatment of financial conglomerates, and revising the capital requirements for credit institutions and securities firms in connection with the current negotiations by the Basel Committee on Banking Supervision.

Improving infrastructure with a view to achieving an efficient internal market for financial services. This

includes, in particular, eliminating national tax provisions which distort competition, and reviewing the current differing arrangements in the area of corporate governance.

The Lisbon European Summit emphasised the importance of the action plan, and called for a tight timetable for implementing it by 2005, with priority being given to capital market aspects, such as:

- introducing a "single passport" for issuers;
- eliminating barriers to pension fund investment;
- making credit institutions' financial statements more comparable;
- implementing the Risk Capital Action Plan by 2003;
- resolving outstanding issues in connection with the adoption of the tax package.

The European Parliament's Position

The European Parliament supports the initiative for the establishment of an efficient and transparent financial market in Europe. On 13 April 2000 it adopted the action plan, essentially endorsing it.

In addition to measures to facilitate the cross-border raising of capital regarded as a priority by the European Council, Parliament considers that there is an urgent need for action to establish a single cross-border retail market, including the improvement of consumer protection.

In this connection, Parliament calls for the existing institutional arrangements to be completely reformed and calls on the Commission to provide a list of the administrative practices and provisions which prevent financial service providers and investors from benefiting from the opportunities offered by a single financial market.

With regard to wholesale markets, the resolution calls in particular for the directive on prospectuses to be revised in order to facilitate cross-border raising of capital, and for the existing reporting and accounting directives to be updated. For the purposes of protecting investors, it also urges revision of the rules on insider trading and adoption of a directive on preventing market manipulation.

Safeguarding Consumers' Interests

The creation of an integrated retail market for financial services, in particular with respect to consumer protection has always been of major concern to the European Parliament and will continue to be in the focus of its attention. Broad acceptance and support

of the single market and the single currency requires that individual citizens are able to draw specific benefits from them in their everyday life. However, there are currently significant shortcomings in this area. Even after the introduction of the euro, consumers wishing to take out a loan with a foreign bank or an insurance policy with a foreign provider, or seeking to conduct some other form of cross-border financial business, are still confronted with a large number of practical and legal (including tax) barriers. That is not least because the principle of mutual recognition as a precondition for cross-border operations on the part of financial institutions is intended to ensure the financial stability of the service provider. In the retail area, this principle comes up against its limits, particularly as far as rules on consumer protection are involved. Whilst financial services providers advocate mutual recognition of the rules on consumer protection in force in the respective country of origin in the interests of cross-border freedom of access to markets, from the point of view of the consumer there are good reasons for applying the rules in force in his place of residence. The destination principle, it is true, frequently works to the disadvantage of consumers in practice by acting as a barrier to market access for foreign service providers and consequently to free competition. Nevertheless, the question arises as to whether it would not be too much for consumers if they were to be confronted with 15 different sets of rules on consumer protection depending on the product and the country of origin of the supplier.

A possible solution may be for consumer protection to be harmonised at the Community level, in accordance with the Commission's proposal for a directive concerning the distance marketing of

financial services, which has been approved in this respect by Parliament at first reading. In the short term, however, there is little chance of this occurring, not least because of the complexity of the subject and the fact that it is closely bound up with national civil law (including the Rome and Brussels conventions, which are currently also due to be revised). It would therefore appear all the more important, in the interests of ensuring a high level of consumer protection, to develop appropriate instruments such as information disclosure and harmonisation of codes of conduct to be applied by companies. If practicable solutions cannot be found quickly in this connection, the growth potential of cross-border e-commerce in the financial services sector will not be able to be fully developed, as this type of business may, despite supposedly favourable conditions, involve incalculable risks for customers.

Creation of a Single European Payment Area

A further important issue concerns facilitating individual cross-border payments. Even since the introduction of the euro, both the costs of cross-border payments and the time required for such payments have remained considerably higher than for domestic payments. This is not only unacceptable from a consumers' point of view, but also because the problem has technically been resolved as far as international gross settlements are concerned. The European Parliament, after several hearings with all interested parties, has repeatedly urged the European Commission and the European Central Bank to develop viable solutions in order to develop a payments infrastructure capable of supporting low-cost and efficient cross-border retail payments in order to prevent the acceptance of the euro by citizens from being seriously undermined.

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The Commission has, it is true, not least in response to Parliament's requests, adopted a series of measures, from investigations into the existence of unpermitted price-fixing to the latest Commission communication on retail payments in the internal market, in which it announces *inter alia* that it will in future be evaluating the level of charges in respect of cross-border payments on a regular basis and publishing its findings. However, great progress has so far not been achieved. Even the provisions of the directive on cross-border credit transfers which entered into force in mid-1999, under which charges are not permitted to be incurred twice (by the originator and the recipient), are not yet being observed by all credit institutions. The initiation of cartel procedures against 120 banks in different Member States for illegal agreement on cross-border transfer fees and conversion charges seems an encouraging sign that the Commission is ready to take the problem more and more seriously, but the final result is still outstanding. Should the current measures not prove successful in the foreseeable future, the possibility of legal measures should be considered.

