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REGULATION AND FINANCIAL INNOVATION TRENDS IN EUROPEAN BANKING AND THE IMPACT ON THE SUPPLY AND DEMAND FOR FINANCIAL SERVICES IN EUROPE

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Abstract

This paper outlines two major regulatory initiatives that are expected to have a substantial impact on the European banking industry and the supply and demand of financial services throughout the European Union. The first initiative is the EU's Financial Services Action Plan (FSAP), approved in 1999 with a calendar of actions to be finalised by 2005. The FSAP aims to review the existing regulatory framework, to adapt it to the demands of single financial markets in order to promote a more integrated and efficient European financial services marketplace. The second regulatory development to be discussed in this paper relates to the implementation of Basle 2, the new capital adequacy guidelines for banks. The New Basle Capital Accord has undergone an extensive review with the last round of consultations being in early 2002. The Basle Committee envisions implementation by 2006. The implementation of Basle 2 into EU banking law is expected to have a substantial impact on capital allocation and bank behaviour. Both Basle 2 and the FSAP place considerable emphasis on areas that are among the least integrated in the European financial services industry - retail lending, SME finance, bancassurance, securitisation and the regulatory treatment of collateral. The removal of barriers to trade in these areas coupled with new capital rules governing their regulation are likely to create a paradigm shift in the way in which this types of business is conducted over the next decade or so.

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1. MAIN FEATURES OF THE FINANCIAL SERVICES ACTION PLAN

The integration of financial markets is of crucial importance for the progress of European integration in general and its function as a driver of growth and creation of employment. There has been constant insistence on this point in recent years by the different organs of the Community, and numerous initiatives of the European Parliament, the European Commission and the ECOFIN Ministers.

The Financial Services Action Plan (FSAP), approved in 1999 with a calendar of actions planned to be finalised by 2005, is the strategic document that integrates the multitude of measures taken and in preparation, with the aim of creating the conditions to allow optimum development of a single financial market. The actions of the FSAP are grouped around three main strategic objectives:

- the development of a single EU wholesale market;
- creation of open and secure retail markets; and to
- establish state-of-the-art prudential rules and supervision.

A range of other regulatory actions focus on establishing more uniform fiscal treatment of financial products and business so as to 'obtain wider conditions for an optimal single financial market'. The main features of the FSAP are outlined in Table 1.

Table 1 The Main Features of the Financial Services Action Plan

STRATEGIC OBJECTIVE 1: A SINGLE EU WHOLESALE MARKET

Raising capital on an EU-wide basis Action	
Action	**Objectives**
1) Upgrade the two Directives on Prospectuses	Overcoming obstacles to the effective mutual recognition of prospectuses, so that a prospectus or offer document approved in one Member state will be accepted in all. In addition, incorporating "shelf registration" will provide for easier access to capital markets on the basis of streamlined prospectuses, derived from annual accounts.
2) Updating and upgrading the Regular Reporting Requirements	More frequent and better quality information will enhance market confidence and attract capital
Establishing a common legal framework for integrated securities and derivatives markets	
Action	**Objectives**
*3) C*ommission Communication on the Application of Conduct of Business Rules	Summary of common interpretation of use of investor protection rules, including conduct of business rules to determine conditions under

Under Article 11 of the ISD (distinction between professional and retail investors)	which host country business rules apply to cross-border securities transactions.
4) Directive on Insider Dealing Market Manipulation (market abuse)	Enhance market integrity by reducing the possibility for institutional investors and intermediaries to rig markets. Set common disciplines for floors to enhance investor confidence in an embryonic single securities market.
5) a) Communication on upgrading the ISD and b) Directive to upgrade the ISD	Wide-ranging review of ISD as basis for integrated and efficient market for investment services. Tackle remaining obstacles to market access for brokers/dealers, obstacles to remote membership, and restrictions on trading in bonds. Address new regulatory challenges such as Alternative Trading systems.
Towards a single set of financial statements for listed companies Action Initial FSAP	
Action	**Objectives**
6) Amend the 4^{th} and 7th Company Law Directives to allow fair value accounting	Enabling European companies to account for certain financial assets at fair value, in accordance with International Accounting Standards
7) a) Commission Communication updating the EU accounting strategy and b) Legislative follow-up to EU Accounting Strategy Communication	Map out strategy for enhancing comparability of financial reports issued by listed EU companies, based on combination of EU accounting Directives and financial statements issued in accordance with agreed accounting standards. Strategy should prefigure mechanism for vetting international benchmark standards so that these can be used (with no national variations) by EU listed companies.
8) Modernisation of the accounting provisions of the 4th and 7^{th} Company Law Directives	Bringing the 4th and 7th Directives in line with the needs of the Single market and to take into account Developments in international accounting standard-setting
9) Commission Recommendation on EU auditing practices	Upgrading the quality of statutory audits in the EU by recommending specific measures in the areas of quality assurance and auditing standards.
Containing systemic risk in securities settlement	
Action	**Objectives**
10) Implementation Settlement Finality Directive	Common and coherent application of the Directive throughout the EU is important for a smooth functioning of systems.
11) Directive on financial collateral arrangements	Legal certainty as regards validity and enforceability of collateral provided to back cross-border securities transactions. and transparent environment for cross-border securities transactions
Towards a secure and transparent environment for cross-border restructuring	
Action	**Objectives**
12) Adoption of the proposed Directive on Take Over Bids	Create EU-wide clarity and transparency in respect of legal issues to be settled in event of take-over bid. Prevent pattern of EU corporate restructuring from Being distorted by arbitrary differences in governance and management cultures.

13) Political agreement on the European Company Statute	Create optional legal structure to facilitate companies to place pan-European operations on a rationalised single legal umbrella. Within this context clarify scope for participation by employees – thereby create further common ground in respect of corporate governance practices.
14) Review of EU corporate governance practices	Identification of legal or administrative barriers and resulting differences in corporate governance regimes.
15) Amend the 10th Company Law Directive	Create the possibility for companies to conduct cross-border mergers
16) 14th Company Law Directive	Allow companies to transfer their corporate seat to another Member State

A Single Market which works for investors:

Action	Objectives
17) Commission Communication on Funded pension Schemes	Consultation on prudential framework for second-pillar pension fund schemes to protect beneficiary rights through stringent prudential safeguards and rigorous supervision.
18) Adoption of the two Directives on UCITS	Proposal 1 will remove barriers to cross-border marketing of units of collective investment by widening assets in which funds can invest. Proposal 2 would provide a European passport for management companies, and widen the activities, which they are allowed to undertake (also be authorised to provide individual portfolio management services).
19) Directive on the Prudential Supervision of Supplementary Pension Funds	Following the policy outlined in Communication, the Commission will propose a Directive on the prudential supervision of pension funds. It will take into account diversity of pension funds currently operating in the EU and will cover authorisation, reporting, fit & proper criteria and rules on liabilities and investments.

STRATEGIC OBJECTIVE 2: OPEN AND SECURE RETAIL MARKETS

Action	Objectives
20) Political agreement on proposal for a Directive on the Distance Marketing of Financial Services	Proposal aims to bring about convergence of rules on business to-consumer marketing and sales techniques. This will limit exposure of consumers to undesirable marketing techniques (inertia and pressure-selling) through inclusion of appropriate provisions (generous right of withdrawal rights, prohibitions). Once in place, distance selling via remote technologies should be free from this category of impediment.
21) Commission Communication on clear and comprehensible information for purchasers	Establish over-arching view of basic information requirements consumers need in order to assess credential of (cross-border) service suppliers, security/performance of services offered by latter (plus redress). Examine extent to which these requirements are complied for range of retail financial services.
22) Recommendation to support best practice in respect of information provision (mortgage credit)	Building on discussions in Consumer Dialogue, the Commission will publish a communication to endorse understanding in respect of information to be provided in event of cross-border provision of mortgage credit services. Commission involvement in monitoring of compliance.
23) Commission report on substantive differences between national arrangements	The report will catalogue obstacles to cross-border business-to consumer transactions for relevant financial services. This will provide

relating to consumer- business transactions	analysis of whether, how and why host-country consumer rules apply and determine conditions under which equivalence of national rules does/does not exist. Provide objective and empirical basis for discussion with MS and EP on how to facilitate cross-border provision of retail financial services without jeopardising consumer safeguards.
24) Interpretative Communication on the freedom to provide services and the general good in insurance	Greater legal certainty and clarity for Member States, insurance undertakings and citizens, contributing to the creation of the single market
25) Proposal for amendment of Insurance Intermediaries Directive	Facilitation of the free provision of services by insurance intermediaries and enhanced consumer protection by updating and introducing safeguards on professionalism and competence. By creating stringent common ground-rules for intermediaries can facilitate placing on market of insurance premia by partner country underwriters.
26) Commission Communication on a single market for payments	Will provide a road-map for public and private agencies with a role to play in ensuring that secure and cost-effective retail payments can be effected on a cross-border basis. At present, such transactions incur charges, which are much higher in average than those within domestic payments systems – a situation which is untenable within a single currency zone. The Communication will focus heavily on credit transfers but will also address card payments, cheques and cash.
27) Commission Action Plan to prevent fraud and counterfeiting in payment systems	Agree on ways to prevent fraud, e.g. in organising the exchange of data or increasing the security of technical systems
28) Commission Communication on an e-commerce policy for financial services	A clear and coherent policy for the whole financial sector, which takes account of existing rules, wider international developments, and technological progress.

