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THE EU EXPERIENCE IN FINANCIAL SERVICES LIBERALIZATION:

A MODEL FOR GATS NEGOTIATIONS?

by Paola Bongini

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**The EU Experience in Financial Services Liberalization:
A Model for GATS Negotiations?**

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THE EU EXPERIENCE IN FINANCIAL SERVICES LIBERALIZATION:

A MODEL FOR GATS NEGOTIATIONS?

Paola Bongini*

Abstract

The investigation of the sequencing of liberalization in the EU financial services industry is the primary object of this study. The relevance of the EU model for financial liberalization is threefold. First, the EU route towards liberalization in financial services could be regarded as a blueprint for opening up markets worldwide, especially in the context of multilateral liberalization within the WTO framework. Second, the EU model calls for an investigation of the degree of compatibility between regional agreements and multilateral commitments. Third, the EU regional experience raises the question of the extent to which it can be transferred in different settings and used elsewhere without the supranational legislative, judicial and administrative structure of the European Community. I argue that the intra-EU approach – minimum harmonization, mutual recognition and home country control – has a potential for widespread validity.

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Study prepared for "Capacity building for the MENA countries in the forthcoming WTO negotiations: the core area of services networks", jointly managed by the Istituto Affari Internazionali and the World Bank Institute.

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The findings and conclusions of the paper are those of the author.

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Introduction: the liberalization and integration process in recent years.

In the past three decades, world-wide financial systems have been characterized by a consolidated trend of steady and continuous liberalization of domestic markets. This has implied a shift from highly regulated financial markets to more open systems, based on prudential regulation, reduced direct intervention by the state in the credit allocation decisions, privatized financial intermediaries, increased level of competition, and encouraged entry of foreign providers of financial services.

The natural by-product of financial liberalization has been an explosion in the international provision of financial services, involving the cross-border supply of financial transactions and the cross-border establishment of offshoots. Given the wide-spread diffusion of international financial services, the need for international agreements as to how the financial business should be conducted has consequently arisen (White, 1996). One such international agreement is represented by the General Agreement on Trade and Services (GATS).

GATS stands on the principle that opening markets is the way forward to greater world prosperity. It came into force in 1995 and set international rules aimed at removing barriers in services generally. It applies to all services sectors, including financial services, encouraging the opening of markets for trade and investments. The GATS rules cover investments as well as trade, requiring transparency and non-discrimination between suppliers. These general rules represent a starting point for reducing trade as well as non-trade barriers, but need to be supplemented by specific commitments in service sectors. These sectoral commitments determine market access, i.e. how foreign firms get into a market, and national treatment, i.e. whether they are treated the same as local firms within the market.

During the GATS negotiations, the European Union played a relevant and leading role in promoting the liberalization program. As a matter of fact, the creation of a “regional market” – the so-called Single Market for Financial Services – well in advance of the WTO negotiations seems to have helped Western European countries which entered the negotiations as a single

compact group relatively prone to extend the benefits of the Single Market to third countries.

The objective of this study is to analyze the liberalization process that has taken place in the EU financial services industry and evaluate it in the context of negotiations on multilateral liberalization within the WTO framework. In particular, three issues warrant a specific investigation.

First, as the path adopted by the EU represents the best case of successful extensive liberalization in the financial services industry, it is worth understanding whether this route could represent a blueprint for opening up markets worldwide. Hence, the sequence of liberalization and the problems faced by the EU in liberalizing its markets are here studied in order to provide insight in the areas that are likely to be most difficult to open internationally and are expected to lift impediments to multilateral negotiations.

Second, the EU model calls for an investigation of the degree of compatibility between regional agreements and multilateral commitments, i.e. whether the former constitute building blocs promoting multilateral liberalization or whether they tend to act as stumbling blocs, impeding further achievements at multilateral level.

Third, the EU model raises the question of the extent to which the intra-EU approach – minimum harmonization, mutual recognition and home country control – can be transferred in different settings and used elsewhere without the supranational legislative, judicial and administrative structure of the European Community.

The paper is organized as follows. Section I defines the financial services that represent the object of study. Section II tackles the first issue and traces the evolution of the market structure and legislative/regulatory framework of the EU financial system culminating in the creation of the Single Market, the main liberalization features of which are also analyzed. While discussing the "European model" of financial integration, this section focuses on those hidden barriers that still constrain the creation of a truly Single Market for financial services and therefore have led the European Commission to launch its Financial Services Action Plan in 1999. Section III examines the potential benefits to users deriving from the EU liberalization program, in terms of reduced costs of services to savers and borrowers and of more efficient credit institutions. The Second issue is dealt with in Section IV which analyzes the level of compatibility between the EU experience in financial services

liberalization and the GATS commitments. Subsequently, the Third issue is investigated in Section V which addresses the question of whether the EU liberalization approach could be transferred in different settings and used to foster openness and a strengthening of domestic regulatory reforms by less developed countries. The issue is investigated with specific reference to the so-called Mediterranean Area countries and the Euromed Agreements. Section VI concludes. An Annex is also included; it overviews the issues covered by the European Commission's Financial Services Action Plan which represents "an aspirational programme for rapid progress towards a single financial market"[1].

[1] COM(1999)232, 11.05.99, p.4.

I. The definition of financial services

In the General Agreement on Trade in Services financial services are broadly divided into two main categories (Article 5 of the Annex): i) *insurance and insurance-related services*; ii) *banking and other financial services*. Each of these two categories includes a more specific list of activities that illustrates, rather than defines, the possible contents of the notion of financial services. The breakdown is rather detailed and it is meant to help the WTO member countries in scheduling commitments in financial services while being well-adapted to face the on-going changes in the financial services industry and markets. The list, in fact, is open to financial innovation; given the rapid pace of change in the sector, any classification strictly based on the existent would become quickly obsolete. This also explains the adoption of a classification based on the content of the service provided and not on the institution that provides the service: as before, the rapid change in the financial services industry and the process of globalization of financial markets tend to reduce the attractiveness of such organizational models based on the separation of the so-called pillars of the financial system (e.g. no intermingling between the activities of banks, securities dealers and insurance companies). In particular, the inclusion of "other financial services" in the list of more traditional banking services – such as "acceptance of deposits and other repayable funds from the public" and "lending of all types" – highlights a wide acknowledgement that the traditional demarcations between investment and commercial banking are no longer justifiable on the grounds of financial system stability purposes and that specialized banking or universal banking models should be the outcome of a decision process internal to the financial institution, rather than the result of specific restrictions imposed by supervisory authorities. On the contrary, insurance and banking are still considered as two distinct businesses notwithstanding the greater appeal that the model of *bancassurance* is gaining. This could be explained by the fact that this organizational model is still at its infancy in developed countries, with varying degree of integration between the two businesses. Besides, it should be noted that the European Community approach towards financial integration has always treated banking, insurance and securities-related activities as three strictly separate segments of the financial industry, each being addressed with specific pieces of legislation. Such a watertight compartments approach reflected what, at national levels, was the operational and normative rule. The Universal banking model was, in

fact, mainly spread in German-speaking countries, while the rest of European countries relied on different degrees of operational, territorial and maturity specialization of their financial institutions.

In spite of these differences, the basic principles underpinning the liberalization process in banking, insurance and the securities industry were similar – minimum harmonization, mutual recognition and home-country control – and the liberalization path followed was also similar.

Given these premises, narrowing the scope of investigation on one particular financial service should not represent a serious omission. Our choice falls upon the banking services which present the best generalization opportunities with respect to the main goal of drawing lessons from the EU experience for developing countries. In fact, the banking services (acceptance of deposits and lending of all types) represent the core of the financial services, irrespectively of the degree of a country development: the primary financial needs of an economy, issuance of liquid "safe"[2] assets (deposits) and the supply of loans of any type, are in fact satisfied by banks; therefore our investigation of the sequence of liberalization in Europe will focus on the banking industry. Securities services and insurance businesses might form object of future investigation.

[2] Deposits are perceived as safe assets, with a degree of safety similar to that attached to T-bills, provided that an efficient and extensive system of safety-net is at work.

II. The evolution of EU banking industry towards the Single Market

Although policymakers tend to recommend a case-by-case approach to financial opening[3], it is commonly agreed that the sequencing of economic liberalization should follow the path outlined in figure 1 (Edwards, 1990; McKinnon 1993; Mohieldin, 1994; Mohieldin and Wabha, 1998; Hanson, 1994): the implementation of domestic real sector reforms should precede the reform of the indigenous financial system; controls on capital movements should be maintained until the liberalization of the external trade sector (second step) and of the domestic financial sector (third step) has been fully undertaken while, at the same time or prior to it, the stabilization program – macroeconomic stability and enforcement of prudential regulation – is implemented. Capital account liberalization, in fact, should be postponed until the system is strong enough to avoid a misdirection of funds flowing into sectors that are not productive and/or that unsound banks intermediate the inflows to gamble for resurrection.

Of course, the exact sequencing and, above all, the speed of opening and whether to adopt a big bang approach or a more gradual approach should depend on the state of development of the economy and of its financial sector.

Once the groundwork has been prepared, in particular with respect to the strengthening of prudential regulation, financial liberalization (step three) can be considered as the result of two related types of reforms: domestic deregulation and internationalization of the financial industry[4].

Domestic deregulation implies allowing market forces to determine who gets and grants credit, and at what price[5]; allowing free entry to the financial services industry to any agent who satisfies objective criteria laid down by prudential supervision rules[6]; giving banks the autonomy to set up internal governance procedures that should be used to determine what types of

[3] See Galbis (1994) and Johnston, Lindgren, Garcia and Saal (1996).

[4] See Williamson and Mahar (1998); Claessens and Glassner (1998).

[5] Eliminating controls on credit and restrictions on interest rates would liberalize the allocative function of banks.

[6] Such as capital, managers and owners' skills and reputation.

business the bank can/is willing to engage in[7]; how managers and staff are appointed, where branches should be opened and/or closed; etc...; reducing/eliminating governmental ownership in the financial system.

The internationalization of the financial industry is fostered by eliminating discrimination in treatment between foreign and domestic financial service providers and by removing barriers to the cross-border provision of financial services.

At this stage, financial liberalization should be complemented by capital account liberalization involving the removal of capital controls and restrictions on the convertibility of the currency.

In this context, the EU model of economic liberalization cannot be considered an exception: trade liberalization was obtained in the first place, while financial reforms and capital account liberalization followed. The general process took place over a long time span: almost three decades were necessary to help EU banking and financial markets in evolving from being comparatively protected towards more open settings. Of course, the path and the speed of the deregulation process differed from country to country, given the different political, economic and social systems which were influencing and shaping the institutional and regulatory settings of individual members' financial markets. At the beginning of the process, the twelve EC banking systems varied significantly in their development, sophistication, operations and openness[8].

Although each member state carried out financial sector reforms choosing its own pace to liberalization[9], the general impression is that the EU banking systems shared the following specific sequence of financial liberalization:

[7] In other words, regulators would reduce or lift demarcation lines between different types of financial service firms.

[8] See Hendrie (1988), Howcroft and Whitehead (1990) and Dixon (1991) for overviews of the EEC financial industries.

[9] Less advanced systems tended to implement financial sector reforms more gradually, making use of the entire time window allowed by the directives and sometimes being late in complying with the dictates of the directives.

1: coordination of bank legislation (the strengthening of prudential measures) while introducing pieces of domestic deregulation[10].

The recognition that a level playing field can be more easily attained if there is a consensus on minimal harmonization of rules represents the focal point of the overall architecture of the Single Market Program (SMP).

Discarding the initial idea that financial integration had to be attained through the harmonizing of all national regulations restraining trade in financial services and the compliance to common laws and policies[11], member states selected a more pragmatic approach embedded in the White Paper (1985) which set out a comprehensive program for the achievement of the single market by 1992. In this respect, the White Paper could be regarded as a full framework for dealing the sequence of liberalization in banking services.

The new approach towards financial liberalization rested on the well-known pillars of:

a) minimum harmonization. The Commission adopted the principle of the "lowest common denominator", i.e. the minimum level of coordination and harmonization among national standards, necessary for a truly integrated internal market[12];
b) mutual recognition. The principle states that, once minimum agreement has been reached on essential rules, each member state would have to recognize the validity of the rules applied in other countries. Thus, if a product or service satisfies the basic standards in one country, it may be sold throughout the Community;
c) home country control. The principle charges each member state's supervisory authority with the responsibility of supervising national financial institutions, even when doing business in the territories of other member states.

[10] It must be noted that for countries with less sophisticated financial markets coordination of bank supervision meant a precondition for domestic financial sector deregulation.

