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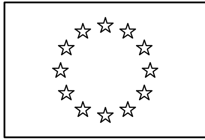


EUROPEAN COMMISSION

Brussels, 11.12.2009
SEC(2009) 1702 final

COMMISSION STAFF WORKING DOCUMENT

EUROPEAN FINANCIAL INTEGRATION REPORT 2009

TABLE OF CONTENTS

1. INTRODUCTION 4
1.1. The challenges for EU financial services policy 4
1.2. The objective of the European Financial Integration Report 5
1.3. The key issues discussed in the report 5
2. FINANCIAL INTEGRATION 7
2.1. Introduction 7
2.2. Financial markets: money, bond and equity markets 7
2.3. Financial institutions; banking and insurance 10
2.4. Financial infrastructure 13
2.5. Retail markets 14
2.6. Conclusions 17
3. EFFICIENCY AND COMPETITION 19
3.1. Recent trends in the main sectors 19
3.2. Securities post-trade market infrastructures 27
4. FINANCIAL STABILITY - RECENT DEVELOPMENTS IN THE EU 31
4.1. Introduction 31
4.2. The financial crisis – recent developments in the European Union 31
4.3. Stability consequences of concentrated cross-border exposures 35
4.4. Conclusions 38
5. EU FINANCIAL SECTOR: GLOBAL COMPETITIVENESS AND THE EXTERNAL DIMENSION 39
5.1. Introduction 39
5.2. The size, trends and relative performance of the EU financial sector 39
5.3. EU global competitiveness and global market dynamics 40
5.4. The global regulatory environment – International regulatory dialogues 44
5.5. Looking ahead – the emerging markets 44
5.6. Conclusions 45
6. CONCLUSIONS - BUILDING A STRONGER FINANCIAL SYSTEM 47
6.1. Introduction 47

6.2. Intensified financial globalisation 47

6.3. Financial integration in Europe and the reform on supervision 49

6.4. The growing importance of Offshore Financial Centres 51

6.5. The impact of hedge funds on financial stability 52

6.6. Strengthening the banking sector 53

6.7. Stability concerns related to risk management 54

6.8. Conclusions 56

ANNEX I: Policy achievements in 2009 57

ANNEX II: Statistical Indicators 64

1. Geographical counterparty breakdown in euro-area money markets (2006-09) 64

2. Convergence of 3-month money market rates in EU countries outside the euro-area (coefficient of variation in %) 64

3. Ten-year government bond yield spread vis-à-vis the German bond 65

4. Convergence in long term government bond yield (coefficient of variation; quarterly data) 65

5. Proportion of variance in local euro area equity returns explained by euro area and US shocks 66

6. Cross-sectional yield spread variance of euro area corporate bonds explained by various factors 66

7. Foreign investment in the equity and bond markets by origin, 2007 67

8. Equity and bond investments in EU by origin of investors, 2001-07 (percentages).. 68

9. Market share of "foreign controlled undertakings" and "branches/agencies of foreign undertakings" in total domestic business (Non Life). 69

10. Number and value of EU27 cross-border deals in financial services 69

11. Euro area MFI cross-border loans (in percentage of total loans) 70

12. Share of premiums written by foreign branches in 2007 70

13. Evolution of retail banking prices 2008-2009 71

14. Market share of branches and subsidiaries of credit institutions from other EU countries (% of total assets of credit institutions) 71

ABBREVIATIONS 72

REFERENCES 73

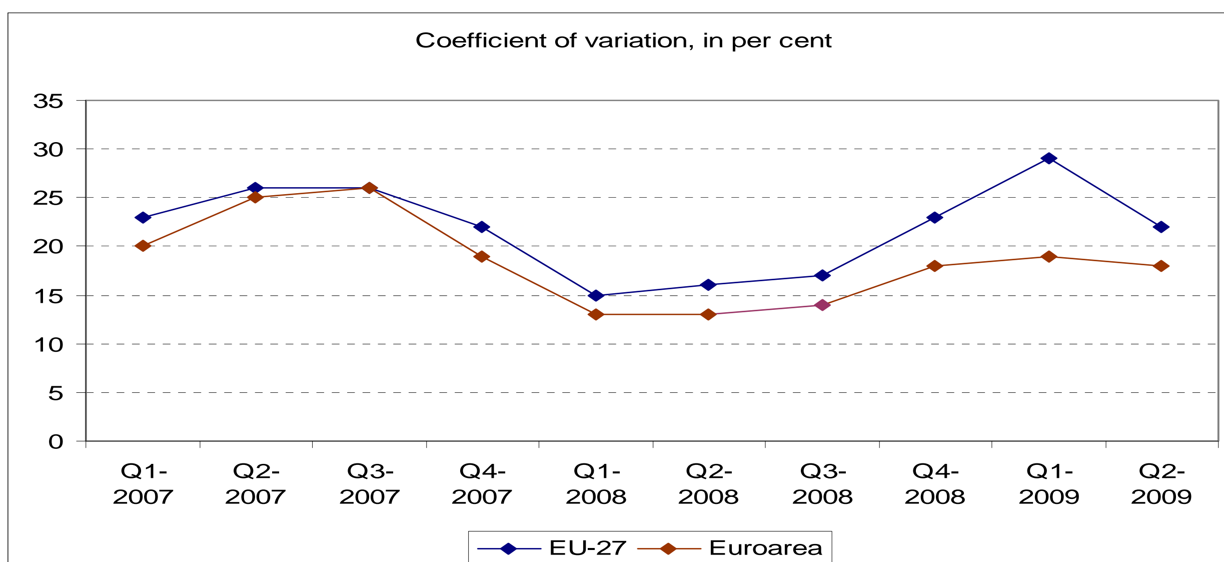
1. INTRODUCTION

1.1. The challenges for EU financial services policy

1. Since mid-2009, the severe financial crisis that has swept across global financial markets seems to be about to recede. There are, however, still considerable uncertainties about whether the recovery will be sustainable. As a result, the development of financial stability is at the centre of interest for financial services policy, as well as the impact of the crisis on the EU financial integration process.

2. There are indications that the financial integration process slowed down when the crisis deepened but that this adverse development came to an end when financial markets started to pick up in the second quarter of 2009. The dispersion of the cost of capital in the EU-27 and in the Euro-area, see chart 1.1 below, illustrates this point. As the financial crisis deepened, the differences among Member States' cost of capital widened. However, this adverse development was only temporary because in the second quarter of 2009 the rate of convergence had returned to its pre-crisis level. The chart also shows that convergence of the cost of capital in the Euroarea is higher than in the whole EU providing further evidence of the contribution of the EMU to the process of financial integration[1]. The following chapter, on the EU financial integration process, analyses the impact of the crisis further based on a broader range of indicators.

Chart 1.1: EU financial integration during the financial crisis - cost of capital dispersion



Source: European Commission, Cost of capital project[2]. Provisional data.

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[1] See for instance Lane (2008).

[2] The coefficient of variation of the cost of capital indicator is calculated starting from the simple average of the squared absolute deviation from the Euro Area reference value (EU-27 reference value). The result is then taken in square root and divided by Euro Area reference value (EU-27 reference value) itself. The cost of capital indicator is calculated as the weighted average of the costs of three sources of debt

3. Why is it so important to monitor the EU financial integration process? The realisation of a Single Market in financial services is an important means of increasing the competitiveness of the EU economy as a whole. By reducing financial barriers between Member States, productivity gains are expected, which in turn generate a more efficient and competitive EU financial sector. This is important, not only for the financial sector itself but also for all other sectors that rely on access to competitive sources of funding.

4. Increasing financial integration, with a backdrop of greater financial globalisation, has generated advantages but has also created new challenges for policy makers. The financial crisis has added a note of urgency in addressing these challenges. This situation has opened up new ways of policy cooperation, both within Europe and globally. One aim has been to promote the recovery of the economy as a whole, including the recovery of the financial sector. Another aim has been to build a stronger financial system, which is more able to resist future financial shocks.

1.2. The objective of the European Financial Integration Report

5. As a point of departure for discussions on financial services policy, there is a need for a map identifying the current state of play – on integration, efficiency, competition, stability and competitiveness - as well as recent developments in the EU financial services sector. The aim of the European Financial Integration Report (EFIR) is to provide such a map.

1.3. The key issues discussed in the report

6. The financial crisis, and the first signs of recovery, is an inevitable point of departure for the 2009 edition of EFIR. Key issues that are being addressed in this report are:

   - Can we expect EU financial integration to continue advancing once financial stability has been restored? (Chapter 2)

   - How has the financial crisis impacted on EU financial sector profitability and efficiency? What is the expected impact over the medium term? How does Europe

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financing of non-financial corporations: loans, corporate debts, and listed equity. The costs and weights of the financing sources are country specific. The costs of loans are measured via the interest rates applied by monetary financial institutions (MFI) on loans to non-financial corporations. The costs of corporate debt are measured via the yields on corporate bond indices. The implied costs of equity are inferred from prices of stock market indices using the dividend yield. Each indicator is calculated for all Member States, as well as for the Euro Area and EU-27.When averaging, the costs of each source of financing in a given country is weighted using the volume share of each source in the total liabilities of all non-financial corporations in that country. The data on liability volumes come from the financial accounts statistics published by Eurostat. When calculating the Euro Area reference value (EU-27 reference value), the costs of each source of financing for the Euro Area (EU-27) as a whole is weighted with an Euro Area (EU-27) weighted average share of each source. The Euro Area (EU-27) weighted average share of each source is calculated using the Member countries' share in the total liabilities of all non-financial corporations in the Euro Area (EU-27). The 'Cost of Capital' project is a joint DG Internal Market and Services and Joint Research Centre (JRC) project.

compare to the United States in terms of financial sector efficiency? (Chapter 3)

- Has the EU financial sector started to recover from the crisis? How have the strong cross-border ties in the EU banking sector impacted on financial stability in home and host countries respectively? (Chapter 4).

7. The European Union is also one of the major global financial players. Financial services policy needs to find the best ways to strengthen competitiveness and to fully reap the benefits of globalisation. The objective is also to strengthen the financial system so it is more able to withstand future financial shocks. Some of the key questions that EFIR also addresses are:

- What is the relative performance of the EU financial sector when looked at from a global perspective? What are the broad financial trends that are likely to shape the future of the financial sector? (Chapter 5)

- How has globalisation and EU financial integration impacted on financial stability? How has the work to build a stronger financial system progressed, at the EU and international level? (Chapter 6)

A summary of the financial services policy achievements in 2009 is provided in the annex of this report.

2. FINANCIAL INTEGRATION

2.1. Introduction

1. Financial integration is considered to be one of the key factors for making Europe more efficient and competitive and, ultimately, for contributing to sustainable economic growth. The EU's financial integration has been an ongoing process during the last decade and has made substantial progress, particularly in the wholesale financial sector. However, since the beginning of the financial crisis, this trend seems to have been broken and several symptoms, including increased segmentation, have been observed. The major objective of this chapter is to analyse recent developments, to get better information for assessing whether the reduction in the degree of financial integration should be interpreted as a temporary phenomenon, or alternatively, as the beginning of a new trend.

   The methodology used in this chapter for assessing financial integration is based on two types of indicators - price and quantity. Price-based indicators include cross-country dispersions and measure discrepancies in prices (or in an asset's returns) that are related to the geographical origin of the services (or assets). To the extent that financial products are comparable, an increase in integration should lead to a higher convergence of prices and yields across countries. This follows from the law of one price; i.e. if markets are integrated, financial assets that have identical characteristics should exhibit the same price regardless of the place where they are traded. The second category of indicators, which are quantity based, follow the principle that integration should lead users of financial services to diversify geographically and to shop beyond national boundaries. Therefore indicators such as the share of cross-border business and geographical segmentation of investors' portfolios have been examined.

2.2. Financial markets: money, bond and equity markets

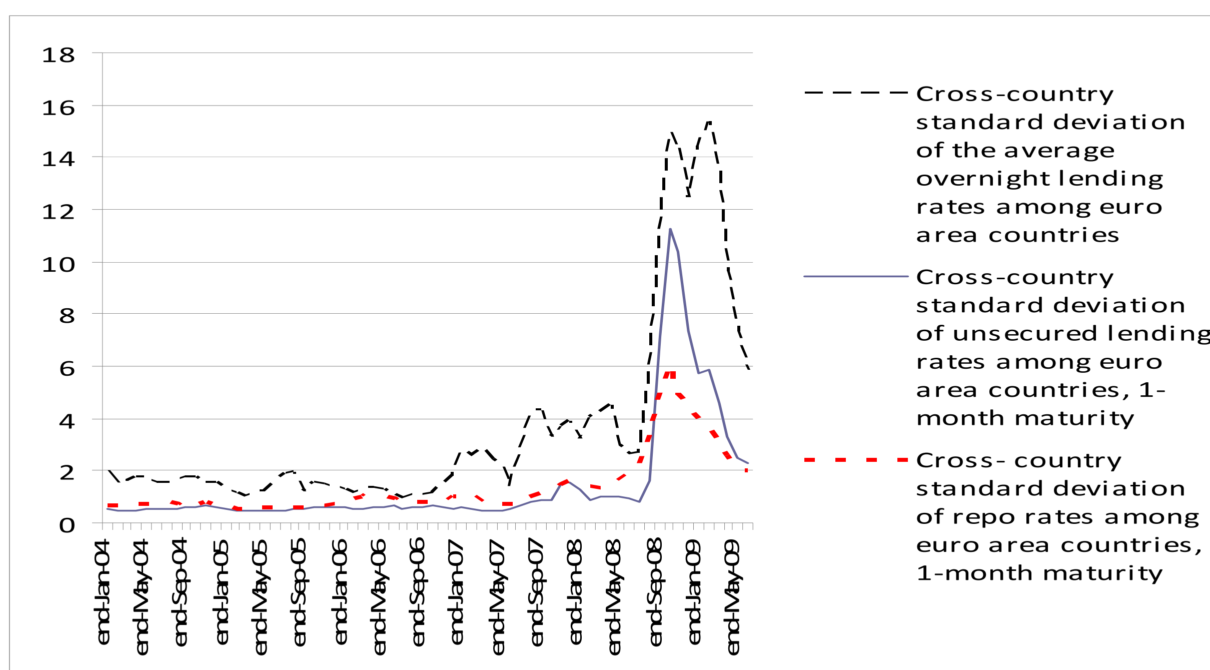
2. In the decade before the advent of the financial turmoil money and bond markets had shown a high level of integration, particularly in the euro area. Convergence of prices of European government bond markets, for instance, has been particularly significant since the advent of the single currency[3]. Corporate bond and equity markets have also shown a positive integration pattern despite the insufficient harmonization of the European post trading infrastructure. The recent financial crisis has had a huge impact particularly on money markets, on government bond markets and on equity markets as evidenced by a deterioration of several integration indicators.

3. The financial turmoil has heavily impacted on the European money market. The country dispersion of the interest rates, of both the unsecured and the secured (repo) segments, reached their peak in the third quarter of 2008 and, over the same period, the cross-country standard deviation of EURIBOR started to exceed that of the EUREPO rates (see chart 2.1 below). This seems to be the result of increased concerns about counterparty risk, particularly for cross-border transactions, which forced many banks

[3] See Weber (2009).

to reduce their unsecured lending business and focus more on the secured segment against higher grade collateral. The conclusion that the secured segment has been less influenced by the financial turbulence is supported by the trend in the geographical counterparty breakdowns. Indeed, while the share of "other euro area" counterparties for the unsecured segment decreased from 50% to 42% over the period 2007-08, it remained almost stable in the repo market (see chart 1 in the annex). Unsecured money markets of non euro area countries have been heavily affected by the market turbulence as well (see chart 2 in the annex). The recent performance of money market integration indicators - at least for the euro area - seems to be linked more to a temporary domestic entrenchment than to a stable reduced level of integration. Indeed, after peaking at the height of the market turbulence, the cross-border standard deviation of money market rates started to decrease in the last quarter of 2008[4] [5].

Chart 2.1: Cross-country standard deviation of euro-area interbank rates (basis points)



Source: ECB (2009a).
Note: The wider standard deviation of the EONIA is partly due to the different calculation method adopted in comparison to that used for the EURIBOR and EUREPO[6].

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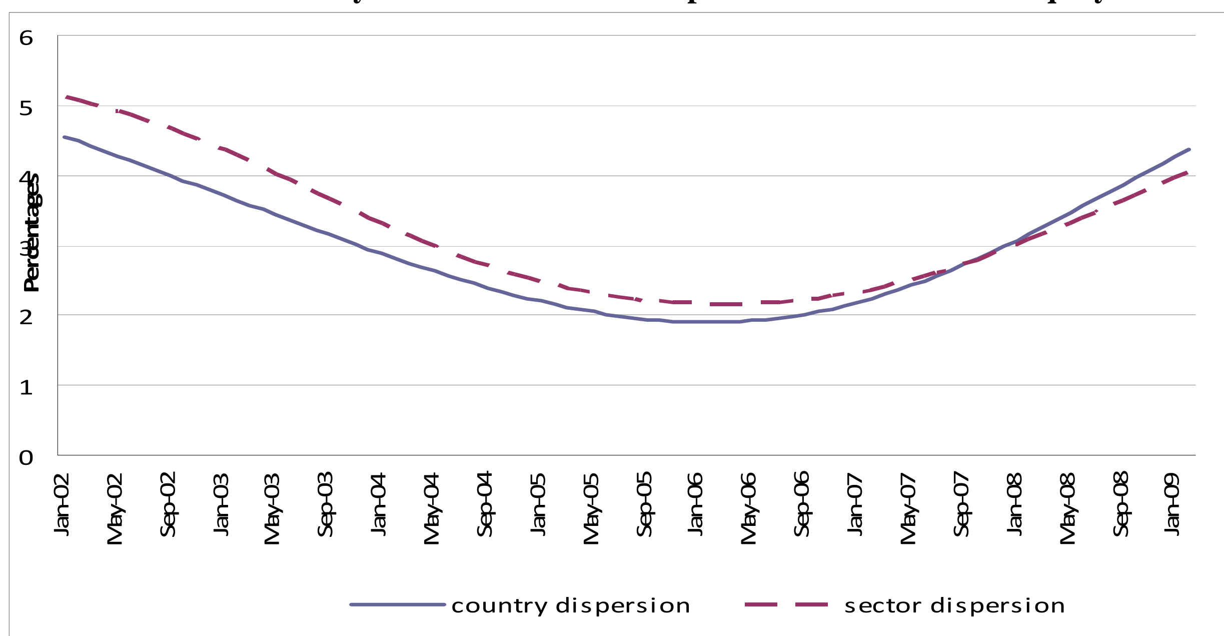
4 Moreover both for the EURIBOR and the EUREPO the (positive) difference between the cross-country dispersion and the domestic (within-country) dispersion started to decrease towards the end of 2008 after having reached record levels during the period September-November 2008. See ECB (2009b).

5 Please note also that, according to a survey conducted by ICMA, the total value of repo contracts of the 61 reporting institutions was EUR 4,868 billion in June 2009, compared to EUR 4,633 billion in December 2008 and the peak of EUR 6,775 billion reached in June 2007. See ICMA (2009).

6 Whereas the EONIA is computed as the weighted average of all overnight unsecured lending transactions undertaken by the panel banks in the interbank market during that day, the EURIBOR and EUREPO fixings reflect the average of the best cash lending rate (eliminating the highest and lowest 15% of all quotes) that each panel bank would quote to another prime bank at around 11:00 a.m. CET. Therefore, the wider cross-country standard deviation for the EONIA shown in Chart 2.1 is partly related to the fact that

4. Euro area equity markets have been hit significantly by the market turbulence. Indeed, since October 2007 the cross-country dispersion has started to rise, reversing the previous trend, and has begun to exceed the cross-sector dispersion with increasing differentials (see chart 2.2 below). The impact of the turmoil on the euro area equity market integration is confirmed by the increasing relevance of global shocks in explaining equity volatility in comparison to euro area events (see chart 5 in the annex)[7]. Moreover data on the origin of total foreign equity investments in the EU give clear evidence of the stagnation of the percentage of equity investments originated from another EU country since 2004 (see chart 8 in the annex). These developments could reflect, as said for interbank markets, an increased (and temporary) tendency by investors to focus more on domestic markets in the midst of the market turbulence due, inter alia, to cross-border information asymmetries.

Chart 2.2: Cross-country and cross-sector dispersion of euro area equity returns



Source: ECB (2009a). Note: The more integrated the market, the greater the benefits of diversification through sector based equity investment strategies rather than through country-based ones. The data shows that the advantages of a geographical diversification have become higher than those of a sector diversification since October 2007.

5. The analysis of government bond yields reveals increasing spread divergences between the German benchmark and other euro area sovereign bonds since the beginning of market turbulence (see chart 3 in the annex). This trend partly reflects the increase of country-specific risks and related credit risk premiums linked to rising concerns about fiscal soundness of certain euro area countries in the midst of the market crisis[8]. Also

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it reflects average rates traded by the panel banks during the whole day, and thus the intraday volatility of overnight market rates. See ECB (2007).

[7] Global factors are proxied by shocks in US equity markets.

[8] According to the ECB calculations the liquidity component has also played a significant role in the evolution of government yield spreads after the start of the financial turmoil, raising some concerns about a slowdown in the integration of the government bond market. In particular the elevated sovereign spreads

non euro area government bond markets have been heavily influenced by the crisis and an increasing divergence among non euro area bond yields has been recorded since 2007 (see chart 4 in the annex). Both indicators show an inversion of the trend in 2009. They suggest that to a certain extent the experienced disintegration might have been a short-term phenomenon linked to the dynamics of the financial crisis.

6. Regarding the corporate bond markets, available data show the limited impact of the crisis on its (quite advanced) degree of integration; the variance in total yield spreads explained by country effects has remained very small during the whole period examined (see chart 6 in the annex)[9]. Quantity-based indicators provide further evidence about the progress of integration in this market. Indeed, the percentage of bond investments originated by other EU countries has recorded a significant increase in 2007 reaching a level of 70%, compared to 67% in 2006 (see chart 8 in the annex). Country level data for 2007 confirms that the EU 'regional' bias is particularly significant for EU-12 countries where, in many cases, EU bond investors account for more than 90% of total bond investments (see chart 7 in the annex).