STRATEGIC OBJECTIVE 3: STATE-OF-THE-ART PRUDENTIAL RULES AND SUPERVISION

Action	Objectives
29) Adopt the proposed Directive on the Reorganisation and Winding-up of Insurance Undertakings	Provide a coherent legal framework for the winding-up and liquidation of insurance companies in the single market through the mutual recognition of proceedings and the principles of unity, universality, publicity and non-discrimination
30) Adopt the proposed Directive on the Winding-up and Liquidation of Banks	Common rules on winding-up and liquidation will establish common principles for procedures to be followed in event of bank insolvency, identify responsible authority. As such will safeguard against continued activities by insolvent institutions that could represent source of counterpart risk.
31) Adopt the proposal for an Electronic Money directive	Ensure market access and adequate regulation of e-money providers: clarify the prudential rules under which traditional credit institutions can provide e-money services. Enable provision of this activity on cross border basis. institutions other than
32) Amendment to the Money Laundering Directive	Combat fraud and money laundering in the financial system to widen definition of predicate offences and to extend reporting (‘suspicious transactions’) requirements to relevant nonfinancial professions.
33) Commission Recommendation on disclosure of financial instruments	Enhanced disclosure of the activities of banks and other financial institutions to allow investors to take informed decisions, and to foster market transparency and discipline as a complement to prudential supervision

34) Amend the Directives Governing the Capital Framework for Banks and Investment Firms	Work on a review of the bank capital framework to reflect market developments is running in parallel with that of the G-10 Basle Committee on Banking Supervision. This work is expected to result in an overhaul of the EU's bank and investment capital framework.
35) Amend the solvency margin requirements in the Insurance Directives	Protection of consumers in the single market by ensuring that insurance undertakings have adequate capital requirements in relation to the nature of their risks.
36) Amendment of the Insurance Directives and the ISD to permit information exchange with third countries	Basis for international exchange of information to underpin financial stability
37) Adopting a Directive on Prudential Rules for Financial Conglomerates	Addressing loopholes in the present sectoral legislation and additional prudential risks to ensure sound supervisory arrangements.
38) a) Commission Decision for a Securities Committee and b) Commission Decision for a Committee of Securities Regulators	A formal regulatory committee in this field will contribute to the elaboration of EU regulation in the securities area. Requires willingness on part of EU institutions to agree an appropriate comitology procedure.

OBJECTIVE: WIDER CONDITIONS FOR AN OPTIMAL SINGLE FINANCIAL MARKET

Action	Objectives
39) Adopt a Directive on taxation of savings income in the form of interest payments	The objective of the proposal is to remove disparities in tax treatment of private savings to complement the removal of obstacles to the free movement of capital and financial services will benefit the financial sector
40) Implementation of the December 1997 Code of Conduct on business taxation	Counter harmful tax competition which may significantly affect the location of business activity in the Union
41) Review of taxation of financial service products (This action has been taken care of in the context of the initiative on taxation supplementary pension funds)	Lower costs and remove disincentives for cross-border business
42) Commission initiative on taxation of cross-border occupational pensions	Building on discussions in Tax Policy Group, proposal for legislative action will be prepared to address tax treatment of cross border contributions of migrant workers to supplementary pension funds. Will serve as a contribution to labour mobility.

So far (July 2002) 25 of these 42 measures have already been implemented into EU legislation, so the regulatory programme is well under way. While the main focus of the legislation is to promote a more integrated, efficient, innovative and safer financial system, however, there are various segments of the industry where substantial obstacles to creating a single market remain. These are outlined below.

2. BARRIERS TO AN INTEGRATED EUROPEAN FINANCIAL INDUSTRY - SOME OBSERVATIONS

2.1 Venture capital

The creation of a pan-European risk capital market is one of the important elements of the FSAP. In the Commission's Communication of April 1998 'Risk Capital: a key to job creation in the European Union' (SEC(98)552) it was noted that there remain substantial barriers to the creation of a single market in this area. In particular, the six barriers found to be inhibiting European risk capital markets are:

- market fragmentation;
- different institutional and regulatory framework across Member States;
- differential tax treatment;
- the paucity of high technology SMEs in Europe;
- lack of human resources; and
- cultural barriers.

The development of a European venture capital market has also been limited by the traditional bank-based focus of most EU financial systems as well as the 'relatively low level of entrepreneurship' [1]. To increase the level of venture capital funding in Europe various actions have been taken at the Community and Member State level to encourage venture capital financing and entrepreneurial activity in general. This incorporates a broad range of initiatives including actions that improve access of firms to specialised markets (such as EASDAQ, AIM and EURO-NM). In addition, various educational and training programmes aimed to encourage entrepreneurial activity have been developed plus plans to simply the administrative burden on SMEs (among other things).

'The Community is implementing a number of financial programmes to stimulate the mobilisation of capital for innovative companies in fields where private investment is lacking: seed capital (CREA, the new Seed Capital action launched by the Commission in November 1998)); innovation (the Innovation and Technology Equity Capital (I-TEC) pilot project, and other measures promoting the co-operation between financial sources, researchers and industry under the research and development framework programme); early stage SMEs (the Luxembourg Growth and Employment Initiative consisting of three schemes : a risk capital

[1] See A Single Market in Financial Services: Effects on Growth, employment and the Real Economy, Working Paper Econ 124N, Economic Affairs Series, European Parliament, 2001

facility ("ETF start-up"), a scheme of financial contributions for the establishment of transnational joint ventures ("Joint European Venture") and a guarantee facility ("the SME Guarantee Facility")' (COM(1999)493-EN).There are also other venture capital financing initiatives relating to the European Regional Development Fund and the European Investment Bank.

The FSAP has introduced a number of actions aimed at creating more transparent and comparable accounts for SMEs, introducing a single prospectus so as to make pan-European equity and other issues less administratively burdensome and so on. This should help in facilitating the development of a pan-European capital market and will help in promoting a European venture capital industry.

However, substantial barriers remain. One such barrier relates to restrictions on pension fund investments in venture capital business. UK pension funds, for instance, are substantial investors in venture funds and other venture capital initiatives but this practice is uncommon in most other EU countries - mainly because of portfolio restrictions placed on pension funds in various Member States.

Also, the tax treatment on equity investment varies substantially across countries, as does the tax treatment of stock option schemes (a main feature of the remuneration packages for individuals involved in high-tech and other new economy start-ups). There is also a general consensus that the tax treatment of debt instruments has historically been more favourable than on equity investments in many EU countries and this also inhibits growth of venture capital business.

2.2 Pension funds

In the Fifth and Sixth Progress Reports on the FSAP it was noted that progress on implementing legislation to create a pan-European pension market remained 'a concern'. This is especially the case, as obstacles to cross-border provision of pensions constitute one of the most significant barriers in the wholesale market in financial services.

The pensions market in most of Europe is significantly underdeveloped. Assets held by private pension funds as a proportion of GDP is much lower in most European countries compared with the US. While pension funds business is strongly established in the Netherlands and the UK within the Euro zone it accounts for less than 5 percent of GDP in Germany, Spain, Italy, Austria and Sweden. At the EU level, the share of financial assets held by pension funds as a proportion of all institutional investor financial assets is decreasing slowly over time whereas the share of investment companies is increasing from 31.11% in 1990 to 41.80%. The Japanese pensions industry is also relatively underdeveloped and is on a par, in terms of its depth, with the Euro zone average.

Because discriminatory tax barriers distort competition and limit labour mobility, supplementary pension schemes are currently not able to benefit from the scale economies associated with the wider single EU market. At present each Member State has its own rules for the pensions industry. The tax treatment of pension products means that the pensions industry is characterised by 'nation-specific' products and has led Member States pensions industry to develop 'idiosyncratic' investment policies. [2]

In particular, country specific products have evolved to acquire unique features that are designed to benefit from national tax treatment. The various portfolio restrictions imposed on pension funds across Member States results in an industry with varying structures and features. For instance:

- In Ireland, Italy, Luxembourg, the Netherlands, Spain, the UK (as in the US) there are no limits of pension fund investment in equities;
- In the following, equity investment in pension funds is limited as follows: Austria (50%), Denmark (40%), Finland (40% quoted, 10% unquoted), France (65% quoted, 0.5% unquoted), Germany (30% quoted, 10% unquoted), Portugal (50%), Spain (quoted no limit, unquoted 10%), Sweden (60%);
- French pension funds must invest a minimum of 50% in EU government bonds, in Denmark pension funds have to invest a minimum of 60% of their portfolio in domestic debt.

This just highlights some of the restrictions that are currently in place creating a highly fragmented a country specific pension fund business.

The differential tax treatment of pensions also has the effect of limiting cross-border labour mobility as pensions contributions are not tax deductible for workers who are employed in one Member State but make payments to a pension based in another Member State. The FSAP Communication (COM(2001)214) of the 19 April 2002 calls upon Member States to eliminate discrimination against occupational schemes established in other Member States. As noted earlier, at the ECOFIN Council of October 2001 the Council and Commission undertook to further develop the Commission's proposals on the exchange of information and the elimination of double taxation and double non-taxation, with a deadline set buy the end of 2002.

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[2] See OECD (2000) Survey on Investment Regulation of Pension Funds, OECD Secretariat: Paris.

The Commission's initiative calls for a comprehensive strategy to address tax obstacles that act as a major disincentive to individuals that wish to contribute to pension schemes outside their home Member State and pension institutions that wish to provide pensions across borders. (This initiative forms part of the strategy to create pan-European labour markets by 2005). In addition, the Directive on the Prudential Supervision of Supplementary Pension Funds aims to establish prudential supervisory rules for supplementary pension funds in the EU covering authorisation, reporting, fit and proper criteria and rules on liabilities and investments so that minimum standards are applicable across all EU Member States.

2.3 Collateral

The use of collateral has become one of the most important and widespread risk mitigation techniques in wholesale financial markets. Financial intermediaries employ collateral in lending, in securities trading and derivatives markets and in payment and settlement systems. Central banks generally require collateral in their credit operations.