[11] Given the very different instances at stake, this goal was too ambitious and proved unsuccessful. The EU legislative record on financial services in the 60's and 70's yielded a very modest harvest: progress towards an integrated financial area was very limited, given the long deferred implementation dates and the possibility of leveraging on safeguards clauses included in the directives, which were extensively used by those member countries willing to defer the impact of liberalization on their banking systems as long as possible.

[12] The change of attitude is also revealed by the reform, in 1986, of the decision-making process of the Community, which abolishes the requirement of unanimity for any Council decision and introduces the concept of a qualified majority for most decisions involving the establishment and the functioning of the internal market. Few exceptions are related to decisions involving fiscal measures, matters concerning the free movements of people and the rights of workers. Of course, the pursuit of such a principle implies the acceptance of compromises and a certain residual of disparities among member countries.

The main advantage in adopting mutual recognition rests on its ability to instigate an endogenous process of convergence in national regulations. The process is no longer imposed top-down by compulsory compliance to the dictate of EC Directives, rather it is induced by bottom-up competitive forces stemming from the interaction of operators, regulatory and organizational systems.

Of course, minimum levels of prudential rules are necessary to ensure that convergence does not occur below a given floor. The 1986 Single European Act (SEA) committed the EC countries to completing a single market in goods and services by the end of 1992. As part of the process, a series of Directives concerning the financial sector were issued by the European Commission and the Council of Ministers and subsequently implemented by member states. Table 1 gives details of the sequence of relevant Directives relating to the issue of banking integration in the EC.

In particular, the coordination has initially dealt with such relevant topics as the definition of what a bank is and does, and the outlining of the objective requirements to be asked by national authorities for granting new licenses. This had the important effect of fostering banks' autonomy on their ability to lend, branch, appoint managers, hold participations in financial and non-financial firms, especially in those countries with more restricted banking systems. This acknowledgment of a bank's autonomy to run its affairs was fundamental in order to: a) reduce and eventually eliminate any state intervention both in the process of credit allocation and in banks' ownership, encouraging privatization of the banking sector; b) evolve banking regulation and supervision from the use of quantitative restrictions (structural regulation) to the application of prudential measures[13].

It was accepted that an authentic level playing field could be attained through: a) the prescription of uniform accounting and reporting standards at EU-wide level; b) the definition of relevant measures enabling supervisory authorities pursuing the goal of a sound and safe financial system (risk adjusted capital ratios; limits to large exposures, depositors' guarantee).

[13] This, in particular, leads to the abandonment of interest rates ceilings and quotas on credit expansion, in the first place; then barriers to market entrance are gradually lifted. For example, licensing of new domestic banks and foreign banks will be carried out on the basis of explicit and objective rules and no longer under the economic needs test.

2: adoption of a simultaneous approach for opening up the financial sector to foreign competition and the freeing of capital account transactions.

Any complete process of financial sector liberalization has to tackle the issue of explicit and implicit barriers, the former comprising limits to cross-border movements of financial services and restrictions to foreign direct investments, the latter comprising differences in regulatory, legal and tax systems.

It is important to understand that regulatory-driven differences in institutional organization do represent implicit barriers to financial integration and market access. In fact, as long as the host country's regulations, determining the range of markets and activities in which the various types of financial intermediaries could operate dramatically varies, foreign banks penetration is hampered, without the setting of explicit barriers: firms structured to operate in one institutional climate could find it too costly to fulfill the requirements they would face in a foreign country, and avoid entering the new market. For instance, a bank resident in universal banking systems would face a deep limitation in the range of its activities and an alteration of its "intermediation formula" when it considers operating in more restricted systems – such as those where no intermingling between banking, financial and insurance activities is permitted –, where it would be denied the security license needed to combine credit and portfolio services.

Explicit trade barriers were present with respect to the following aspects of regulation: a) controls on international capital movements and foreign exchange transactions; b) restrictions on entry by foreign institutions. The former tends to limit the free cross-border provision of financial services, i.e. the provision of financial services by a financial firm located in a country to a customer residing in another country, without the establishment of a commercial presence in the country of the customer[14]. The latter involves restrictions or discriminatory administrative practices on direct foreign investments in financial services.

[14] Cross-border trade is, in fact, often associated with an international capital transaction. Several examples can be given: accepting deposit from a non-resident customer or making loans to a non-resident require international capital transactions as well as the trading of securities for the account of non-resident customers; contingent claims financial services, such as insurance policies, may involve capital transactions, when the occurrence of the insured event involves a payout. Services such as investment advisory services, when provided cross-border, are not associated with capital transaction Controls on cross-border movements of financial services discriminates domestic versus foreign services, by establishing a different regulatory treatment. The removal of such controls is, therefore, a prerequisite for an integrated financial market.

Complete liberalization on controls on capital account movements is now a rule among EU countries[15]. However, this is the result of a fairly recent process. In fact, although the Treaty of Rome (1957) envisioned the free movement of capital – along with that of persons and services – as one of the essential conditions towards the establishment of a common market, in the early ’70s only Germany had fairly liberal capital-account policies.

The process of capital movement liberalization showed a slow progress due to the trade-off that national authorities were facing when trying to obtain the contrasting goals of free commercial and financial trade and of retaining a persistent and autonomous control over domestic economic and monetary policies. In particular, a complete liberalization of capital-account movements was seen as a major threat to the domestic exchange-rate policy, especially by those countries with considerable balance-of-payment imbalances such as France and Italy.

The trade-off between macroeconomic goals and free circulation of goods and capital was particularly stringent in the economic environment of the ’70s: the uncertainties in world financial markets following the crisis of the dollar, the collapse of the Bretton Woods system of fixed parities and the two oil shocks led a number of countries to postpone the ease of capital controls or even to reintroduce them to help “weather” the growing financial instabilities. Free trade in goods thus came to coexist in Europe with a system of restricted financial flows[16]. Capital movements started to be liberalized in the second half of the ’80s, when both the world macro conditions had improved and the EC had accelerated the process of creation of the Single Market, with a renovated confidence in its ability to pursue this important goal. Therefore, at the end of 1983, only the UK and Germany had completely liberalized their capital movements. Partial freedom of capital movements existed in the Netherlands, Luxembourg and Belgium. All other countries had opted for the safeguard clause and delayed, although to different extents, the ease of their extensive exchange controls[17].

Negotiations on ending capital controls saw two different types of players. On the one end, stood the Germans and the British, with their vision of a market

[15] Indeed, it is virtually complete in all OECD countries. See Edey and Hviding (1995).

[16] See Dini (1986).

[17] See OECD (1984) and OECD (1987) for excellent surveys on exchange controls and other measures affecting both cross-border international banking operations and the international trade in securities in the EC countries.

open to the world; on the other end, stood the French aspiration to create a more exclusive internal financial space, subject to EC law and policy and clearly distinct from world markets[18]. Liberalization of capital flows entailed a compromise between these two divergent positions: free traders versus proponents of a single, European internal market, distinct from global-market integration. The former were focusing on the mere elimination of the remaining obstacles to free capital flows; the latter were looking for an agreement on minimum common rules ruling an EU-wide integrated financial space. Other members' position, such as of those countries with large public-sector deficits – Italy, Spain, Ireland, Greece, Portugal –, was mainly concentrated on struggling for the maintenance of safeguard clauses, in order to avoid the political consequences of having to lift capital controls and to face "the political consequences of a cutting back on budgetary outlays"[19].

The above mentioned divergences also arose with respect to the decision of whether to extend the freedom of capital flows to non-EU countries. Free traders supported the idea that the liberalization should be extended *erga omnes*, leveraging on to the benefits that a globalized market could bring about. Eventually, German and British support for the idea of a European integrated financial area was only won by full acceptance of the principle of capital liberalization *erga omnes*[20]. Therefore, the June 1988 directive confirmed the two principles of complete unconditional, free movement of capital and of non-discrimination based on nationality[21].

Regulatory barriers are not confined to the impediments of free capital movement across borders. In trade in services, either the consumer has to be taken physically to the product (as in tourism) or the service has to be provided to consumers through some directly-connecting mechanisms. Given the modern telecommunication techniques and the success of internet banking, one could now easily imagine all banking services being supplied directly to customers in other countries, without the need of an established presence of the supplier in the importing country. In principle, the internationalization of banking is assured and foreign market access becomes

[18] See Story and Walter (1997), p. 256.

[19] Story and Walter (1997), p. 255

[20] Lelakis (1988)

[21] Nevertheless, the latter remained subject to some national susceptibilities: each country could, in fact, impose unilateral restrictions when legitimate national interests – such as problems of monetary regulation – were at stake. All in all, it represented a political commitment by EC countries to offer national treatment to third countries as far as inflows and outflows of capitals concern.

no longer an issue. In practice, in the financial services industry, especially in its retail segment, other factors[22] play an important role and might require a physical presence in the local market. Therefore, long distance transactions in the provision of financial services are not very widespread, and mainly concentrated in the securities trading business. The supply of a large bunch of traditional banking services still requires some form of foreign direct investment (FDI), ranging from a low-level presence (representative offices) to successively higher levels of involvement in the form of subsidiaries, joint ventures and full branches in host country. Consequently, in the 1970s barriers to entry represented the main impediment to a free financial area.

In general, barriers to entry reduce the contestability of a market, i.e. the extent to which the market is open to competition by potential newcomers. As a result, both the system as a whole and each banking institution are not compelled to attain higher standards of efficiency at the expense of consumers, who usually end up with a smaller range of traditional financial products and services, highly priced and of lower quality with respect to a situation where greater competition is in place.

Limits to market entry were the rule during the ’70s in all EU banking systems[23], given the pre-eminence ascribed to structural regulation on the grounds that supervisory authorities were entrusted with the primary goal of guaranteeing the stability of financial markets, even at the expenses of the other two somewhat contrasting goals of improving the efficiency of the system and of promoting a sound competition among institutions. The implied restrictions on entry could apply to both domestic and foreign banks; however, foreign banks were generally at a disadvantage with respect to their host country counterparts, when trying to compete in their local markets. A major reason for justifying the imposition of entry restraints was the desire to preclude or limit foreign ownership in a sector that is regarded as vital to the proper functioning of the national economy and the attainment of national policy goals[24].

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[22] Albeit the process of globalization in financial services, local customs, local tastes as well as the ability of the seller to provide adequate “after-sale” assistance are still vital factors in retail banking. Besides, knowledge of the local market facilitates the credit evaluation of potential customers: as such it is an extremely valuable asset which might constitute an economic barrier to entry.

[23] See Pecchioli (1983) and OECD (1983) for an exhaustive survey on the legal restrictions applied by member countries on foreign banks entry.

[24] See Pecchioli (1983).

The delicate question of liberalizing market access was tackled for the first time with the First Banking Coordination Directive (77/780/EEC) issued in 1977 and introducing the principle of national treatment to be applied to foreign banks' branches. However, such a principle is applicable to a notion of "foreign bank's branch" that comprises only EC banks. Hence, the entry and the establishment rules for foreign EC banks are the same as for domestic institutions in each member state. Art. 9 regulates the treatment of branches of non-member states banks and requires member states not to apply less stringent rules to branches of credit institutions from third countries than to branches of credit institutions from member states.

National treatment, however, states nothing more than foreign and domestic firms should compete on a level playing field, provided that they play in accordance to the host country national requirements. This means that foreign banks need to obtain the authorization from the competent supervisory body of each host country where they wish to establish a branch and to conform to the host country's requirements on such things as minimum capital, solvency ratios, legal form, organizational and operational structure. Given the institutional differences among member states, national treatment meant substituting restrictions on entry with explicit restrictions on the range of activities allowed. The Second Banking Coordination Directive (89/646/EEC) introduced the application of the principle of mutual recognition, better known under the name of "single passport". This provides member states banks both the freedom of supply and the freedom of establishment within the EU[25].

The above mentioned different regulations have resulted in EU domestic banking markets that were far from being homogeneous in terms of market openness. Table 2 provides some rough evidence of this heterogeneity: even in more recent times, the degree of openness to foreign penetration of EC markets varies considerably within the EU. The share of foreign banks' assets to total banking assets in 1997 varied from a minimum of 2.8% in Germany[26]

[25] Besides, the single passport helped completing the process of domestic deregulation towards the elimination of those restrictions limiting the bank's choice over the range of activities to be performed. As such, a convergence process in institutional organization descended and a potential for greater competition within the Single Market was led down (see par. III)

[26] The degree of financial liberalization and the absence of other restrictive measures are necessary yet not sufficient conditions to explain the foreign bank presence in a country. Germany is emblematic in this sense. Albeit its banking system was relatively free from discriminatory regulations and attracted a relatively large number of foreign banks, their impact on the indigenous market was limited, given their very low market share. In fact, the German market was characterized by close bank-firm relationships, which in practice insulated it from external competition.

to a maximum of 99% in Luxembourg. The main reasons for such a variation are to be attributed, on the one side, to the still existing legal, fiscal and institutional obstacles and, on the other side, to the ongoing process of cross-EU merging and acquisition activity, joint ventures and strategic alliances that allows an easier, quicker and most cost-effective entry into foreign markets. The UK and Luxembourg are confirmed as international financial centers by overall market shares of foreign branches and subsidiaries of more than 50%; the presence of foreign banks in Ireland is increasing, which demonstrates that, external barriers being the same, fiscal exemptions are crucial in attracting foreign capital.