2.3. Financial institutions; banking and insurance

7. In 2008 the number and the value of cross-border mergers and acquisitions (M&As) declined substantially, with the number of deals falling by 11% and the value of completed deals by 37.5% (see chart 10 in the annex). Domestic M&As consistently outperformed cross-border deals and were influenced, as far as the banking sector is concerned, by injection of government capital into financial institutions hit by the financial crisis (see chart 2.3 below). Deals involving EU governments accounted for 70% of total value of EU financial services M&As in 2008. While the banking sector kept its traditional leading role, the value of transactions involving insurers decreased sharply despite some significant deals registered in EU-12 Countries. Notwithstanding a significant increase of the number of the branches of EU/EEA Countries in 2007 (+ 12% in comparison to the 2006 data), the share of premiums written by foreign branches in the EU remained low, i.e. around 3.4% on average of total activity in the country (see chart 12 in the annex).

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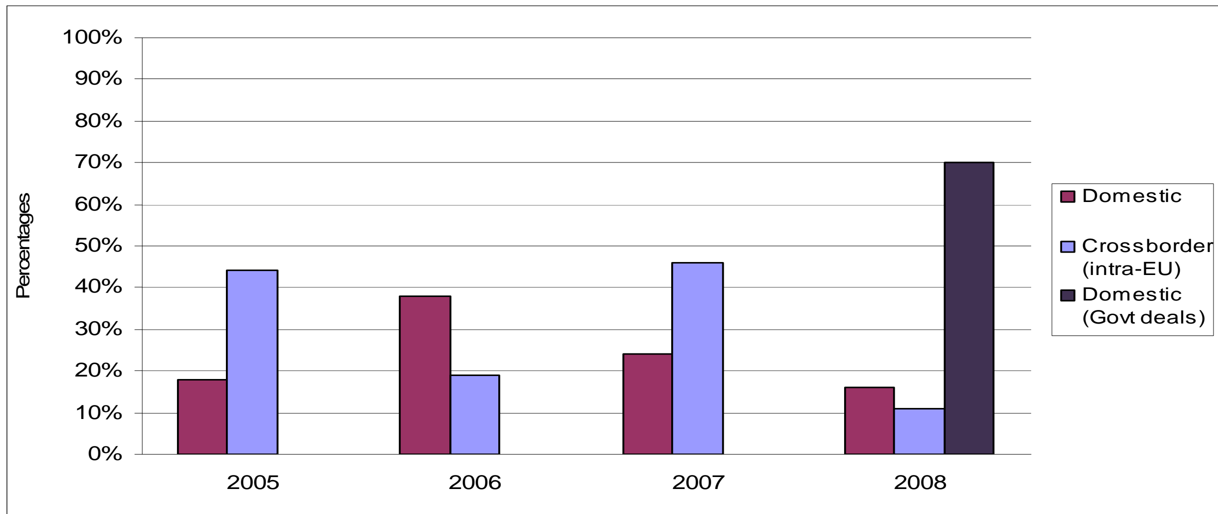
partly reflected changes in liquidity premia rather than relative changes in the perceived quality of the EU countries (from 'flight-to-quality' to 'flight-to-liquidity') See ECB (2009b) and ECB (2009c). According to Abad, Chulia and Gomez-Puig, who examine the EU government bond market between January 1999 and June 2008, 'EMU countries are only partially integrated with the German market since their markets are still segmented and present differences in their *market liquidity* or default risk'; See Abad, Chulia and Gomez-Puig (2009).

[9] Other factors, such as rating, remained relevant and are related to the overall conditions of European corporations' market-based debt financing.

Chart 2.3: European Financial Services M&A. Domestic versus cross border.



Source: PWC (2006-2009), Commission services calculations. Data refers to the top 20 european FS deals announced for each year. Note: total of domestic M&As (including government deals) was 86%.

8. Direct government involvement significantly contributed to the M&A volume in the banking sector in 2008[10] with some significant interventions like the co-ordinated bailout of Fortis by the three Benelux Countries. Other drivers of the 2008 deals were disinvestment of non-core core activities and the consolidation of the domestic position[11]. The limited cross-border activity has been characterized by 'opportunistic' acquisitions of weakened institutions in foreign markets (e.g. BNP Paribas agreed to acquire Belgian and Luxembourg businesses of Fortis from the Belgian and Luxembourg Governments). The increasing focus on domestic market by EU banks is confirmed by the decline in the market share of other EU branches and subsidiaries in 2008 (18.8% compared to 20.5% in 2007)[12](see chart 14 in annex). Subsidiaries remain the preferred form of establishment to access foreign markets, particularly in EU-12 where EU subsidiaries accounted for around 59% of total assets in 2008.

9. The flow of cross-border interbank loans has been marked by a substantial decline since the intensification of the financial turbulence in 2008, particularly in the segment of the transactions between euro-area countries and the rest of the EU (see chart 11 in annex). The retail segment remains fragmented as witnessed by the small proportion of cross-border loans to non-MFI. Nevertheless the retail cross-border lending to other euro area residents has increased even during the turmoil (from 4.5% in June 2007 to 5.4% in March 2009, see also chart 11 in the annex). More in general it can be

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[10] Of the top 20 European deals, 10 involved government action accounting for more than half the value of all transactions. See PCW (2006-2009).

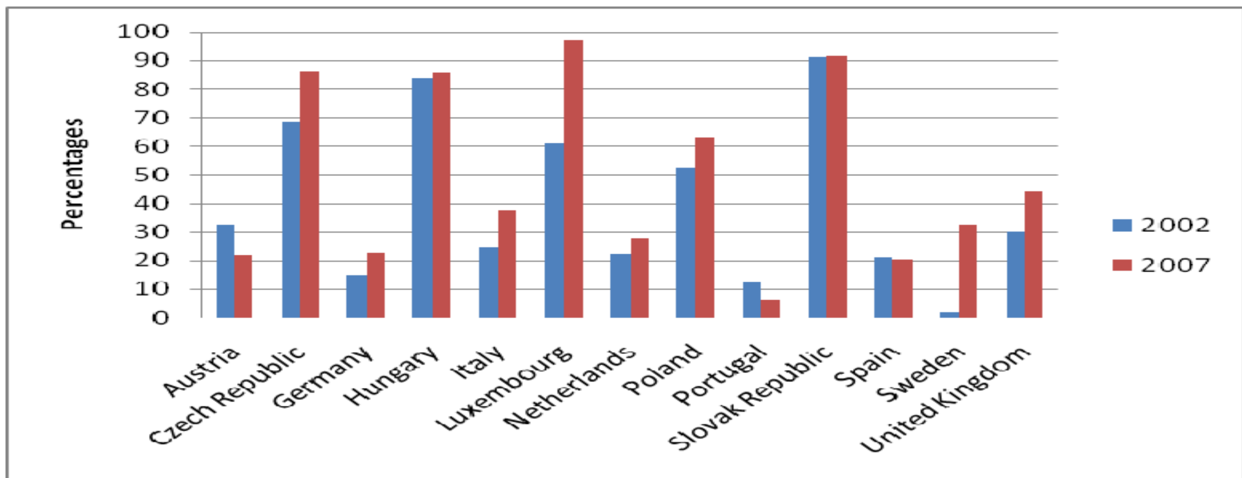
[11] Another factor to be taken into account is the shortcomings in the valuation of illiquid financial instruments and in the transparency of risk exposures that have created uncertainty about the real level of losses and write-downs by banks.

[12] The figures referring to all foreign branches and subsidiaries, including those of third countries, were 29.1% for 2007 and 26.4% for 2008. Source: ECB (2009).

concluded that the financial crisis has pushed EU banks to move their geographic focus towards domestic markets, partly reverting the pre-crisis pattern[13].

10. After the strong growth in the total deal value during 2007, M&A activity in the insurance sector has been heavily affected in 2008 by the financial crisis which restricted the capacity of many potential acquirers in continuing the process of consolidation and geographical diversification. The slowdown has been less marked in the EU-12 area where the largest deals were driven by the disinvestment of captive insurance businesses by banks to ease capital constraints (Erste Group Bank/Vienna Insurance Group; OTP Bank/Groupama). Available data confirm that access to foreign markets has occurred over the years mainly through subsidiaries, with several EU-12 markets dominated by foreign insurance companies[14]. The market share of foreign companies has increased in the period 2002-2007 throughout the entire EU, with a few exceptions (see chart 2.4 below and chart 9 in annex)[15]. The bulk of this positive performance has to be attributed to the foreign controlled undertakings which benefit from substantial competitive advantages over the branching and the direct cross-border provision. As a result, the share of premiums written by foreign branches has remained fairly limited and stable over recent years (see chart 12 in the annex).

Chart 2.4: Market share of "foreign controlled undertakings" and "branches/agencies of foreign undertakings" in total domestic business (Life).



Source OECD (2009). Data on NL refer to years 2003 and 2007; data on SK refer to years 2002 and 2006; and data on SE refer to years 2001 and 2007.

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[13] Among the possible factors the following can be mentioned: involvement of national governments (which usually tend to favour domestic consolidation and the availability of finance to home markets); uncertainty on current and future developments of foreign markets, better knowledge of home markets, long term relationships with investors and depositors, etc. See DB Research (2009a).

[14] According to the Boston Consulting Group in 2006 the major EU-15 Groups (Allianz, Generali, and Vienna Insurance Group) active in the EU-12 markets accounted for around 22% of total premium written. See BCG (2008).

[15] Available OECD data doesn't make distinction between the market share of EU companies and that of non-EU companies. However, anecdotal evidence allows attributing the biggest part of the increase in the period examined to other EU countries. This is particularly true for EU-12 Countries where EU-15 companies have historically played a leading role among non domestic providers (see footnote 9 above).

2.4. Financial infrastructure

11. During 2008 and the first half of 2009, integration in the post-trade sector has been boosted as a result of (i) developments in the trading sector following the entry into force of MiFID[16] in 2007 and (ii) the effects of the Code of Conduct on clearing and settlement[17]. Since the entry into force of MiFID in November 2007, the provision of trading services has become increasingly contestable[18]. New trading venues in the form of multilateral trading facilities (MTFs) have entered the market and during the course of 2008 they captured significant market shares from incumbent trading venues in the form of regulated markets[19]. The appearance of new actors has boosted integration not only in the trading arena but also in the post-trading area with MTFs pushing for increased competition and interoperability among CCPs (Central Clearing Counterparties). Links among incumbent operators have also progressed. In December 2008, competitive clearing for trades done on the London Stock Exchange became operational, with LCH.Clearnet Ltd and SIS x-clear becoming interoperable. Since then, further interoperability agreements have been concluded (e.g. Eurex Clearing and SIS x-clear).

12. Turning to settlement services, further cross-border consolidation, increasing links between central securities depositories (CSDs) and TARGET2-Securities (T2S) have continued to reshape the market structure and enhance cross-border integration. As regards consolidation, in December 2008 the Euroclear Group expanded by adding[20]the Swedish and Finnish CSDs to those of France, Netherlands, Belgium, United Kingdom, Ireland and Portugal. Regarding links, the 'Link Up Markets'[21] initiative, launched on 30 March 2009, is expected to improve efficiency and reduce costs of post-trade processing of cross-border transactions. Concerning T2S, the project achieved a major milestone on 16 July 2009 with the signing of the T2S Memorandum of Understanding between the Eurosystem and 27 CSDs located in 25 European

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16 Directive 2004/39/EC 'Markets in Financial Instruments Directive'.

17 The Code of Conduct on clearing and settlement, signed on 7.11.2006, is a self –regulatory initiative promoted by the European Commission to boost interoperability between different trading and post-trading platform providers. It aims at enhancing price transparency and increase competition in the post-trading sector.

18 MiFID allows free competition between regulated markets (i.e. existing stock exchanges) and other alternative trading venues, offering their services in several cases on a pan-European basis.

19 Chi-X, Turquoise, BATS Europe, Nasdaq OMX Europe, and Burgundy reached in July 2009 an aggregated market share of around 8.15% of the total volume of all traded European equities. See Thomson Reuters (2009).

20 On 31.10.2008 Euroclear acquired NCSD (Nordic Central Securities Depository) and its subsidiaries, APK and VPC, the Finnish and Swedish CSDs.

21 Link Up Markets is the initiative launched by 8 European CSD to establish a common infrastructure allowing links to be easily implemented between CSD markets and introducing efficient cross-border processing capabilities. By connecting to the common infrastructure, each participating CSD has access to the services of the other participating CSD markets across all available asset classes. Currently six links are active (Clearstream Banking Frankfurt, Hellenic Exchanges, IBERCLEAR, Oesterreichische Kontrollbank, SIX SIS, VP).

countries (including two from non-EU countries, Iceland and Switzerland) which committed to settle euro-denominated securities in T2S[22].

13. The harmonization of the wholesale payments sector, through TARGET2, has introduced in the EU a truly uniform wholesale payment infrastructure by means of a single technical platform. This allows firms to offer harmonized services at EU level with a single price structure applicable to both domestic and cross-border transactions. Moreover TARGET 2 enables banks, particularly those active in several countries, to further consolidate their internal processes, such as treasury and back office functions, and to increase the efficiency of their euro liquidity management. In 2008 TARGET 2 accounted for 90% in value terms and 59% in volume terms of all payments flowing through all large payment systems operating in euro[23]. The impact of the turbulence on TARGET2 settlement activities was relatively limited and resulted in a slowdown of the volume growth in 2008 (only 1% in comparison to 2007).

14. The 'go-live' of the SEPA credit transfer (SCT) in January 2008 marked the beginning of a new chapter in European retail payment history towards less fragmentation and higher harmonization of instruments and services available to customers. Although SCT migration is proceeding slowly and certain market actors are delaying migration, the use of the SEPA credit transfer has continued to increase steadily in 2008-09, reaching a share in total credit transfer transactions of 4.4% in July 2009[24]. As a result, SEPA is contributing to lower prices for payments in the euro area (see paragraph 2.5 below). The adoption rate for the SCT is expected to accelerate in the near future, particularly since public authorities in a number of countries have planned to start using this scheme by the end of 2009 or during 2010. Moreover substantial progress can be reported as regards the realization of the SEPA Direct Debit[25] whose launch in November 2009 has provided a new impetus to SCT migration.

2.5. Retail markets

15. A truly single internal market for retail financial services has still not been achieved. Financial services providers and consumers continue to be primarily focused on national domestic markets which show significant differences in terms of prices, range of products and distribution channels. The slow pace of retail market integration partly stems from existing "natural" barriers, such as structural differences in languages and customers' habits, which have proved to be difficult to overcome and, certainly, cannot be addressed in the short-medium term. The remarkable differences between the

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22 In addition to settlement in euro, the CSDs of Denmark, Lithuania and Sweden also signed up for settlement in T2S of securities denominated in their domestic currency.

23 See ECB (2009b).

24 It was 1.9 % in January of the same year.

25 First, the further clarification on multilateral interchange fees (MIFs) was published by the European Commission and the ECB in March, providing the market with a clear scenario for the medium as well as the long term. Second, a reviewed regulation on cross-border payments in euro was adopted by the European Parliament and the EU Council ensuring reachability for direct debit transactions as of 1 November 2010. Third, the European Payments Council Plenary's final adoption of the SDD rulebooks made it possible for banks to sign up for participation in the SDD schemes and to start delivering euro direct debit services as of 2 November 2009.

wholesale markets and the retail markets in terms of impact of these ‘natural’ impediments might raise doubts on the use of the identical definition of integration for both segments[26]. However, even though “natural” barriers will continue to exist in the near future, it is recognized that initiatives to enhance, for instance, the financial literacy of consumers can help in lowering even 'natural' barriers and empower consumers to shop around and reap the benefits of the single market[27].

16. Given the limited progress recorded in the previous years, it is not surprising to observe that the recent financial crisis has had only a limited impact on the degree of integration of EU retail markets, except for its effect on the cross-border consolidation of the EU financial industry. Indeed, as we have already observed, in 2008 cross-border financial services M&As experienced a sharp decline in favour of domestic consolidation and, more in general, internationalization of EU banks has started to slow down (see par 2.3 above). However, despite the negative consequences of the turmoil, some positive signals in terms of increasing financial integration and reduced prices for EU consumers can be detected. One example comes from the recent initiatives to reduce fragmentation in payment infrastructures, particularly in the euro area.

17. The crisis had a limited impact on the degree of integration of retail banking markets, in contrast to the wholesale segment where the impact of the crisis was far more pronounced. Only the consumer credit dispersion has increased significantly over the entire duration of financial turmoil[28]. Interest rates on loans to non financial corporations and those for house purchases started to diverge in the second half of 2008 (see chart 2.5 below). Nevertheless, over the long and medium period a certain degree of convergence can be observed with reference to all categories of interest rates[29]. In the medium/long term the lowest level of heterogeneity in the euro area can be observed for large loans to non financial corporations[30] while the relatively low dispersion of housing loans interest rates needs to be interpreted with cautions in the light of product and regulatory differences among countries. More in general, as underlined in the previous edition, retail interest rate comparability is affected by differences among countries regarding the situation of the real economy, the structure of financial markets, and the regulatory framework.

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26 Other possible definitions of integration could be used for the retail markets like 'a situation in which financial services providers and users see the whole of the EU as their domestic market even without the positive effects' or, alternatively, 'a situation in which all regulatory impediments have been removed'. See DB research (2009b).

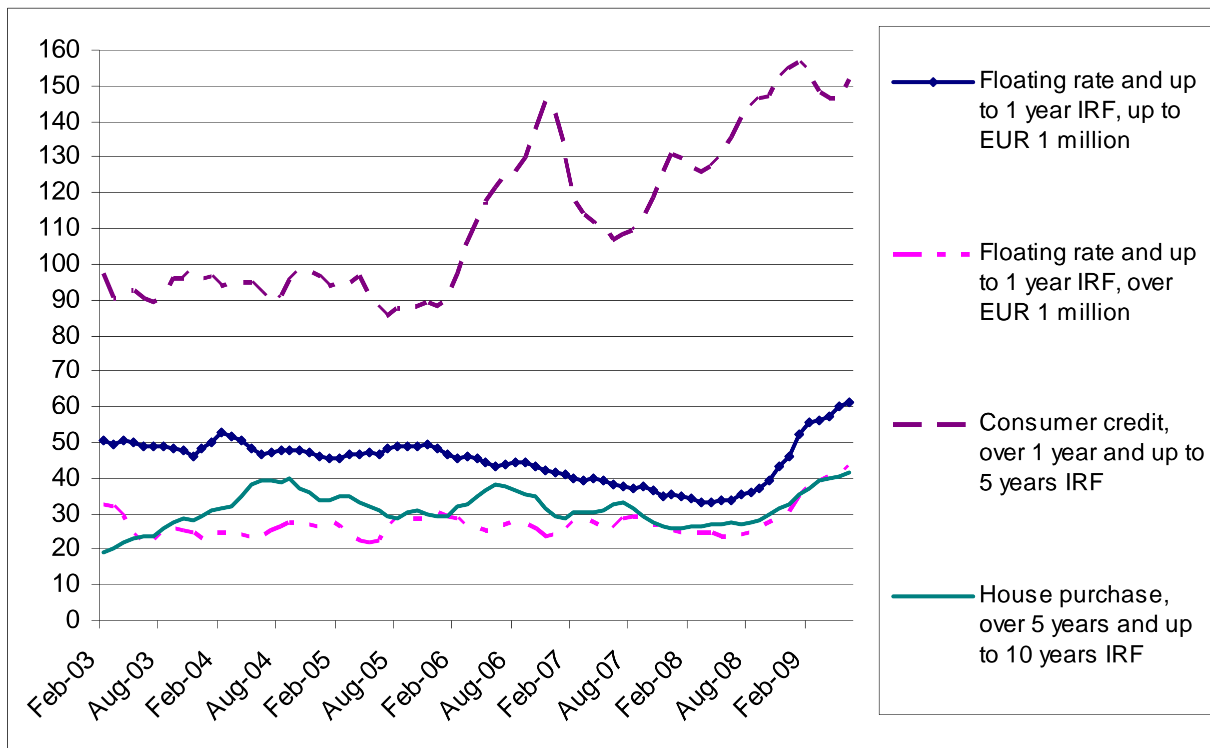
27 In this domain the Commission has undertaken various initiatives as follow-up to its Communication on Financial Education of 2007. For more details see Annex I

28 It has to be underlined that this indicator has shown a high volatility since mid-2005.

29 The analysis of the so-called "beta convergence", which measures the speed with which different rates converge to a specific benchmark (i.e. the lowest country interest rate level for each instrument), clearly illustrates that the process of convergence of retail interest rates has been on going during the whole period under examination. For additional details see ECB (2009b).

30 This can be explained by the greater market power and better information, also in the cross-border context, of large corporations compared to households and SMEs. See Affinito and Farabullini (2009).

Chart 2.5: Standard deviation of euro area retail interest rates (basis points)

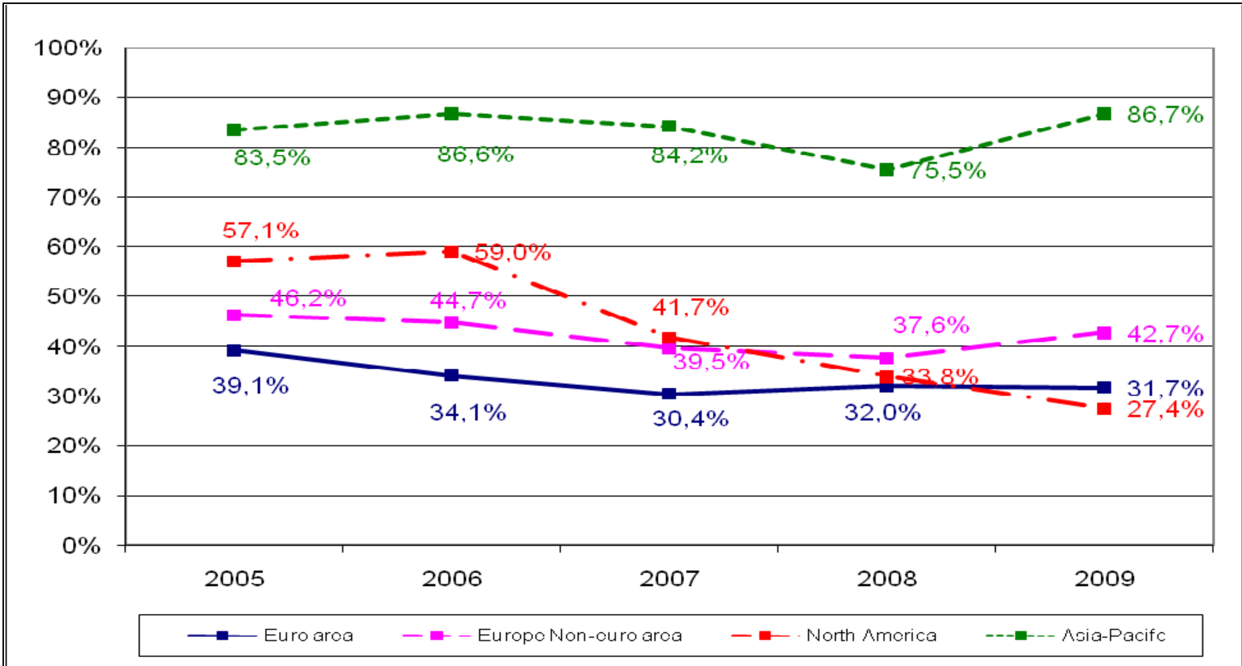


Source: ECB (2009a).