The report of the Committee on the Global Financial System Working Group on Collateral shows[3] how over the last decade the use of collateral in wholesale markets has grown rapidly. Collateral markets are at different stages of development. In the US, the collateralisation of trading exposures has been a longstanding feature of securities markets: outstanding repos and reverse repos of securities dealers grew by an average 13.5% a year in the second half of the 1990's, amounting to US$ 2,500 billion by mid-2000. In the euro area countries, the start of EMU caused a strong expansion of repo transactions, and cross-border activity has grown significantly. The market, however, still faces obstacles that to some extent hamper arbitrage across the currency area, such as differences in the legal and tax framework across countries and a lack of integration of market infrastructures.

The lack of a clear framework of rules for collateral in the EU has been a major disincentive to cross-border transactions. To this aim, on 15th of May 2002, agreement was reached on the Directive on financial collateral arrangements. The new Directive is due to be implemented by Member States within 18 months of its forthcoming publication in the EU´s Official Journal (i.e. around the end of 2003). By determining which law governs cross-border collateral arrangements and by allowing market participants to set up such arrangements in the same way all over the EU, the Directive will reinforce financial stability and make borrowing easier and cheaper.

[3] Bank for International Settlements (2001): “Collateral in wholesale financial markets: recent trends, risk management and market dynamics”, Committee on the Global Financial System, March 2001.

In analysing the effectiveness of the Directive, it would be convenient to quantify an indicator of the development of the use of cross-border collateral in EU financial markets. As far as we are aware, the only publicly available information is the ratio "cross-border collateral/total collateral provided to the Eurosystem" provided by the European Central Bank, although this information is not available by countries[4]. According to this indicator, the ratio has increased from around 12% in 1999 (July) to 25% in 2001 (December).

2.4 Clearing and Settlement

The existence of different clearance and settlement systems in countries of the EU (there are 19 International Central Securities Depository –ICSDs- and 2 Central Securities Depository –CSDs- providing various types of services and, although cross-border links exist between many of these providers, evidence suggests that these links are not used) limits the integration of financial markets. As stated in the Giovannini Group report (2001)[5] on "Cross-Border Clearing and Settlement Arrangements in the European Union", the lack of integration of the clearance and settlement systems in the EU is made clear by the fact that the per-transaction income (as a proxy for fee) of the ICSDs is about 11 times higher than the per-transaction income of national CSDs. However, when comparing the per-transaction income between EU and USA, the settlement of domestic securities transactions in the EU appears to be relatively cost efficient

The same report from the Giovannini Group concludes that the EU infrastructure for clearing and settling cross-border transactions remains highly fragmented due to the existence of 15 barriers, grouped in three types: national differences in technical requirements/market practice (10 barriers as differences in information technology, in settlement periods, in securities issuance practice, etc), national differences in tax procedures (2 barriers), and issues relating to legal certainty (3 barriers). Consequently, the inefficient delivery of clearing and settlement services created by these barriers is reflected in higher cost to pan-EU investors and is inconsistent with the objective of creating an integrated financial system in Europe.

The Lamfalussy report has also underlined the role of efficient clearing and settlement arrangements in delivering the economic benefit from the broader process of EU financial

[4] The total collateral provided to the Eurosystem refers to the sum of domestic collateral, cross-border collateral held via the CCBM (the correspondent central banking model) and cross-border collateral held via the links between SSSs (securities settlement systems). The CCBM came into operation on 4 January 1999 and it was established in order to facilitate the cross-border use of collateral in the Eurosystem´s money policy operations and intraday credit operations.

[5] A futher report, examining possible developments in the clearing and settlement architecture will be produced later this year.

integration, stressing that the process of consolidation should largely be in the hands of the private sector (market forces). However, if the private sector were unable to deliver an efficient pan-European clearing and settlement system for the European Union, then a public policy orientation would be necessary. Finally, the Wise Men's Committee advises that the European Commission, through its Directorate General for Competition, examines the current situation in order to guarantee competition in the sector. Additionally, it is also suggested that a study should be carried out examining whether the European Union should introduce a regulatory framework for clearance and settlement activities.

Conscious of the importance of the proper functioning of settlement systems, the BIS, through the Committee on Payment and Settlement Systems and the Technical Committee of the International Organisation of Securities Commissions, published in November 2001 a report on "*Recommendations for securities settlement system*s". This report details 19 recommendations that identifies the minimum standards that securities settlement systems should meet with the aim of achieving significant improvements in the safety and efficiency of these systems. The 19 recommendations are related to different types of risks (credit risk, liquidity risk, risk of settlement bank failure, custody risk, operational risk, legal risk, systemic risk). Of special interest for the European Union are the risks associated with cross-border transactions identified in the BIS report.

a) The recent Communication (28th of May, 2002) from the Commission to the Council and the European Parliament on "Clearing and settlement in the European Union. Main policy issuers and future challenges" (COM(2002)257) also identifies two main policy objectives: a) to remove barriers to the finalisation of individual cross-border transactions in the form of national differences in technical requirements/market practice, tax procedures and laws applying to securities; b) to remove competitive distortions or unequal treatment of entities performing similar clearing and settlement activities.

b) Two Actions of the FSAP (the implementation settlement finality directive and the proposed directive of financial collateral arrangements) along with the implementation of the advice of the Giovannini Group (the Communication mentioned above), aim to remove the distortions to cross-border payments and settlement. In the latter case, there is a consensus within the Giovannini Group that EU clearing and settlement could be improved by market-led convergence in technical requirements/markets practice across national systems.

c) Given that inefficiencies in clearing and settlement represent important barriers to integrated financial markets in Europe, on-going study of the impact of the FSAP actions on the cost of clearing and settling cross-border securities transactions, similar to the ones accomplished by the Giovannini Group, are required.

2.5 Financial Stability

A crucial policy issue is whether systemic financial risks, and therefore the stability of the system, has increased during the process of integration and whether EU financial legislation can be used as a preventive tools to reduce the risks of a systemic crisis.

Regulatory and supervisory structures are continually influenced by financial market trends and therefore have to be updated regularly in order to help safeguard financial stability in Europe[6]. The linkages between financial markets and financial institutions, both cross-borders and cross-sectors, are intensifying. This has a positive effect on financial stability, since financial markets become deeper, more liquid and more diversified. However, this higher degree of integration can facilitate the transmission of risk and contagion effects.

Since the introduction of the euro monetary policy has been conducted by the ECB while prudential supervision continues to be undertaken by national authorities. So, if there were a financial crisis, the Eurosystem would use the monetary instrument to smooth the functioning of the payment system, while national authorities would decide on how to deal with the problems of individual institutions.

Technological progress and deregulation have resulted in many new financial products that allow the various risks which are implicit in a financial product to be unbundled and traded separately. This process has contributed to the efficiency of global financial markets, and it has encouraged competition, both at the national as well as international level. However, this process has increased the vulnerability of individual firms to adverse global events. The risk of contagion between market participants therefore has important systemic risk implications.

Additionally, the process of disintermediation and consolidation also impacts on systemic risk. The former implies that firms raise capital directly in the market instead of obtaining loans from banks. Because of this, the financial system that used to be bank-based is shifting to a more market based system. As bank's assets have become more liquid and marketable, one implication could be that the likelihood of liquidity problems is reduced.

On the other hand the trend towards consolidation has several implications for financial stability. Efforts to improve product and geographical diversification could make banks more resistant to local or national cycles, reducing the risk of instability. However, consolidation practices can reduce potential diversification gains. Besides, the problem of moral hazard ("too big to fail") could also increase as a consequence of consolidation. Market power may increase

[6] Economic Papers, number 143. May 2000.

and competition could fall. Since an increase in market concentration within a specific sector could indicate that there has been an increase in contagion risk, we can consider one indicator of concentration, such as the Herfindahl index. There has been an increase in the Herfindahl index in banking as well as in the insurance sector throughout Europe during the 1990's suggesting a possible increases in market power and contagion risks in these sectors.

Additionally, banking losses as well as sharp fluctuations of the profitability ratios could indicate instability in the system. The evolution of ROA and ROE in banking firms suggests that there has been a small increase in profitability during the 1990s. Besides, the variation in profitability has not changed markedly over the period. These features suggest that at present there are no strong signals of potential systemic banking problems in the EU.

Another interesting indicator is the quality of the international assets of banks, measured by the risk that banks assume when they invest in other countries. The average weighted country credit rating of the countries where banks invest has increased, suggesting that country credit risk is not a source of potential financial instability.

While the aforementioned indicator is not suggestive of increasing systemic risk, if a financial shock appears, regulators have to ensure that there is a sufficient capital cushion to cover any potential losses. Evidence suggests that the levels of Tier 1, Tier 2 and capital resources for the European banks are reasonable and capital strength has increased during the 1990s.

2.6 Mortgage Market

Objective 2 of the FSAP is to achieve open and secure retail markets. Among the different financial markets, mortgage credit is seen as particularly important especially as home loans are generally the largest financial transactions undertaken by consumers. The European Commission has expressed concerns, however, relating to the low level of cross-border mortgage lending. The European Single Passport for financial services and other measures intending to create a single retail cross-border financial market do not seem to have produced the results desired, especially in the case of mortgage credit.

The first issue to address is why there should be a cross-border market for mortgage credit? In other words, do consumers and firms have the incentives to deal with third parties located in different countries when signing a mortgage? The answer to these questions is twofold: cross-border transactions are more likely if there are advantageous price differentials for customers, and/or there is increased scope of products in other countries.