In sum, the simultaneous approach indicated as *point 2* was rendered possible by the fact that the process towards the completion of the Single Market started with a set of measures aimed at strengthening minimum common rules for prudential regulation (see table 1), such as the harmonization of accounting and reporting rules or the requirements for consolidated supervision. The strengthening and the harmonization of prudential regulation measures determined the success of the Single Market project, allowing mutual recognition of national standards replacing full harmonization of rules as a realizable goal. However, it should be noted that countries with less developed financial markets were allowed to postpone complete capital flows liberalization on the grounds that measures to limit short-term foreign currency denominated inflows and outflows are deemed necessary as long as relevant domestic reforms, pertaining to the strengthening of the markets and regulation, are not fully undertaken. For such countries, complete financial sector reform preceded the freeing of capital account transactions (as suggested in the classic formula for financial liberalization).

Notwithstanding the profound strides made in the last three decades towards providing a single European market for financial services, the EU financial markets in 1999 "remain segmented and business and consumers continue to be deprived of direct access to cross-border financial institutions"[27].

There are many reasons why the creation of a legal framework to permit a single internal market will not immediately bring one into existence. In retail markets for financial services, local tastes, local customs and the physical ability to market products and to provide an adequate "after sale"

[27] European Commission (1999).

service are vital factors in selling products across frontiers. According to White (1996), retail-banking services in Europe are still "overwhelmingly provided by national corporate entities". On the contrary, a greater level of internationalization was easier to achieve in wholesale markets, where the above mentioned elements are less important: BIS data on international financial activity and bank's external positions confirm a steady growth of cross-border wholesale commercial banking[28]. This situation may change in the near future when a greater use of internet and the spread of remote delivery systems[29] will help fostering cross-border retail banking.

Recognizing the existence of substantive differences between the set of EU legislation and the national arrangements relating to financial transactions, at the end of 1998 the EU Commission identified a range of issues calling for urgent action in order to reap the commercial opportunities offered by a single financial market. Subsequently, in May 1999 the Commission presented its "Financial Services Action Plan"[30], meant to highlight the priorities for a true single financial market; guide the financial services policy over the next coming years; plan the needed legislation, in terms of priority of action (what comes first) and time-scale achievements (when results should be tentatively obtained); identify a number of mechanisms which may contribute to the realization of these priorities[31]. Similarly to the 1985 white paper, the "financial services action plan" sets up a framework for future action and represents "an aspirational programme for rapid progress towards a single financial market".

What is immediately apparent is the fact that the new plan considers the financial industry as a whole, no longer segmented in the three main sectors of banking, insurance and securities business. Therefore priorities are not set-up with regard to this common tri-partition of the financial industry; instead, a new approach is undertaken, which considers separately the specific issues pertaining to the wholesale market, to the retail markets and sound supervisory structures.

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[28] See OECD (2000), for a complete survey on these trends in wholesale commercial banking, investment banking and wholesale investment services.

[29] Telephone banking and PC banking are examples of non-traditional delivery channels, becoming increasingly popular as the population become more IT literate, more attentive on cost-saving and, finally, more confident on the matter of security in personal data transfer.

[30] COM (1999) 232. 11.5.99 Financial services: implementing the framework for financial markets: action plan. European Commission.

[31] See European Commission (1999).

Along with these specific measures, two "more general" conditions are deemed to apply for the sake of a smoothly functioning, efficient EU financial market: corporate governance and tax-coordination. Efforts are to be taken in order to harmonize national codes of corporate governance – arrangements for the exercise of voting rights by shareholders in other member countries, to provide one example – and co-ordinate the tax treatment of savings. Truly the harmonization of taxation is proving one of the most difficult areas for member states to resolve.

The sequence of further liberalization in the financial industry is periodically monitored in order to assess the progress, direction and results of the integration of the EU financial services sector[32].

In sum, room for improvement rests upon the achievement of truly enhanced transparency of laws and regulations and of effective cross-border trade in response to the information technology revolution. Eventually, only differences in language, culture and customs should remain as potential barriers to a free movement of banking services throughout the EU region.

[32] See "Progress on the Financial Services Action Plan", (2002 November), Commission of the European Communities.

III. The assessment of the impact of the Single Market

Benefits of financial reforms and liberalization to users of financial services take two essential forms: an increase in quality and array of services provided by (more efficient) institutions and reduced costs of services, for both savers and borrowers. The financial integration undertaken by the European Union thus represents a valuable experiment to assess the presence and the extent of such benefits.

Before the 1992 initiative, the Commission had envisaged (Cecchini Report, 1988) that the Single Market would have brought about widespread reduction in unit costs of financial services thanks to greater competition in oligopolistic markets, which in fact would have been the driver for the reduction of excess profits, a better control of costs by bank managers and an effective exploitation of economies of scale and scope. Besides, a substantial increase in cross-border trade and cross-border merger and acquisition activity was envisaged as a direct response by banks seeking for economies of scale and scope.

More recently, an ex post evaluation of the Single Market Program's impact was commissioned to several independent consultants by the European Commission (1997)[33]. The study's key findings can be summarized as follows:

- no dramatic price reduction in financial services was found[34]; besides, the potential for price convergence on lower average EU prices as highlighted by the Cecchini Report was not fully gained. Nonetheless, those countries with relatively more regulated banking system prior to the program (Spain, Italy, Greece and Portugal) experienced the largest level of price reduction (in particular in the wholesale lending business) and this was mainly attributed (by the interviewed bankers) to the Single Market Program (SMP) implementation. Conversely, banks in the UK attributed

[33] See Gardener, Edward P.M., Molyneux, Philip & Moore, Barry (eds.), (2002), for the most updated evaluation of the effects of the SMP. The degree of banking sector integration in Europe and its evolution over time is also investigated in a recent occasional paper from the ECB (Cabral et al., December 2002).

[34] Price refers to the difference between the rate charged on corporate and retail loans (or deposits) and the three months interbank rate. Evidence is derived from postal and Eurostat surveys alongside with OECD data on international and domestic markets' interest rates.

very little of margin reduction to the SMP and this, in turn, is consistent with their relatively more open banking markets;

- the most common strategic response by banks to increased competition from the SMP was the widening of the array of services offered (diversification and innovation), an increase in their quality, the introduction of new delivery and selling channels as well as a shifting of their activities into areas such as fee and commission based investment advice. The trend towards the universalization of the model of bank was also an important driver for the increase of the range of products and services delivered;

- there was a large potential for scale and scope economies, as the SMP has extended the relevant market size particularly at the wholesale end of the market. EU banks were generally targeting – yet with different degrees of emphasis and willingness – to reduce their cost/income ratios, reduce X-inefficiencies and deploy technology to achieve this;

- the SMP stimulated a degree of internationalization of EU banks, a phenomenon which took a number of forms ranging from increased trade in financial services to cross-border investment activity including mergers and acquisitions, strategic alliances and joint ventures and the opening of cross-border branches.

Two main reasons can explain the mixed results on the impact of the SMP on the banking sector, i.e. higher rate of product and services diversification and improved quality, increased banks' efficiency but little impact on financial services prices. First, the time horizon of the study – three years after the SMP implementation – might have been too short; more time may need to elapse before the benefits of the liberalization could be fully appreciated. Second, that other barriers were, and might be still in force which present obstacles to banks in fully exploiting the opportunities afforded by the single market. As a matter of fact, a range of non-trade barriers remains in the banking sector as the previous paragraph highlighted.

More recent data on the cost of banking services in Europe, on banks' performance and cross-border M&A activity can be only partially informative, with respect to our goal of documenting the benefits to consumers from financial services liberalization, since another major ingredient, the creation of the European Monetary Union (EMU) and the introduction of the euro, has come into play. Distinguishing between the

impact of reduced inflation – induced by the EMU – and the effect of increased competition – caused by the SMP – on the prices of banking services in not an easy task. Is the convergence in interest rates, towards the lowest price, that characterized the most recent years explained by the first aspect or by the second influence?

A simple and rough measure of the degree of interest rate convergence is an index of dispersion, measured by the non-weighted standard deviation of (real) interest rates, or "σ-convergence" (Adam et al. 2001; Fernandez de Guevara et al., 2002).

Figures 2 and 3 show the empirical evidence of σ-convergence in retail interest rates for selected EU countries[35], during the period 1980–2000[36]. This measure declines steadily over time after 1992 for deposit rates, although in year 2000 deposit rates can vary from a minimum of 0.4% in Ireland to a maximum of 4.39% in France. The increase in deposit interest rates reflected increases in money market interest rates associated with increases in ECB interest rates in year 2000. The different reactions of national bank interest rates can be explained by differences in the sluggishness in the pass-through of market rates to bank interest rates reflecting segmented markets at the national level, where banks enjoy different degree of market power.

As far as the lending rates are concerned (figure 3), the process of convergence is less clear, at least in the years subsequent to the SMP, while this trend becomes more evident starting from 1998, when the EMU factor come directly into play and can be considered the main driver[37]. The increase

[35] Figure 2 illustrates deposit rates paid on time deposits while figure 3 shows lending rates on short term loan to enterprises. A caveat must be introduced when using these figures, since, although they can be considered to be, at the moment, the main indicators of retail financial market conditions in the member state concerned, international comparisons could be hampered by the fact that these rates are not EU harmonized and differences may be attributable to differentiation in product characteristics and/or in the risk of borrowers. Countries under investigation are: Belgium, France, Germany, Ireland, Italy, the Netherlands, Portugal and Spain, for which a complete time-series of relevant deposit and lending rates were available.

[36] Alternatively, one could compare the standard deviation of the average monthly retail interest rates calculated over two different one-year periods, say before and after the SMP or before and after the introduction of the Euro. A decrease in the level of this measure suggests across countries convergence in banking interest rates. See Cabral et al., (2002).

[37] See also Cabral et al. (2002, p.35):"Between 1998–99 and 2001–2002 differences across countries in household and corporate lending rates and deposit rates declined sharply in the euro area. However, this development seems to be mainly due to convergence in the macro-level monetary conditions brought about by the introduction of the euro".

in the index of dispersion right after the implementation of the SMP in 1993–1994 may reflect different degrees of borrowers' risk in a period of generalized recession and specific fragility in the national economy after the EMS crisis in the autumn of 1992.

A more sophisticated investigation of interest convergence could be based on moving principal component analysis[38]. This has been applied to interest rate changes, over a moving period of 70 months from 1984 onward; figures 4 and 5 show the explanatory power of the first four principal components[39] of changes in respectively deposit and lending interest rates over time in selected EU countries[40]. As Fase and Vlaar (1998) explained with respect to capital markets interest rates, the first principal component captures the maximum percentage of the total variation in the series that can be explained by just one common factor. If such first component strengthens its explanatory power over time, it means that the correlations between national rates have increased during the period under study, thus indicating increased convergence. With respect to our sample, it should be noticed that such convergence does not make its appearance immediately after the SMP implementation, but sometime later, at the end of the '90s, when the realization of the monetary union comes into direct play. This is particularly evident for lending rates, for which the first component steadily reduces its importance starting from 1992 when domestic factors, such as the different degree of recession and/or the diverse impact of the EMS crisis experienced by each member state, become more relevant in explaining domestic banking rates. Beginning with 1999, things start to change and a main common factor, this time being the EMU, captures the trend towards greater convergence.

Along with the level of convergence in interest rates, it is interesting to analyze the trend in the level of the mark-up and mark-down, defined respectively as the difference between the 3-month money market rate and the lending/deposit rate (see table 3) and expressing the margin earned by banks in their intermediation activity (or the cost of financial intermediation) with respect to a risk-free activity. The dimension of these measures depends, among other things, on the monetary policy, market power of banks, risk of

[38] See Fase M.M.G.(1999) for applications of this powerful statistical tool to market interest rates.

[39] These represent more than 80% of total variation; up to three principal components, a good 70% of total variation is explained.