18. Fee structure and product composition of retail banking services have remained highly diversified throughout the whole EU. Little progress has been observed in the convergence of prices amongst euro-area Member States while price discrepancy in non-euro area Member States has increased significantly (see chart 2.6 below). In comparison to other regions, Euro-area Member States scored the highest decrease in retail banking prices over 2008-2009 (-6.1%) due particularly to the reduction in the price of payment and cash utilisation services (particularly in Ireland and Spain) (see chart 13 in the annex). As far as payments are concerned the downward trend has been driven by the impact of SEPA on the degree of competition and standardization of payment means which accounted for 50% of sources of fees for core banking services in the Region[31]. Outside the euro-area prices of retail banking products showed an opposite trend (+1.6%).

[31] See Capgemini (2009). According to the Authors SEPA has led to a decrease of payment products from euro 60,9 to euro 57.

Chart 2.6: Regional price discrepancy for local active users of banking services



Source: Capgemini (2009).

Note: the data refer to the price discrepancy around the regions' average price for day-to-day banking services (account management, cash utilisation, exceptions handling, payments) in the period 2005-2009. Price discrepancy is calculated as the standard deviation of a region's bank prices divided by the region's average price. A minor discrepancy means that a region's prices are close to the average and relatively homogeneous, while a larger discrepancy indicates that price levels vary greatly among banks in a region.

2.6. Conclusions

19. The impact of the financial crisis on the process of financial integration has not been homogenous. Those segments that had experienced the highest degree of integration over the last decade have been heavily hit by the crisis, and in many cases have seen a sharp reversal in the positive trend over the period 2007-2008. This is especially the case for unsecured money markets, government bond markets and equity markets. There is not enough evidence at this stage to assess whether these recent trends can be interpreted as a symptom of increasing long-term market segmentation or if they are linked to a temporary entrenchment by market actors within domestic borders. This latter hypothesis seems to be confirmed by the reversal of the trend of some indicators (i.e. in the interbank lending market and in the government bond markets) in the latter part of 2008 and beginning of 2009. However, further information and time are needed to clearly decode these developments.

20. The financial crisis has pushed EU banks to shift their focus to domestic issues and markets and engage less in internationalisation. Government interventions - in the form of rescue acquisitions - significantly re-shaped the process of consolidation, boosting domestic M&As and contributing to a reduction in the transnational footprint of EU banks. A sharp decrease in cross-border consolidation, with a few exceptions (the EU-12 Countries), has also been observed in the insurance sector. The cross-border flow of

premiums remains low while, particularly in the EU-12, an increasing market share is held by subsidiaries of foreign companies. While domestic markets are likely to remain the primary focus of EU companies, the cross-border expansion might resume in the longer term[32].

21. Some relevant progress can be reported in the area of clearing and settlement services. Enhanced competition and interoperability amongst CCPs has been boosted by the impact of the MIFID and the Code of Conduct. Also, within the area of settlement services, integration has advanced thanks, inter alia, to increasing links amongst CSDs and cross-border consolidation. Further achievements can be expected in the future as a result of various initiatives, including the implementation of T2S[33]. Additional progress in this area will be critical to help the EU bond and equity markets to resume their trend towards integration. As far as payments are concerned the advent of SEPA and its increasing implementation have marked an important step towards enhanced harmonization of retail instruments and services across the EU.

22. Retail financial markets have been less affected by the financial crisis even though the degree of integration remains fairly limited, particularly for consumers and SMEs. However some positive signals of increasing integration can be found in the moderate improvement in the convergence of retail interest rates over the long period and in the price reduction in the area of payment services. As regards the latter, further gains in terms of lower prices for EU consumers can be expected as a result of the continuing progress in the implementation of the SEPA initiative.

[32] See DB research (2009).

[33] The go-live of T2S is foreseen on June 2013.

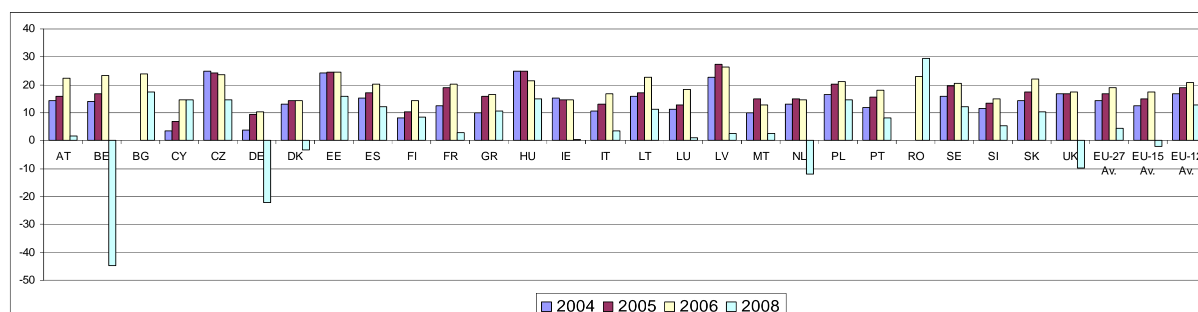
3. EFFICIENCY AND COMPETITION

3.1. Recent trends in the main sectors

1. The global financial crisis has had a major impact on the performance of the EU financial sector. For the first time in years, business activity in the European financial services sector shrank. The size of the EU wholesale financial sector fell by 0.3% in 2008, with a further contraction of 6.2% forecast for 2009[34]. Moreover, it was shrinking at a faster pace than the overall economic activity. The real GDP in the EU-27 grew by 0.8% in 2008 while it was forecasted to fall by 4% in 2009[35]. The retail financial services business was hampered by high risk aversion of financial institutions and their clients, worsening financial standing of households and enterprises and a range of other negative consequences of the economic slowdown.

2. The EU banking sector's profitability was severely hit by the recent crisis. Asset write-downs and loss provisioning in banks (see also chart 4.4) combined with lower revenues resulted in very low profits for the sector. The average ROE (return on equity) in the EU banking sector fell to 4.5%[36] in 2008 from 19% in 2006. During the same period, the new Member States performed better than the EU average. The ROE for the EU-12 at 13% exceeded the ROE for the EU-15 which was -2%. The latter was dragged down by several countries that experienced high losses in the sector (BE, DE, NL and UK, see Chart 3.1).

Chart 3.1: Banking: return on equity (%)



Note: data for 2007 are not published.
Source: ECB (2005-2009).

3. Similar differences can be observed in efficiency dynamics. Higher costs and lower revenues were behind the general worsening of the cost-to-income ratios[37] (CTI) for EU banks. In 2008, after declines recorded in the preceding years, the average CTI increased to 59.8% in the EU-27 and 66% in the EU-15. In the EU-12, however, the CTI showed continued improvement in 2008 reaching 49.5% (see Chart 3.2).

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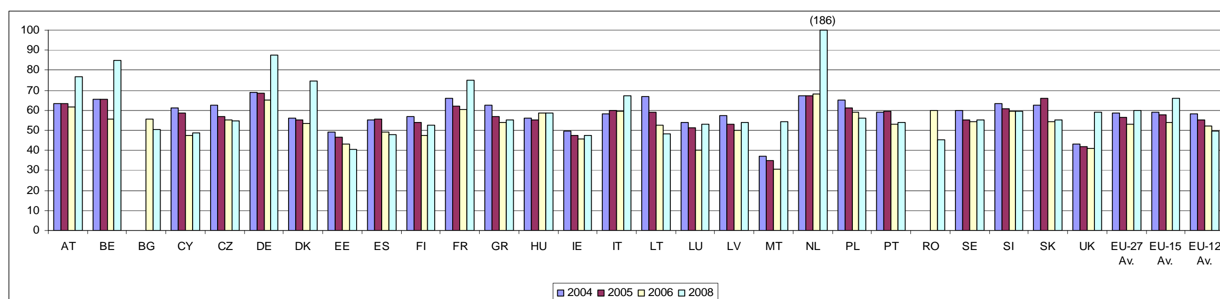
[34] Measured by Gross Value Added (GVA). Source: London Economics (2009).
[35] Commission European Economic Forecast – Autumn 2009.
[36] Calculated as simple average of country values.
[37] Sum of non-interest expenses as a percentage of the aggregate sum of net interest revenues and non-interest revenues.

4. Over the medium term, the pressure linked with difficult economic conditions is expected to provide incentives to banks to reduce their expenses, for example by improving cost control (e.g. stopping non-core business activities), exploiting restructuring synergies (M&As) or investing more in IT technologies (e.g increasing IT intensity of branch operations). Banks will need to adapt their cost basis to the forecasted slow economic recovery (meaning also slow revenue growth) in next few years. It is expected that this could lead to further efficiency improvements in the EU banking sector.

Chart 3.2: Banking: cost to income ratio (%)

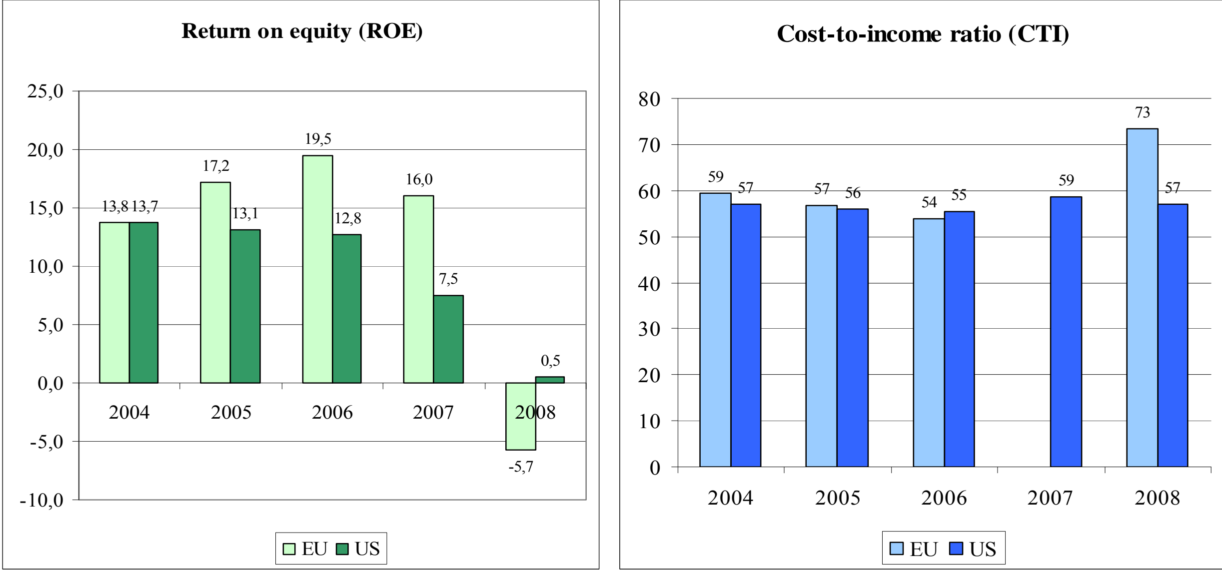


Note: data for 2007 are not published.
Source: ECB (2005-2009).

5. Chart 3.3 compares the performance of large banks in the EU and the US in terms of profitability and efficiency. Although the European banks tended to be more profitable in recent years, in 2008 they experienced higher losses than their American counterparts, resulting in a negative average ROE. This may be linked with high exposure of Europe's largest banks to US toxic assets. As for efficiency, the CTI indicator shows that efficiency improvements occurred for the EU banks up until 2006. But in the crisis their operational performance worsened quite dramatically when compared against the US[38]. In addition to the factors already mentioned, this may be the effect of lower flexibility of European banks in reducing their cost basis (e.g. by laying off staff).

[38] To a certain extent differences may result from imperfect methodology, i.e. the difference between the numbers of compared banks.

Chart 3.3: ROE and CTI of large banks in the EU and the US[39] (in %)



Source: ECB (2005-2009); Federal Deposit Insurance Corporation (2005-2009).

6. The crisis has also had an influence on the competitiveness of the EU banking sector. Faced with insolvency risk and other balance sheet problems, many EU governments decided to offer financial support to banks in their respective jurisdictions, including partial or full state involvement in the restructuring process. The government stakes in banks have raised some concerns on cross-border competition and the existence of a true level playing field in the Internal Market. However, basic indicators of competition, such as net interest margins[40], did not show significant movements in 2008, neither in the countries which experienced the biggest problems in their banking sector nor in the EU overall (Chart 3.4). This situation will need to be monitored over the next few years.

7. The EU's competition policy played a central role in finding solutions to the financial crisis. In compliance with State aid rules, the Commission approved and coordinated Member States' extraordinary measures taken to safeguard financial stability, such as the guarantee umbrellas, recapitalisation measures and *ad hoc* rescue and restructuring measures in favour of individual financial institutions. It set out the conditions for granting these special state aids and monitored if these conditions and the relevant EC Treaty rules were being observed. The Commission oversight was aimed at maintaining the level playing field by limiting as much as possible competitive distortions, fighting protectionism and preserving the functioning of the Single Market.

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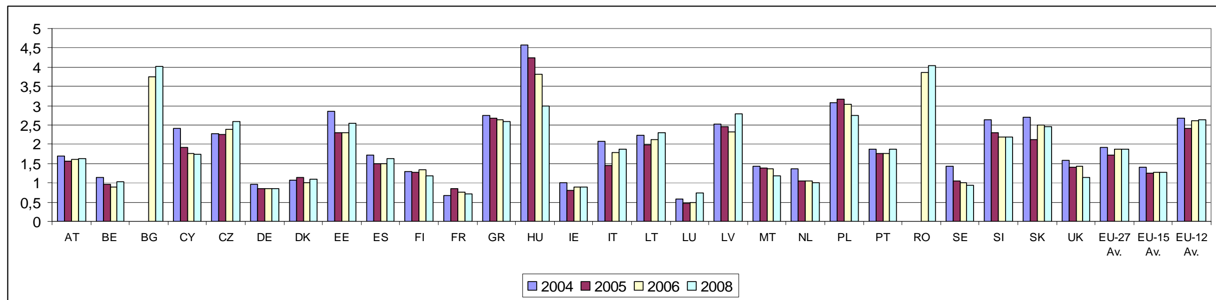
[39] 'Large domestic banks' in the EU (as defined by ECB Banking Supervision Committee): in 2008, banks with total assets above € 171 million. The 114 largest banks in the US. For the US, the CTI equivalent is the 'efficiency ratio'.

[40] Net interest margin (NIM) is the difference between interest income and interest expense as a percentage of total assets. A banks' interest margin is one of the most important indicators of the cost of financial intermediation. The NIM can be used as an indicator for the actual degree of competitive condition in a market, but can also reflect other factors, such as market power and risk appetite.

Chart 3.4: Banking: net interest margin (% of total assets)

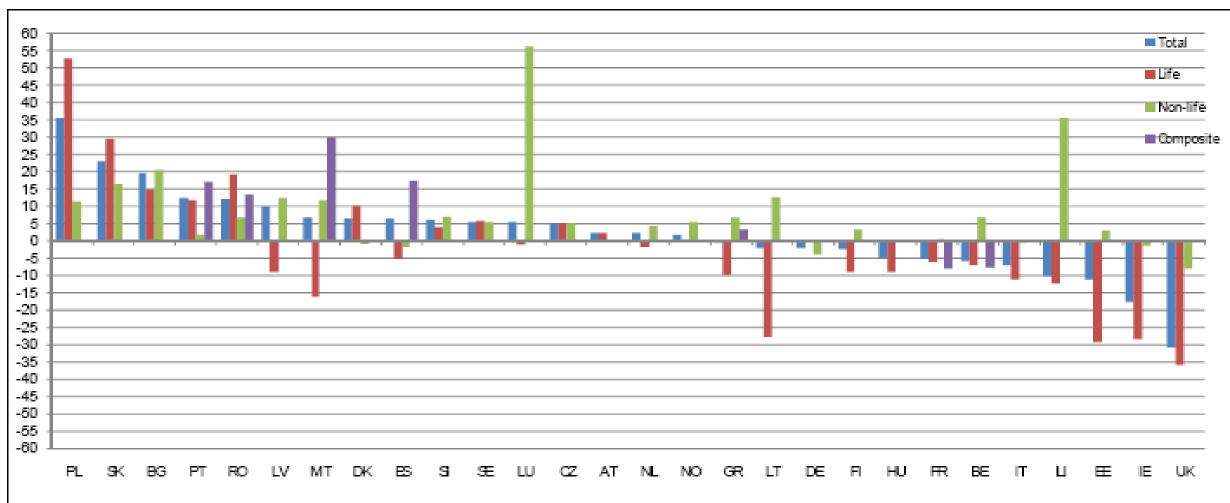


Note: data for 2007 is not published.
Source: ECB (2005-2009).

8. The 2008 developments show a mixed picture of the EU insurance sector. According to CEIOPS data, in fifteen reporting Member States the total premium grew whereas it fell in eleven. The annual change rates varied from +35% in Poland to -30% in the UK. Slovakia, Bulgaria, Portugal and Romania also experienced high growth, while Ireland and Estonia neighboured the UK on the other end of the scale (see Chart 3.5). On average, the total insurance premiums in the EU grew over 3%, compared to just under 2% in 2007.

9. As a result of plummeting stock indexes and increased risk aversion of retail customers, the life sector experienced a negative impact (-1.3% premium decline) during the crisis while the non-life sector experienced a growth of 8%[41]. The contraction of the life sector featured particularly the UK, Ireland and the Baltic states. Until the last quarter of 2008, the life insurance business in Europe also experienced intensive competition from banking products linked with high interest rates both in the Euro area and beyond.

Chart 3.5: Insurance: gross written premiums growth in 2008 (in %)



Source: CEIOPS (2009).

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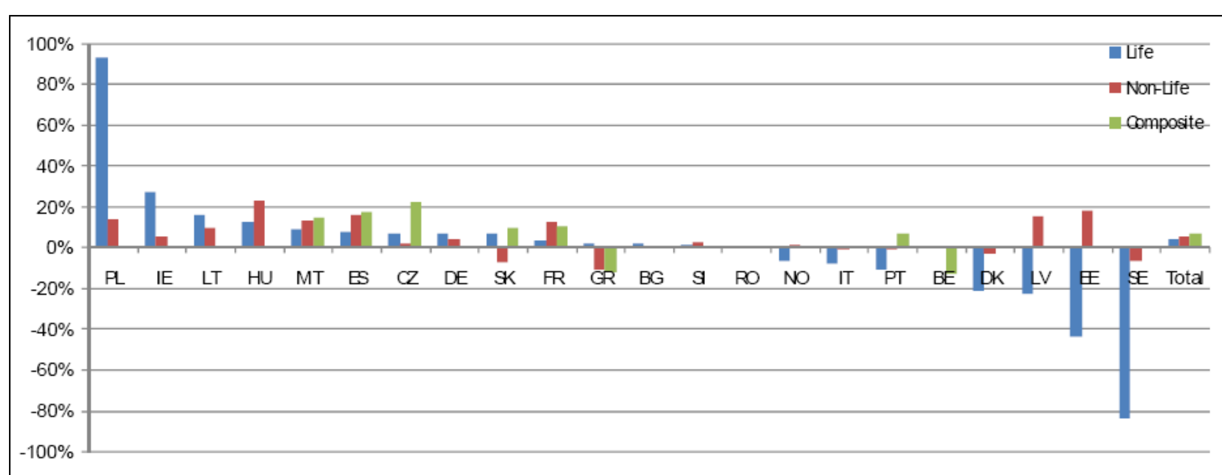
41 CEIOPS (2009).

10. In 2008, for the first time in many years, the profitability of the European insurance sector radically deteriorated. The average return on equity in the EU fell to 3.9% in the life sector and 5.3% in the non-life sector, from (respectively) 14.4% and 16.6% in the previous year[42]. ROE figures for individual countries show great disparities between Member States, especially in the life sector (see Chart 3.6). The high profitability of the life insurance business in Poland was caused primarily by high volume sales of investment insurance policies, linked with tax incentives[43] and the perception of such policies as "safe" financial products.

11. Regarding the non-life insurance sector, its efficiency measured by the net combined ratio (NCR)[44] improved on average in the EU. The weighted aggregate NCR increased to 99.7% from 96.3% in 2007.

Chart 3.6: EU insurance sector: return on equity (2008)



Source: CEIOPS (2009).

12. In line with the global developments, autumn 2008 saw plummeting European stock markets. As a result, end of the year capitalisation of the main exchanges fell almost half, and by as much as 60% on the smaller markets. The European investors lost in total almost 5.2 trillion euros, which corresponds to about 40% of GDP[45]. (Chart 3.7).

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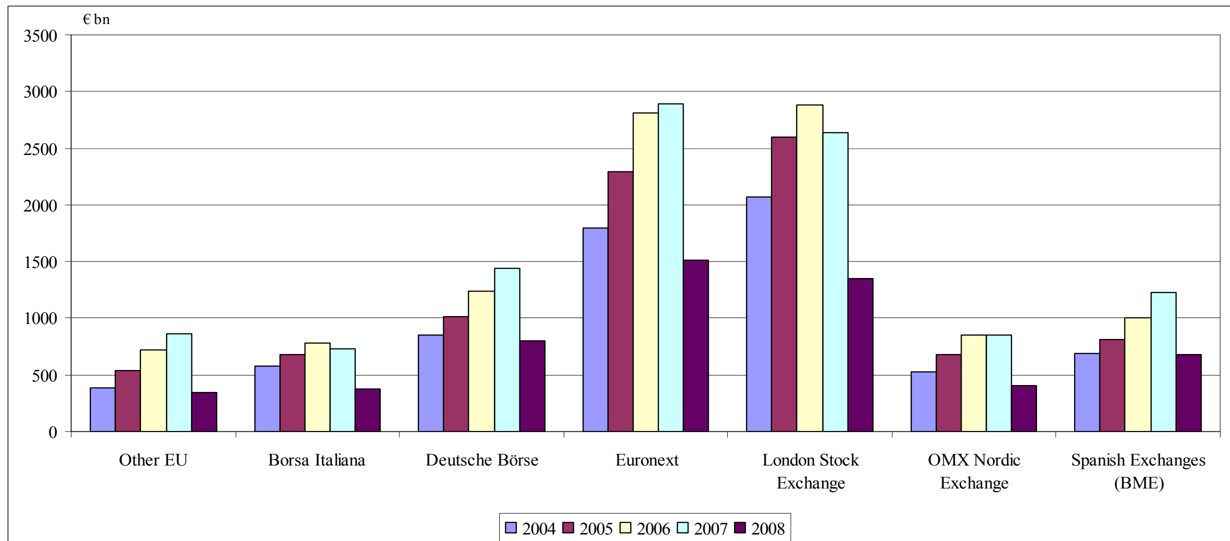
42 CEIOPS (2009).