The first reason under which cross-border trade in financial services could flourish is when customers could have favourable price spreads between domestic products and those offered by foreign companies. Although mortgage interest rates comparisons across countries need to be treated with certain caution[7], it is clear that mortgage spreads have fallen in all countries. Furthermore, this reduction is stronger in those countries with higher initial values such as Spain, Portugal and even. Nevertheless, the evolution of mortgage spreads after the introduction of the Euro in 1999 shows stagnation in their reduction and even a widening of spreads in countries like Belgium, Spain, France, Italy, Austria and Portugal (though spreads are still lower than what they were at the beginning of the nineties).

Overall it appears that price convergence in the market for mortgage loans has taken place. But it is also true that interest rate convergence has been more intense in wholesale markets than retail markets. Thus, there remain differences in the prices of mortgages that could create incentives for further cross-border business in mortgage lending. Furthermore, and given the almost void cross-border mortgage business in the European Union[8], it can be concluded that the convergence observed is due more to the process of nominal convergence rather than to the existence of a unique market for mortgages in which the "Law of Single Price" holds.

A second reason why development in the cross-border mortgage loans market might occur is because customers can have access to differentiated products in other countries compared with products in their own countries. As the European Mortgage Federation states[9], Europe's mortgage markets are still characterised by national peculiarities and features. Such differences have arisen because of supply characteristics e.g. types of lenders in each country or type of products (duration of mortgage loans, type of interest rate, loan-to-value ratio, annual percent rate of charge); or demand characteristics (tenure structure in the country, number of dwelling and so on). Consequently, the choices facing customers is greater for those products that are readily available throughout the European Union. This is despite the fact that within countries there appears to be significant choice of products and lenders for consumers, even when a particular contract type or institutional lender dominates.

In the light of what has just been said, it is thought that there is greater scope for extending the market in cross-border mortgage loans. Both the price spreads and the different financial techniques in each country (that makes for differentiated products) create enough incentives for citizens and firms to operate cross-border. However, reality shows that there is little actual trade. What is hindering the progress of a single market for mortgage loans? If these barriers or inefficiencies are identified, policy actions should be taken in order to reduce them.

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[7] This caution comes from the fact that differences in the definitions of interest rates exists, average maturity of loans and their variability, level of inflation and even differences in the legal frameworks established in each country

[8] As far as we know, there is no available information regarding cross-border mortgage loans.

[9] "Hypostat 1990-2000. Mortgage and property markets in the European Union and Norway", European Mortgage Federation. December, 2001. Brussels

In 1997 the European Commission published a report[10] which addressed the main limitations to cross-border mortgage loans. Firstly, the characteristics of customers in local markets were recognised. Customers continuously reveal a preference towards known institutions and products especially in large and long-term contracts. Furthermore, mortgage loans have certain characteristics that are nation specific and which vary over countries, such as, registration, valuation and foreclosure systems. In addition, the best way in which financial firms can access relevant information on borrowers, properties to underwrite borrowers and price risk, is also by means of local physical presence.

Additional barriers stem from difficulties that firms may have when securitising the mortgage loans either on-balance (mortgage bonds) or off-balance sheet (mortgage-backed securities). As long as financial institutions face impediments to securisation in other member states, the increasing activity associated with new cross-border activities may not be a viable source of funding. In this sense, access to local capital markets can be an important piece of a cross-border lending strategy.

Fiscal differences across countries also affect the feasibility of cross-country transactions. For instance, the imposition of withholding taxes on interest on mortgages in a particular country, or remitted to another country, can raise funding costs for cross border lenders. This latter point emphasises the importance of cross-border treaties on withholding tax.

With the event of the single currency in the Euro zone, an impediment cited in the report published by the European Commission has been eliminated. Exchange rate risk in cross-border commitments has been eliminated, which reduces risks for both customers and lenders. The introduction of a single currency has also reduced transaction costs associated with operations in foreign currencies.

Additionally, with the progress in the execution of the measures of the FSAP, the lack of standardised disclosure has been, in part, resolved. European credit associations and consumer associations have reached an agreement regarding the homogeneous information to be provided in the pre-contractual stages of mortgage loans. This information, called the Voluntary Code of Conduct of pre-contractual Information for Home Loans, was approved as a Recommendation of the European Commission on Mach 21st of 2001[11] and is to be voluntarily implemented by financial institutions[12].

[10] Lea, M.J., Welter, R. and Dübel, A., “Study on mortgage credit in the European Economic Area. Structure of the sector and application of the rules in the directives 87/102 and 90/88”. Final report on Tender nºXXIV/26/U26/21.
[11] C(2001) 477 final.
[12] See description of this measure in section 3.2 of this report.

For the European Union as a whole, a quarter of monetary companies have implemented the Code. Although the Voluntary Code has helped minimise existing barriers to competition, other obstacles that remain. For instance regarding questions raised by the DG. of Health and Consumer Protection concerning the modification of the Consumer Credit Directive. Two areas require attention, particularly if certain kinds of mortgage credits are to be included in the aforementioned directive, and if calculations of the Annual Percent Rate of Charge are to be harmonised.

2.7 International Accounting Standards

The different accounting and auditing standards applied to companies throughout the EU acts as a barrier to cross-border equity trading because of the lack of transparency and comparability of financial statements. In order to remove this barrier the FSAP's International Accounting Standards regulation (IAS) stipulates that listed EU companies will have to prepare consolidated accounts in accordance with IAS by 2005. So as to enable Member States to adapt accounting legislation to make it compatible with IAS the Commission also aims to present Directives modernising the Fourth and Seventh Accounting Directives. These Directives will remain the basis for financial reporting for all limited liability companies. Other related FSAP initiatives aim at improving auditor independence as well as introducing rules for the regular reporting of financial accounts.

Given current international concerns post ENRON and WorldCom the introduction of standard reporting requirements based on international best practice should make it easier for investors to compare company accounts throughout the EU. This in turn will help increase market efficiency and reduce the cost of raising capital for companies. The plan to introduce comparable accounting rules and audit practices for all limited liability companies should also help facilitate cross-border venture capital business as investors will be able to rely on more transparent accounts on which they can make their investment decisions.

2.8 Prospectuses

The new regulation concerning the standardisation of prospectuses will make it considerably easier and cheaper for companies of all sizes to raise capital across frontiers in Europe. At present prospectuses relating to the issue of equity tend to be Member State specific and it is rare that one single prospectus can be used to raise capital on a pan-European basis. This creates a substantial administrative burden for issuers and a lack of comparability and transparency for investors. The aim of the Prospectuses Directive is to create a 'single passport' principle. In the case of an issuer there should be only one set of disclosure documents, approved by the home country authority (of the issuer), and this should be accepted throughout the EU for public offer and/or admission to trading on regulated markets.

Various obstacles, however, remain concerning the adoption of the Prospectuses Directives, not least those associated with how SME's should be incorporated into the legislation (Sixth Progress Report, 3 June 2002). As it stands, the proposed Directive provides for a single set of disclosure documents, irrespective of the size of issuer. This may prove to be over burdensome for SME issuers that may only wish to enter lower tier markets like AIM. However, given current market concern about accounting standards and disclosure it may well be circumspect to enforce uniform prospectus requirements especially if confidence is to be instilled for the small European retail investor.

2.9 UCITS (Undertakings for Collective Investment in Transferable Securities-Investment Funds)

The two Directives on UCITS, 2001/107/EC and 2001/108/EC, adopted on 21 January 2002 remove barriers to cross-border marketing of units of collective investment funds by widening the range of assets in which they can invest and providing a single 'passport'. Under the legislation funds will now be able to use modern investment techniques and also benefit from the single passport thus enhancing cross-border activity. In addition, investors should also be able to rely on enhanced investor protection standards as the legislation introduces simplified rules for prospectuses and on other supervisory issues. Member States have five years to adapt to adapt to the new rules.

A major obstacle relates to discriminatory tax barriers that severely inhibit cross-border transactions[13] as well as onerous administrative procedures. Another important barrier relates to advertising and marketing of funds cross-border. Advertising and marketing rules still remain firmly in the remit of host countries. (Although the newly introduced simplified prospectus will go some way to reduce this obstacle to the extent that host country authorities can no longer ask for additional information in the cross-border fund registration process). Legal uncertainty, however, still remains as to cross-border marketing and advertising of fund products and this continues to restrict the development of pan-European distribution strategies via the Internet[14].

[13] See FEFSI (2001) Report to the European investment funds industry. Discriminatory tax barriers in the single European investment funds market: a discussion paper. PriceWaterHouseCoopers/FEFSI, June 2001.

[14] FEFSI (2001) Cross-border marketing of 'harmonised' UCIT in Europe. PriceWaterHouseCoopers/FEFSI, November 2001.

2.10 Other Retail financial services

One of the priorities in order to achieve a single market for financial services is to pave the way for open and secure retail markets. In the table below the main benefits of integration are noted for both consumers and the macro economy overall. Given that retail markets are closer to citizens, the benefits of integration in this area are particularly important. The benefits derived from integration are substantial. They range from the increased amount of financial services intermediated, the lower prices derived from either greater competition between financial firms or, additionally, from scale economies emerging from large markets, and the improvement in portfolio diversification with lower risk. The macroeconomic benefits associated with retail financial service integration relate to the expected generation of employment, the stimulation of capital accumulation and of financial market development, and, lastly, the improvement of the efficiency of capital allocation.

Benefits of integration on EU markets for financial services

CONSUMER BENEFITS	MACROECONOMIC BENEFITS
- Product choice	- Stimulation of capital accumulation.
- Lower prices: Economies of scale and more intense competition.	- Stimulation of financial market developments - Improving efficiency of capital allocation
- Improving the portfolio composition	- Positive growth and employment effect
	- Impact on the global role of the euro

Source: Heinemann and Jopp (2002): "The Benefits of a Working European Retail Market for Financial Services". Report to European Financial Services Roundtable.