[40] The exercise was carried over a moving sample of 70 months, considering interest rates changes in order to guarantee that the original series are statistically stationary. All series were weighted equally, having based the estimations on the correlation matrix.

borrowers. In order to take into consideration the effect of decreasing market interest rates, that characterized the period 1993–1999 relevant to our study, it is useful to compare the percent change of money market rates and the analogous change in the mark-up and mark-down. Apart from Belgium, EU banks have experienced a cost of funding (through deposits) that has over-incorporated the reductions in market rates, which might reflect the competitive conditions in the domestic banking markets (in particular, in France, Germany Portugal and Spain). With respect to the lending side, figures confirm a non homogeneous picture within the EU. Decreasing mark-ups can be observed in Italy, Portugal and Spain over the period 1993–97, confirming the trend found by the European Commission report (1997) of price reduction in the retail loan markets of these countries[41]. These reductions can be partially attributable to an increase in bank competition as the pronounced fall in the mark-ups provides evidence of a drop in lending rates higher than the reduction in money market rates. More interestingly, mark-ups in Belgium, Germany, Ireland and the Netherlands have increased over the same period, where one can observe lending rates' sluggishness in responding to money market rates' decline. Again, this is not sufficient to stipulate that these countries have benefited less from increased competition. Higher lending rates can, among other things, be consistent with better banks' expertise in pricing borrowers.

As the EU report predicted, the large potential for economies of scale and scope has been the driver for concentration activity in the EU area. The number of M&A, joint ventures and strategic alliances has increased, although this process is mainly confined to national boundaries and led to the creation of large national institutions, ready to compete in the Single Market (see ECB, 2000). Indeed, the EMU, more than the SMP, is considered the main driver for the reduction of existing excess capacity, for profitability enhancement and increased internationalization and geographical diversification of EU banks (see The ECB, 1999 and Cabral et al., 2002, for extensive data on concentration, capacity and profitability ratios of the EU banking systems).

[41] For more recent years, covering the period 1998–2002, Cabral et al. (2002) find similar results both in household and corporate lending sectors.

IV. The EU Single Market and the GATS agreements: degree of compatibility

We now turn our attention to the relationships existing between the EU regional program and the first multilateral agreement on financial services, i.e. the GATS.

It has been argued that the degree of compatibility between regional liberalization of services (including financial services) and multilateral liberalization depends on "whether regional agreements effectively lead to significant liberalization and if such arrangements go substantially beyond what is already feasible in the multilateral context" (Mohieldin and Wahba, 1998). In general, it is broadly recognized that regional agreements exert many positive influences on multilateral integration and openness, since they act as useful laboratories for experimenting what could be achieved at a higher, and more complex, level[42]. Hence, regional integrated areas are considered "as important mechanisms for ensuring forms of international governance, contributing to a more liberal multilateral trading system" (Falautano and Guerrieri, 2000).

So far, the analysis seems to highlight the existence of a one-way relationship among the two different levels of commitments in services liberalization – regional and multilateral –, with the lower level greatly influencing the higher level of negotiations, yet not being influenced by the latter. In other words, multilateral agreements appear to benefit from regional agreements, yet without enlarging the scope of liberalization already achieved at the lower, regional level, for they tend to merely endorse the status quo. A more optimistic point of view would stress the fact that, at least, multilateral commitments impose certain constraints on the domestic/regional level – no possibility to roll-back from what achieved; the principle of progressive liberalization is embedded in GATS/WTO negotiations so that regional

[42] See Summers, 1991; Whalley, 1996; Francois, 1997 (unilateral trade reforms are implemented in order to favor multilateral liberalization); Lawrence, 1996 (regional agreements are levers for addressing more complex issues at the multilateral level); Krugman, 1993 (reduction of number of players at multilateral levels makes collective actions easier).

agreements most likely act as building blocs for further achievement in trade and services liberalization.

An opposite stream of literature (Krugman, 1991; Bhagwati and Panagariya, 1996; Bond and Syropoulos, 1996; Levy, 1996) suggests that regional agreements do not foster multilateralism for they intrinsically tend to be substitutes for multilateral liberalization, for instance developing their own capital markets, separate from the global market (as Europe tried and partially was able to do so), or pursuing regional development strategies, discriminating against outsiders. As such, regional integration agreements would act as stumbling blocs more than building blocs (Falautano and Guerrieri, 2000).

The fact that those regional liberalization agreements, such as the EU and NAFTA, heavily influenced the decision to launch the GATS negotiations and represented the driving forces for the progress achieved in the multilateral discussions seems to give credit to the "building blocs" hypothesis (Hoekman and Sauvé, 1994). In fact, during the GATS negotiations, the European Union played a significant and leading role in promoting the liberalization program. The creation of a "regional market" – the so-called Single Market for Financial Services – well in advance of the GATS negotiations helped EU countries appreciate the positive effects of such agreements, for both consumers and producers. Therefore, they entered the GATS negotiations as a single compact group supported by strong arguments in favor of liberalization and with no specific fears to extend to third parties the degree of liberalization achieved among member states.

Although this cannot represent conclusive evidence in favor of the desirability of regional agreements, it clearly points out that regionalism can represent a positive lever for multilateral trade cooperation, depending on the circumstances. This can explain why the EU Trade Ministers welcome and push towards the creation of a regional integration among Middle East and North Africa (MENA) countries as a first important step leading to a truly beneficial EU-Mediterranean partnership[43].

[43] See Communications from Trade Directorate-General of the EU Commission (Presidency conclusions, Brussels, 29 May, 2001). In particular it is stressed that "the Commission is ready to support any initiative as well as other project contributing to regional integration by providing the necessary technical assistance". A recent study published in the ECB occasional paper series (Mazzaferro et al., December 2002) reviews the economics aspects of the institutional arrangements between the euro area and the four main regions surrounding it, among which the Middle East and Northern Africa region. This study also analyzes the economic relations (trade, financial and monetary links) between the Euro area and its neighbouring regions.

As such, it becomes vital to investigate the degree of compatibility between the EU experience in financial services liberalization and the GATS commitments, while highlighting, if any, what circumstances were capable of ensuring that the EU Single Market could promote multilateral liberalization in financial services and, on the other side, whether the interaction between the two different levels of negotiation, regional and multilateral, led the latter to extend the provisions embedded in the Single Market Program with respect to the treatment of third countries.

In general, as an effect of the regional liberalization, the EC financial services sector is very open to foreign competition. Establishment of banking, insurance and securities subsidiaries is subject to no restrictions other than the usual prudential measures. Foreign institutions can establish subsidiaries which benefit from a "single passport" under national treatment conditions, while direct branching is regulated under national treatment conditions in each member state[44]. More specifically, looking at the precise commitments made by the European Communities and their member states (see table 4)[45] in the banking and other financial services sectors, the following remarks arise:

a) commitments are binding for all member states, except where specific national reservations are made. Limitations are based on existing national legislation and, in general, they typically apply equally to both European and non-EU firms; as such national treatment is preserved[46].

b) commitments are made in both trade and investments, as per the Understanding. In fact, during the negotiation of the GATS, a group of mainly developed countries decided that they would make their

[44] It should be noted that third-countries' banking institutions can obtain the single license if and only if they are established directly in the form of a subsidiary. On the contrary, branches established directly in a member-state by non-Community banking institutions are not eligible for the single passport, i.e. they only receive an authorization to operate in the territory of the member state under national treatment and may be required to satisfy a number of specific prudential requirements such as separate capitalization. See GATS 2000: financial services. Proposal from the EC and their member states. Downloadable from http://europa.eu.int/comm/trade/services/nspw07.htm

[45] Downloadable from http://gats-info.eu.int/gats-info. It should be noted that, although the European Community entered the negotiations representing 15 countries (which counted as one), the nature of the GATS is such that it partly resides in the Community's responsibility and partly in each member state's responsibility. See Court of Justice 1/94. Hence, differences in each member's reservations to financial services commitments are explained.

[46] See, for instance, limitations concerning the issue of national currency-denominated securities, where in most countries it is required that they should be lead managed only by banks established in the country or in the European Economic Area.

commitments subject to stricter criteria than GATS itself requires. These are set out in the "Understanding on Commitments in Financial services" attached to the GATS. In sum, the Understanding obliges countries to bind to their current legislation and practice and covers both trade and investment in financial services;

c) no MFN (Most Favored Nation) exemption was undertaken. The EU waives definitively the right to apply reciprocity provisions in EU legislation. The inclusion of reciprocity provision in EU directives has been a subject of great debate inside and outside the Community, especially at the delivery of the Proposal of the Second Banking Directive. At that time, in fact, the reciprocity provisions that the Commission initially included in the proposal were fiercely opposed by some member countries and by third countries, *in primis* the U.S. and Japan. Eventually the Commission toned down its demand for reciprocal treatment into one of either national treatment or market access. At first sight, it seems that no improvement has been reached under this aspect; however, it should be noted that the EU legislation, as any legislation, is potentially subject to changes. In this respect, the Understanding on Commitments in financial services avoids that the EU might offer in the future a regime that is worse than what it offers at present;

d) limitations on national treatment are circumscribed. In particular, the European Community and its member states commit themselves to ensuring that a foreign service supplier is guaranteed the same level of fair treatment as domestic counterparts as far as "cross-border supply" and "consumption abroad" modes of supply are concerned. Few restrictions concern the third mode of supply (commercial presence) and are mainly related to the securities and investment management business, i.e. those businesses most recently liberalized in the EU area itself[47]. The fourth mode of supply (presence of natural persons) was left "unbound", i.e. EU countries did not make any commitment either to open-up their markets or to keep them as open as they were at the time of accessing the WTO, following a general behavior common to all WTO members;

e) limitations on market access, i.e. specific restrictions on foreign suppliers willing to enter national market, outnumber those on national treatment.

[47] The Investment Services Directive (93/22/EEC) was issued in 1993; its implementation could have been as late as the 1996 for some countries given the possibility of a deferred implementation date.

> There is just one EU-wide limit, i.e. operating throughout the EU, requiring the establishment of a specialized company to manage unit trusts, under the UCITS directive. Remaining restrictions are nation-based, mainly setting conditions on the cross-border supply and the consumption abroad of securities and investment management business. Although to different extents[48], almost all member states require certain services to be provided by firms established either in the member state itself or in the EU as a whole. These services essentially comprise investment services and investment advice, lead management of issues denominated in the domestic currency, venture capital, pension fund management. Commercial presence is subject to the regulations in force in each member state, which are generally non-discriminatory as the Second Banking Directive states[49]. However, the directive makes a clear distinction between the two different forms of establishment by a third country foreign intermediary, subsidiary or branch. Only the former is granted access to the whole EU on the same terms as domestic banks, i.e. is granted the single passport; the latter may only operate in the member state where it is situated. This distinction is carried over in the WTO agreement[50].

Four main points deserve to be underlined.

First, the EU schedules seem to embrace the belief that commitments should also consider the potential interrelations between the rules governing each mode of supply, especially for those modes where differences are becoming progressively more blurred, as it happens for mode 1 (cross border supply) and mode 2 (consumption abroad). The underestimation of this fact may, indeed, generate divergences or doubts as to the true level of openness to foreign competition; therefore care must be taken to ensure that commitments undertaken and limitations imposed for one mode do not contrast or, better, are consistent with those undertaken and imposed for another mode of supply.

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[48] Countries that joined the European Community most recently tend to maintain a lower degree of openness to third countries.

[49] Exceptions are present; see for instance Greece, which imposes minimum capital imports.

[50] "Member states may apply the restrictions indicated in this schedule only with regard to the direct establishment from a third country of a commercial presence or the provision of cross-border services from a third country; consequently a Member state may not apply these restrictions, including those concerning establishment, to third country subsidiaries established in other Member states of the community, unless these restrictions can also be applied to companies or nationals of other Member states in conformity with Community law". European Community and its member states schedules for financial services commitments; see http://gats-info.eu.int

For instance, if, in principle, the consumer is allowed to purchase any kind of securities-related service from abroad (mode 2), but at the same time foreign competitors are not allowed to provide investment services if not incorporated in the host country (restrictions on mode 1), then, in practice, the consumer is not allowed to exercise his right. On this specific point, the EU schedules do not separate limitations on the two modes, carrying the idea that the restrictions affect both modes.

Second, limited commitments were made in those subjects where no specific prior EU-wide legislation was already achieved and in force. See for instance mode 4 of supply (presence of natural persons) which was left unbound; on the contrary where EU consensus had already been achieved, as in the case of national treatment, more commitments and less restrictions were adopted by member states.