43 According to Polish tax provisions insurance policy holders do not pay tax on interest and capital incomes, contrary to those who invest in banking deposits or investment funds. This brought about transfer of the financial means from the banking sector and the investment fund sector to the life insurance sector.

44 Net combined ratio (NCR) is showing the percentage of premiums an insurer has to pay out in claims and operating expenses. In highly competitive markets, the NCR tends towards 100%, as insurers are under competitive pressure to price their premiums no higher than the estimated coverage price (i.e. coverage of expected claims and expenses).

45 Based on Eurostat data.

Chart 3.7: EU stock exchanges: market capitalisation



Source: FESE (2009).

13. At the same time, total trading volumes continued to grow on the big exchanges, while falling slightly on the small markets (from € 466 to 451 billion; see Chart 3.8). In spite of the crushing indexes, the EU equity markets maintained their liquidity. This is also illustrated by (on average) stable turnover velocity ratios[46] (Chart 3.9). These positive trends can be partly attributed to the positive effects of measures aimed at the creation of the Single Financial Market under the Commission's Financial Services Action Plan (see Box 3.1).

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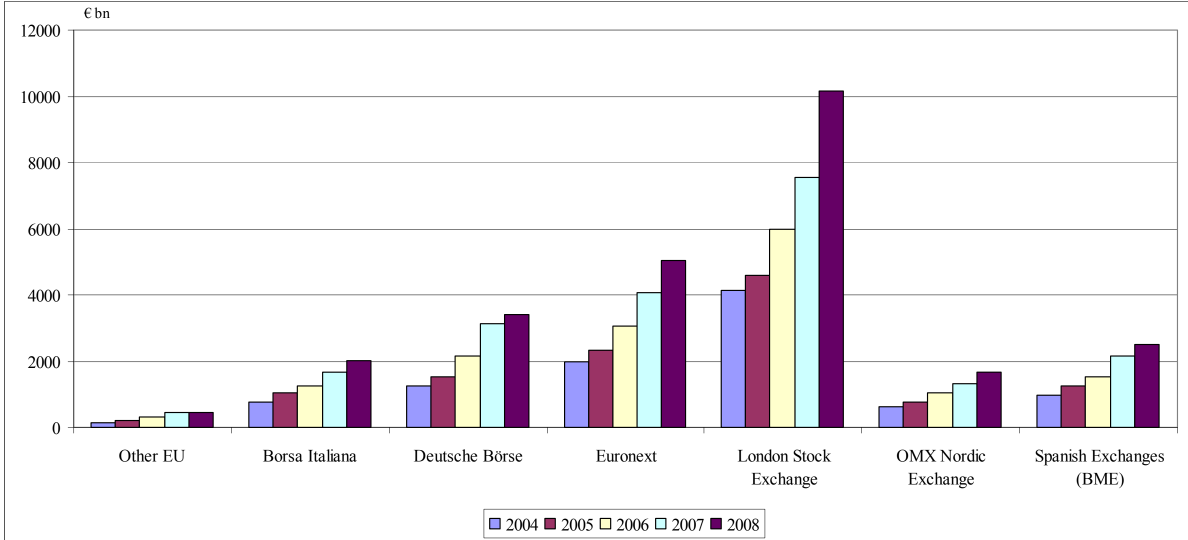
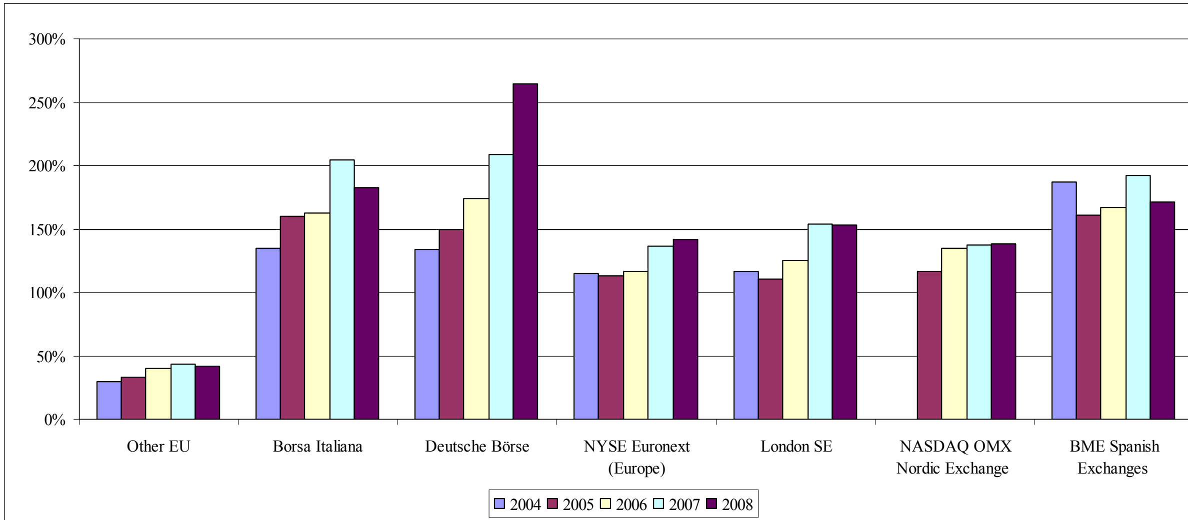
46 According to the World Federation of Exchanges definition, the turnover velocity is the ratio between the turnover of domestic shares and their market capitalization. The value is annualized by multiplying the monthly moving average by 12, according to the following formula: Monthly Domestic Share Turnover*12 / Month-end Domestic Market Capitalization. Turnover velocity is calculated in 2 steps. Step 1: we first calculate for each month the annualized ratio between the domestic share turnover and the domestic market capitalization, multiplied by 12. Step 2: we add together, using a moving average methodology, the percentage ratios obtained in step 1, divided by 12

Chart 3.8: EU stock exchanges: total annual turnover



Source: FESE (2009).

Chart 3.9: EU stock exchanges: turnover velocity of domestic shares



Source: WFE (2009).

Box 3.1: Results of the economic evaluation of the Financial Services Action Plan[47]

In July 2009 the Commission published two studies:
(available at: http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm)

1. ***Evaluation of the economic impacts of the Financial Services Action Plan*** by CRA International

The primary conclusion from the study is that the FSAP has resulted in observable market impacts across all of the three sectors that were examined - banking, securities and insurance. However, the degree to which these impacts can be observed differs significantly.

For **securities**, there are many currently observable market impacts of the FSAP and an expectation that the level of impact will increase with time. The Markets in Financial Instruments Directive (MiFID) stands out as the single measure of most importance with clear impacts on the securities trading and post trading markets. The removal of the concentration rule and the clear focus towards increasing competition has led to a number of new trading venues being set up in recent times, has contributed to a significant increase in trading volumes, and to a reduction in trading and post-trading costs. The best execution requirements are expected to have an impact over the medium term (around 3 years); the same goes for increasing the quality of investment advice.

The Prospectus Directive has harmonised information for investors and made access to foreign markets easier, which is evidenced by the increased number of prospectuses that have been passported into other countries. It has also promoted structural changes in European equity markets and the expansion of Exchange Regulated markets.

In the post-trading area, the Settlement Finality and the Financial Collateral Directives as well as the MiFID put in place the necessary conditions for the Code of Conduct to be effective, which has led to improved price transparency and enhanced competition in the clearing and settlement industry.

For investment funds, the UCITS III Directive has encouraged the use of funds of funds and has broadened the scope of eligible assets which has increased the flexibility in asset management.

In **banking**, the most significant measure included within the FSAP, the Capital Requirements Directives (CRD) took full effect in 2008. As a result, the annual data reflecting the impact of the advanced approaches to risk measurement were not available for the analysis. The ability to observe the impact of the CRD was also complicated by the current banking crisis. Therefore, it was not possible to come to a final conclusion on the impact of the CRD on regulatory capital levels. The market participants surveyed by the consultants supported the view that the CRD was a major driver of bank's investment in modern risk management systems. This has been observed by the high share of banks which have recently gained the IRB status (above 80% in a number of countries).

Looking beyond prudential regulation, one measure with a clearly observable market impact in the banking sector was the Regulation 2560/2001 on cross border payments in Euro which radically lowered the cost of cross-border transfers across the EU.

The **insurance** sector has been the least affected by the FSAP, however positive market impacts from a number of recent measures, in particular the Insurance Mediation Directive (IMD), have been observed. The impact of the IMD depended on the pre-existing level of regulation of intermediaries in a given national market, but there is consensus that in the majority of markets it has led to an improvement in professional standards, levels of disclosure and consumer protection. On the other hand, the study also found that the IMD has led to a decrease in the number of registered intermediaries in a number of countries.

Overall, there was general support by the surveyed firms and authorities that the FSAP had provided certainty regarding the direction of financial regulation in the EU and that this, itself, has been beneficial to firms.

This cost measuring study was a survey of 78 financial companies across EU and covered six selected Directives[48]. The main observation was the significant variation in the results depending on the size of the firm, its market sector and where it is located. →

[47] The FSAP was a 5 year Commission policy programme aimed at completing the Single Financial Market following the introduction of the Euro. It included more than 40 policy measures (of which 24 legislative) grouped under four general objectives related to the wholesale market, the retail markets, supervisory rules and the wider conditions for an optimal single financial market. The FSAP was launched in 1999 and successfully completed in 2004.

2. ***Study on the cost of compliance with selected FSAP measures*** by Europe Economics.

In general, the implementation (one-off) costs of compliance were typically significantly higher than the ongoing costs associated with the directives. In addition, it appears that banks and investment banks incurred significantly higher implementation costs than were the case for asset managers and financial markets.

Across the four sectors examined, the average (median) cost of implementing a directive was between 1.03% and 2.16% of the firm's total operating cost with the average (median) ongoing cost ranging from 0.14% to 0.45%. The study includes a detailed breakdown for both one-off and ongoing costs as well as the estimated value (in Euros) for an average company in each sector. For example, for small banks, the average compliance costs linked with implementing the selected Directives (one-off costs) amounted to 1.75% or €1.9m of total operating costs in the 'Northern' Member States, 4.26% or €6.1m in the 'Southern' Member States and 0.97% or €2.4m in the 'new' Member States.

The MiFID, CRD and 3rd Anti Money Laundering Directives were identified in this study as the Directives that generated the highest compliance costs for firms with MiFID and the CRD also being identified by many of the surveyed firms as the most significant cause of regulatory-driven incremental costs in recent times.

3.2. Securities post-trade market infrastructures

14. The restructuring of the post-trade sector that was taking place in 2008 was linked with changes to the price and costs of post-trade services. The expanding multilateral trading facilities (MTFs) have been able to offer effective post-trade solutions. Typically, the new trading venues have chosen to use equally new central counterparties (CCPs), independent from incumbent exchanges (e.g. EMCF, EuroCCP). From having used initially one CCP, the new trading venues have pushed for competitive clearing. For example, the CCPs serving Chi-x, BATS Europe, NASDAQ OMX Europe and NYSE Arca Europe (i.e. EuroCCP, EMCF, LCH.Clearnet and SIS x-clear) have all agreed to become interoperable in the near future.

Table 3.1: Post-trading at new MTFs

Venue	Parent	Focus	Post-trade partner	HQ	Category
BATS Europe	BATS	Trading and routing platform	EMCF SIS x-clear LCH.Clearnet	UK	MTF
Burgundy	Swedbank, Handelsbanken, SEB, Neonet, Carnegie, Nordnet, Kaupthing, Ohman, Avanza and Evli	Electronic trading platform for mid-cap and smaller Nordic stocks listed in Stockholm, Oslo and Copenhagen.	EMCF	SE	MTF
Chi-x	Instinet Europe Ltd	Order driven pan-European matching engine and central limit order book	EMCF SIS x-clear	UK	MTF
Equiduct Trading	Börse Berlin	Integrated pan-European single point of connectivity for	LCH.Clearnet SA	DE (UK, FR)	Regulated market

[48] The Capital Requirements Directives (the CRDs); the Transparency Directive; the Markets in Financial Instruments Directive (MiFID); the Third Anti-Money Laundering Directive (3AMLD); the Prospectus Directive and the Financial Conglomerates Directive.

		trading services			
NASDAQ OMX Europe	NASDAQ OMX	Trading and routing platform for the most actively traded European stocks	EMCF SIS x-clear	UK	MTF
NYSE Arca Europe	NYSE Euronext	Trading of pan-European blue-chip stocks	EuroCCP EMCF LCH.Clearnet SIS x-clear	NL	MTF
SmartPool	NYSE Euronext, HSBC, BNP Paribas	Block-trading of pan-European stocks	EuroCCP and LCH.Clearnet	UK	MTF
Turquoise	BNP Paribas, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley, Société Généralé and UBS	Mixed market model: dark pool and visible order book	EuroCCP EMCF SIS x-clear LCH.Clearnet. Citi as settlement agent.	UK	MTF

Source: European Commission.

15. Another structural development was the increasing use of CCPs. In equities, this is illustrated by the decision of NASDAQ OMX to introduce CCP clearing (EMCF) for its Nordic market in January 2009 on a voluntary basis, and from October 2009 on a compulsory basis. In addition NASDAQ OMX intends to introduce CCP interoperability in its Nordic market by January 2010.

16. Following the financial crisis, CCP clearing has become more widely used in over-the-counter (OTC) derivatives as well, due to an increased focus on counterparty credit risk from market participants and regulators alike. For example, ICE Clear Europe and Eurex Clearing have both been offering CCP clearing services for credit default swaps (CDS) since July 2009 and a third CCP (LCH.Clearnet SA) intends to start offering its services in this area by the end of 2009.

17. Previous reports have documented in an ad-hoc manner how the prices and costs of clearing services have decreased in the wake of the restructuring of the trade and the post-trade sectors. Based on a new report commissioned by the European Commission by Oxera, it is now possible to more systematically analyse how trade and post-trade services are provided and how trading and post-trading prices have evolved since 2006.[49]

18. The analysis covering the diverse picture in 18 financial centres[50] confirmed previous findings that selling, buying or holding a security is all but simple. The market

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[49] Oxera (2009), Monitoring prices, costs and volumes of trading and post-trading services, http://ec.europa.eu/internal_market/financial-markets/docs/clearing/2009_07_ec_report_oxera_en.pdf.

[50] These are classified in *major* financial centres (France, Germany, Italy, Spain, Switzerland and the UK), *secondary* financial centres (Belgium, Luxembourg, the Netherlands, Norway, Poland and Sweden) and *other* financial centres (Austria, Czech Republic, Denmark, Greece, Ireland and Portugal).

structure and trade and post-trade processes are complex, involving many types of institutions that perform the functions necessary to process a trade. This holds for domestic transactions, but even more so for cross-border transfers.

19. This complex landscape makes it difficult to measure prices. The Oxera report provides a first glimpse into how prices have evolved between 2006 and 2008 for services provided by trading venues, CCPs and central securities depositories (CSDs). In particular it finds that, across financial centres, trading costs in terms of costs per transaction have decreased significantly since 2006.

Table 3.2: Changes in on-book trading costs between 2006 and 2008 (per number of transactions)

	% change of per-transaction **costs of on-book trading**							
	<-60	-60 to -40	-40 to -20	-20 to 0	0 to 20	20 to 40	40 to 60	>60
Frequency of results	**1**	**4**	**5**	**4**	**-**	**-**	**-**	**-**

Source: Oxera (2009)

20. Equally, it shows that CCP clearing costs per transaction have decreased significantly since 2006 across financial centres. This confirms the anecdotal evidence documented in the previous issue of the EFIR.

Table 3.3: Changes in central counterparty clearing costs between 2006 and 2008

	% change of per-transaction **central counterparty clearing costs**							
	<-60	-60 to -40	-40 to -20	-20 to 0	0 to 20	20 to 40	40 to 60	>60
Frequency of results	**1**	**4**	**1**	**-**	**1**	**-**	**-**	**-**

Source: Oxera (2009)

21. The picture is more diverse for CSDs. While the costs of account provision and servicing have decreased in most centres, they have nevertheless increased in some. Part of the increases may be explained by changes in the mix of services offered.

Table 3.4: CSDs: changes in clearing and settlement costs between 2006 and 2008

	% change of per-transaction **cost of clearing and settlement**							
	<-60	-60 to -40	-40 to -20	-20 to 0	0 to 20	20 to 40	40 to 60	>60
Frequency of results	**1**	**1**	**-**	**9**	**2**	**-**	**-**	**1**

Source: Oxera (2009).

22. The Commission Services will continue monitoring prices in the post trading markets.[51] Depending on the results, new policy measures might be launched to further enhance the competition levels in this sector.

23. The analysis of indicators of efficiency and competition shows the negative impact of the crisis on the EU financial services sector. However, in the long term the pressure stemming from the less favourable economic environment and the adaptation process in European banks and insurance companies should lead to improvements in their overall efficiency. The risk of competitive distortions caused by the state aid schemes for financial institutions should be reduced with a progressive return to normal market conditions as government support measures are gradually phased out in line with the pace of economic recovery.

[51] The Oxera study will be repeated in 2010.

4. FINANCIAL STABILITY - RECENT DEVELOPMENTS IN THE EU

4.1. Introduction

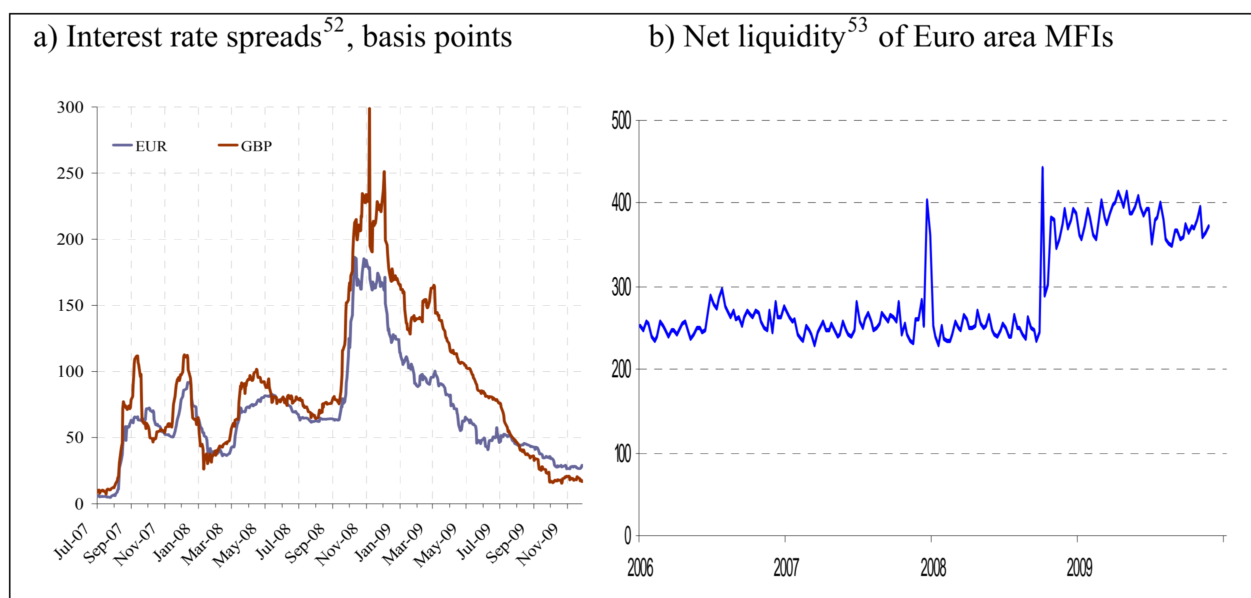
1. By mid-2009 the financial crisis started to recede, mainly as a result of vigorous public interventions. Such interventions have been impressive in size as well as in range and have included monetary, fiscal and financial services support measures. The regulatory reform measures have been broadly coordinated, both at G-20 and at European Union level. Joint efforts were needed to restore confidence as well as to address the roots of the crisis, reflecting the advance of financial globalization and the deepening EU financial integration.

2. This chapter provides an update of recent developments in EU financial sector as well as an update of the policies that supported the recovery of the financial sector. The last section of the chapter reports on the concentrated cross-border exposures in the EU banking sector and how they have impacted on financial stability.

4.2. The financial crisis – recent developments in the European Union

3. By mid-2009 the EU financial sector, while continuing to be fragile, showed some signs towards stabilisation; the banking sector experienced improved access to market liquidity and investors seemed to have regained some confidence.