To achieve the single market in retail financial services, the FSAP in Objective 2 establishes areas in which EU institutions should work. In particular, it is stated that there is a need to equip consumers with enough information and safeguards (rights and effective dispute settlements) that enable them to participate in the single market; to identify areas relating to cross-border services in which relationships between consumers and business are not harmonised; to create the mechanism to overcome the problems in the retail markets originated by differences in private law; to regulate the legal conditions under which the new channels of distribution and distance technologies are to be developed in the European Union; and, lastly, to promote the existence of an efficient, secure and costless cross-border payment system.

To achieve these objectives the FSAP proposes nine actions in the area of retail markets shown in Table 1. As stated above, significant convergence in interest rates has occurred in the 90's. The standard deviation of the different interest rates analysed in the report has declined. But behind this common fact of convergence in the countries of the European Union, there are certain aspects that are worth mentioning. The convergence has been more intense in wholesale interest rates (3-year government debt yields and long term government debt yields) compared with retail markets, as illustrated by the lower standard deviation of wholesale interest rates. Mortgage credit interest rate convergence has been more intense, whereas for consumer loans or loans to enterprises (both medium and long term) the differences in interest rates among countries have not been reduced. Consequently, the Law of Single Price seems to have played a role more in the wholesale markets than in the retail ones that appear to be still fragmented.

To fully understand why this fragmentation occurs, it may be useful to observe the way in which financial companies can provide their financial services to customers in other countries. Historically, cross-border retail financial services are either provided by financial firms opening branches in the local market or by mergers or acquisitions with companies that operate in such markets. Indicators of branch penetration of foreign banks suggest that there has been an overall increase in branch penetration in recent years in the European Union. In the insurance sector a similar picture can be drawn. In the insurance sector data suggest that foreign penetration is carried out to a greater extent through foreign control of companies rather than though branching.

It is also possible, of course, to access other Member State’s markets without establishment. This involves the offering of cross-border services through distance selling, via the Internet and so on. It is in this area where almost all of the measures included in the Objective 2 of the FSAP are addressed. Supposedly, new channels of distribution like the Internet need to be developed to foster growth in cross-border transactions. But despite the measures implemented in the FSAP, barriers still remain to the realisation of cross-border transactions as can be seen in the following Table 2[15].

Table 2 Obstacles to full integration of EU financial retail markets

	Natural	**Policy induced**
Demand side	- Differences in language, culture	- Discriminatory tax treatment of foreign financial services
	- Consumer trust in established national suppliers	- Still existence of national currencies
	- Distance and the desire to personal contact	- Insufficient knowledge about cross-border redress procedures.
Supply side	- Information costs caused by natural factors (cultural differences, legal tradition and so on)	- Information and adjustment costs derived from national differences in regulation
	-Sunk costs	- Obstacles to cross-border information flows (e.g. limited access to foreign credit registers).

[15] A deeper analysis of the benefits and obstacles to a retail financial market can be found in Heinemann, H., Jopp, M. (2002): *The benefits of a working European retail market for financial services*. Report to European Financial Services Round Table.

	-Bias for home products in distribution channels - Smaller national market may be commercially not attractive	- Competitive privileges of domestic suppliers - Lags in the regulation of Internal Markets -Particular costs of cross-border operations (money transfers, identification procedures…)

Source: Heinemann and Jopp (2002): "The Benefits of a Working European Retail Market for Financial Services". Report to European Financial Services Rountable

Natural barriers –those independent of policy measures adopted because they are caused by preferences, technology or the inherent characteristics of markets– relate to such factors as different languages and culture. It is also important to mention that, although measures to achieve a single market for financial services have been implemented years ago, the fact is that Europe is still in its first steps towards real financial integration. Consumers still appear to have grater trust in national providers of financial services compared with their foreign counterparts. This is especially relevant for example in the case of the insurance industry, where a good reputation is particularly important. Furthermore, in financial transactions, as in general economic transactions, personal contact is perceived as a key part in the generation of the trust necessary to reach an agreement between parties. Consequently, one of the most evident advantages for firms associated with cross-border transactions – lower cost derived for not needing a branch network in the host country - may be overridden by other expenses derived from specific marketing strategies. This may relate to up-front advertising costs associated with establishing a brand name, consumer awareness and confidence.

On the supply side there are also natural barriers to cross-border retail trade. Financial intermediation theory states that one of the causes of existence of firms specialised in the intermediation between agents that supply and demand funds is the comparative advantage in evaluating the risks involved. Very often the feasibility of gathering the information necessary to perform this evaluation can be obtained only, or it is too costly otherwise, by establishing a physical presence in the market. Frequently there are substantial sunk costs associated with access to various markets that acts as a barrier to new entrants.

Table 2 also shows the policy-induced barriers that can be tackled by the legislator. On the demand side, three barriers are mentioned: the distinct, and generally discriminatory, tax treatment of foreign financial products with respect to domestic products, the existence of national currencies for three countries of the European Union (Denmark, Sweden and UK), and, lastly, the fact that customers are unaware of redress procedures in the event of problems.

Additionally, on the supply side, obstacles to cross-border transactions still persist such as differences in regulation (supervision, customer protection, accounting standards, etc) that generate information cost and may act as instruments of protectionism. There are also restrictions to the flow of cross-border information. This means that as long as foreign markets entrants do not have the same access to credit registers as their domestic competitors, the possibility of running effective credit risk management of the foreign firms may be hindered.

Important barriers may relate to domestic privileges afforded to local producers that increase their competitive advantage. In addition, mismatches in the reality of what is happening in the financial markets and what is being regulated due to the lags in legislative actions may also hinder the growth in cross-border business. Furthermore, an area of special concern is that cross-border operations have special costs associated with identification procedures and the cost of credit transfers. Identification procedures are particularly important in cross-border transactions. As long as in this kind of agreement the customer and the firm do not meet face to face, there should be procedures established for the effective identification of clients. If procedures of identification are too complicated (e.g. to visit an embassy or to the notary), cross-border transactions are discouraged.

Also important are the costs associated with cross-border credit. As seen before in the description of Action 26 relating to the Commission communication on a single market for payments, in the European Union it is still more expensive to make cross-border credit transfers than domestic transactions. Moreover, the higher costs associated with cross-border transfers has not fallen[16]. In view of this, and taking into account that in the Euro zone all countries share the same currency, the European Parliament and the Council have adopted a Regulation[17] to ensure that cross-border charges for payments up to 50,000 euro are the same as payments in euro within a Member State. To achieve equality of charges up to the aforementioned credit transfer amount there is a transitional schedule that will end in 2006.

To sum up, despite the process of integration and liberalisation, retail financial markets are still far from a single market as intended. Substantial barriers remain making retail markets fragmented. Some of these obstacles are natural barriers over which policy-makers can have little influence. On the other hand, there are various areas where the authorities need to focus to reduce the level of fragmentation in retail markets. Facilitating cheaper and equal-to-domestic credit transfers may be a necessary condition to cross-border transactions, but it is not sufficient. As it has been seen, there are more barriers to overcome. Policy actions should focus on those barriers that could speed up the process of integration by reducing the fragmentation: reducing

[16] For further details see European Commission (2001): Study on the verification of a common and coherent application of Directive 97/5/EC on cross-border credit transfers in the 15 Member States, Retail Banking Research, London, England, 17th September 2001 and European Commission (2001): *Bank charges in Europe*, report for the European Commission, IEIC, May 2001

[17] Regulation (EC) No 2560/2000 of 19th of December of 2001. This Regulation amend the Directive 97/5/EC of 27th of January of 1997.

the different tax treatment between domestic and foreign suppliers, working towards harmonisation in consumer protection and supervision areas, and fostering consumer confidence. In this sense, the measures adopted in the FSAP with a view to increasing consumer information are working in the right direction. Lastly, further action needs to be made to facilitate cross-border eCommerce via the Internet. Consumer access to the Internet needs to be broadened and problems associated with the e-based provision of financial services (identification problem, facilitating cross-border transfers and so on) need to be resolved.

2.11 SMEs access to finance

According to "The European Observatory for SMEs", there are 19.370.000 SMEs (firms with less than 250 employees) in the EU, which represent 99% of total European enterprises and are responsible for two thirds of total employment. A competitive financing environment for all companies is a key element in promoting an entrepreneurial economy and fostering economic growth.

The FSAP aims to improve the general financial conditions under which companies operate irrespective of their size. It is more general than the Risk-Capital Action Plan (RCAP) which aims to improve the general financial conditions affecting specifically small and medium enterprises (SMEs) and in particular those SMEs showing a fast-growth profile. All the measures of financial nature identified in the RCAP have been integrated into the FSAP so as to achieve coherence and maintain pressure for changes in order to improve access to finance for SMEs. Of particular relevance for SMEs are measures to reduce costs and red-tape in relation to access to capital market financing in the EU.

Various commentators have emphasised the growth in importance of own funds as a source of financing for European companies. The growth in the importance of own funds is pronounced in large enterprises (LEs) as well as for SMEs, even though own financing is relatively more important in LEs. Therefore, the increase in equity makes enterprises less dependent on bank finance.The importance of bank financing to European companies is notable compared with American firms, although differences have been reduced in recent years. Bank financing, however, remains much more important for SMEs and the cost of this type of finance has fallen. For instance, in the case of the loans to enterprises, short term as well as medium and long term loan rates have declined (the average value for the EU fell from around 15% in 1990 to 6,5% in 2001). Consequently, SMEs can now obtain loans at rates that vary between 4% in Belgium to 9% in Ireland, whereas in the early 1990s rates of up to 25% were common in some member states.