Third, the Single Market has represented a building bloc promoting multilateral liberalization. In fact, those EU member states which had domestic pieces of legislation less favorable to foreign non-EC intermediaries and initially bound their status quo, were later prone to lift such burdens and relax some of the restriction introduced in the schedules (see last column of table 4, for removed restrictions). In most cases, these country-specific improvements were prompted by the need for compliance to the dictates of the single program[51]. In other cases, they might have stemmed from a need to better address the issues of foreign competition when moving from regional integration to multilateral agreements.

Fourth, it is evident that the EU bounds its existing regulatory regime for financial services, as reflected in the EU legislation and practice. In other words, the status quo has been secured. One exception regards the fact that no MFN exemption was taken, which implies that EU cannot use in the future those provisions entitling the European Union to deny entry to countries not offering reciprocal treatment to European firms. This reciprocity rule is for instance present in the first banking directive (art. 9) as far as branches of non-EC banks are concerned and is still governing the issue of authorization for these kind of offshoot. The Agreement in force has therefore an immediate and direct influence on the Community law.

[51] See for instance the elimination of the economic need test in banking by Austria, or the opening of the Irish banking market to representative offices.

In sum, the Single Market Program shows both a level of compatibility with the WTO Financial Services Agreement (status quo binding) and a certain degree of interaction between the different layers of negotiation, regional commitments (EU-wide) versus multilateral commitments (GATS), (prior restrictions lifted, no MFN exemption).

What circumstances are at the basis of such a successful story? Mainly the prevailing notion that the ultimate aim of the Single Market was to ensure open world markets through multilateral negotiations[52]. As already underlined, this liberal orientation was strongly inspired and led by the UK, whose main purpose was to maintain and extend the City of London's role as an international financial center, in contrast with the French attempts to create a European economic and financial area distinguishable from world markets, a sort of a "Fortress Europe" discriminating against outsiders[53]. The importance of the role played by the UK in leading the charge for liberalization and the opening of markets is underlined by the recent involvement of the private sector in the WTO negotiations as principal supporter of the EC negotiators. In fact, the work undertaken by the British "LOTIS Committee" (Liberalization of trade in Services committee), which represents, since the 1980's, the established voice for the UK financial services interests in connection with negotiations in the WTO, inspired the establishment of both a EU-wide private sector forum, the European Services Leaders Group[54], and a trans-Atlantic forum, the Financial Leaders Group, aimed at providing valuable, direct expert advice, information and support to the negotiators (governments) at the WTO. This indirect involvement of the private sector in the WTO negotiation is nowadays regarded as one of the primary factors conducive to the improvements obtained in subsequent liberalization talks.

[52] See EU Commission, Press Information, *Europe World Partner*, October 19,1988.

[53] Remarkable is the statement by the Belgian EU Trade Commissioner, Willy De Clerq: "We see no reason why the benefit of our internal liberalization should be extended unilaterally to third countries" (Financial Times, July 14, 1988).

[54] The European Services Leaders Group brings together Chairmen, CEO's and Senior Partners from companies from all EU member states.

V. The EU experience: a model for liberalization in the financial sector?

As the financial sector is at the crossroad of many aspects of the economy, it is vital for developing countries to achieve a certain level of development for their financial system. In fact, it is a widely held view that there is no true and sustainable economic growth without a financial sector efficiently and effectively playing its function of channeling savings from the household sector into productive investments.

The key pillars for a successful financial sector development are:

a) strong internal and external governance;

b) competition, both at the domestic and at the international level;

c) effective regulation and supervision.

Financial liberalization helps these three pillars to work properly, as it enhances efficient sectoral, inter-temporal and international resource allocation. A number of empirical studies have, in fact, demonstrated the existence of a link between financial liberalization, financial sector efficiency and growth for both developed and developing countries (Levine, 1996, 1997; King and Levine, 1993, Harris and Pigot, 1997; Edey and Hviding, 1995).

The subsequent question of how the liberalization program should be implemented – a big bang or a gradual reform – mostly depend on individual countries circumstances. The EU is a successful story of reforms introduced gradually over a number of years with much emphasis on public persuasion regarding the benefits of liberalization and integration. The big bang, on the contrary, seems to adapt well with countries with low savings and poorly performing financial systems (Johnston, 1994).

What can we learn from the EU experience? The EU formula for reducing barriers in financial markets comprises: 1) coordination of financial legislation (necessary for the acceptance of the home country control principle); 2) adoption of a simultaneous approach for domestic and international liberalization (at least for more advanced systems); 3) single passport (mutual recognition as a pre-requisite for increasing competition).

Two conditions helped the EU project to realize a successful story of financial liberalization: macroeconomic stability and a constructive role by the government in the regulation and supervision of the financial system[55].

Indeed, liberalization cannot proceed at a fast and successful pace in time of political and/or economic turmoil. As mentioned in section II of this paper, it is only in the second half of the eighties, when the world and EC macro conditions had improved, that the Community showed a renewed willingness and confidence in its ability to pursue the important goal of creating the Single Market.

Moreover, the support of national governments in strengthening prudential regulation and supervision was vital to sustain the whole architecture of the SMP based on "minimum harmonization, mutual recognition and home country control". Two features should not be underestimated.

First, that each EU government was relatively free from pressures of influential interest groups being the political *élites* usually separated from the economic *élites*. Since regulation is a political bureaucratic process, where producers and consumers' interests are usually opposed, it is reasonable to assume that the final outcome is influenced by a rent-seeking struggle among different interest groups. According to the public choice theory[56], economically oriented interest groups such as business groups have a higher probability of striking a bargain with the member of the key legislative committees and obtain a distributional favor such as a regulation that shelters domestic producers from foreign competition. However, under certain circumstances, in a competitive democracy such distributional coalitions cannot oppose for ever welfare-maximizing reforms; therefore a set of reforms beneficial to the consumers but not necessarily, or at least not immediately, to the economic *élites* is eventually introduced[57]. This can prove

[55] Kono et al. (1997).

[56] Buchanan and Tullock (1962) and Olson (1965) represent the founding fathers of this stream of literature; Mueller (1989) provides an excellent review of the state of the art in public finance. In a more recent approach, the making of economic policy is analyzed from a transaction-costs perspective (Dixit, 1996), that views policymaking as a process in real time where many participants (principals) try to affect the action of the immediate policymaker (agent).

[57] In this respect, it is important to understand that the EU legislation stems from a political game between different governments, each of them representing specific economic systems and cultures and being influenced by different interest groups, showing sometimes divergent interests. In sum, the agreements that emerged reflect a reconciliation between the pursuit of national interests and the need for a larger cooperation among member states. As Story and Walter (1997, pp. 2) clearly depict, EU legislation on financial services was a negotiated product of the clash of ambitions and inhibitions among the states and the interests which negotiated it.

difficult in political systems where the political and economic interests are extremely entrenched, as it happens in too many developing countries.

Second, a system of "sticks and carrots" was in force, working efficiently especially with those countries that had to liberalize the most (and apparently could lose most from their opening up to foreign competition). The potential benefits stemming from being an "in-country" were sufficiently strong to help swallow the dismantling of protectionist barriers. For some countries, with less developed banking systems and financial markets, it meant a greater level of prior adjustment (costs) in expectation of reaping future (and as such not sure) benefits.

Given the above mentioned pre-conditions, can this model be regarded as a blueprint for opening up markets for MENA countries[58] or for developing countries in general? In this respect the second condition – the government's role – might present the greatest uncertainties. The power of entrenched interests tend to be greater in developing countries, where linkages between politicians, influential families and economic interests are more stringent, as the Asian countries have recently demonstrated. If tough measures need to be implemented in a short period of time[59] , governments can only gain the social support if a system of sticks and carrots is at work. What could be the carrot? An enhanced partnership with the EU, particularly on the matter of movement of natural persons, could be the answer. In this regard, it is worth recalling that the Euro-Mediterranean partnership is intended to promote a new phase of the relationship, including bilateral trade and development cooperation, among the 15 Member States and the 12 Mediterranean Countries, forming the so-called MENA region. This partnership is expected to create, among the others, shared prosperity through free trade and economic and financial assistance. However, up until now, the talks and negotiations on free trade were only related to goods, with no specific references to services, in particular financial services. Indeed, the level and quality of financial supervision in Mediterranean countries is a delicate matter. In a recent speech, the EU Commissioner responsible for External Relations has clearly stated that harmonizing measures relating to

[58] The main political, economic and financial features of MENA countries are analyzed in Gomel and Roccas (eds.), (2000) and Mazzaferro et al., (2002).

[59] The EU countries had almost 20 years to phase out their process of financial liberalization. Such a long time window is no longer available to countries that are nowadays confronting with the task of opening up their markets, since the globalization process and the IT revolution have increased the speed of any action and the need for conforming to a set of world-wide accepted rules.

the single market is crucial to any project for increasing the attractiveness of the region to investors. The EU is looking for decompartmentalised and open markets with sound and predictable legal and administrative laws. One useful way to use the partnership could be to include technical assistance concerning regulation. After having strengthened their regulatory systems, these countries could then start their process of liberalization with respect to the EU, as an intermediate and useful step towards the negotiations within the WTO-GATS.

As far as the stick is concerned, this would be represented by the sanctions that the non-compliance with the negotiations would carry along. Commitments made at the supranational level tend to weaken the power of entrenched interests, thus facilitating the pursuit of welfare-enhancing policies. This is exactly, though to different extents, what the Central and Eastern European countries (CEECs) are doing. Their experience is illuminating in this respect. The Council of Copenhagen has in fact stressed that accession to the EU for CEEC's and/or any future applicant will depend on full acceptance of EU legislation, i.e. each applicant must go through a process of transposing and implementing the entire body of the EU legislation, through appropriate administrative and judicial structures.

VI. Conclusions

The investigation of the sequencing of liberalization in the EU financial services industry was the primary object of this study.

The relevance of the EU model for financial liberalization is threefold.

First, the route towards liberalization in financial services taken by the EU might represent a blueprint for opening up markets worldwide, illustrating which obstacles might arise in multilateral negotiations.

Second, the EU model calls for an investigation of the degree of compatibility between regional agreements and multilateral commitments, i.e. whether the former constitute building blocs promoting multilateral liberalization or they tend to act as stumbling blocs, impeding further achievements at multilateral level.

Third, the EU model raises the question of the extent to which the intra-EU approach – minimum harmonization, mutual recognition and home country control – can be transferred in different settings and used elsewhere without the supranational legislative, judicial and administrative structure of the European Community.

As far as the first issue is concerned, the EU path towards the creation of an integrated, common market highlights the need for minimum harmonization as a realizable goal instead of full harmonization of rules. Minimum harmonization requires minimum agreement on essential rules, mainly in the field of prudential regulation and supervision. It represents an important pre-condition for attaining any further achievement in liberalization, through mutual recognition of home country rules and standards and the acceptance of home country responsibility in the supervision of financial intermediaries. The *EU-formula* for reducing barriers in trade and investments and granting market access to foreign firms is made up of <u>mutual recognition</u> and <u>host country control</u> as founding general principles for reducing diversity in regulations, while producing a pattern of regulation that could be conducive to effective openness in financial markets. There are advantages in adopting the mutual recognition of national standards: banking and financial integration could be enhanced by the adoption of the home country rule which

in turn would facilitate the integration among different regulatory regimes. Agreements on what constitutes a minimum standard in prudential regulation are easier to achieve than agreements about uniform standards. Once regulatory competition has drastically reduced differences in national standards, the transition from the principle of mutual recognition to a uniform standard becomes relatively easy to obtain (Fratianni, 1997). The issue is quite important and reveals the degree of successfulness of the Single Market project. In fact, as long as only the principle of "national treatment" is pursued – as in the case of the First Banking Directive – no true genuine market-opening can be achieved. A regulation that is non-discriminatory and equal in its effect on domestic and foreign players, yet where there are great differences from that of any neighbor or any competitor, *de facto* is not user-friendly to newcomers and impedes the release of competition. Striking differences in national regulatory regimes and standards may make national offers of liberalization, within the GATS, very diverse, leading to sharply differing degrees of liberalization. GATS Article VII provides for mutual recognition by countries of each others' regulatory regimes, on the basis of multilaterally agreed criteria. The very diverse standard of prudential regulation or supervisory systems around the globe might explain why industrial countries offered a somewhat cautious liberalization in the GATS, compared to their more liberal commitments in other fora, e.g. the EU or NAFTA. This could reflect a reluctance to open up their markets to financial institutions from countries with regulations and supervisory systems deemed insufficient to pursue a goal of safe and sound financial institutions and markets (Sorsa, 1997). It could also explain why, in the recent Euromed agreements, the topic of financial liberalization was not included in the agenda. The level and quality of financial supervision in Mediterranean countries is indeed a delicate matter. Future GATS rounds will need to deal more with how regulation should be carried out, and come to a general agreement on which relevant ingredients should characterize a truly pro-competitive regulation.