Chart 4.1: Euro area liquidity indicators



Sources: (a) Bloomberg/ECB; (b) ECB; Statistical data warehouse on line

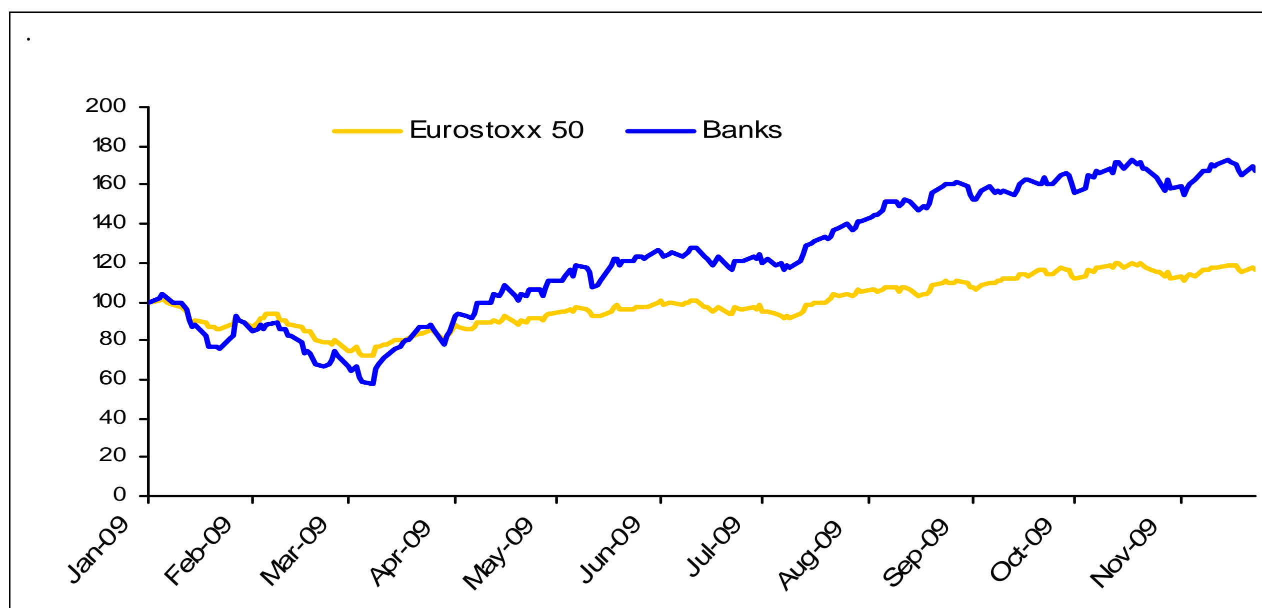
52 The spreads refer to the differences between three months' unsecured interbank deposit rates and overnight index swap rates.

53 Difference between Monetary Financial Institutions' borrowing and deposits at ESCB, weekly data in Euro billion.

4. Already from the start of the crisis, the ECB made liquidity injections in the market. By mid-2009, the acute lack of money market interbank funding started to ease. One indication of the improved liquidity situation is based on survey results. By mid-2009, the majority of Euroarea banks did not any longer experience any problems in their access to the money market as a result of the turmoil[54]. Narrowing spreads between three months' unsecured interbank rates and overnight index swap rates offered another indication of improved liquidity conditions (see chart 4.1a). The increasing net liquidity volumes in the Euroarea monetary financial institutions (see chart 4.1b) conveyed the same message.

5. By mid-2009, confidence had also started to return to European capital markets. Euro area equity market prices progressively increased since the spring of 2009, with a parallel reduction of price volatility. These developments reflect a more positive market sentiment among investors as well as reduced uncertainty. This was particularly the case for the European bank equity price index; which took off even more vigorously than the general Eurostoxx index (see chart 4.2).

Chart 4.2: Euro area bank equity index vs. general index in 2009



Source: Data Bloomberg, Commission Services' calculations

6. The challenging question is whether the European financial sector will continue to stabilise. Without doubt policy measures have so far had a great impact on developments. Box 4.1, at the next page, summarises the major policy tools that have been used in the crisis management phase to promote a stabilisation of the EU financial system. This policy has also been coordinated at the global level, within G-20, taking account of the increasing financial globalisation and the progress of EU financial integration.

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54 ECB (2009d).

7. There are many examples of how the policy measures have supported the financial system. One example is the important role public guarantees and recapitalisation has played for the stabilisation of the European financial system. In the period between October 2008 and August 2009, the Commission approved a total of Euro 3.7 trillion – equivalent to 31.4 per cent of GDP – of state aid measures to financial institutions. Up to August, Euro 1.5 trillion (12.6 per cent of GDP) had been effectively used[55].

Box 4.1: The present EU toolbox for financial crisis management

- To improve credit conditions and ensure the functioning of the money markets, ECB and other central banks have, since the beginning of the financial turmoil, made repeated liquidity injections. In parallel, there has been a progressive cut down of interest rates,

- To address funding problems of liquidity constrained but solvent EU banks, a concerted European action programme[56] was launched where EU leaders committed to make available for an interim period and on appropriate commercial terms, directly or indirectly, a Government guarantee, insurance, or similar arrangement of medium term (up to 5 years) bank senior debt issuance. Leaders also encouraged Member States to facilitate medium term funding of banks through purchase of high quality assets or through swaps of government securities. Moreover, Governments remained committed to support the financial system through appropriate means, including recapitalisation, while respecting the interest of tax payers and ensuring that existing shareholders and management bear the due consequences of the interventions.

- To strengthen retail customers' confidence in the financial system and to promote a level playing field, the Commission proposed urgent legislative change in October 2008, which entered into force in March 2009. Minimum retail deposit guarantee levels has already been raised from €20,000 to €50 000 across Member States, and will be increased to €100 000 by the end of 2010[57].

- The Commission has set out the principles governing the application of State aid rules to ailing EU financial institutions[58]. Specific guidance has been published as regards Member States' involvement, in particular in bank guarantees and recapitalisation and in designing restructuring and asset relief measures.

- A comprehensive reform package to build a stronger financial system for the future is under delivery, as presented in the Commission Communication on Driving the European Recovery[59] (for more information see also chapter 6). Even though these measures will be implemented in the future, they are also expected to strengthen confidence in the short term. Key areas that are addressed are supervision and oversight, the bank capital framework, the remuneration structure in the financial sector and regulatory gaps in jurisdictions/market segments that are crucial for the sound operations of markets. The European policy has been broadly coordinated at international level.

- To support the real economy, a fiscal stimulus package is under implementation in Member States. It was coordinated by the Commission, as presented in the Commission Communication "A European Recovery Plan"[60]. The discretionary European and national stimulus packages are expected to amount to 2.1% of GDP for 2009-2010; if automatic stabilisers are included the total stimulus is expected to amount to 5-6 % of GDP.[61]

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55 Source: Commission services.

56 See the Euro Area Summit declaration of October 12, 2008 and European Council Conclusions of 15-16 October 2008.

57 COM (2008) 661 final of 15.10.2008.

58 See COM (2008) 270 (on guidance on principles of state aid rules to banks in financial crisis), COM (2009)10 (on recapitalisation) and COM(2009)72 (on impaired assets) and COM(2009) 195 (on restructuring and viability).

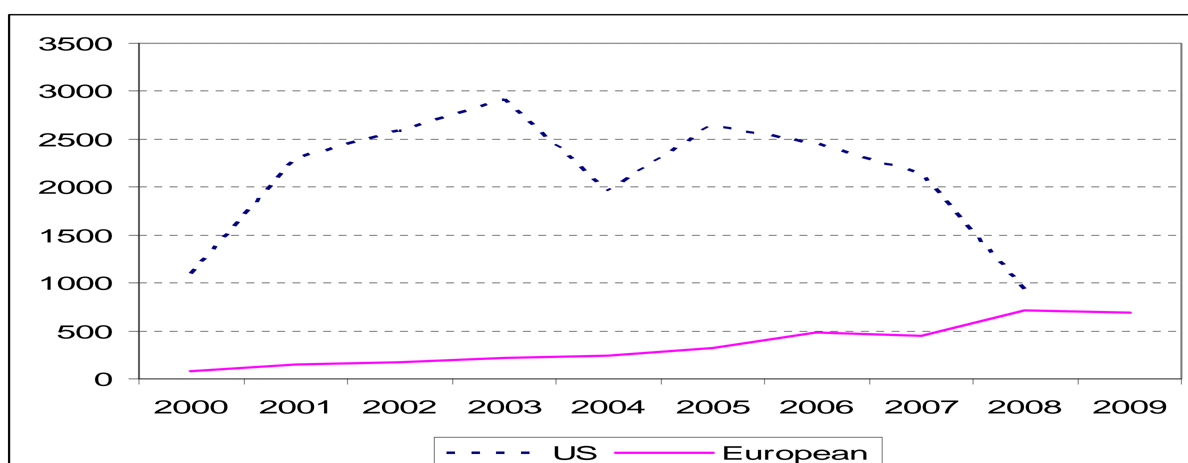
59 COM (2009)114 final of 04.03.2009.

60 COM (2008) 2008 final of 26.11.2008.

61 Commission services.

8. Another area where policy has had a considerable impact is securitisation. Looking at gross securitisation issuance volumes (see chart 4.3) European issuance has been quite sustained during the turmoil, while US gross issuance volumes have sharply declined. However, when interpreting these statistics, it is important to be aware that primary markets continued to remain next to closed in the first half of 2009. While 81.2 billion Euro was issued in the second quarter in Europe, 99 per cent of all securities were retained on the balance sheet of the issuing banks. This reflected the endeavour by many central banks to enhance liquidity and availability of credit by making securitisation eligible as collateral for repo funding. Recently, however, there are some signs of improvements also in the European securitisation market. In the second quarter of 2009, market spreads of European securitisation started tightening due to improved market sentiments[62].

Chart 4.3: Securitization issuance in Europe and in the United States, in billion euros.
2009 issuance estimate based on results from I-II Q 2009, at an annual rate.



Source: European Securitisation Forum (2009).

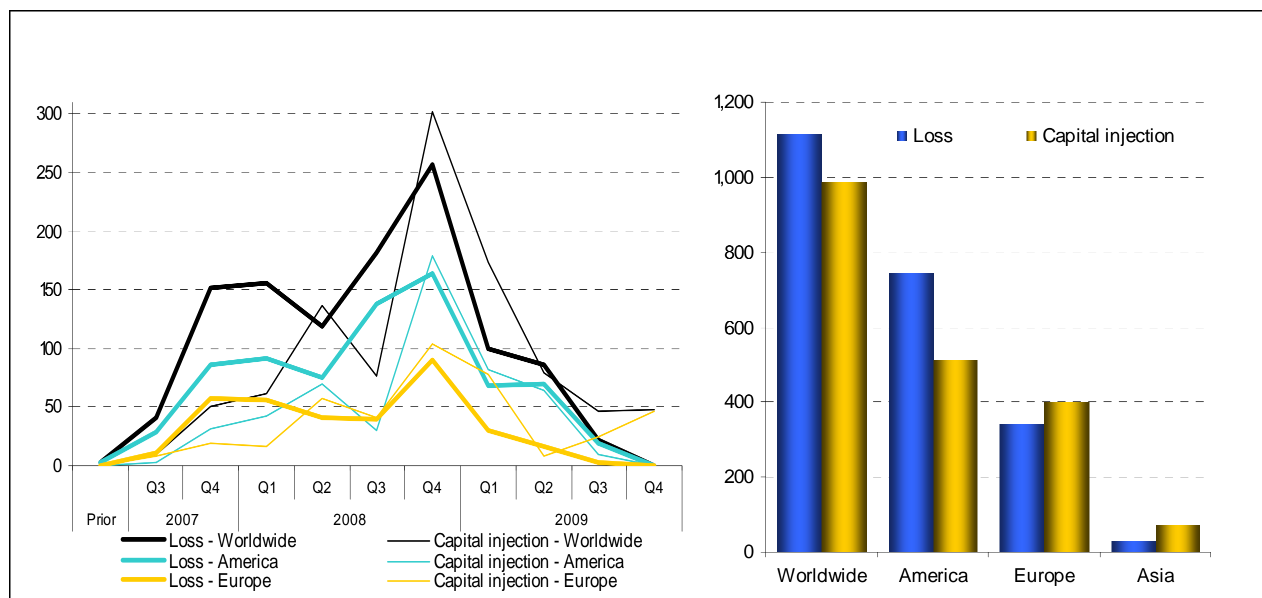
9. Can it be expected that the present market stabilisation will be durable and that the situation in the European financial sector will continue improving? It is too early to know. Even if the improvements we have seen so far mainly have been policy induced, this may have started a self-generating positive process. The decrease of market volatility and rise of stock market prices indicate that such a process may have started. Ultimately the recovery of the financial sector will depend on the development of the real economy, on investments and consumption, both in Europe and globally. Most forecasts on the general economic prospects are cautiously optimistic, indicating that the worst may be over.

10. It is also worth noting that while a melt-down of the financial system has been avoided, and recent signals are positive, the European banking sector is yet fragile. At the funding side, the European banking sector is considerably weakened by massive losses.

[62] Source: The European Securitisation Forum (2009).

Since the beginning of the crisis (including data known up to 5 November 2009), the losses of top European banks amounted to almost 350 billion euros, due to a combination of mark-to-market losses and credit losses (see chart 4.4 on the next page).

Chart 4.4: Write-downs (losses) and capital injections in top European banks, regional breakdown in billion euros.



Source: Bloomberg, cutting date of data 05/11/2009.

11. Capital injections – from private and public sources - have been made to fund the bulk of the losses and avoid systemic consequences. Most banks have not started their repayments of their public funds, which should be only available on a temporary basis. As a result, many European banks have become dependent on public guarantees and funding Additional fresh capital could also be needed to bring down banks' leverage ratios further and to finance new credit losses. This could require considerable efforts since financing costs are more expensive than before, as a result of the downgrading of many banks' credit ratings. Moreover, most European banks face bleak prospects at their earning side due to the weak economy and mounting credit losses.

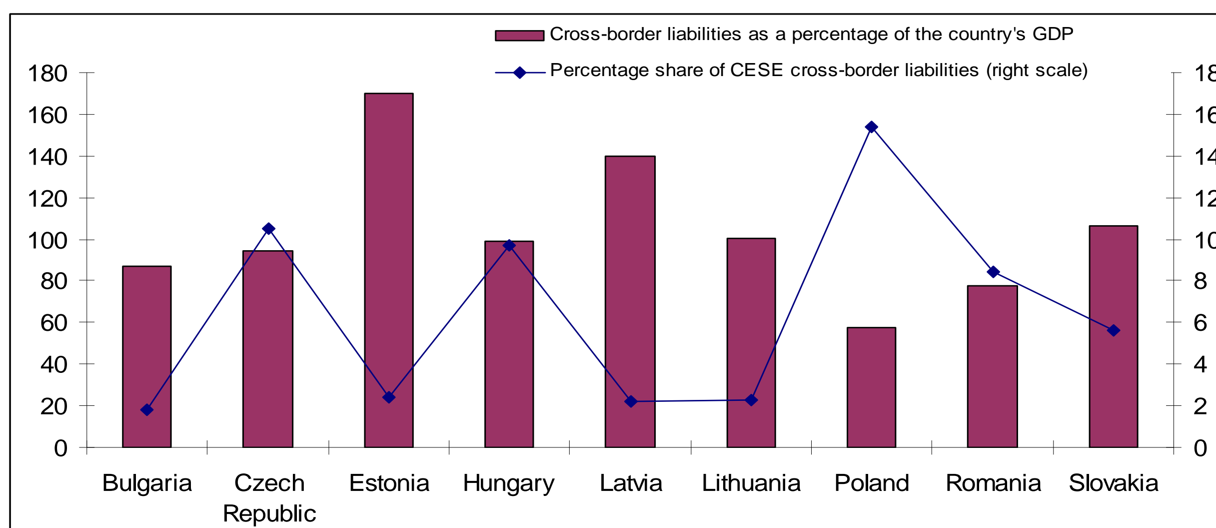
4.3. Stability consequences of concentrated cross-border exposures

12. EU financial integration, through cross-border establishment, has risen sharply over the past decade and has brought with it a range of benefits to both home and host countries. Benefits range from increased income generation, improvements in technology and risk management, increased access to funds, risk diversification and deepening of financial markets.

13. The most notable example of the rise in foreign participation in the domestic banking market is found in Central, Eastern and Southern Europe Countries (CESE). In many of these markets, the pattern of financial integration has been less diversified and concentrated exposures have developed on individual markets. The majority of CESE

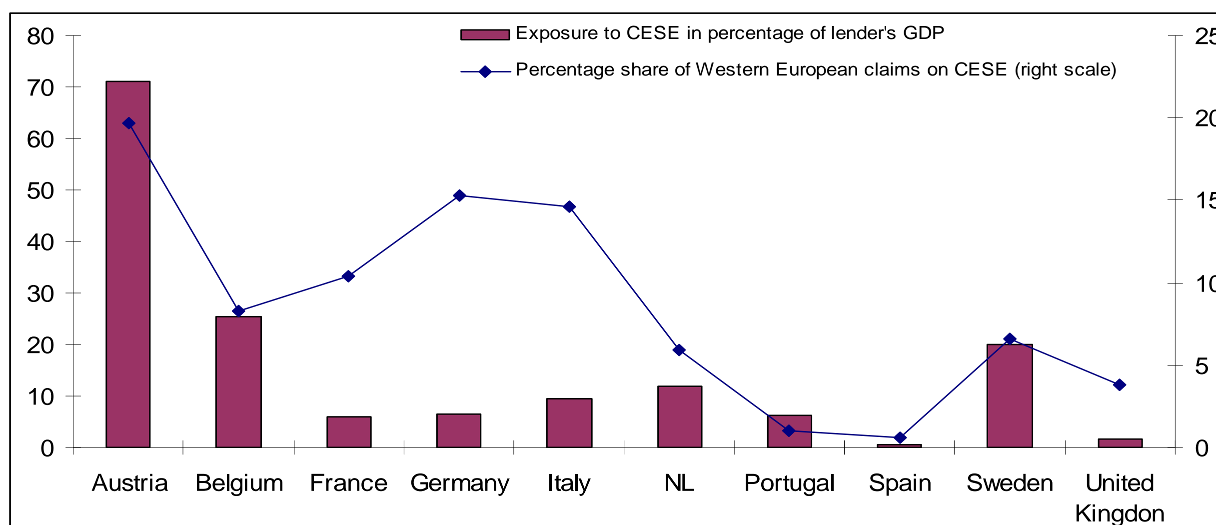
rely on western European banks for their funding, with Austria, Germany and Italy accounting for the largest share and the Baltic States (Estonia, Latvia and Lithuania) obtaining funding from Sweden. Chart 4.5 illustrates the percentage share of CESE cross-border liabilities for a selection of EU countries. In terms of lending exposure, Austria has the largest exposure to CESE. The claims of its banks on CESE amount to over 70 percent of the Austrian GDP and 26 percent of its banking system assets. The relative exposures of Western European banks on CESE are illustrated in Chart 4.6.

Chart 4.5: Central, Eastern and Southern European (CESE) cross-border liabilities



Source: IMF Global Financial Stability Report (2009a).

Chart 4.6: Lender's exposure to CESE



Source: IMF Global Financial Stability Report (2009a) , based on Arvai, Driessen and Otker-Robe (2009).

14. The current crisis has demonstrated that there is a risk in building up major concentrated exposures. If several CESE use a 'common funding channel', such as Austria or Sweden, this significantly increases their risk and vulnerability to fluctuations in home countries. The same conversely applies for home countries in the event of excessive concentration of the cross-border lending business of their banking sector on a few countries.

15. Swedish bank establishments in the Baltic region provide an illustration of the difficulties that may occur for both home and host countries when there is a common lender/funding channel and when inadequate regulation and risk management in both home and host countries allow major risk exposures to build up. For example, Swedbank accounts for almost 45 percent of total lending in Estonia, while SEB accounts for 30 percent of lending in Lithuania. Jointly Swedbank and SEB market shares come to 67 percent in Estonia, 40 percent in Latvia and 51 percent in Lithuania[63].

16. For the home country, Sweden, the establishment of banks in the Baltic countries has had significant benefits for the Swedish banking sector, in particular in terms of market expansion and creation of new revenue streams. However, when the global crisis emerged, the credit expansion came to an end and credit losses started to increase in the Baltic region. Many commentators then explained the fall in the Swedish Krona and falls in market confidence as directly stemming from Sweden's high exposure to the Baltic region. Swedish banks also experienced substantial loan losses, estimated to be in the order of SEK 30 billion for the first six months of 2009, with 44 percent of these losses directly attributable to the Swedish banks' operations in the Baltic Member States.

17. For the Baltic region the rapid increase of foreign bank presence has had considerable, but different consequences. On the one hand, it contributed to the growth of financial infrastructure, facilitating economic growth. The fact that the Baltic banking market was dominated by subsidiaries of reputable Swedish banks with a better access to capital markets during the turmoil than local institutions also worked to enhance confidence in these subsidiaries and local banking systems.

18. On the other hand, the high concentration of exposures and the lack of adequate risk management and regulation contributed to the building up of major imbalances. The easy access to foreign loans, denominated in euro, also resulted in the building up of a speculative property bubble as well as substantial current account deficits in the Baltic region. When the financial crisis hit, and sources of credit dried up, assets were re-valued and credit ratings were downgraded, leaving these Member States highly exposed to foreign exchange denominated debt, falling property prices and internal revaluations.

[63] Nyberg.L (2009), Market shares as of June 2009.

4.4. Conclusions

19. Since the spring 2009, there has been a stabilisation of the European financial sector. To a large extent this recovery has been policy induced, and has been based on large scale coordination - both at the global and European level – involving a combination of monetary, fiscal and financial services policy instruments. This unprecedented policy action has been necessary to re-establish confidence and get markets back to normal, in view of the increasing financial globalisation and deepening financial integration within the European Union.

20. The rapid foreign establishment in the CEE banking markets has been less diversified, generating concentrated lending/funding exposures for home and host countries. Inadequate regulation, supervision and risk management have facilitated the building up of major exposures and imbalances. While integrated financial markets have brought clear benefits, the financial stability aspects have not received sufficient attention. In an integrated market safeguarding financial stability should be a common interest.

5. EU FINANCIAL SECTOR: GLOBAL COMPETITIVENESS AND THE EXTERNAL DIMENSION

5.1. Introduction

1. The global financial crisis has had a significant effect, not only on the performance of the financial services sector, but its impact has quickly spread to the real economy and has now negatively effected global production, employment and incomes. This in turn has led to a second round of negative effects on the financial sector. The negative impact of the crisis has been strongest felt in the US, closely followed by Europe. One of the major challenges to the competitiveness of financial sector has been declining global demand.

2. In addition to the current financial crisis, over the medium to longer term, factors such as the continued growth in the emerging economies, including India and China, as well as global trends such as increased globalisation, competition, an ageing population, climate change and the changing global regulatory structure in financial services are all expected to have a lasting impact on the efficiency, profitability and even structure of the global financial services sector.

3. Faced with the challenge of the financial crisis and the above-mentioned global trends it is important that the EU works out strategies to improve its competitiveness and attractiveness as a global financial centre, not only to support the industry during difficult times but to ensure continued development and growth of the sector over the medium and longer term.