Financial Legislation and Supervision

The Basel Committee on Banking Supervision is presently revising the 1988 capital accord. The results will have to be implemented within the EU in the form of a directive, in the adoption of which the European Parliament will participate through the codecision procedure. From the point of view of the people's elected representatives, this is an unsatisfactory way of proceeding, given that the Basel Committee is merely an informal body, on which neither all the EU Member States nor the European Commission are represented as members (the latter merely has observer status). Although this way of proceeding goes against all traditional principles of democratic decision-making, the work of the Basel Committee has undeniably been thoroughly successful in the past. There is little prospect, therefore, at least in the short term, of "democratisation" of this process. From Parliament's point of view, therefore, it is all the more important to follow the negotiations closely and already at this stage to clarify specific European positions. That applies in particular to the proposed recognition of rating procedures. Such procedures must ensure that internal ratings may be used by smaller credit institutions and that the new rules on capital do not lead to higher financing costs for small and medium-sized companies. For reasons of fair competition, it is necessary, in addition, to ensure that the new Basel capital accord does not enter into force

earlier than the corresponding EU directive in the individual Member States. Parliament's Committee on Economic and Monetary Affairs has made it clear both to the Commission and to the chairman of the Basel Committee, that these aspects will be crucial to Parliament's assessment of the outcome of the negotiations during the EU implementation procedure.

A further aspect to which particular attention is to be paid by Parliament during the current parliamentary term is that of the co-ordination of financial supervision. Whilst, on the one hand, markets are growing closer and closer together, responsibility for supervising banks, insurance companies and securities firms continues to be at national level. Although it would be premature, in view of differences in systems between the individual Member States, for micro-prudential supervisory powers to be transferred to the European Central Bank, it is essential, in the interests of efficient financial supervision, that all opportunities for closer co-ordination and co-operation between the national supervisory authorities are used to the full and commonly agreed standards (business codes of conduct) are respected and equally applied in all Member States. It is imperative, in particular, that supervisory powers are clearly defined. In view of the dynamic nature of the markets (the latest example being the announcement of a merger between the Frankfurt and London stock exchanges, just days after the Paris, Amsterdam and Brussels stock exchanges agreed to merge), those responsible for taking political decisions will be unable in the long run to avoid discussing the establishment of central supervisory structures. The sooner such discussions are begun, the less politicians risk coming under pressure from the financial markets to take action. The Group of Wise Men, established by the ECOFIN Council with the specific mandate of assessing securities markets regulation in the EU will provide for valuable input to the discussion.

Tax Policy

Completion of the internal market for financial services necessarily requires the removal of tax barriers to integration, such as unfavourable tax treatment of foreign service providers or financial products, which is often found in particular in the insurance sector. At the same time, it is necessary to prevent open and liberalised financial markets from being misused for purposes of tax evasion or tax avoidance. As long ago as 1988, when the movement of capital was liberalised in what was one of the most important steps towards establishing a single internal market for

financial services, it was the intention to provide for parallel measures in the area of taxation of interest income. However, as unanimity is required on tax issues, the Council has to date been unable to reach agreement in this area, or on checking tax "dumping" in the corporate sector. This means considerable distortion of competition, in so far as investment decisions and cross-border capital movements are often primarily made in response to favourable tax treatment rather than on the basis of considerations of long-term returns.

The conclusions of the Feira Summit in June have not brought an agreement on the Commission's tax package on the basis of the compromise proposals presented. Repercussions for the further liberalisation of financial services can therefore not be excluded. But nevertheless the agreement does allow the promotion of more coordination. The situation remains difficult regarding the taxation of interest on savings, especially in view of the practices of third countries like Switzerland, Monaco and the United States. Possibly the courageous proposals of the OECD on tax havens will help to speed up decision-making in the European Union. The European Parliament is urging the introduction of the principle of qualified majority voting on tax matters where the smooth functioning of the Single Market is affected and unfair tax competition occurs.

Revision of the UCITS Directive

The revision of the directive on undertakings for collective investment in transferable securities (investment funds) represents a key element of the financial services action plan. It is of the highest priority that the draft directives submitted by the Commission for this purpose are adopted, as the current directive dates back to 1985 and consequently does not cover, or does not adequately cover, a large proportion of the financial products and investment options which have since been developed. The fact that, at the end of 1999, more than € 3 billion of private savings was invested in "harmonised" investment funds, i.e. funds subject to the rules of the directive in force, and the fact that the fund industry as a whole continues to show exceptionally high growth highlights the urgent need for the rules to be revised, particularly as there is an increasing risk of countries going it alone. That would directly jeopardise the "European passport" for investment funds, which would represent an extremely serious step backward from the point of view of consumer protection.