With respect to the second issue of investigation, the EU regional agreement shows a high degree of compatibility with GATS, with the multilateral agreement on services, being one of its inspiring forces. Since its inception, the Single Market was not meant to exclude third countries from the economic benefits deriving from a larger, integrated financial area. The UK position was decisive for the relative openness of the Single Market for financial services. The British negotiators aimed at maintaining the role of London as international financial center. However by no means does this imply that the area is free from any kind of barrier and encourages or favors

foreign market entry. Truly, the completion of the internal financial market, denationalized and open, still lies ahead for EU firms.

Finally, is the EU model exportable in different settings? And to what extent? Some have argued (OECD, 2000) that the EU experience is too specific and represents the outcome of the supranational legislative, judicial and administrative structure of the European Community. The argument is strong and should not be undervalued. Indeed, participation in the EU project for a Single Market – a project that was not confined to financial market, it should be recalled – meant benefits and costs for each member country. For some countries, with less developed banking systems and financial markets, it meant a greater level of prior adjustment (costs) in expectation of reaping future (and as such not sure) benefits. The regional agreements proved successful thanks to the operating of the well known system of "stick and carrots": sanctions were imposed on those countries that were too slow to comply with EU legislation. Under this point of view, no room for generalizing the EU experience seems to exist. However, it is reasonable to argue that the main lesson to be learned from the EU regional experience, i.e. that the primary target for a liberalizing sequence is that of adopting and strengthening prudential regulation and harmonizing these rules with that of neighbors, has a universal validity. Moreover, the continuing work on globally acceptable guidelines for supervision seems to support this conclusion.

Annex I

The realization of a truly integrated financial market in Europe is living a new momentum since 1999. In fact, in June 1999 the Cologne European Council endorsed the Financial Services Action Plan (FSAP) which details the work that has to be accomplished in order to reap the full benefits of a single financial market.

In particular, action is envisaged under three headings or strategic objectives: a single EU wholesale market; an open and secure retail market; and sound supervisory structures. For each strategic objective, the FSAP identifies key areas for action, details the specific measures to be taken and establishes priorities for each measure identified[60].

A single wholesale market

Under this heading, action is needed under six chapters:

1. enabling corporations to raise finance on competitive terms on a EU-wide basis. This imposes, in particular, the rapid overcoming of the obstacles to an effective mutual recognition of corporate issuers' prospectuses, so that a prospectus or offer document approved in one member country will be accepted in all;

2. establishing a common legal framework for integrated securities and derivatives markets. In this respect, a more clear-cut definition of the boundaries between the sophisticated investor and the less professional "household" investor is deemed essential. In fact, the effective cross-border provision of investment services is limited by the extent to which host country investor protection rules, including business conduct rules, vary

[60] Priority 1 actions are those which call for immediate attention since they are deemed crucial for the realization of the full benefits of the euro and for ensuing the competitiveness of the Union's financial services sector and industry whilst consumer interests; Priority 2 is given to those actions directed to amending existing legislation or adapting present structures to meet new challenges and fostering the functioning of the single market for financial services; Priority 3 is accorded to important areas where a clear and general consensus exists that new work should be undertaken with a view to finalizing a coherent policy by the end of the transitional period. See Commission of the European Union (1999), p. 21.

greatly among member states. It is commonly accepted that these rules should be less stringent when it comes to sophisticated investors – where the choice of "conduct of business regime" could be left to the contracting parties –; instead, small, unsophisticated investors should continue to be protected by local rules, supposedly best tailored to meet their needs;

3. providing a single set of financial statements for listed companies. Enhancing the comparability of financial reports issued by listed companies; providing clarity and transparency with respect to the legal issues to be settled in the event of take-over bids; creating an EU legal structure to facilitate companies to place pan-European operations on a rationalized single umbrella, i.e. a European company statute, are all needed measures in order to allow investors and intermediaries operate in an uniform and transparent environment;

4. containing systemic risk in securities settlements. This requires common and coherent finality frameworks and legal certainty as regards the validity and enforceability of collateral provided to back cross-border securities transactions;

5. creating a secure and transparent environment for cross-border restructuring. In particular, clarity and common rules are deemed necessary in the legal issues concerning cross-border take over bids and mergers, company statutes, and corporate governance;

6. establishing a sound and well integrated prudential framework which works for investors, by setting stringent prudential safeguards and rigorous supervision of pension funds, by widening the range of assets in which UCITS can invest and providing a European passport for management companies.

Retail markets

Establishing open and secure retail markets calls for attention in the following key areas:

1. equipping consumers with the necessary instruments and safeguards to permit their full and active participation in the single financial market. This translates into supporting best practices in respect of information provision – needed to assess credential of cross-border service supplier and the integrity and performance of the services provided –, establishing

clear rights for consumers and effective dispute settlement (redress procedures). The Commission approach is that of pursuing mutual recognition of essential requirements rather than attempting a full harmonization of financial products;

2. identifying and reducing non-harmonized consumer protection rules as serious unjustified obstacles to cross-border provision of services. A balanced application of consumer protection rules calls for a convergence of rules on business-to-consumer marketing and sales techniques. This will limit the exposure of consumers to undesirable marketing techniques and enhance distance selling via remote technologies. The aim is that of determining conditions under which equivalence of national rules could exist as to facilitate the cross-border provision of financial products without jeopardizing consumer safeguards;

3. creating legal conditions in which new distribution channels and remote technologies can be put to work on a pan-European scale. The major step towards this direction is represented by a green paper on e-commerce policy for financial services;

4. encouraging the emergence of cost-effective and secure payment systems for small-value, retail cross-border payments. TARGET represents an efficient and secure option only for wholesale cross-border payments given the costs associated with this trans-European mechanism of payment transmission. On the contrary, retail cross-border payments are mainly operated through correspondent banking mechanisms; as such they tend to incur in charges which are much higher on average than those within domestic payment systems.

Sound supervisory structures

The state-of-the-art in prudential rules and supervision highlights urgent improvements as to:

1. up-dating and strengthening the EU prudential framework and supervisory structures as to sustain stability and confidence in response to quick market development, intensification of competitive pressures and to globalization;

2. develop a regulatory and supervisory approach that will serve as the basis for successful enlargement;

3. reinforcing EU collaboration among supervisors, in such instances as fraud and money laundering, winding-up and liquidation of financial intermediaries.

Besides, two "more general" conditions are deemed to apply for the sake of a smoothly functioning, efficient EU financial market: corporate governance and tax-coordination. Efforts are to be taken in order to harmonize national codes of corporate governance – arrangements for the exercise of voting rights by shareholders in other member countries, to provide one example – and co-ordinate the tax treatment of savings.

The Lisbon European Council in March 2000 set the deadline of 2005 for the FSAP implementation, while the Barcelona European Council in March 2002 set the deadline of 2002 for the adoption of a package of eight legislative measures: proposals for a Regulation on International Accounting Standards and for Directives on Collateral, Distance Marketing, Market Abuse, Financial Conglomerates, Insurance Intermediaries, Pension Funds and Prospectuses. Almost all of these measures have been adopted by the set deadline or are in their final phases of adoption (early 2003).

Table AI.1 provides an overview of progress on the individual actions in the FSAP, as detailed in the several Progress Reports published up to December 2002, available on the Commission's website:

http://europa.eu.int/comm/internal_market/en/finances/actionplan

A double plus sign indicates that the targets set in the FSAP were met; a single plus sign indicates that progress has been achieved in meeting those targets; a minus sign indicates no progress.

Table AI.1 Progress on the Financial Services Action Plan

Strategic objective 1: a single EU wholesale market				
Raising capital on a EU-wide basis				
Action	**priority**	**Initial FSAP Timeframe (present timeframe)**	**State of play/follow up**	
Directive on Prospectuses	1	Adoption 2002 (Adoption June 2003)	Proposal for a Directive adopted: COM(2001)280, 30.05.2001. Amended Proposal adopted: COM(2002)460, 9.09.2002. Political agreement (5 November 2002)	+
Directive on Regular Reporting	3	Adoption 2002 (adoption 2004)	A second consultation concluded in July 2002.	–
Establishing a common legal framework for integrated securities and derivatives markets				
Commission Communication on distinction between professional and retail investors	1	Draft for issue by 1999	Issued on 14 November 2000: COM(2000)722, 14.11.2000	+
Market abuse Directive	2	Adoption 2003	Common position: CONS9359/6/02 Rev.6-19 July 2002	+
Upgrading the ISD	*[61]	(Proposal November 2002; adoption end-2004)	Proposal for a Directive adopted: COM(2002)625, 19.11.2002	+
Towards a single set of financial statements for listed companies				
Amend the 4th and 7th Company Law Directive to allow fair value accounting	2	Adoption 2001	Directive 2001/65/EC adopted on 31 May 2001	++
Commission Communication updating the EU accounting strategy	1	Issue by end-1999	Issued on 13 June 2000: COM(2000)359, 13.06.2000 Legislative follow-up: regulation on International Accounting Standards adopted on 19 July 2002 (EC)1606/2002	++
Modernization of the accounting provisions of the 4th and 7th Company Law Directives	2	Adoption 2002 (Adoption early 2003)	Proposal adopted: COM(2002)259, 28.05.2002	+
Commission Recommendation on EU auditing practices	2	Issue by end-1999	Issued 15 November 2000: C(2002)3304, 15.11.2000	++

[61] The FSAP included the publication of a green paper on upgrading the ISD. This was issued on 15 November 2000 [COM(2000)359, 15.11.2000] and, as a result of this study, a directive upgrading the ISD was deemed necessary.

Containing systemic risk in securities settlement				
Implementation of the Settlement Finality Directive	1	Commission report by end-2002 (Commission report beginning 2002)	All member states have implemented the necessary measures. A study on the implementation is expected to be finalized in March 2003	+
Directive on cross-border use of collateral	1	Adoption 2003	Directive 2002/47/EC adopted on 6 June 2002	++
Secure and transparent environment for cross-border restructuring				
Political agreement on the proposed directive on take-over bids	1	Adoption 2000 (adoption 2003)	New Proposal presented: COM(2002)534, 2.10.2002 after the EP rejected the comprise text on 4 July 2001.	–
Political agreement on the European Company Statute	1	Adoption 2000	Directive 2001/86/EC and Regulation (EC)2157/2001 adopted on 8 October 2001	++
Review of EU corporate governance practices	3	Launch review early 2000	Final report published on 27 March 2002, available on DG Market's website: http://europa.eu.int/comm/internal_market	++
Amend the 10th Company Law Directive	3	Adoption 2002 (adoption 2004)	New proposal expected 1st quarter 2003	–
14th Company Law Directive	3	Adoption 2002 (no proposal before 2003)	Reassessment is expected from the follow-up to the final report of the High Level Group of Company Law Experts and from pertinent decisions of the EU Court of Justice	–
A single market which works for investors				
Commission Communication on Funded Pension Schemes	1	Issue by May 1999	Issued on 11 May 1999. COM(1999)134, 11.5.1999	++
Two Directives on UCITS	1	Adoption 2000	Directives 2001/107/EC and 2001/108/EC adopted on 21 January 2002	++
Directive on the prudential supervision of pension fund	1	Adoption 2002 (adoption 2003)	Proposal adopted on 11 October 2000: COM(2000)507, 11.10.2000	+
Communication on clearing and Settlement	*		Consultation launched: COM(2002)257, 28.05.2002 Action and priorities in this area will be defined by the 1st Q 2003	+
Open and secure retail markets				
Distance Marketing Directive	1	Adoption 2002	Directive 2002/65/EC adopted on 23 September 2002	++
Commission Communication on clear and comprehensible information for purchasers	2	Communication: mid 2000	COM(2001)66 ,07.02.2001	++