5.2. The size, trends and relative performance of the EU financial sector

4. The EU, the US and Japan remain the three key players in global financial services. The impact of the crisis and of emerging economies, namely China and India, are being felt. Chart 5.1 (below) captures the relative market shares of the major global players in key segments in financial services

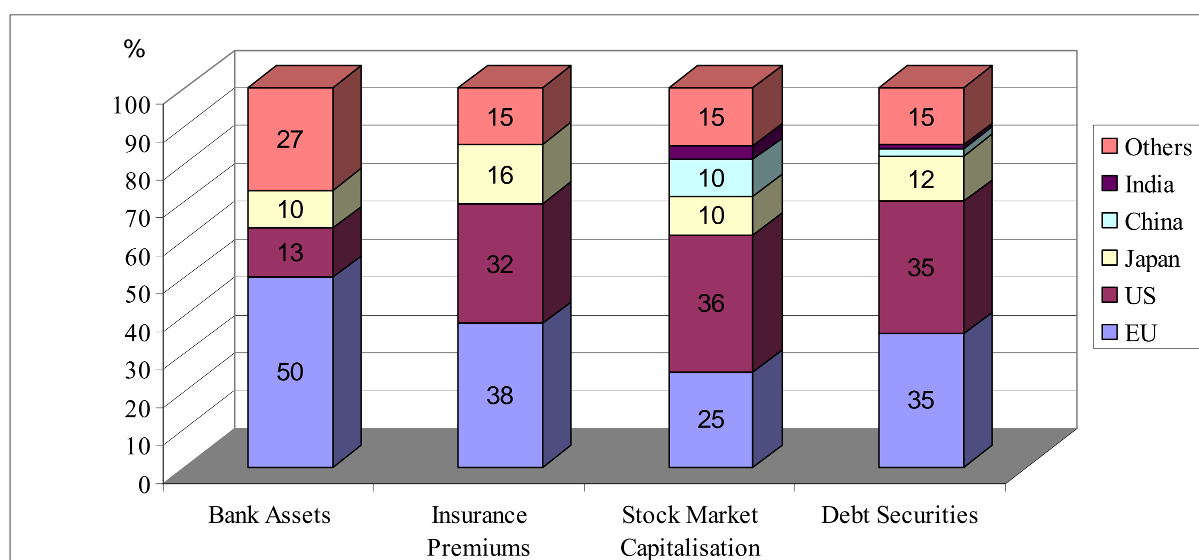
5. As mentioned, the recent financial crisis has had a significant effect on the functioning and competitiveness of global financial markets. Equity markets have been hardest hit by the crisis, falling by a record 47% over 2008 from $US 60,693 bn to $US 32,575 bn in 2008. Although comparative market shares have altered over time, it is important to note that over the past year, in areas such as Stock Market Capitalisation, the market share of the emerging countries, namely China and India, have fallen slightly, as they appear to be harder hit by the crisis than established markets such as those in the US and Japan.

6. The tightening of liquidity due to the crisis has increased the importance of debt securities as a source of alternative finance. One observation from the market during the crisis has been the strength and increased competitiveness of those countries who can provide liquidity to the market – such as China and the Middle East. Overall amounts outstanding rose 16% in 2008 to $US 83 trillion. Towards the end of 2008 and during the start of 2009 corporate bonds increased to record levels as companies

issued bonds as a source of finance. Italy, Germany and France remain the key issuers of public sector debt in Europe, with this trend expected to continue. The current trend in Europe is a move towards a US-style bond market as companies move away from relying on banks as their main source of funds. This trend is expected to continue, but at present is limited to those companies with strong credit ratings.

7. Although the EU and US remain the key markets for insurance products, accounting for around 70% of premiums, we continue to see growth in the emerging economies as domestic demand, financial sophistication and incomes rise. This distinction points to the growing demand for insurance products by emerging economies, such as India, and the increased competition coming from these growing sectors. Global insurance premiums in 2008 were estimated at $US 4,270 bn, yet, for the first time since the 1980 recession, premiums declined in real terms by 2%. However, what this decline does not show is that premiums actually declined by 3.4% in the industrialised countries however this was off-set by a continuation in the growth of the emerging markets, even during the crisis, where both life and non-life premiums grew by 14.6% and 7.1% respectively.

Chart 5.1: EU contribution to world financial activity in % (2008/2009)



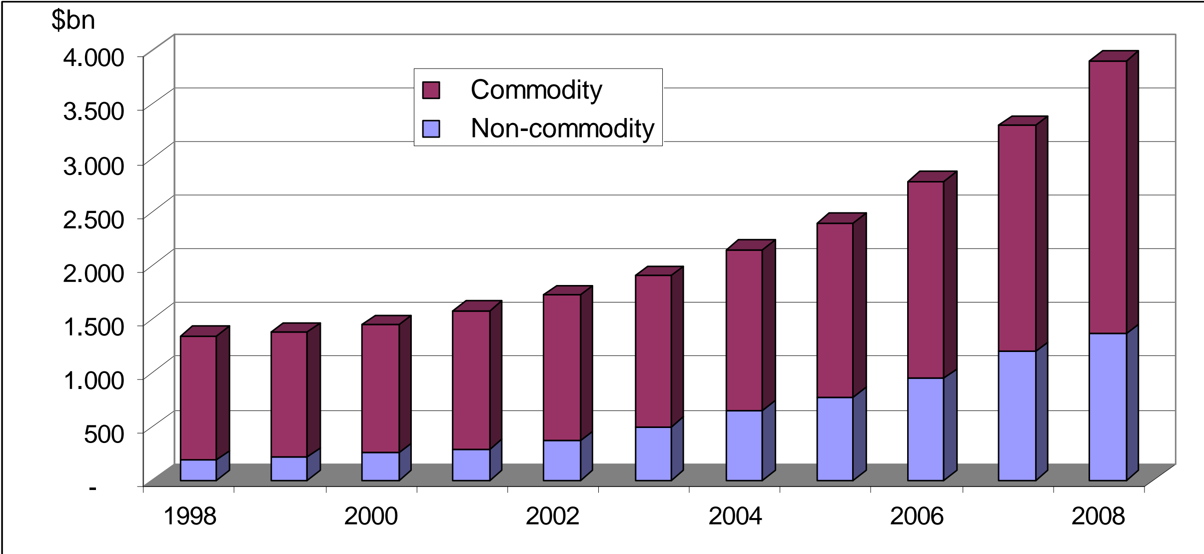
Sources: World Federation of Exchanges (2009), IMF (2008), BIS (2009) and SwissRe (2009).

5.3. EU global competitiveness and global market dynamics

8. Although the global financial services industry has gone through a period of substantial change over the past decade, the current global financial crisis is expected to result in an even greater shift away from the long established historical financial markets, such as the US and EU, and towards the emerging markets of China, India and the Middle East. Many market commentators expect that the crisis will also lead to increased growth for other non-traditional actors in the financial sector including sovereign wealth funds, government holding companies, pension funds and private equity companies.

9. Although Sovereign Wealth Funds have been around for decades the number of funds has grown dramatically since 2000. Given that these funds bring significant benefits to global capital markets in terms of increased market liquidity and financial resource allocation, their profile has risen during the current financial crisis. Many market analysts expect that these funds will continue to increase in importance going forward. IFSL estimate that assets under management by sovereign wealth funds rose by 18% in 2008 reaching $US 3.9 trillion (Chart 5.2). This significant growth occurred due to SWF investments in the financial sector to offset crisis related losses. This strength illustrates why these funds will continue to play a major role in global financial markets. It is expected that these funds will double in size by 2015[64].

Chart 5.2: Sovereign Wealth Funds – Assets under management ($US bn)



Source: IFSL Research, Sovereign Wealth Funds 2009, March 2009.

10. According to OECD estimates, the current financial crisis has also had a significant impact on global pension assets, with an estimated $US 5.4 trillion loss (over 20% of total assets) as at the end of 2008. Although pension funds have been hit hard, it is important to note that these funds have also played an important role in stabilising the financial markets due to the nature of the business. The pension fund industry is unique since it has no leverage, little use of derivatives and structured products and as an institutional investor, pension funds have no liquidity problems given the long term nature of their liabilities and their regular cash supply from employer and employee contributions. This explains why many commentators are looking to pension funds as having an increased role in financial markets going forward. Although the US still dominates the pension market, Europe has some significant players, especially the UK and the Netherlands who each hold around 6.5% of global assets of the world's top 300 funds[65].

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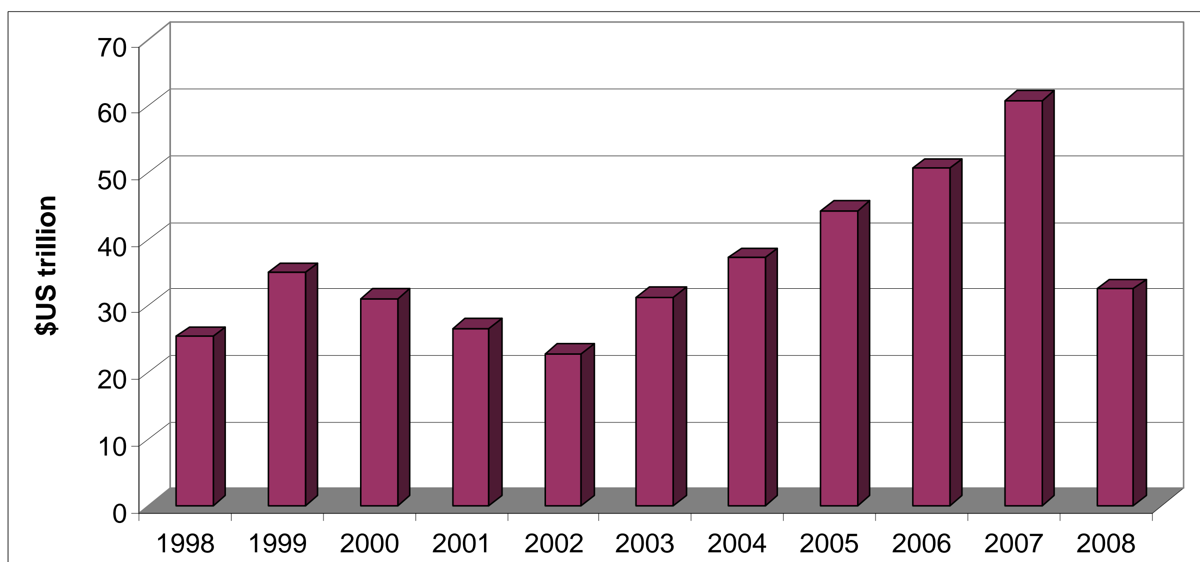
64 IFSL Research (2009).

65 Watson and Wyatt (2009).

11. The value of the global equity market fell by a staggering 47% in 2008 to $US32.6 trillion, back to levels experienced in 2003[66] (Chart 5.3). EU and US markets by around 50% but emerging markets were even harder hit due to high investor risk aversion in these markets. As we have seen in earlier reports, the EU and US equity markets have seen a significant increase in correlation in terms of private equity returns over the past 20 years. However, established markets, due to higher investor confidence, can, and do, perform better than the emerging markets in periods where investor confidence has deteriorated.

Chart 5.3: Global equity markets domestic market capitalisation



Source: World Federation of Exchanges (2009).

12. Initial Public Offerings have also seen a dramatic fall over 2008 with estimates putting the fall in this market at around 50%. Although IPOs fell due to their sensitivity to overall macroeconomic conditions, there was a significant growth in 2008 and 2009 of new capital, estimated at over $US 1 trillion in 2008 as companies moved away from bank borrowing as a source of finance (Chart 5.4). We expect that once conditions improve IPOs that are currently 'on hold' will enter the market with the EU continuing to play a key role in this medium-term growth market. As such we expect that this will be a return to the strength that the EU has seen in recent times in IPOs and an opportunity to improve the EU's competitiveness in this area.

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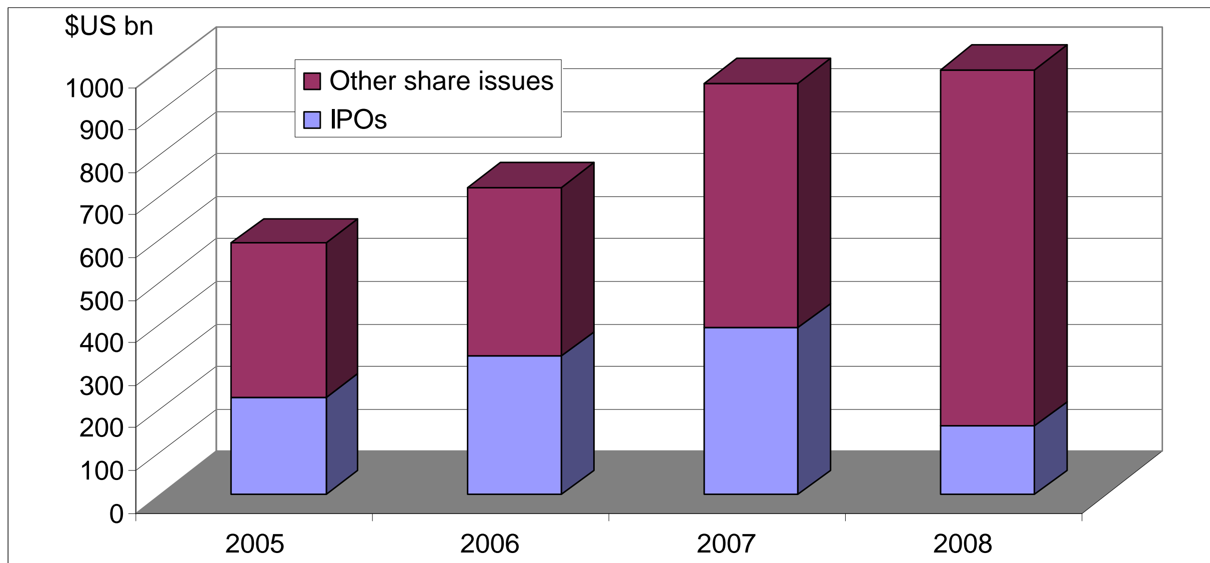
[66] World Federation of Exchanges (2009).

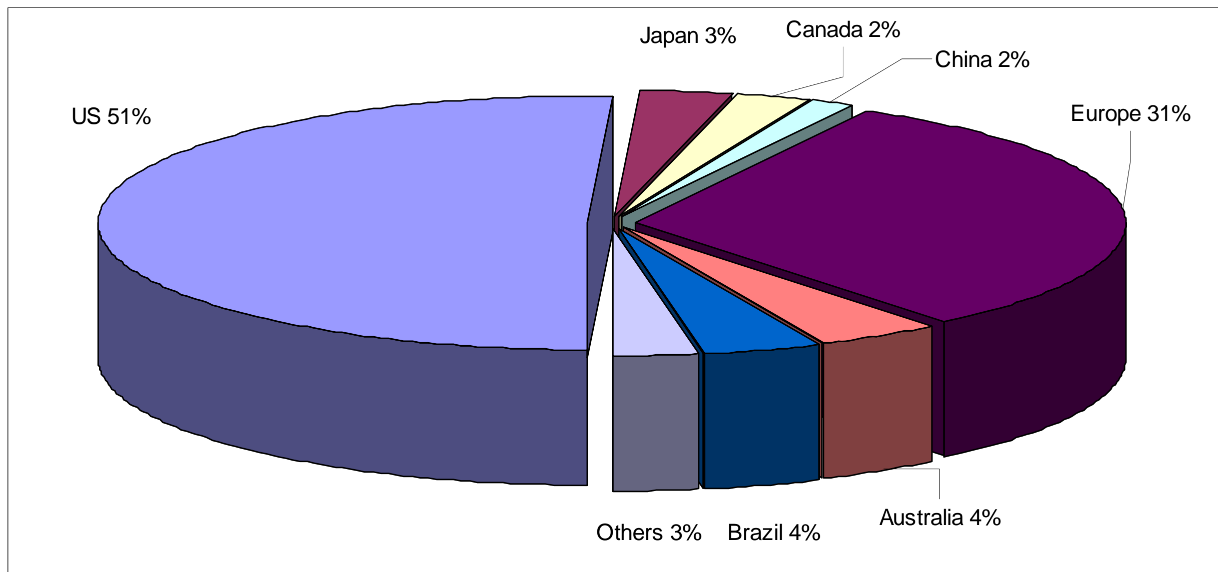
Chart 5.4 New share capital



Source: World Federation of Exchanges (2009)

13. At the end of Q1 2009, the total value of investment fund assets worldwide increased to 13.64 trillion euros. The US and EU are by far the two largest players in this sector, accounting for 51% and 31% respectively (Chart 5.5)[67].

Chart 5.5: Worldwide Investment Fund Assets – Q1:2009



Source: EFAMA (2009).

14. In Europe, investment fund assets have doubled in size over the past decade growing from EUR 3,042 billion at the end of 1998 to EUR 6,142 billion at end 2008. However

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[67] EFAMA (2009).

the current financial crisis has hit this industry hard with total assets falling by 22% (EUR 1,768 billion) in 2008 with UCITS net outflows of EUR 335 billion. Demand for investment funds is expected to remain subdued in the short term due to continued uncertainty in the global financial markets[68].

15. As a direct result of the current crisis, we have seen a major deleveraging across households, financial institutions and corporations due to the restriction in the availability of credit. As a result, the tightening in the credit market is expected to have significant impact on businesses that rely on high leveraging and which have high working-capital requirements. It is in these areas where further industry consolidation is expected and where once profitable business models will need to change.

16. Most notably, the crisis has resulted in some significant mergers within the banking sector. This is a continuation of the existing trend in consolidation that has been occurring in the global banking sector, most notably in the US but also within individual EU Member States. In the US the largest 10 banks now hold around 50% of the country's banking assets, up from only 29% a decade ago.

5.4. The global regulatory environment – International regulatory dialogues

17. The aim of the EU's international regulatory dialogues on financial services is to promote the EU's regulatory framework, by working towards regulatory convergence and/or equivalence, improved market access and by providing a forum for financial market cooperation on issues of common interest, such as the response to the financial turmoil. These forums, especially in times of crisis, provide a forum for open cooperation and discussion between the EU and other global markets to discuss current policy issues, and complement the work undertaken by multilateral bodies such as the G20, Financial Stability Board, IMF and the OECD.

18. To date the most advanced dialogue has been between the EU and the US. The EU is also undertaking dialogues with Japan China, India, Russia and Brazil. The importance and success of these dialogues, between the EU and cross-dialogues between other players in global financial services will continue to promote regulatory integration and increase competitiveness in the future.

5.5. Looking ahead – the emerging markets

19. China continues to grow as a key player in global financial services, with financial services reform accelerating this growth since China's WTO accession in 2001. China has coped well with the financial crisis, and is one of the few economies, along with India and Indonesia, that continued to grow during this period. The introduction of a significant fiscal stimulus package of over $US 500 billion and active lending by financial institutions is now playing a major role to contain the intensity of the economic downturn. In particular China's banking system is holding up well so far and its capital market has substantially recovered from its bottom in October 2008, after loosing 70% of its value in less than a year. In summary, China continues to

[68] EFAMA (2009).

grow as a power in global financial services, not only due to its high liquidity, but its continued economic development and importance in global trade. According to a recent Gallup survey, despite the rise in Chinese commercial banking revenue, Chinese retail banking customers are less engaged, that is, they have no real relationship or loyalty with their bank, compared to their counterparts throughout Asia and the rest of the world. Many forecasters see China's growing retail financial services sector as a major source of future growth given the population size, significant rises in per capita incomes and improvements in China's payment systems.

20. India has also had sustained economic growth despite the global economic slowdown. In India, financial services reforms began in the early nineties with a slow liberalisation of the banking activities, increased disintermediation, a relaxation of many restrictions to provide operational flexibility and improve efficiency, strengthening of the legal and prudential frameworks and the introduction of more competition from private and foreign banks. Many commentators have pointed to India's relatively slow pace of reform and its restrictions on foreign ownership as stifling growth in India's financial services sector. However, despite these limitations, and due to their growing middle class, India has seen a dramatic increase in its demand for retail banking services, especially over the last 5 years. It is expected that India will increase its role in global financial services led by its increasing domestic growth and continued economic development.

21. The Middle East, with its significant involvement in established global financial markets, is expected to increase its global importance in the future. It is estimated that currently (2008) around 45% of sovereign wealth funds under management come from the oil rich countries in the Middle East, with the United Arab Emirates accounting for a quarter of the global total. The Middle East is also continuing to develop Dubai as a financial hub for the region and is currently developing their financial markets and regulatory structures to further promote this growth. In late November 2009, however, the request by Dubai World – a major government holding company - for a debt standstill unsettled investors' confidence in the Middle East's major trading hub. The event caused market turmoil and fears of contagion and resulted in interventions by the United Arab Emirate's central bank. It is, however, yet too early to assess whether this event will have any lasting impact.

5.6. Conclusions

22. Global financial services markets have been hard hit by the current financial crisis. However, despite this slowdown several key observations can be made. Firstly, that it is the established markets that are generally less affected by falls in confidence, which is a positive sign for the continued strength of Europe and the US markets. Second, some commentators expect that the crisis will result in a further shift in both the market structure and the important 'players' in the market. As we have seen, both China and India continued to see positive economic growth during these difficult times. This strength is expected to increase their dominance in financial services going forward. The key factors here being continued domestic economic growth and moreover the substantial liquidity reserves these countries hold compared to the developed economies. The Middle East and other 'oil' nations are expected to continue to play a major role, through the increasing importance of Sovereign Wealth Funds as a source

of liquidity and through their search for investment returns. These factors need to be monitored closely and considered when looking at the competitiveness and growth of EU financial services.

23. We have also seen increasing co-operation and convergence between the EU and US markets and the convergence of global regulatory approaches in financial services. It is important that these developments continue and that the dialogues between all markets remain open.

6. CONCLUSIONS - BUILDING A STRONGER FINANCIAL SYSTEM

6.1. Introduction

1. Throughout the previous chapters we have seen that the financial crisis has had a substantial negative impact on financial integration, efficiency and competition in the EU financial sector. We have seen various indicators pointing towards a slow down, or even financial market segmentation, such as a substantial decline in cross-border mergers and acquisitions and a divergence in money and bond market interest rates across the EU. Recently, however, there are indications that the decline may have stopped, or at least slowed down. Since the spring of 2009, EU financial markets have begun to stabilise; a majority of Euro-area banks do not experience any problem in their access to liquidity. Confidence has also returned to the equity markets with increasing equity prices and decreasing volatility. This financial stabilisation has had a positive impact on the EU financial integration process as well; e.g. money and bond market interest rates differences in the Euro-zone have recently started to converge again. Even if it is too early to know whether the recovery of the EU financial sector will continue, a stabilisation process has at least started.