The reduction in the cost of finance of corporate enterprises is also observed in various other measures. The ratio of financial charges/non-commercial debt for example, suggests that the cost of finance in the European firms has decreased from 8% in 1994 to 5% in 1999[18].

2.12 Mergers and Acquisitions (M&A)

Mergers and acquisitions (M&A) represent one of the key aspects within the context of a single market for financial services in the European Union. In particular, with the evolution towards a single market, M&As were expected to grow and help facilitate greater financial market integration. M&A activity also poses threats in terms of potential increased risk and market power.

The FSAP offers various actions and objectives that are clearly inspired by (or may affect substantially) M&A activity at both the domestic and cross-border level. Since M&As are viewed as a strategic response to a progressively more open, integrated and competitive financial environment in Europe, the main concern has been expressed in terms of regulation and supervision of risks and to guarantee a certain level of competition. In particular, Objective 3 of the FSAP refers to the introduction of state-of-the-art prudential rules and supervision that partially reflect some of the regulatory concerns associated with greater M&A activity. Factors such as the setting of appropriate standards to ensure competition and the development of supervisory rules to sustain stability and confidence –where financial institutions are enlarging and operating as conglomerates- have deserved specific attention. However, M&As may be affected directly or indirectly by other strategic objectives and actions contained in the FSAP seeking the achievement of highly integrated, open and secure markets since financial institutions will be more likely to merge when their customers are willing to operate in wider markets with access to a wider range of products at a lower cost.

It is important to note that regulatory objectives are not specifically geared to prevent or encourage financial institution mergers. There are many industry specific and other factors determining the causes and consequences of M&A. In this sense, the role of authorities in the context of M&A activity is limited to facilitate integration and competition and to prevent potential risks. Evidence suggests that M&A deals increased with the advent of the Single

[18] Unfortunately, the indicators of cost of finance could not be estimated separately for LEs and SMEs. Nevertheless, the few studies that offer compared evidence of the cost of finance between LEs and SMEs using the BACH database ("Comparison between the financial structure of SMEs and that of large enterprises (LES) using the BACH database", by Rivaud-Danset et al., Economic Peper, ECFIN/396/01-EN, European Commission, 2001; and "Enterprise size and profitability, Studies and Research, European Commission, Eurostat, Edition 1999) show that SMEs incur proportionately higher financial charges than large enterprises.

Market in Europe, although this growth is not linear and most of the deals were domestic. Therefore, two main questions should be answered:

- Why have European financial institutions not yet completely exploited the opportunities and possible advantages of expansion and consolidation with the advent of a Single Market for financial services?
- Have the relevant authorities provided a complete supervisory and regulatory scheme both nationally and throughout Europe to guarantee competition and risk prevention resulting from the consolidation process?

Answering the first question requires an analysis of domestic and cross-border incentives for M&A activity. On the one hand, market power within a certain region and economies of scope seem to be the main objectives in domestic deals, while size ("the need to be large enough in the market or to match the size for new clients") is the general objective in cross-border deals[19]. In terms of size, small bank mergers aim to achieve critical mass to benefit from the synergies arising from scale and diversification while large bank domestic mergers seek to increase market power and a larger capital base, increasing revenues and shareholder value. Cross-border M&As may also pursue economies of scale and scope offering different services in different national markets for a wider range of customers, raising the crucial mass for offering certain products such as international asset management and so on.

However, the theoretical benefits and threats are not always realised in practice. Recent European empirical and consultant studies[20] have revealed the difficulties in determining the economics of financial M&As, where the objectives of the merging institutions *ex-ante* and the results they obtained *ex-post* rarely coincide. Similarly, increasing concentration resulting from financial consolidation have not generally been found to affect the underlying market structure significantly since the positive effects of deregulation and integration in promoting competition have been clearly stronger than those of consolidation. Having these results in mind, it is important to note that most of the mergers have taken place within the boundaries of a national market.

If one considers the evolution of cross-border M&As relative to domestic deals in the insurance and bank sectors from 1990 to 1999 the number of cross-border deals in these areas hardly achieves half the number of domestic M&As until 1998. However, from 1998 onwards cross-border activities seem to have accelerated. Although these figures reveal the limited impact of cross-border deals in Europe, the ratio is significantly higher than in the United States.

[19] See ECB (2000): "Mergers and acquisitions involving the EU banking industry –facts and implications", December.
[20] See, among others, Berger and Humphrey (1992), Rhoades (1993) and Rhoades (1998).

The reasons explaining the relatively low number of cross-border mergers are various. As recent studies have pointed out, it does not seem to be possible that bank markets become fully globalised, since some (mainly retail) banking services –such as relationship lending– can always be provided primarily by small, local institutions operating in domestic markets. Other services, such as syndicated loans to large borrowers, are more likely to be provided by large international institutions where demanders of the services have a higher negotiation power. In any case, there are some other important barriers inhibiting cross-border M&A activity. One such barrier relates to the difficulty that banks' face in rationalising costs cross-border. A second problem arises from the frictions between different cultural environments or management conflicts, a problem that has been observed mainly in financial conglomeration. Third, greater integration resulting from cross-border M&A activity is only possible if other types of "integration" are developed. This relates to further integration of capital markets, payment and settlement systems, tax systems, and the widening of retail financial services markets.

The second question refers to changes in the supervisory and regulatory framework for M&A's. The FSAP has mainly filled the gap existing in the previous domestic and European prudential legislation concerning M&As with two main actions: (1) amending the directives governing the capital framework for banks; and (2) developing prudential rules for financial conglomerates. As for risk prevention, recent empirical evidence[21] suggests that cross-border takeovers are more likely to happen if the foreign bank is small (relative to the foreign banking market) and its investments are risky (relative to those of the domestic bank). This evidence reveals that acquirers can be expected to be less risky than targets that, in turn, may reduce the global risk in an integrated financial environment. A possible reason –*inter alia*- for banks to merge is to adjust their capital position to meet capital requirements standards, although the effectiveness of this practice will depend significantly upon the effectiveness of these standards themselves. If changes in prudential rules are finally adapted to include the new standards of the Second Basle Capital Accord, both domestic and cross-border M&As may improve substantially in terms of risk prevention, including not only credit but also market and operational risk. Since mergers are likely to continue, it seems to be necessary to adopt these rules as soon as possible. Secondly, as for the development of prudential rules for financial conglomerates, the potential for risk comes here from the differences in cross-sectoral activities and intra-group transactions, resulting in differential behaviour in areas such as risk exposure, capitalisation practices or managerial professionalism. By adopting prudential rules that reduce these risks, authorities will help create a regulatory environment that favours diversification, integration and risk prevention.

[21] Repullo, R. (2001): "A Model of Takeovers of Foreign Banks", *Spanish Economic Review*, 3, pp.1-21.

As for the prospects for further M&A growth, it is convenient to introduce an additional factor in the analysis, namely, the effect of information technology improvements in promoting cross-border deals. The factors that represent efficiency barriers to cross-border M&As can be grouped into two: (1) costs of collecting information, that tend to be higher between rather than within countries and (2) differences in regulations[22]. Developments in technology that promote more efficient information processing and delivery channels may change the ways in which consumers have access to banks' services and products and, hence, may enhance the contestability of markets, especially in retail banking. In particular, Internet banking may contribute considerably to the reduction of sunk costs in retail markets. When sunk costs are high, the cost of participating in the market is also high and the degree of contestability limited. The reduction in sunk costs is mainly expected to impact on products where e-banking is expected to grow at a higher rate, especially time deposits. As for loans, the cost will be still high until credit markets become more fully integrated. In any case, as these cost reductions become larger, customer dependence and entry barriers in retail markets may progressively be reduced while cross-border M&As for all type of financial services can be promoted. However, greater financial integration in retail services through mergers will not be possible unless two conditions are met: (1) the adoption of the actions to develop a single market for retail financial services; and (2) the adoption of new national and European regulations that permit a deeper and more homogeneous development of Internet and e-finance infrastructure across countries.

[22] Buch, C.M.and G. DeLong (2002) "Cross-Border Bank Mergers: What Lures the Rare Animal?", paper presented at the workshop of the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe".

3. OVERVIEW OF THE FSAP

The integration of financial markets is of crucial importance for the progress of European integration in general and its function as a driver of growth and creation of employment. There has been constant insistence on this point in recent years by the different organs of the Community, and numerous initiatives of the European Parliament, the European Commission and the ECOFIN Ministers.

The Financial Services Action Plan (FSAP), approved in 1999 with a calendar of actions planned to finalise in 2005, is the strategic document that integrates the multitude of measures taken and in preparation, with the aim of creating the conditions to allow optimum development of a single financial market. The FSAP as a whole aims to review the existing regulatory framework, to adapt it to the demands of single financial markets and to current conditions. To achieve this, the European regulatory policy must determinedly promote the efficiency of financial institutions and markets and face the risks deriving from financial instability.

Valuations of the progress achieved in integrating financial markets and advancing the European regulation of the sector are diverse and complex. On the one hand, substantial progress has been made in designing a new regulatory framework, by the approval of 25 of the 42 measures foreseen in the FSAP. On the other hand, there are difficulties for the completion of the remaining actions and for ensuring the effective implementation of the new regulatory policy. Meanwhile, as indicated in the Wise Men's report, the European Union's current regulatory framework is too slow, too rigid, too ambiguous and ill adapted to the pace of financial market change. There is therefore concern about the measures still pending, as well as for the effective and rapid adaptation to the new European regulatory framework of the markets and institutions of the member states. It is therefore necessary to continuously monitor the policies adopted, their implementation and their effects.

From the above we have shown that certain barriers to further integration are apparent in a wide range of financial areas ranging from SME finance, mortgage credit, retail financial services and a host of other areas. It is in these segments that the EU is likely to focus its regulatory attentions over the next few years.