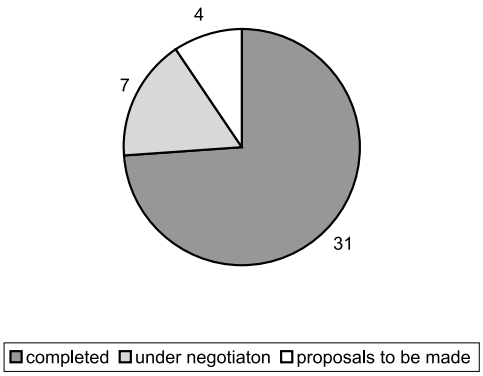
Commission Recommendation to support best practice in respect of information provision	1	Issue by end 1999	C(2001)477, 01.01.2001	++
Commission Report on differences between national arrangements relating consumer-business transactions	3	Discussion to begin end-2000	Discussions with industry and consumers are concluded. Information gathered are used for further Commission initiatives in the field of retail financial services	++
Interpretative Communication on the freedom to provide services and the general good in insurance	2	Issue by summer '99	Issued on 2 February 2000: C(1999)5046	++
Insurance Intermediaries Directive	2	Adoption 2002	Directive on Insurance Intermediaries adopted on 30 September 2002	++
Commission Communication on a single market for payments	2	Issue by summer '99	Issued on 31 January 2000, COM(2000)66, 31.01.2000	++
Commission Action Plan to prevent fraud in payment systems	2	Issue by end-1999	Issued on 9 February 2001: COM(2001)11, 09.02.2001 Follow up will run from 2001to 2003.	++
Green paper on e-commerce policy for financial services	1	Issue by mid-2000	Issued on 7 February 2001: COM(2001)66, 07.02.2001. FIN-Net established in 2001 as an EU network of out-of-court redress bodies in the member states for financial services.	++
State of the art prudential rules and supervision				
Directive on the winding-up and liquidation of insurance undertakings and banks	1	Adoption 2001	Directive 2001/17/EC adopted on 19 March 2001 (insurance undertakings) Directive 2001/24/EC adopted on 4 April 2001 (banks)	++
Electronic Money Directive	1	Adoption 2000	Directive 2000/46/EC adopted on 18 September 2000	++
Amendment to the Money laundering Directive	1	Adoption 2001	Directive 2001/97/EC adopted on 4 December 2001	++
Commission Recommendation on disclosure of financial instruments	2	Communication mid 1999	Commission Recommendation 2000/48 of 23 June 2000 [C(2000)1372]	++

Amend the directives concerning capital adequacy of banks and investments firms	2	Adoption 2002 (adoption 2005)	Pending developments in Basel II	–
Amend the solvency margin requirements in the insurance directives	3	Adoption 2003	Directive 2002/12/EC and 2002/13/EC adopted on 5 March 2002	++
Amend the insurance directive and the ISD to permit information exchange with third countries	3	Adoption 2001	Directive 2000/64/EC adopted on 7 November 2000	++
Financial Conglomerate Directive	1	Adoption 2002	Directive adopted on 20 November 2002: CONS9754/3/02Rev.3	++
Creation of a Securities Committee	2	Adoption 2002	European Securities Committee (ESC): C(2001)493,6.06.2001 and Committee of European Securities Regulators (CESR): C(2001)1501, 6.06.2001	++
Reinsurance supervision	*	(ongoing 2003)	Commission proposal to be presented towards the end of 2003	+
Insurance Solvency II	*	(ongoing 2005)	Long- term project to define a new solvency framework for EU insurance companies	+
Third Money Laundering Directive	*	(Proposal end 2003)		
Wider conditions for an optimal single financial market				
Directive on savings tax	1	Adoption 2000 (Adoption Dec-2002)	In 2001 draft directive approved for the purpose of negotiations with third countries to promote the introduction of equivalent measures.	+
Implementation of the 1997 Code of Conduct on business taxation		Ongoing examination in the Code of Conduct Group	A report identifying the harmful tax measures was submitted to the ECOFIN Council in November 1999.	+
Review of taxation of financial services	3	Discuss in Tax Policy group	Action taken care of in the context of the initiative on taxation of cross-border occupational pensions	++
Commission initiative on taxation of cross-border occupational pensions	2	Adoption 2002	CO(2001)214, 19.04.2001	+

* measures in response to wider market developments since the adoption of the FSAP, but not included in the original plan

Our elaboration of information present in several Progress Reports published up to December 2002.

Figure AI.1 summarizes the situation of individual measures of the FSAP



Source: Financial Services. Meeting the Barcelona Priorities and Looking ahead. Seventh Report, Brussels, 3 December 2002

Annex II

Table 1: The Single Market- Banking services: the sequence of liberalization

Directive	Issue date	implementation date (by)	
First EC Banking Directive (77/780/EEC)	1977	1979	establishes authorization procedures for deposit taking institutions
Consolidated Supervision Directive (86/635/EEC)	1983	1985	brings EC supervisory arrangements in line with the revised Basel Concordat
Bank Accounts Directive (86/635/EEC)	1986	1993	harmonizes accounting rules and reporting requirements
Capital Liberalization Directive (88/361/EEC)	1988	1992	requires the removal of exchange controls with the aim of enabling free movement of capital within EC.
Own Fund Directive (89/299/EEC)	1989	1993	provides a common definition of banking capital in accordance to the 1988 Basel Capital Adequacy Agreement
Solvency Ratio Directive (89/647/EEC)	1989	1993	sets common minimum risk-adjusted capital adequacy requirements in accordance to the 1988 Basel Capital Adequacy Agreement
Second EC Banking Directive (89/646/EEC)	1989	1993	provides for a "single passport" and gives a broad definition of banking activities
Monitoring and Control of Large Exposures (92/121/EEC)	1992	1994	institutions have to make an annual report to the supervisory authorities, detailing all large exposures (defined as more than 15% of the institutions' own funds) as well as their largest exposures, even if these are less than the mentioned ceiling.
Capital Adequacy Directives (93/6/EEC and 93/31/EEC)	1993	1996	extend the risk-adjusted capital requirements to investment firms and set capital requirements for market risks.
Deposit Guarantee Directive (94/191/EEC)	1994	1996	establishes common rules for the implementation and functioning of depositor compensation schemes in all member countries

Source: http://europa.eu.int/eur-lex/en/index.html

Table 2: Foreign bank presence in selective EC countries: number of establishments* and share of assets as a percentage of total domestic banking assets

Host country	1970		1980		1995		1997		2001	
	number	% asset	number	% asset	number	% asset	number	% asset	number	% asset
Belgium	35	22.5	73	41.5	74	28.4	71	36.3	79	n.a.
France	96	12.3	183 (a)	14.3 (a)	310	12.2	305	5.2 **(b)**	328**(c)**	n.a.
Germany	150	1.4	n.a.	3.2 (a)	157	n.a.	153	2.8	146 **(c)**	n.a.
Greece	5	n.a.	15 (a)	-	29	18.6	29	21.9	22 **(c)**	13.7**(c)**
Ireland	n.a.	n.a.	n.a.	-	36	40.6	49	53.6	32	n.a.
Italy	11	n.a.		0.02	58	5.4	61	8.8	115	n.a.
Luxembourg	23	n.a.	99	n.a.	216	99.7	211	99.9	182	99.9
Netherlands	39	n.a.	60	n.a.	52	9.8	49	7.7	33	n.a.
Portugal	4	0.9	10	1.2 (a)	16	9.4	22	10.5	27	17.7
Spain	37	0.6	89 (a)	3.1 (a)	83	Na	80	6.4	121	n.a.
United Kingdom	95	n.a.	383	59 (a)	392	51.6	387	52.1	307	n.a.

*number of foreign representative offices, branches or subsidiaries operating in the host country.

(a)1979; (b) 1998; (c) 2000

Source: Pecchioli (1983) for 1970's and 1980's figures; ECB (1999; 2002) and supervisory authorities for more recent years.

Table 3: Mark-ups and mark-downs in EU selected countries.

	Mark-up – lending rate minus money market rate -							
	BE	**FR**	**GER**	**IRL**	**IT**	**NL**	**PT**	**SP**
1980	3,70	11,85	1,99	1,33		0,87		1,76
1981	4,51	15,30	2,53	0,70		0,91		1,19
1982	3,47	14,87	3,45	1,17		0,73		0,46
1983	3,36	12,53	3,14	1,84		0,68		2,14
1984	2,78	1,80	2,79	0,79		0,60		3,98
1985	2,20	2,79	2,74	2,10		0,45		1,91
1986	2,13	3,59	2,51	2,59		0,30		0,70
1987	2,38	2,20	2,99	3,15		0,24		0,21
1988	2,67	2,12	2,61	3,22		0,54		1,33
1989	2,53	0,90	1,69	2,47	1,57	1,01		1,46
1990	2,44	1,53	2,01	3,18	1,71	0,71	10,79	1,56
1991	0,87	1,41	2,06	3,26	1,69	0,64	9,04	1,36
1992	0,68	1,04	2,59	14,15	1,74	0,73	5,00	1,29
1993	n.a.	1,34	3,64	3,59	3,67	0,55	6,54	1,07
1994	0,91	1,82	4,30	4,48	2,71	0,40	6,81	1,07
1995	0,85	1,86	4,31	4,29	2,02	0,26	6,79	1,09
1996	0,96	3,91	4,63	4,26	3,24	0,81	6,14	0,96
1997	1,01	2,56	4,54	4,08	2,87	0,31	5,78	0,63
1998	0,95	1,40	4,23	6,74	2,89	0,54	5,20	0,82
1999	0,89	1,29	4,74	5,17	2,63	0,49	4,81	1,27
% change 93–97	49%	91%	25%	14%	-22%	-44%	-12%	-41%
% change 93–97 in the money market rate	-64%	-66%	-64%	-65%	-71%	-58%	-80%	-78%
% change 93–99	31%	-4%	30%	44%	-28%	-11%	-26%	19%
% change 93–99 in the money market rate	-58%	-63%	-57%	-33%	-33%	-57%	-56%	-55%
	mark-down – money market rates minus deposit rate-							
	BE	**FR**	**GER**	**IRL**	**IT**	**NL**	**PT**	**SP**
1980	3,53	-0,36	1,15	5,42		8,73		5,37
1981	3,97	0,04	1,56	6,47		9,61		4,46
1982	3,98	0,25	1,16	6,35		6,69		5,17
1983	1,51	0,06	0,84	5,09		4,31		7,53
1984	2,03	0,04	0,64	6,05		4,84		0,59
1985	1,58	-0,02	0,76	5,76		5,45		0,91
1986	1,31	0,04	0,89	5,84		4,97		2,20
1987	0,67	-0,29	0,50	4,96		4,36		7,04
1988	0,50	-0,42	0,71	4,63		3,68		2,13
1989	1,88	-0,33	1,10	5,63		6,19		4,72
1990	2,17	-0,47	0,83	4,99	5,24	7,49		3,99

(continuing)	mark-down – money market rates minus deposit rate-							
	BE	**FR**	**GER**	**IRL**	**IT**	**NL**	**PT**	**SP**
1991	3,13	-0,13	1,18	5,16	5,22	8,21	0,70	2,50
1992	3,13	0,00	1,39	-5,29	6,55	8,37	2,16	2,86
1993	1,10	0,16	1,23	6,82	3,74	6,33	1,59	2,86
1994	0,85	-0,16	0,83	5,57	3,49	4,47	1,42	0,96
1995	0,76	-0,23	0,65	5,76	4,97	3,57	0,36	0,85
1996	0,58	-0,21	0,46	5,08	3,56	1,64	0,71	1,37
1997	0,58	-0,22	0,43	5,58	3,15	2,45	0,76	1,40
1998	0,57	-0,17	0,43	2,77	2,49	2,56	0,49	1,23
1999	0,55	0,00	0,19	3,01	1,77	2,52	0,06	0,59
% change 93–97	-47%	-237%	-65%	-18%	-16%	-61%	-53%	-51%
% change 93–97 in the money market rate	-64%	-66%	-64%	-65%	-71%	-58%	-80%	-78%
% change 93–99	-50%	-97%	-85%	-56%	-53%	-60%	-96%	-79%
% change 93–99 in the money market rate	-58%	-63%	-57%	-33%	-33%	-57%	-56%	-55%

Source: ECB national retail bank interest rates, IMF, International Financial Statistics

Table 4: GATS commitments by EU countries in Banking and other Financial services

Limitation to MARKET ACCESS: any limitation on access to its markets by foreign service suppliers	
CROSS BORDER SUPPLY (mode 1)	
EU legislation	**GATS exemption by single member countries (and subsequent removal)**
Freedom to provide cross border services throughout the Community granted to foreign subsidiaries which have received an authorization to establish in the territory of a member state. Such a freedom is not shared by foreign branches established directly in a Member-State	***Unbound, e.g. the EC has not bound its actions for the banking sector and this particular mode of supply. It is making no commitments either to open-up its market or to keep it as open as it was at the time of accession to the WTO.*** **Belgium**: establishment in Belgium is required for the provision of investment advisory services. **Removed** **Germany:** issues of securities denominated in Deutschmarks can be lead managed only by a financial institution established in Germany **Greece**: establishment in Greece required for the provision of custodial and depository services on securities issued in Greece **Italy**: a) unbound for salesmen; b) establishment in Italy required for the provision of the entire range of investment services **Finland**: payments from governmental entities are required to be transmitted through the Finnish Postal Giro System. **Ireland:** provision of investment services/advice requires incorporation either in Ireland or authorization in another member State **Sweden**: Custody, depository and settlement services can only be supplied by suppliers who are account operating institutions and are supervised by the domestic Financial Supervisory Authority. **UK**: incorporation in the EC is required for provision of lead management services of sterling issues