2. Can we expect that the financial system will go back to business as usual, once the crisis is over, or will the crisis leave any lasting legacy? The global financial crisis has revealed that the capacity of the financial system to handle major risks cannot be taken for granted. Major reforms have been agreed, at the G-20 and European level, to address the roots of the financial crisis as well as adapting financial regulation and supervision to the fundamental changes in market structure and practices that have occurred in recent years. The objective has been to mitigate the risks of future financial crises.

3. The reform of the financial system has been intense since the financial turmoil started. The major focus of work, up to the end of 2008, was to enhance market transparency, to strengthen capital buffers, to increase depositor protection and to ensure the high quality of credit ratings. This broad thrust of policy was agreed at an international level, within the G-20. The challenges in the initial phase of the crisis and the EU/international policy response were reported in the 2008 edition of the European Financial Integration Report.

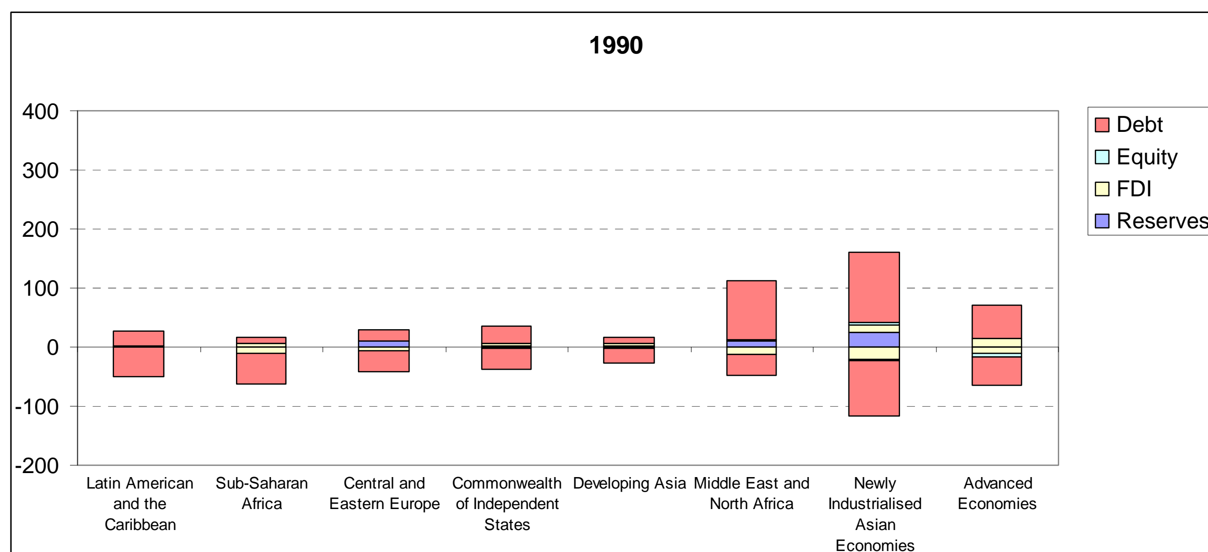
4. The work to build a stronger financial system has continued throughout 2009. This chapter highlights some of the major trends that have reshaped the financial system while at the same time creating new challenges for policy makers. A complete list of EU financial services policy achievements in 2009 is provided in annex 1.

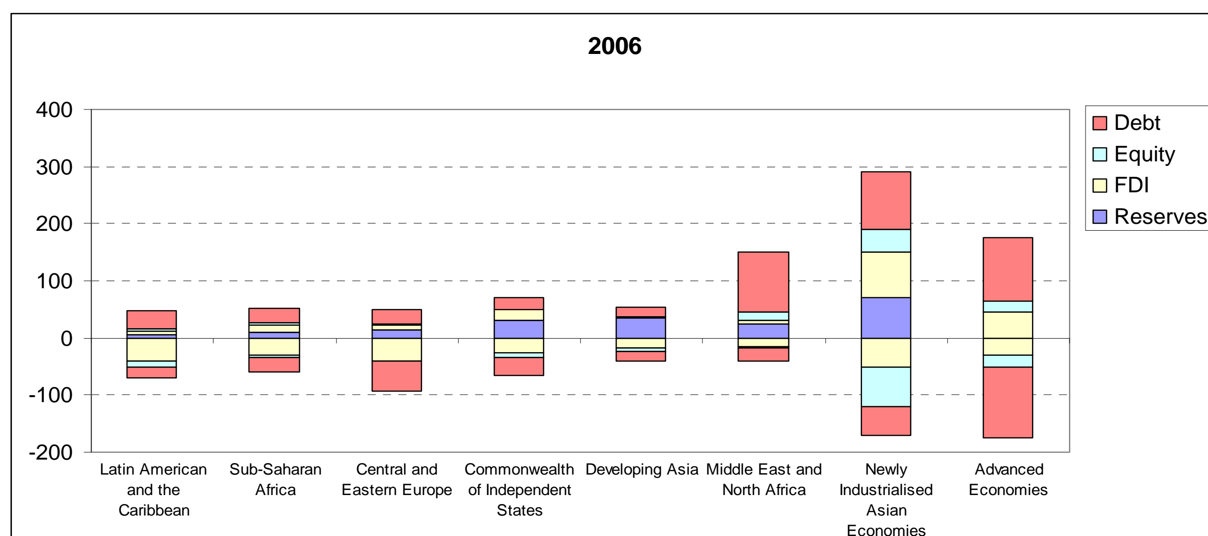
6.2. Intensified financial globalisation

5. The challenge of safeguarding stability has a clear global dimension, not at least because of the rapid advance of financial globalisation, see chart 6.1. The trend towards increasing cross-border financial linkages has been particularly pronounced between the advanced economies and the newly industrialised Asian economies. These linkages have been created through cross-border ownership (foreign direct

investments), as well as through financial exposures, originating from portfolio investments in equity and debt markets. To some extent this reflects the global financial imbalances.

6.1: Cross-border assets and liabilities, in per cent of GDP





Source: IMF (2008b).

6. It is worth noting that while financial debt instruments represented a substantial share of financial cross-border operations in 1990, foreign direct investments has increased over recent years. This indicates that financial globalisation has entered into a more mature, permanent phase, as foreign expansion through establishment can be expected to have a longer term investment horizon than portfolio investments. As a result, the importance of institutional risks as a potential source for creating systemic risks at international level has increased. We can also expect that the cross-border ownership linkages have increased over the last few years, during the financial crisis, in particular

as Sovereign Wealth Funds from emerging countries in Asia and the Middle East have been active players in funding ailing European and US financial institutions[69].

7. The advance of financial globalisation has had considerable consequences for many governments. To deal with international risks requires concerted actions to be taken at an international level. The speed at which the US originated sub-prime crisis was transferred to the EU banking system demonstrated how effective global market linkages have become as channels for financial contagion.

8. 2009 has been an intense year. Two G-20 summits have been held, in April and September, where agreements were reached to jointly stimulate the major economies and to advance the reform of global financial regulation. A key pillar of the reform program was the changes proposed to the financial architecture. In particular the International Monetary Fund and the recently established Financial Stability Board have been reinforced, and have been charged with identifying and providing early warning signals of possible vulnerabilities in the international financial system going forward. Another important change is that the circle of countries that are steering the international financial reform process has been widened to involve major emerging economies, e.g. China and India. Europe has also strengthened its role in the new global governance process; the European Commission is represented in the G-20 process, including in the recently established Financial Stability Board.

6.3. Financial integration in Europe and the reform on supervision

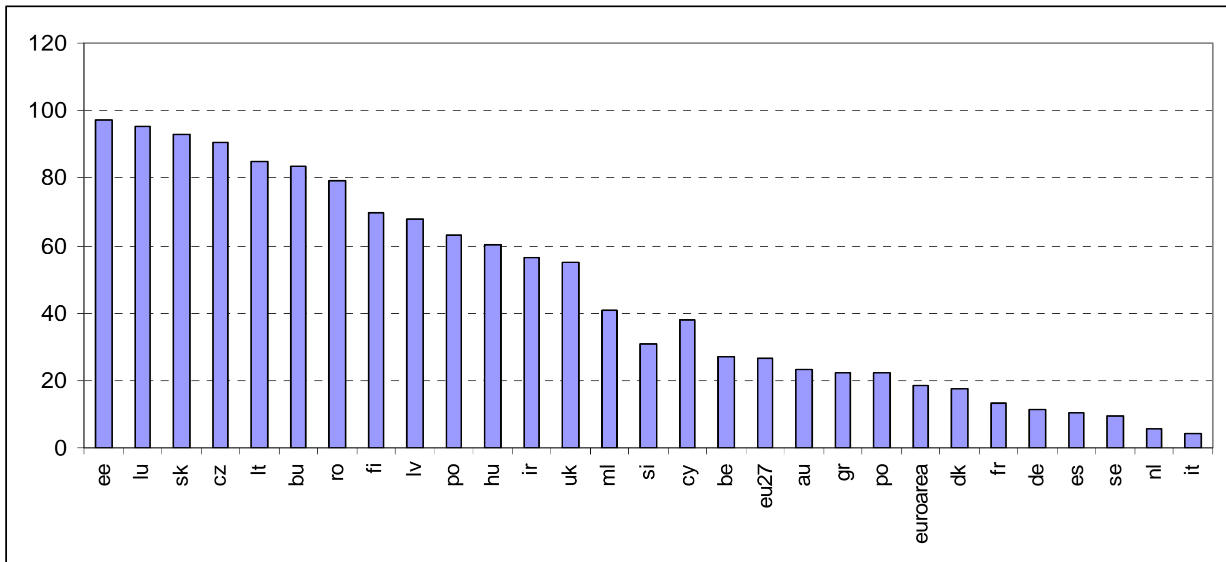
9. The need to reshape the financial architecture has not only been identified at the international level. In 2009 this issue was also at the centre of debate within the European Union. The policy to realise a Single Market in financial services, the increasing number of Member States that have opted for the euro and successive enlargements – all these factors, as well general factors such as information technology, have contributed to the advance of financial integration within the European Union. At present, this process has reached a stage where cross-border financial flows are substantial, where the number of cross-border financial groups in the European Union is important and where interest rates and prices of financial assets have converged over a longer time period. Chapter 2 documents these developments.

10. The high level of foreign ownership in the EU banking market, see chart 6.2, provides another example of the advanced degree of integration in the European financial sector. It shows that in most Member States the foreign banks represents more than half of the national banking market in terms of assets.

[69] See also www.dbresearch.com with chart on SWF investors by region.

Chart 6.2: Market share of foreign-owned banks in EU Member States in 2008

Per cent of total assets



Source: ECB (2009).

11. The advance of EU financial integration has profound implications for the way financial stability can be monitored. Several challenges can be identified.

- There are a growing number of large financial groups and infrastructures that are operating on a pan-European basis. Many of them are so large that a potential failure by one of them would risk disturbing overall market stability. The segmented, national-based organisation of supervision and crisis management no longer match their field of operation. This is also true for financial regulation, where considerable variations exist amongst Member States, despite a harmonised EU financial framework.

- Financial integration also impacts on risk transmission; while cross-border market linkages can sometimes dilute risks, they also provide vehicles for financial contagion.

- Supervision and financial stability responsibilities are not always well aligned. Both home and host countries with strong cross-border ownership ties in the financial sector are heavily exposed to the development of the counterparty's market, both as regards the financial sector developments and the general health of the economy (see also chapter 4, section 4.3). The division of responsibilities between micro- and macro- supervision are particularly divided when it comes to branches. The responsibilities for supervision and regulatory implementation of branches are in the hands of the home country while the host country has the responsibility to effectively monitor and react to financial stability threats.

- While the financial risks have become EU-wide, and sometimes even global, there is no effective oversight function at the EU level that, on a systematic basis, identifies possible problems for the financial system and communicates them to the political level for action.

12. Throughout 2009 the future of European supervision has been one of the most discussed themes in European high-level political discussions. A first step was taken in January 2009 when the Commission took action to strengthen the powers of the three existing European committees of supervisors and proposed a financial instrument to give them a secure financial basis.

13. February 2009 marked the point of departure for a deep and far-reaching reform of European supervision. At the initiative of the President of the European Commission a high-level expert group, chaired by Mr de Larosière, published recommendations which provided a blueprint for a new European supervisory architecture. One of the key recommendations in the report was to establish a European System of Financial Supervisors (ESFS). The idea was to transform the three existing European committees of supervisors into three European Authorities. Another key recommendation was to establish a European Systemic Risk Board (ESRB).

14. The European Commission welcomed these recommendations in its Communication of 4 March and then built on them to present an outline for a new European supervisory architecture in May 2009. The Commission's proposals were broadly endorsed by the European Council in June. The European Council concluded that the European Systemic Risk Board will monitor and assess potential threats to financial stability and, where necessary, issue risk warning and recommendations for action and monitor their implementation. The aim with the creation of the three new European Supervisory Authorities was to upgrade the quality and consistency of national supervision, strengthen the oversight of cross border groups through the setting up of supervisory colleges and to establish a European single rule book applicable to all financial institutions in the Single Market.

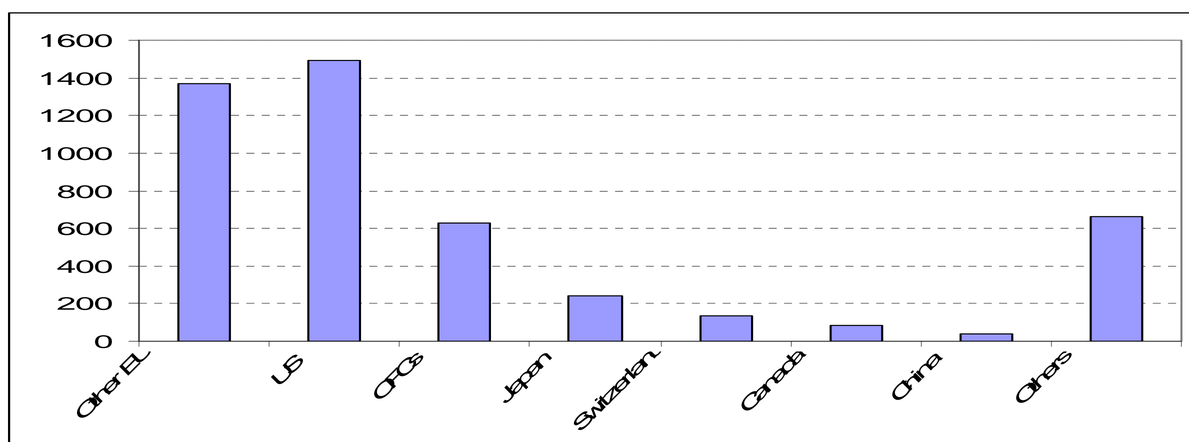
15. The Commission has taken these recommendations forward throughout 2009. In September 2009 the Commission came forward with a formal proposal on the future of European supervision, tabling the concrete legislative provisions for the establishment of the ESFS and the ESRB. It subsequently presented a first Omnibus proposal setting out a first set of changes to the relevant sectoral legislation; further changes to the sectoral legislation will be required in due course.

6.4. The growing importance of Offshore Financial Centres

16. Another high profile issue that has been discussed at an international level is the need to better monitor risks from non-cooperative and/or under-regulated jurisdictions. From an EU perspective, the importance of Offshore Financial Centres (OFCs) as a location for EU portfolio investments has grown. As illustrated in chart 6.3, OFCs have become the second most important destination for Euro-area portfolio investments outside the EU markets after the United States.

17. Although OFC-related problems have not been mentioned as being among the roots of the financial crisis, problems arising in one or several of these centres could have considerable repercussions on the EU financial sector and on global financial markets. One argument is the overall importance of such centres for EU financial business. In a situation of common financial market unrest, capital flows from such centres could have a considerable market impact. Another argument relates to the high importance of individual OFCs in special segments of the financial market (e.g. for hedge funds, reinsurance or securitisation). A problem in one of these centres could also have a major market impact. Finally the financial business volume in OFCs is often very high in relation to the size of their respective economy. This could make it difficult for home market authorities to intervene, if needed, to support the stability of the domestic financial system.

Chart 6.3: Outstanding amount of Euro-area portfolio investment assets (end 2007)
€ billion



Source: ECB (2009e).

18. In 2009, both EU and G20 leaders have called for enhanced international efforts to ensure that financial centres respect generally acknowledged standards - in the prudential, anti-money laundering/ counter-terrorist financing areas as well as on tax cooperation. The follow up of all three strands of work is ongoing under the auspices of the Financial Stability Forum (on prudential standards), of the FATF (on money laundering/counterterrorist financing standards), of the OECD (on tax cooperation standards) and at Community level. Work is also ongoing in the field of tax cooperation, following up the strategy presented in April 2009[70].

6.5. The impact of hedge funds on financial stability

19. Another area of intensified work, both at global and European level, is to ensure that all systemically important market segments are properly monitored and safeguarded.

[70] COM (2009)201 of 28/04/09 Promoting Good Governance in tax matters.

20. From a European perspective, the hedge fund industry provides an example of such a market segment. While hedge funds were not at the origin of the financial crisis, they can, in turbulent market conditions, contribute to a further destabilisation of financial markets. Over the ten years prior to 2009, the hedge fund market experienced rapid growth. In the second quarter of 2009, total industry capital peaked and reached US $ 1.93 trillion[71], which corresponds to around 3.5 per cent of all outstanding global public debt instruments[72].

21. Although there have been some hedge fund collapses during the crisis, there has not been a single one that has been sufficiently important to have a systemic impact. Recent developments have, however, demonstrated that the hedge fund industry, as an aggregate, could play an important role for financial market stability. This became clear during the second half of 2008 when hedge fund industry capital started to decline rapidly. The industry then had to respond to the many redemption calls by investors, which had often been made several months earlier as a result of the general turbulence and liquidity drain in financial markets. Many hedge fund managers – some of them highly leveraged – then had to quickly unwind some of their positions, resulting in associated collateral sales. These developments exerted pressure on financial asset prices, which were already suffering from the financial crisis. The high correlation between different funds' investment strategies may also have exacerbated the market impact. There is also increasing evidence that hedge funds dominate trading activities in more and more financial markets. This contributes to their potential systemic impact.

22. This new situation led to regulatory action. In Europe, the Commission tabled a proposal on Alternative Investment Fund Managers on 29 April, targeting not only hedge fund managers but also equity fund and other alternative investment fund managers. The proposal was to harmonise the regulatory framework and to introduce equivalent standards of supervision and transparency for all alternative investment fund managers. It also ensured that equivalent standards of supervision and transparency apply when funds, managers and other entities (e.g. depositaries and valuation agents) providing services for European investors are located outside the EU. In the United States, a bill, "the Private Fund Investment Advisers Registration Act", has been tabled that would amend the Advisers Act to generally require all advisers to private funds to register with the Securities and Exchange Commission. The SEC would be granted broad rulemaking authority with respect to disclosure. This shows that the general approaches of the EU and US are similar; a broad scope focusing on fund managers/advisors and increased disclosure requirements.

6.6. Strengthening the banking sector

23. A strong, solid banking sector provides the necessary backbone for a stable financial system. The amount of public money that has been used in the financial crisis reveals the seriousness of the prevailing problems.

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[71] According to the European Securitisation Forum.

[72] According to the IMF Global financial stability report, public debt securities amounted to 28,629 bill dollars in 2007.

24. One such problem relates to banks´ incentive structures. Several factors encouraged banks´ excessive risk taking. One of them was the remuneration structure, which was sometimes based only on short term returns without fully acknowledging the longer term implications of such risk exposures; see also section 6.7 (below). Another incentive for excessive risk taking was due to the capital requirements provisions relating to the securitisation of financial assets. In 2009, the European Commission tabled proposals to address these and other risks relating to regulatory capital, see box 6.1 at the next page.

Box 6.1: Reinforcing the resilience of the EU banking sector – Commission proposals on regulatory capital in 2009

To address risks related to resecuritisations:

- Resecuritisations held in the banking book will be subject to higher capital requirements, to make certain that banks take proper account of the risks of investing in such complex products. Banks will be also required in their investment decision-making process to conduct comprehensive due diligence and if they fail to do so, they will be subject to penalties. These rules complement the proposals of the Commission from 2008 that were adopted by the European Parliament and by the Council in 2009 which will require banks that repackage loans into securitisations to retain a certain exposure to these securities on their books.

- To enhance transparency and market confidence, disclosure requirements for resecuritisation operations will be strengthened.

To promote a balanced remuneration structure in the financial sector:

- Banks and investment firms have been requested to ensure that they have a sound remuneration policy in place that does not encourage or reward excessive risk-taking. Banking supervisors will be given the power to sanction banks and investment firms that do not comply with the new requirements.

To reinforce regulatory capital for the trading book activities of EU banks and investment firms:

- Volatility of capital requirements will be minimized and their level enhanced in order to better contain potential losses from adverse market movements with respect to financial instruments on banks' trading books.

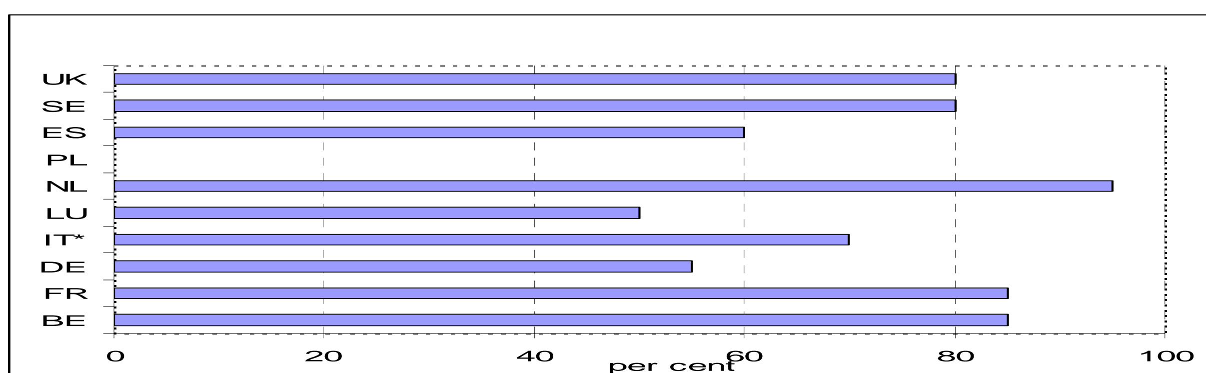
25. The reforms to strengthen the banking sector are not yet complete. At the G-20 summit in September 2009 it was agreed that the level of bank capital requirements should be increased, along with its quality. Counter-cyclical capital buffers, higher capital requirements for risky products and off-balance sheet activities were also part of the agreement. This overhaul of capital requirements should be accompanied by strengthened liquidity risk requirements and forward looking provisioning – in order to reduce incentives for banks to take excessive risks and to create a financial system that is better prepared to withstand adverse shocks.