Although revision of the UCITS directive has been on the political agenda for years, it has not to date been possible to find a compromise balancing market liberalisation with the need for investor protection which is capable of producing a consensus, particularly as individual Member States have very different concepts concerning these issues. The difficulties are due not least to the fact that the current UCITS directive takes a product-oriented approach, while detailed, product-related rules have largely been dispensed with in the process of gradually implementing the European single market for financial services. The relevant directives adopted in this connection focus primarily on the reliability and financial stability of the individual financial institutions as a precondition for cross-border freedom of establishment and freedom to provide services.

The draft directive on UCITS, which recently underwent its first reading by Parliament, aims to retain in principle the product-oriented approach, whilst widening the range of assets in which UCITS are permitted to invest and facilitating the cross-border marketing of units. A proposal for a second directive, which supplements the first, provides for a "European passport" for management companies and a broadening of the activities permitted to be carried out by management companies.

The debate in Parliament, in the course of which well over 100 amendments to the draft directive were tabled, not only reflects the complexity of the issue, but also demonstrates how difficult it can be to put the principle of optimum investor protection into concrete form in individual cases. One point at issue, in connection with the aspect of adequate risk spreading, was that of the authorisation of "master feeder funds", i.e. funds which invest only in a single "master fund". Other points at issue included the question of prohibiting, or laying down limits on, investment by UCITS in other, "non-harmonised" funds in order to prevent the directive being circumvented, and the issue of investment in financial derivative instruments, and in particular in over-the-counter (OTC) derivatives.

With regard to the key aspects, the European Parliament agreed on the following position:

- retention of the directive's product-related approach in the interests of the best possible protection for investors;
- requirement for the greatest possible transparency, both in relation to an undertaking's investment policy (in particular, the incurring of risks) and to its charges;

- percentage limit on investment in "non-harmonised funds", which, moreover, are required to meet stringent supervision criteria;
- introduction of a percentage limit on investment in OTC derivatives;
- minimum capital requirements for investment funds;
- no authorisation of "master feeder funds".

The French Presidency, finally, see to it that the directive is swiftly adopted.

A Legal Framework for Pension Funds

A further important initiative under the Financial Services Action plan relates to the establishment of a prudential framework for supplementary pension schemes (pension funds), on which there are currently no legislative provisions at Community level. In view of the establishment of a single currency area and the growing importance of supplementary, funded provision for old age within the context of national pension schemes, schemes of this kind should be able to invest in an optimum way; at present, investment is often subject to restrictive national rules. In addition, supervisory and tax systems should be co-ordinated in order to create the preconditions for cross-border membership in the interests of freedom of movement for workers.

In recent years extensive consultations were held on this issue, the results of which were published in a communication in May 1999. At the start of this year, Parliament adopted a resolution expressing its position on the issues raised in the communication.

The intention to establish a uniform legal framework for supplementary, funded pensions is expressly welcomed by Parliament, as is the proposed abolition of quantitative restrictions on investment.

At the same time, the resolution clearly sets out the criteria to be applied by Parliament in assessing future legislative initiatives:

- no structural changes to existing national pension schemes;
- emphasis on the complementary nature of funded, supplementary pensions in relation to first pillar pay-as-you-go schemes;
- clear preference for pension products which, in addition to providing a pension for the lifetime of the beneficiary, also cover other biometric risks;
- emphasis on security aspects in connection with prudential rules governing supplementary pension schemes;

- harmonisation of qualifying periods; facilitating the transfer of acquired rights and cross-border membership;
- harmonisation of the tax treatment of contributions, with the aim of avoiding the double taxation of pensions;
- general shift to taxation during the pension payout period at Community level.

In view of the current institutional and tax differences, it will take considerable time for these demands to be implemented at the political level, and it will certainly not be possible for them to be achieved in one step. The draft directive on the prudential supervision of occupational pension schemes is a first important step in the right direction. It should be followed as soon as possible by other measures, such as prohibiting discriminatory treatment of contributions to foreign pension institutions. In view of the growing importance of such schemes, the lack of freedom of movement in this area threatens to represent a serious barrier to the mobility of workers, which may be increasingly difficult to explain to citizens in view of the existence of a single economic and currency area.

Need for Rapid Progress

There are encouraging signs that industry and policy makers all over Europe have taken up the challenge to catch up with the United States in terms of economic growth and employment creation. For this reason, no time must be lost in removing existing obstacles to capital market integration in Europe. The issues at stake are enormous: financial services already represent about 6% of EU GDP and more than 2.5% of employment. If we further consider that overall assets of UCITS and pension funds in Europe presently amount to € 10,000 billion, i.e. the equivalent of annual GDP in Europe, an efficiency gain of 1% would mean a contribution of 1% to economic growth. The Lisbon European Council has therefore confirmed the realisation of the Action Plan for Financial Services as a matter of urgency in order to fully exploit the potential of rapidly expanding markets. The Council has also asked for the measures envisaged by the Action Plan to be speeded up by giving top priority to capital-market related elements. The European Parliament fully supports this request and will continue its monitoring on the basis of regular progress reports, the latest of which was presented at the end of May 2000. The timetable seems rather ambitious; however, every effort should be made to meet the deadlines, given the impact on the economy as a whole.