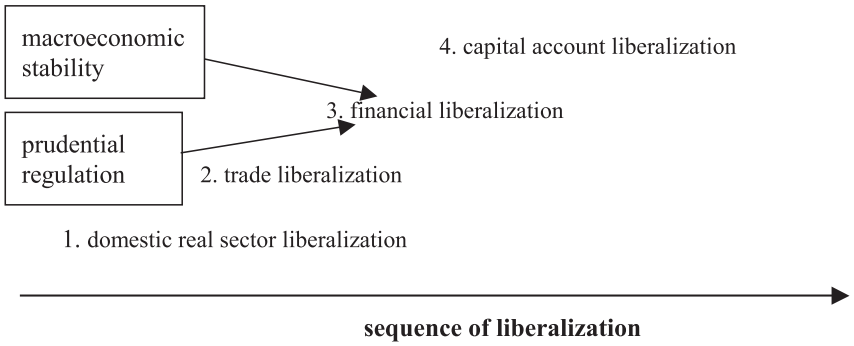
CONSUMPTION ABROAD (mode 2)-	
EU legislation	**GATS exemption by single member countries (and subsequent removal)**
No specific broad-EU legislation on this mode of supply. Only national legislation applies.	Nation-specific limitations which are applied equally to domestic institution, EU and non-Community financial institutions. Some of these limitations have been removed, such as the restriction on Portuguese residents to issue securities and other negotiable instruments in foreign markets or the 25% compulsory investment in Portuguese Government funds by local investment funds.
COMMERCIAL PRESENCE (mode 3)	
EU legislation	**GATS exemption by single member countries (and subsequent removal)**
Foreign subsidiaries are granted the single passport; branches established directly in a member state by a non-Community financial institution only receive an authorization to operate in that country and may be required to satisfy a number of specific prudential requirements.	**For all member states:** the establishment of a specialized company is required to perform the activities of unit trusts and investment companies; only firms incorporated in the EC can act as depositories of the assets of investment funds. **Austria:** a) licensing of branches and subsidiaries is subject to an economic interest test. **Removed;** b) specific pre-requisites are required for the provision of investment services (for instances, membership to the Austrian Stock Exchange; specific legal entity incorporated in Austria, specific authorizations by the domestic supervisory authority) **Belgium**: firms trading in securities are required to incorporate in Belgium. **Removed.** **Denmark and Spain:** firms trading in securities are required to incorporate in the host country **Finland**: a) residence requirements apply to the founder, the Supervisory Board and the Board Management as well as the CEO and auditors; b) national interest test for acquisition of shares giving more than 1/3 voting rights in banks. **Removed;** c) legal entities requirements for the provision of securities and derivatives intermediation services

	Greece: a) minimum capital imports are imposed for the establishment and the operations of foreign banks' branches. Up to four branches, this requirement is equal to half of the minimum amount of share capital required to domestically incorporated banks; b) firms trading in securities are required to incorporate in Greece **Ireland**: the right of establishment does not cover the establishment of representative offices of foreign banks **Removed;** **Italy**: a) suppliers of securities related services (other than banks) must adopt a specific legal form; b) no clearing and settlement of securities services can be offered; same applies to deposit custody and administration services for Government securities c)public offer of securities other than shares or debt securities can only be made by companies duly authorized. **Netherlands**: incorporation requirements to access to Amsterdam Stock Exchange. **Removed** **Portugal**: licensing of branches and subsidiaries is subject to an economic interest test. **Removed** **UK:** incorporation in UK required to act as gilt-edged market maker, primary dealer of Treasury bills and stock exchange money broker. **Removed**
PRESENCE OF NATURAL PERSONS (mode 4)	
EU legislation	**GATS exemption by single member countries (and subsequent removal)**
No specific broad-EU legislation on this mode of supply. Only national legislation applies	Unbound **France**: condition of nationality for the president of the Board of Directors, the Director general and no less than 2/3 of the administrators, in Societés d'investissment/capital fixe. **Greece**: condition of residency applies to the two persons that must be named as responsible for the operation of a credit institution

Limitation on NATIONAL TREATMENT: any limitation in the treatment of foreign service suppliers which puts them in a less favorable position than their domestic counterparts	
CROSS BORDER SUPPLY (mode 1)	
EU legislation	**GATS exemption by single member countries (and subsequent removal)**
Branches of foreign non EC intermediaries are not offered the single passport	The limitation to national treatment carries over in the GATS commitments EU countries commit to ensuring that there are no restrictions which are inconsistent with GATS rules.
CONSUMPTION ABROAD (mode 2)	
EU legislation	**GATS exemption by single member countries (and subsequent removal)**
No specific broad-EU legislation on this mode of supply. Only national legislation applies	No specific nation-based restrictions EU countries commit to ensuring that there are no restrictions which are inconsistent with GATS rules.
COMMERCIAL PRESENCE (mode 3)	
EU legislation	**GATS exemption by single member countries (and subsequent removal)**
Branches established directly in a member state by a non-Community financial institution only receive an authorization to operate in that country and may be required to satisfy a number of specific prudential requirements, different from what required to domestic and EU branches	**France**: domestic-denominated issues may be lead managed only by French subsidiaries of non French-banks **Italy**: restrictions in providing investment services apply to representative offices of foreign intermediaries **Sweden**: a) residence requirements for founders of a banking company; b) operation restrictions apply to branches of a fund management company.
PRESENCE OF NATURAL PERSONS (mode 4)	
EU legislation	**GATS exemption by single member countries (and subsequent removal)**
No specific broad-EU legislation on this mode of supply. Only national legislation applies	Unbound. **Italy**: condition of residence within the EC for financial salesmen

See: elaboration from WTO service database, http://gats-info.eu.int

Figure 1: Sequencing of economic liberalization



Source: Mohieldin (1994), p.40.

Figure 2: σ-convergence of real deposit rates for selected EU countries

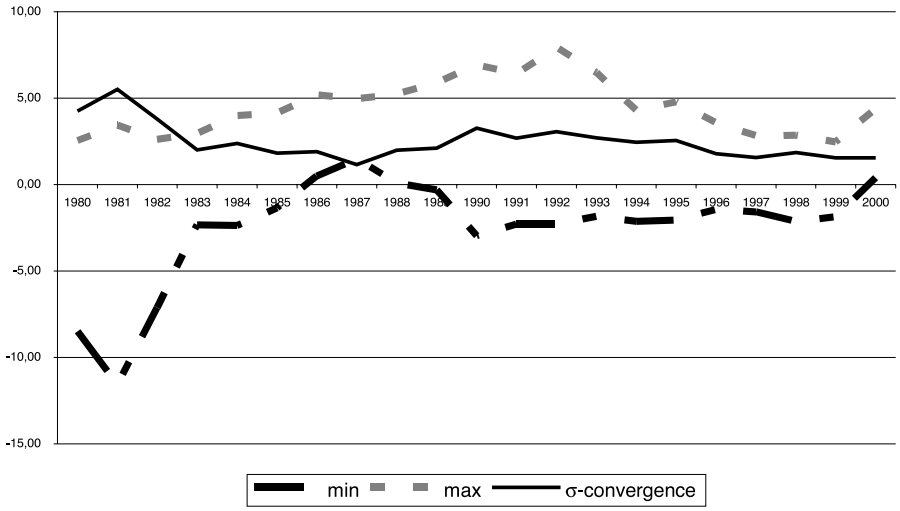
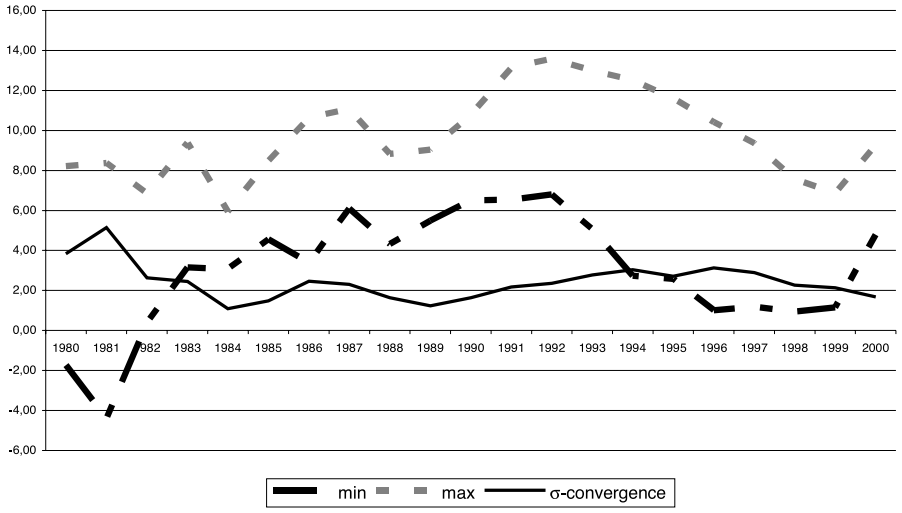


Figure 3: σ-convergence of real lending rates for selected EU countries



Source: ECB; national retail bank interest rates.

Figure 4: The first four principal components of the deposit interest rate changes (for selected EU countries, over a moving period of 70 months)

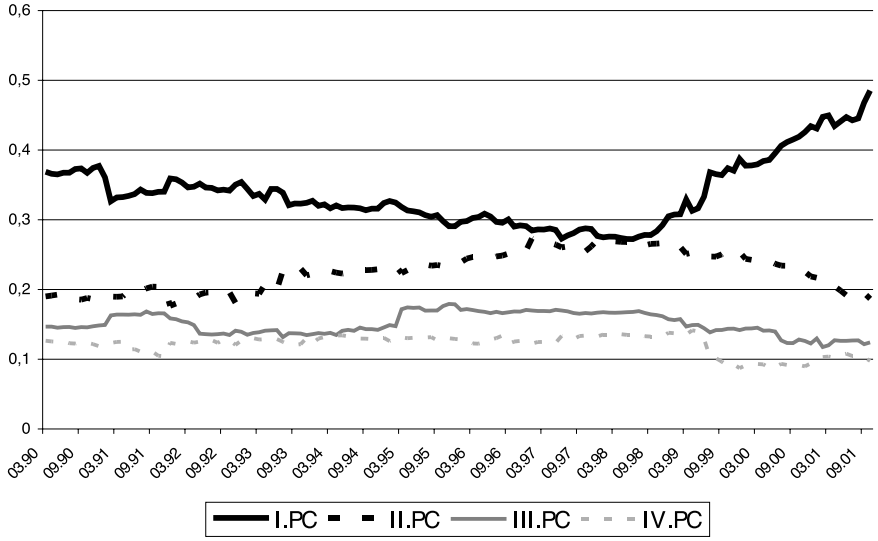
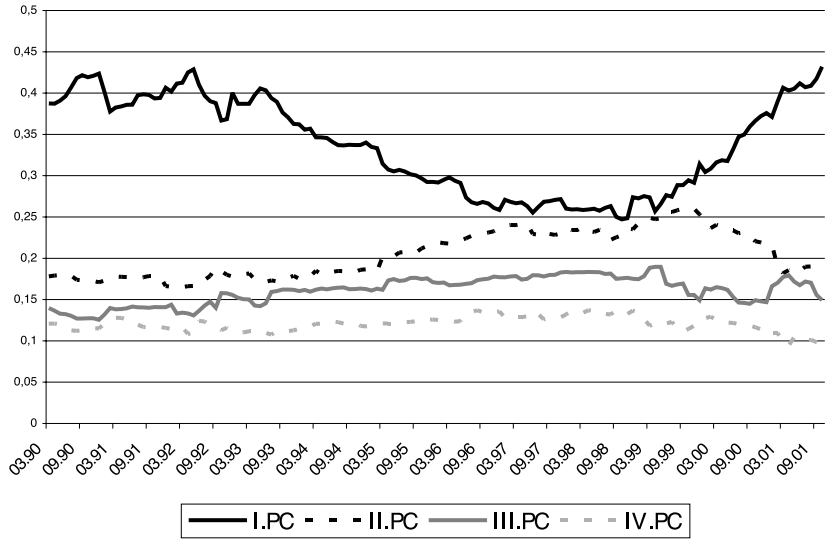


Figure 5: The first four principal components of the lending interest rate changes (for selected EU countries, over a moving period of 70 months)



Source: ECB; national retail bank interest rates

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