To complicate matters further, European banks will also be subject to a new capital adequacy regime once Basle 2 (the New Capital Accord) is agreed and implemented into EU law. These new rules on how banks should allocate their capital for regulatory purposes are likely to have a very large impact on the strategic behaviour on the EU (and global) banking industry. The main features of the New Accord are briefly discussed below.

4. BASLE 2 - THE NEW CAPITAL ACCORD

On June 3, 1999, the Basle Committee on Banking Supervision formally launched proposals for a new capital adequacy framework (Basel 2). The original 1988 Accord established an international standard around a capital ratio of 8%. The new Accord main aim is to introduce a more comprehensive and risk-sensitive treatment of banking risks so as to ensure that regulatory capital bears a closer relationship to credit risk. In particular, the setting of minimum capital requirements will be based on an update of the current risk-weighting approach including the use of banks' internal risk ratings and external credit risk assessments. The New Basle Capital Accord has undergone an extensive review with the last round of consultation being in early 2002. The Basle Committee envisions implementation by 2006.

Basel 2 is built on three main pillars. Pillar 1 deals with the quantification of new capital charges and relies heavily on banks internal risk weighting models and on external rating agencies. Pillar 2 defines the supervisory review process and Pillar 3 focuses on market discipline, imposing greater disclosure standards on banks in order to increase transparency.

Pillar 1 seeks to amend the old rules by introducing risk weightings that are more closely linked to borrowers credit standing. The existing risk-weighting classification requires credit institutions (banks) and investment firms to hold at least 8% of their assets as capital. Assets are adjusted using a risk-weighting formula, allowing loans judged to be less risky to be backed by less capital. However, this method has been criticised on grounds that the original Accord's risk-weighting categories are too crude, so that they bear little relationship to the actual likelihood of default. For instance, unsecured loans to large companies and sole traders are counted as bearing the same 100% risk. This means banks have to hold the same amount of capital for regulatory purposes for these types of loans even if the former are viewed as being substantially less risky than the latter. In consequence, banks have tended to migrate towards riskier loans, which command higher interest rates while requiring the same level of capital backing.

The new Basel proposals refine the old methodology, to reflect with greater precision the varying underlying risks against which banks are required to hold capital. The new Accord does not propose changes to the current definition of capital or the minimum requirement of 8% capital to risk-weighted assets. The proposal mainly affects how banking risks (credit risk, operational risk and market risk) are going to be measured. Methods for measuring credit risk are more complex than in the current Accord, a measure for operational risk has been explicitly proposed, while the measure of market risk remains unchanged.

The biggest changes relate to the calculation of capital backing for credit risk. Under Basel 2, banks will be able to choose between what is known as the 'standardised approach' and the Internal Ratings Based (IRB) approach. In the standardised approach the new Accord defines risk weights within broad categories of sovereigns, banks and corporates, by reference to an external credit assessment firm (credit rating agency) subject to strict standards. Under IRB banks are allowed to use their internal credit risk assessments subject to strict methodological and disclosure requirements.

Together with changes to the risk-weighting scheme (pillar 1), the proposed Accord rest on two other 'pillars', namely improved supervision and enhanced market discipline. These are intended to act as a lever to strengthen the safety and soundness of the banking system.

Pillar 2, the supervisory review process, aims to ensure that a bank’s capital adequacy position is consistent with its overall risk profile. To this end, bank regulators must be able to make qualitative judgements on the ability of each bank to measure and manage its own risks. The US Federal Reserve has recently supported the idea that bank examiners should evaluate capital management processes on a continuous basis, but also contends that supervisors should establish explicit capital adequacy goals after assessing the potential risks to the institution concerned. Supervisors should also have the ability to require banks to hold capital in excess of minimum regulatory requirements. The Basle Committee’s discussions with regulators from outside the G10 area emphasised the need for higher capital requirements for weaker or riskier institutions. This is already the practice in some countries; for instance, some financial sector regulators in the G10 require various banks to hold capital equivalent to more than 20% of their assets. However, such a practice is not common in most of Europe. Such a review process is likely to require a substantial increase in supervisory resources in many countries, where the regulatory systems are currently geared only towards adhering to standard quantitative guidelines.

Pillar 3 third pillar seeks to enhance effective market discipline facilitated by introducing high disclosure standards with regard to bank capital. This requires banks to provide more reliable and timely information enabling market participants to make better risk assessments.

Taken together, Pillar 1 provides the rules for quantifying risk sensitivity and the minimum capital charges associated with these risks. This is balanced by the supervisory judgements available under Pillar 2 and market disclosure rules of Pillar 3. Ultimately, the new Accord seeks to create a more comprehensive and flexible regulatory framework, without sacrificing the safety and soundness achieved by the current Accord.

4.1 The Expected Impact of Basel 2

a) Large Corporations

Under Basel 2 large (top quality) companies are likely to be substantial beneficiaries of the Accord, mainly because of lower risk weighting associated with loans to these types of firms. The process whereby banks use their own internal risk assessments to determine risk weightings will apply to all of their portfolios. In short, good quality credits will have weightings considerably lower than the current 100%. (The risk weight assigned to firms with high credit ratings, A- and above, will fall to between 50% and 20% of their current 100% weighting). Banks will need less capital to support top (credit) quality loan portfolios and bond holdings. As a consequence, large firms will be able to fund themselves more cheaply.

b) SME's

While it is widely recognised that large high credit quality companies would benefit from the new Accord the opposite was generally thought to be the case for SME's that (typically) are of lower credit quality and have benefited from the old 100% risk weighting. SME's, especially the higher risk medium and larger sized firms are likely be assigned higher risk weightings. Those SME's that are of high quality, however, are expected to benefit from the new scheme. In the standardised approach, SME exposures (that are managed in a similar way to retail credit exposures) will attract a weight of 75%, compared to 100% currently. Under the IRB, the weight depends on the risk exposure, but in most cases is expected to be less than the present risk weight.

On 10th July the Basel Committee proposed that risk weightings for smaller firms (defined as those with less than Euro 50 million in annual sales) will be able to receive a lower capital requirement than exposures to larger firms. 'The reduction in the required amount of capital will be as high as twenty percent, depending on the size of the borrower, and should result in an average reduction of approximately ten percent across the entire set of SME borrowers in the IRB framework for corporate loans'. (Small-business-related exposures managed in a similar way to retail exposures will be permitted to apply the retail IRB treatment to such exposures, provided that the total exposure of a bank to an individual SME is less than Euro 1 million. A similar threshold will be established in the standardised approach).

These proposed adjustments, aimed at reducing the adverse impact of higher risk assessments for SME credits, have also been supplemented by another proposal. The Basel Committee has also announced that smaller domestic firms (defined as those with consolidated sales and consolidated assets of less than Euro 500 million) can be exempted from the maturity framework (where risk weights are adjusted according to the maturity of loans). Exemptions will be granted at the national level, rather than on a bank-by-bank basis. If the exemption is applied, 'all exposures to qualifying smaller domestic firms will be assumed to have an average maturity of 2.5 years, as under the foundation IRB approach'.

While these new proposals go some way to allay fears about capital charge increases applied to SME lending there still remains concerns that SME's, in general, will be adversely affected by the new Accord. These concerns relate to a number of factors:

- Despite the aforementioned capital adjustments, there is a general view that the SME's, and small firms in particular, are the most risky. While a small firm that has the same credit risk as a large firm will be subject to a lower capital charge it is uncertain whether this reduction will incentivise banks to continue exposure to the sector. This will especially be the case when banks can obtain larger gains by diversifying into much lower risk top quality (large) corporate lending. Or to put it another way, given available evidence, the incentive structure put in place by the new Accord still appears to strongly favour large banks reducing their SME exposure in favour of lending to top quality borrowers;
- The BIS Quantitative Impact Studies that gauge the possible effects of implementing the new Accord illustrate that moderate changes to the assumptions underlying risk weightings (and other) assumptions can have a big impact on capital charges for corporates. (See BIS Quantitative Impact Study 2.5, 25 June 2002) Unfortunately, it is by no means clear how these changes are distributed among different sized firms;
- While the reduced capital charges for SME's 'should result in an average reduction of approximately ten percent across the entire set of SME borrowers' it is uncertain how these benefits will be distributed across different types of firms/sectors and countries. Given that the risk attributes of the SME market differs across countries, SME's in some countries could see substantial capital charge increases while other may experience declines;
- Issues concerning the treatment of SME collateral still remain unclear. It is interesting to note that in the aforementioned Impact Study 2.5, the sample banks noted that around 33% of their SME lending was backed by collateral. The nature of collateral varies across banks and jurisdictions and includes: physical collateral, receivables, commercial and residential real estate and financial collateral. However, it still remains uncertain as to how the treatment of collateral can be factored into risk weighting assessments for SME's;

Overall, there still remains considerable uncertainty regarding the impact of the new Accord on SME borrowing. The impact clearly depends on the risk profile of the SME sector compared to other competing borrowers - large corporates, sovereigns, retail customers and so on, and how this influences the portfolio selection of different types of banks. While the BIS Accord is directed at internationally diversified banks it would be illuminating to see how an Impact study on the new Accord affected banks primarily engaged in SME lending compared with larger more diversified counterparts. How the new Accord impacts capital charges for SME's in different countries and sectors would also provide clearer information on how any potential gains are distributed.

Assuming a satisfactory solution to the risk-weighting of exposures to SMEs, Basel II still does not solve many of the financing problems SMEs are faced with especially relating to the financing of start-ups. As part of the Financial Services Action Plan, continued legislative action is needed to help promote the fledgling EU venture capital industry. One specific area relates to freeing up portfolio restrictions on pension funds so they can invest more in venture capital firms.

c) Retail Banking

Throughout the 1990's European banks strategically focused on growing their personal lending and mortgage business because of the relatively low capital charges and high margins in this area. The general expectation was that Basel 2 would seek to quantify the risks and recognise the high probability of loss and high loss per default in retail lending. Conversely, the risk weighting of 50% on mortgage lending was perceived to be excessive and substantial reductions in the capital charges for this type of business were expected. In general, non-mortgage and credit card lending were expected to be subject to much higher risk ratings with lower weights for mortgage lending.[23]

Recent proposals from the BIS (July 2002) suggest that the risk weightings on unsecured retail lending have not increased as much as was expected whereas those for mortgage lending have not fallen by so much. The July proposals state that for non-mortgage retail lending, two distinct IRB risk-weight curves will now be available for this set of exposures. 'The first curve for "other retail" lending will produce capital requirements modestly higher than those proposed last November and will apply to those exposures that do not qualify for use of the second curve. The second curve will apply to qualifying revolving exposures and will produce capital requirements materially below those previously proposed by the Committee…….risk weights for residential mortgage exposures under the standardised approach will be reduced from 50% to 40%. Risk weights for non-mortgage retail exposures (including SME exposures less than Euro 1 million) will be reduced from 100% to 75%'.

[23] See Morgan Stanley (2001)

Overall, these proposals are likely to maintain the status quo and continue to encourage banks to strategically prioritise retail lending, perhaps at the expense of SME credit.

d) Financial Industry

As already mentioned, as the distributional effects of the new Accord have not been empirically investigated it is difficult say how different countries banking systems will be influenced by the new Accord. Much depends on the risk features of local markets and business areas.

In terms of the competitive environment the largest international banks will be strengthened, in terms of both their capital positions and performance, as they will probably no longer be required to hold such a large proportion of their capital. This advantage will stem from their highly developed internal credit risk management systems, and the fact that they are the most advanced users of credit portfolio models and credit risk derivatives. The high costs involved in developing sophisticated risk management systems for smaller banks may inhibit them from using IRB and therefore they will not be able to benefit from the lower capital charges that the use of such systems and techniques are expected to deliver. Overall, large banks will have a capital advantage over smaller firms, this will lead to increased capital concentration (further lowering the cost of capital for large banks) and (more than likely) greater industry consolidation. While level playing field considerations suggest that banks, irrespective of size, should be subject to the same rules, it is unlikely that small banks will be able to benefit from these.

Another dimension relates to international competition. As noted above, it is unclear as to how the implementation of the Accord will affect different countries banking systems. It is also uncertain as to whether banks from various jurisdictions (say any of the G10 countries) will have a competitive advantage if they adopt the Accord when others do not or are slow to adopt.

If the EU adopts the Accord single licence arrangements suggest the need to extend these rules to all banks so that competitive equality is ensured. Domestic banks could be exempt if they do not wish to benefit from the passport arrangements but this may place them at a competitive disadvantage if the market judges them to be more risky. As was the case in the implementation of the EU's Second Banking Directive and the attendant Solvency Ratio and Own Funds Directives, it seems almost essential that the new Accord be implemented by the adoption of a Directive applied to all credit institutions with the relevant degree of flexibility.

Another area of concern relates to the impact on banking groups, especially those engaged in banking and insurance business. EU solvency rules for insurance companies are simple but not as transparent as in the banking sector. Substantial 'hidden measures' relating to nation specific accounting measures and actuarial practices exist that make it very difficult to equate banking regulations (including Basel rules) with those of the insurance sector. Greater transparency in solvency rules for EU insurance companies would help improve the quantification of risks faced by banking groups and therefore the competitive environment. Efforts need to be made to encourage greater use of risk management systems in the insurance industry so the approach to risk quantification in banking and insurance becomes more similar. This should help aid comparability and transparency.

Investment firms, especially important in the UK, due to the specific features of the UK investment firm industry, are expected to be adversely effected by the new Accord. The rules governing operational risks mean that these types of firms will have to hold much higher levels of capital than they do at present. Under the new Basel framework investment firms will be put at a competitive disadvantage. If the new Accord is adopted they are likely to seek exemption (similar to credit unions under the current Accord). Alternatively, specific capital rules addressing the particular features of this sector will need to be developed, either in Basel or if implemented in Europe at the EU level.

e) Emerging Economies

Emerging economies will be subject to more expensive credit as a result of the implementation of new Basel rules. The new accord proposes replacing the existing system by a scale of different risk weights, reflecting the external credit assessments of the various sovereigns by independent ratings agencies.

The zero risk-weighting category (currently applicable to OECD sovereigns) will be reserved only for highly rated sovereign debt (AAA/AA). Not all OECD member states are rated this highly, and so the debt of countries like the Czech Republic, South Korea, and Mexico will become less attractive. By contrast, a number of non-OECD countries could benefit from the new system (for example, Hong Kong). In general, low rated countries are likely to face much higher borrowing costs and a subsequent reduction in loans.

Banks in emerging economies are also likely to rely on the standardised approach to capital calculations that will place them at a competitive disadvantage to developed country banks. They are therefore unlikely to benefit from the IRB approach. There may also be a higher cost of borrowing for SMEs.

f) Securitisation

The proposed risk-weighting scheme provides a clear capital advantage for various high-grade types of securitised issues. This appears to be particularly the case for securitised corporate debt with A+ to A- ratings. Global banks are likely to be the major beneficiaries of this change because they have traditionally been the main lenders to the top quality corporates. The more attractive risk-weightings assigned to such corporate debt securitisation is likely to increase investor (both bank and other financial institution) demand for such paper as well as to encourage them to securitise a larger proportion of their corporate lending books in order to free-up scarce capital. Overall, changes to the way in which capital is allocated to back securitised risks could boost growth in the European securitisation industry, which is significantly under-developed compared with the US.

The original proposals accorded AAA/AA securitisation tranches a 20% risk weighting, like claims on equivalent-rated corporate debt. This is lower than the 100% risk-weighting currently accorded to most securitisation assets, and is lower even than the 50% weighting presently attached to residential mortgage securitisations. Moreover, the proposed weightings classifications gives single A-rated securitisation tranches a 50% weighting, lower than equivalently rated corporate paper. The proposals also recognise the risk-reducing effects of any collateral or guarantee which has a lower risk weighting than the secured exposure.

In addition, various securitisation transactions currently do not have capital charges and Basel 2 is continuing to develop various risk sensitive approaches to set capital charges that reflect the risks faced by originators and investors in these transactions.

g) Macroeconomic Stability

Basel 2 is predicated on the basis that banking risks can be measured more accurately and as such will have more appropriate capital charges allocated to these risks. When risks increase banks will need to hold more capital. When the economy turns down then banks reduce their lending increasing the likelihood of a credit crunch. The new Accord, therefore, one could argue is potentially pro-cyclical as it exacerbates the likelihood of a credit crunch.

In any macroeconomic downturn credit and other banking risks increase and this results in increased write-offs and provisioning. Banks need to restructure their portfolios and credit is allocated to lower risk areas. The new Accord is likely to penalise higher credit risks more rapidly via reduced loan supply. Changes in default probabilities may also result in more rapid restructuring of business mix at the time of a downturn. As such it seems likely that the new rules will increase the likelihood of a credit crunch at the time of an economic downturn. The situation may be further exacerbated as the biggest banks are likely to hold less capital than at present.

Overall, it is difficult to see how the procyclical impact of the new rules can be avoided. However, on a positive note, Basel 2 allows for more rapid adjustment of the banking system - risks will be measured more accurately, losses recognised earlier and upswings accommodated more readily. This means that the new rules should provide the financial sector with greater flexibility in adjusting to an adverse shock.

5. CONCLUSION

This paper discusses the main features of two landmark regulatory developments that are likely to have a significant impact on the way European banks and other financial firms operate. The barrage of measures outlined in the FSAP seek to promote a more integrated, efficient and safer European financial marketplace. The ultimate aim is to create a single market across the broader spectrum of the financial services industry thus facilitating cross-border trade and improving competition, innovation and access to lower cost finance for individuals and companies. This, of course, is an ambitious objective and one that has become increasingly important since the advent of the single currency. One can see that the removal, or reduction, of existing barriers is likely to have a substantial impact in promoting European wide change in the financial industry. Sectors that are currently viewed as the least integrated - such as mortgage business, pensions, SME finance, insurance, securitisation activity and so on may well experience the biggest changes.

Having said this, however, the implementation of Basel 2 is likely to have a larger impact on the strategic behaviour of banks. As in the original 1988 Accord it will set the benchmark for regulators over the next decade and longer. The 1988 rules were transformed into EU legislation without major changes and (by all accounts) it has served its purpose well. A major issue relates to how the EU should implement the new Accord. The new rules need to be implemented with the authority of a Directive but have the flexibility embodied under the Lamfalussy framework. The new rules require the stipulation of minimum standards that allow for flexibility in implementation but also credibility in ensuring that they establish a uniform and competitively equivalent framework for financial service regulation in the EU. Where the new rules allow for substantial flexibility - such as in the area of operational risk - minimum standards can be set with national supervisory agencies having substantial discretion in implementation. In the supervisory review (Pillar 2) and market discipline (Pillar 3) these areas also lend themselves to the setting of minimum standards based on mutual recognition and home country control that embrace the single market programme ethos.

Interestingly, both Basle 2 and the FSAP place considerable emphasis on areas that are among the least integrated in the European financial services industry - retail lending, SME finance, bancassurance, securitisation and the regulatory treatment of collateral. The removal of barriers to trade in these areas coupled with new capital rules governing their regulation are likely to create a paradigm shift in the way in which this types of business is conducted over the next decade or so

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