6.7. Stability concerns related to risk management

26. The weakness of risk management in the financial sector, both in Europe and in the US, has been one of the elements at the heart of the crisis. What was it that went so wrong? Is a stronger risk management function required? These key issues have been discussed throughout 2009, both by the business community and by politicians.

27. Looking deeper into this issue, there is both positive and negative news. Starting with the positive, the deadline of the full implementation of the Basel II[73] package has most probably increased the risk management capability of the banking sector. The IRB status is only granted to the bank by the home country supervisor after the applicant has proven the integrity of the bank's risk models, data bases, processes and controls. To be eligible, a bank normally needs to deploy considerable resources to reengineer the bank's credit process. We can therefore expect that banks that have been granted IRB status will have stronger risk management capabilities than those that apply the standard approach. Chart 6.4 shows that the market shares of IRB-banks lies between 50-95 per cent in the selected Member States. This provides an indication of the considerable upgrading that has taken place in recent years of European banks' risk management capabilities.

Chart 6.4: Market share of IRB banks in selected Member States



*Italy – estimated market share in the future, in Poland all banks used the standard approach.
Source: CRA International (2009).

28. On the negative side, however, it is clear that the implementation of the Basel II provisions did not cover all relevant risks. For example, it did not fully address the weaknesses of the existing risk models. There could be several explanations to why risk models did not warn about the accumulation of risks in financial institutions before the crisis erupted. One possible reason could be that the historical data on which models were based were not fit to adequately predict the future; innovative instruments and techniques that were at the heart of the crisis had only played an important role in recent years and moreover, financial markets had been unusually benign in this period. Another reason could be the limitations of the models themselves; many of them seemed to have faced difficulties in correctly assessing second-round effects resulting from herd behaviour.

29. As mentioned before, another concern relates to the incentive structure in the financial sector. It is well acknowledged that the remuneration structure has played a role in encouraging executives and others with variable pay to become less risk sensitive. Bonuses and other types of variable pay have often been based on market shares and

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73 The deadline for the full implementation of the Basel II Accord in the European Union, embodied in the Capital Requirement Directive, was 1st of January 2008.

other indicators of short-term profitability, without taking full account of risks over the medium term. The modified incentive structure provides an additional explanation to many financial institutions' readiness to increase their leverage ratios.

30. The possible impact of the remuneration structure on systemic risks has been a high profile political issue throughout 2008-2009, both at the European Union and international level. The common point of departure has been that it is in the public interest to ensure that the remuneration structure does not encourage excessive risk taking, which ultimately could destabilise the financial system.

31. At the EU level, a Commission Recommendation on sound remuneration policies in the financial sector was tabled in April 2009, followed by binding obligations, in July, for credit institutions and investment firms, see box 6.1. The EU policy on remuneration has been coordinated at international level and is consistent with the Financial Stability Board's principles on Sound Compensation. These principles are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes but do not prescribe levels of compensations.

6.8. Conclusions

32. The financial crisis has left a legacy. The crisis demonstrated that there is a need to strengthen the financial system to make it more able to withstand future financial shocks. In particular, the reform of the system needs take into account the increasing pace of financial globalisation as well as the deepening of financial integration within the European Union.

33. One of the key approaches to deal with the challenge of more internationalised financial market is through concerted international action, at both a global level and within Europe. The G-20 has provided a new platform for international policy coordination, to restore financial stability in the short term and to build a stronger financial system for the future.

34. The level of financial integration is particularly high in the European Union. The reform of European supervision has been at the heart of the political discussion on financial services policy over 2009. The objective has been to more effectively monitor cross-border risks throughout the European Union, in particular related to large cross-border entities, with a view of promoting efficiency as well as stability. Initiatives have also been taken to ensure that remuneration structures are commensurate with risks, that capital buffers are strengthened and are of a sufficiently high quality, that standardisation and transparency are enhanced at the derivative markets and that regulatory gaps of all other important financial segments are addressed. One example of the latter is the enhanced efforts, steered by the G-20, to ensure that under-regulated and/or uncooperative jurisdictions across the world comply with international standards. Another example, where the EU has been in the lead, is the regulation of alternative investment managers, among them hedge fund managers. The reform work serves to strengthen the financial sector for the future, with a view of improving its efficiency and stability.

ANNEX I: POLICY ACHIEVEMENTS IN 2009

1. In 2009 and in the wake of the financial crisis the Commission launched a comprehensive review of the EU regulatory and supervisory framework for financial services. This review was based on two Strategic Initiatives included in the Commission Legislative and Work Programme: 'Financial Markets for the Future Package', which aimed at filling regulatory gaps, and 'Supervision of EU Financial Markets', which took forward the recommendations of the de Larosière group that was established in late 2008.

2. Individual policy initiatives aimed at addressing the problems highlighted by the crisis were outlined in the Programme for Financial Market Reform which accompanied the Commission Communication 'Driving European recovery' that was adopted on 4 March 2009. The main elements of the Programme were devoted to supervision, alternative investment management, remuneration, prudential requirements for banks and measures to strengthen consumer and investor confidence. They were largely consistent with the global agenda for reform outlined by the G-20.

3. Apart from this new Programme, the Commission continued with the implementation of policy initiatives started in previous years, such as the Ecofin Roadmaps ('Actions taken in response to the financial turmoil', 'Review of the Lamfalussy process' and 'Strengthening EU arrangements for financial stability'), the SEPA, and the simplification and the administrative burden reduction exercises.

Financial market supervision

4. Implementing the conclusions of the Lamfalussy process carried out in 2007, the revised Commission Decisions establishing the EU Committees of Supervisors were adopted in January 2009. The CESR[74], CEBS[75] and CEIOPS[76] status was strengthened and their tasks updated and aligned. At the same time, the Commission adopted a proposal for a European Parliament and Council Decision establishing a Community financial grant programme to support the Level 3 Committees activities as well as the work of IASCF, EFRAG and PIOB in the field of financial reporting and statutory audit (see also below). The EP and the Council adopted this Decision in September.

5. The President of the European Commission set up the High Level Group on financial supervision in the EU under the chairmanship of Jacques de Larosière in October 2008. The Group delivered its report in February 2009. It recommended the reform of the EU supervisory architecture based on two pillars: one for macro- and the other one for micro-prudential supervision, aimed at enhancing financial stability in Europe and ensuring a level playing field for the financial services industry. The report also included a number of recommendations for regulatory reform of the EU framework for financial services.

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[74] Committee of European Securities Regulators.

[75] Committee of European Banking Supervisors.

[76] Committee of European Insurance and Occupational Pensions Supervisors.

6. The Commission endorsed the de Larosière Group's recommendations in the Communication of the 4th March and subsequently developed the policy proposals which were presented in the Communication 'European financial supervision' of the 27th May. The Commission proposed the creation of a European Systemic Risk Council (later renamed 'Board') for monitoring risks to macro-financial stability, and a European System of Financial Supervisors as a network of new European Supervisory Authorities and the national supervisors to ensure the most effective and efficient organisation of micro-prudential supervision. The European Council on 19 June largely endorsed the 27th May Communication, inviting the Commission to prepare the respective legislative proposals.

7. The Commission adopted a package of measures to establish the European Systemic Risk Board (one Regulation and one Council Decision) and the European System of Financial Supervisors (three Regulations establishing respectively the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities Markets Authority) on 23 September 2009. The package included also a working document outlining the planned changes in legislation to make the new Authorities operational.

8. The so-called 'Omnibus' proposal for a Directive, including changes to a series of sectoral directives to define the scope of powers of the new European Supervisory Authorities, was adopted by the Commission in October. It is expected that the new system for financial supervision will become operational in 2011, following the co-decision negotiations and the adoption by the Parliament and the Council.

Prudential legal framework

9. Following the amendments to the Capital Requirements Directives that were adopted in October 2008 (the CRD II package) that introduced rules on the securitisation retention, in July 2009 the Commission adopted a proposal to further amend the CRD (the CRD III package). The proposed amendments address capital requirements for the trading book and re-securitisations, disclosure of securitisation exposures, and remuneration policies (see also below). They aim at reinforcing the prudential framework for banks in those areas which were linked with causes of the crisis. In July 2009 a public consultation was launched on possible changes to the Capital Requirement Directive (the CRD IV package) relating to the following areas: through-the-cycle expected loss provisioning; specific incremental capital requirements for residential mortgages denominated in a foreign currency; and the removal of national options and discretions.

10. In October, the Commission published a Communication on EU framework on cross-border crisis management in the banking sector, scoping out a broad range of issues that need to be addressed at the EU level to ensure stability of the banking sector and create the conditions under which failure of a cross-border banking group can be effectively handled. An operational framework would provide the necessary safety net and as such would fully complement the reform of the EU system of financial supervision. After adoption the Communication was submitted to a public consultation.

11. In June, the Commission published a report on compliance with the Anti-Money Laundering Directive. The report analyses how banks belonging to a group of companies comply, as a group, with their obligations pursuant to the AML Directive in a cross-border context and the difficulties they face.

12. In April, the European Parliament and Council adopted the Solvency II directive on the take-up and pursuit of insurance and reinsurance business. The formal adoption took place a few months later, pending the legal revision of the texts. In the meantime, the Commission, together with national supervisors, worked on the preparation of the implementing (Level 2) measures.

13. In April, the Commission published a report on Institutions for Occupational Retirement Provision (IORP) Directive focussing on the calculation of technical provisions, application of investment rules, adaptation of national supervisory systems and cross-border custodianship.

14. The Regulation on Credit Rating Agencies, proposed by the Commission in November 2008, was adopted in September. The CRA Regulation, covering the operation and supervision of credit rating agencies in the EU, entered into force in December.

15. Under the 'Better Regulation' principles, in September, the Commission proposed amendments to the Prospectus Directive. The changes were aimed at increasing legal clarity and efficiency, enhancing investor protection and eliminating unnecessary administrative burdens.

16. In April, the Commission adopted a proposal for a Directive on Alternative Investment Fund Managers (AIFM). The proposal covered all types of non-UCITS funds such as hedge funds, private equity and other types of institutional funds, and thus filled an important gap in EU regulation. The managers of those funds would have to be authorised and subject to ongoing supervision to ensure that the funds are transparent, have appropriate governance standards and have robust systems in place for the management of risks, liquidity and conflicts of interest. The proposal differentiated between various types of funds to address inherent risks in the different business models.

Retail financial services

17. The financial crisis underscored the need for a regulatory environment which provides a sound basis for informed decision making, and one in which investors are confident about the information and services they receive. In April, the Commission adopted a Communication on Packaged Retail Investment Products which outlined the need to update the current EU regulatory framework in this area and to introduce new legislation on product disclosure and selling processes. The overarching aim of this policy initiative was to foster consistency in the approach taken for different packaged investment products, such as investment funds, insurance-based investments and the various types of structured products.

18. The recast of the UCITS Directive (2009/65/EC) was published in the Official Journal of the European Union on 17 November 2009. The new directive introduces provisions

that will increase the efficiency of the EU regulated investment fund framework, enhance consumer protection and strengthen supervisory mechanisms. The Commission Services have been working on implementing legislation with the aim of having them adopted by July 2010.

19. The crisis has demonstrated that a lack of retail clients' trust in their banks can have dramatic consequences. In October 2008, the Commission proposed amendments to the Deposit Guarantee Scheme Directive, increasing the coverage levels to €50,000 (€100,000 in the long term) and shortening of the pay out period. These amendments were adopted by the Parliament and the Council in March. Throughout 2009, the Commission Services have continued to examine ways to further enhance effectiveness and resilience of the deposit protection system in the EU. Over the same period, preparatory work has been carried out for a review of the Investor Compensation Schemes Directive, to be completed in the first months of 2010, as well as in view of possible policy proposals on Insurance Guarantee Schemes.

20. The Commission Services pursued several other work strands aimed an enhancing the confidence of consumers and investors, based on the Programme set out in the 4 March Communication. These included preparatory work on responsible lending and borrowing, an analysis of rules and practices to avoid mortgage foreclosure procedures; and the preparation of initiatives to strengthen consumer stakeholder groups' capacity to provide input to policy making at the EU level. The Commission Services also continued to pursue initiatives started in previous years in the areas of financial education, financial inclusion, customer mobility and credit, including work with Member States to prepare for the national implementation of the Consumer Credit Directive[77] before 11 June 2010.

Financial market infrastructure

21. The Commission Services continued to monitor the implementation of the Code of Conduct for Clearing and Settlement that was signed in 2006. In 2009 the Monitoring Group met on a quarterly basis (February, July, and October) and the Commission Services reported to the ECOFIN in November. The progress achieved by infrastructures in terms of price transparency and price reduction, ensuring multilateral access and interoperability, service unbundling and accounting separation etc., is evidenced in Chapters 2 and 3 of the present report.

22. In October, the Commission - building on the findings of the FISCO Group regarding the fiscal barriers for clearing and settlement, better known as "Giovannini barriers 11 and 12" - adopted a Recommendation on withholding tax relief procedures. The purpose of the Recommendation was to make it easier for investors resident in one EU Member State to claim entitlements to relief from withholding tax on securities income (mainly dividends and interest) received from another Member State. The Recommendation also provided guidance in how to ensure that procedures to verify entitlement to tax relief do not hinder the functioning of the Single Market.

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[77] Directive 2008/48/EC.

23. The developments during the financial crisis showed that the lack of central counterparties for clearing over-the-counter (OTC) derivatives, particularly Credit Default Swaps, exposed the financial system to serious risks. Therefore, the Commission Services fostered work on improving safety in the OTC derivatives markets, especially regarding CDS. A report was published in July, looking at the role played by derivatives in the financial crisis, their benefits and risks, and assessing how these risks can be reduced. This was followed by a public consultation. In October, the Commission issued a Communication presenting the operational conclusions based on the report and on the consultation, and signalling appropriate legislative initiatives to be pursued going forward.

24. In 2009 the Commission Services, following a request of the ECOFIN Council in December 2008, prepared a draft for a future "Securities Law Directive". The instrument is designed to enhance legal certainty in securities holding and transactions in the financial market and to strengthen the investor's position as regards the exercise in a cross-border context; furthermore, central securities depositories are granted freedom to provide their services throughout the Internal Market. A public consultation was held in the first half of the year as part of the impact assessment procedure.

25. In September, the Commission adopted a Communication outlining the Roadmap 2009-2012 to complete implementation of the Single Euro Payments Area (SEPA). The Communication identified a series of actions to be undertaken by the EU and national authorities, industry and users, grouped under six priority objectives: (1) foster migration, (2) increase SEPA awareness and promote SEPA products (3) design a sound legal environment and strengthen SEPA compliance, (4) promote innovation, (5) ensure necessary standardisation, interoperability and security, and (6) clarify and improve SEPA governance. Throughout the year the Commission also worked through other means to foster migration towards SEPA, in particular its benchmarking surveys on SEPA preparedness and migration by public authorities and the major public consultation on possible end-dates for SEPA migration. As from 2 November 2009, European banks have started, for the first time, to offer customers, both consumers and businesses, the new SEPA Direct Debit which can be used for national and cross-border euro direct debits throughout the 32 SEPA countries (EU 27, plus Iceland, Liechtenstein, Norway, Switzerland and Monaco). The Commission supported this launch by providing necessary legal platform for SEPA, in particular for SEPA Direct Debit, through the Payment Services Directive. In addition, the new Regulation on cross-border payments[78] provided further legal clarity needed to launch the SEPA Direct Debit. Both, Payment Services Directive[79] and the new Regulation on cross-border payments entered into force on 1 November 2009.

Corporate environment

26. The financial crisis raised serious questions about the adequacy of the existing corporate governance practices in financial institutions. Taking into account the lessons

[78] Regulation (EC) No 924/2009 on cross-border payments in the Community.

[79] Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market.

of the crisis, in April the Commission adopted a Communication and two complementary Recommendations on remuneration policies. The objective of the Recommendation on remuneration in the financial services sector was to encourage financial institutions to develop remuneration policies for risk-taking staff that are consistent with sound and effective risk-management. The Recommendation on the regime for the remuneration of directors of listed companies promoted appropriate remuneration policies to link pay with performance and to stimulate directors to ensure the medium and long term sustainability of the company.

27. To give effect to the principles set out in the Recommendations, in July the Commission proposed the relevant amendments to the Capital Requirements Directive (see also above). The purpose of these amendments was to bring remuneration policies in banks within the scope of the supervisory review so that supervisors would be able to check whether remuneration policies and practices of credit institutions are consistent with sound risk management. In the future, the Commission Services will also examine the analogue measures in relation to non-banking financial services.

28. In November, the Commission adopted a progress report and a Green Paper on the interconnection of the European business registers. The objective of the initiative was to explore, in the context of a public consultation, ways to improve access to business information and facilitate direct communication between registries. The Paper also examined the need for legislative action and outlined options for follow-up.

29. In February, the Commission adopted proposals for amendments to the 4th Company Law Directive to exempt micro-enterprises[80] from accounting requirements. The proposal would allow Member States to exempt the EU's smallest companies from the requirement of the Accounting Directives. This would alleviate the regulatory burden: the total cost reduction potential was estimated at around € 6.3 billion or €1,200 per year per individual company.

30. The crisis raised serious concerns on some aspects of international accounting standards. A number of important accounting issues were examined at the global level, in particular the use of fair-value measurement in distressed market conditions, the potential pro-cyclical effects of fair value reporting, the reporting requirements for off-balance-sheet items and loan loss provisioning. In line with progress of the G-20 work, the Commission, assisted by the Accounting Regulatory Committee, endorsed new IFRS standards and interpretations throughout the year.

31. In September, the European Parliament and the Council adopted the Decision on financing of the International Accounting Standards Committee Foundation (IASCF), the European Financial Reporting Advisory Group (EFRAG) and the Public Interest Oversight Body (PIOB) (see also above). The purpose of the EU funding was to increase independence and effectiveness of these bodies in fulfilling their statutory tasks.

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[80] Micro entities are defined as those companies that on their balance sheet dates do not exceed the limits of two of the three following criteria: balance sheet total of EUR 500,000, net turnover of EUR 1,000,000 and an average number of employees during the financial year of 10.

32. In July, the Commission Services published a summary report of the responses to the public consultation on control structures of audit firms, launched in November 2008. The stakeholders recognised the need to open up the market for the audit of international companies to more suppliers and favoured removing all barriers that may prevent new firms from entering the market.

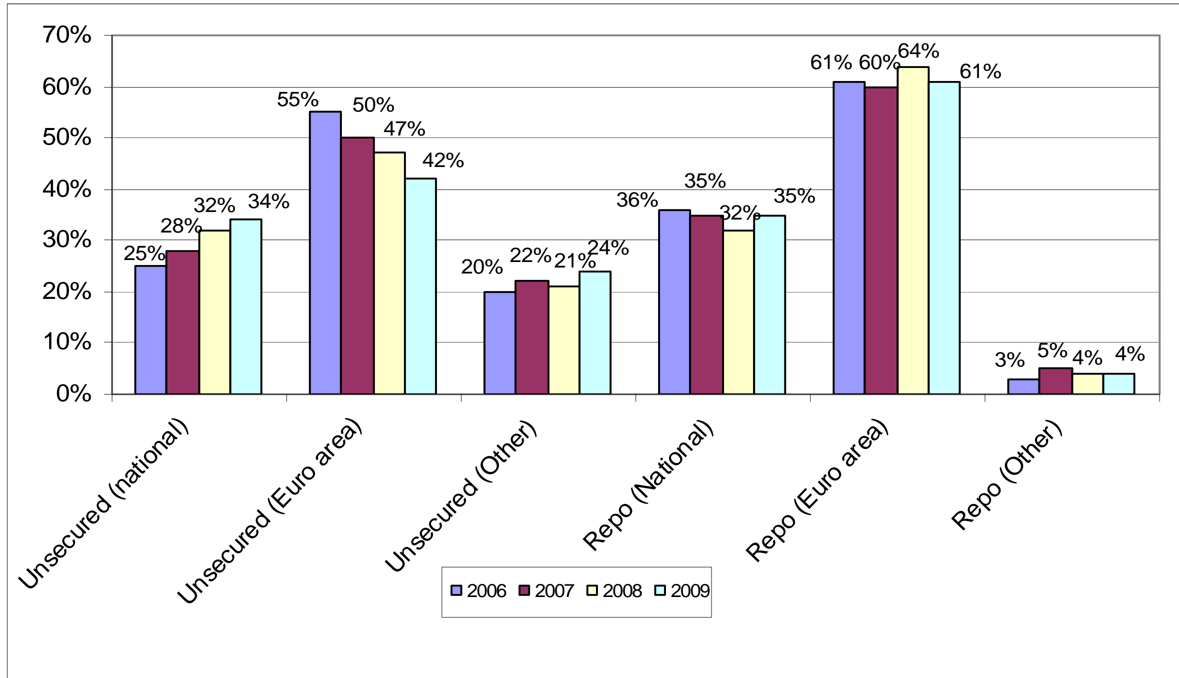
International regulatory dialogues

33. In 2009, the Commission continued to be active in deepening international financial services regulatory dialogues with the US, Japan, Russia India and China. A number of meetings took place. The work on those dialogues also benefited from the Commission's membership in the G20 and the Financial Stability Board (FSB), which was created by the decision of the April 2009 London Leaders Summit. The FSB was an instrumental body for ensuring the delivery of the G20 commitments in the run up to Pittsburgh summit in September. The Commission actively contributed to the meetings of the Board and its various subgroups. It also monitored the implementation of the G20 commitments in the EU, whilst promoting the EU regulatory framework at a global level, driven by the objective of achieving a level playing field.

34. The EU-US Financial Markets Regulatory Dialogue (FMRD) was impacted by global developments in 2008 and 2009. When it comes to the substance of the dialogue, the proposals in the area of financial regulation currently discussed in the EU and US have fully reflected the G20 commitments to the extent that they go in the same direction and present the same degree of ambition (in particular in relation to credit rating agencies, alternative investment managers or OTC derivatives). However, it has been essential to ensure that the implementation of these commitments in the EU and the US are compatible, and do not create overlaps, duplication or even extraterritorial effects, with the ultimate effect of fragmenting investor protection or markets, imposing unnecessary burdens on economic players or damaging the level playing field. The FMRD, as it had proven in the past, has continued to be the forum of choice to identify upstream issues and come forward with solutions, subject to political and/ or legislative validation.

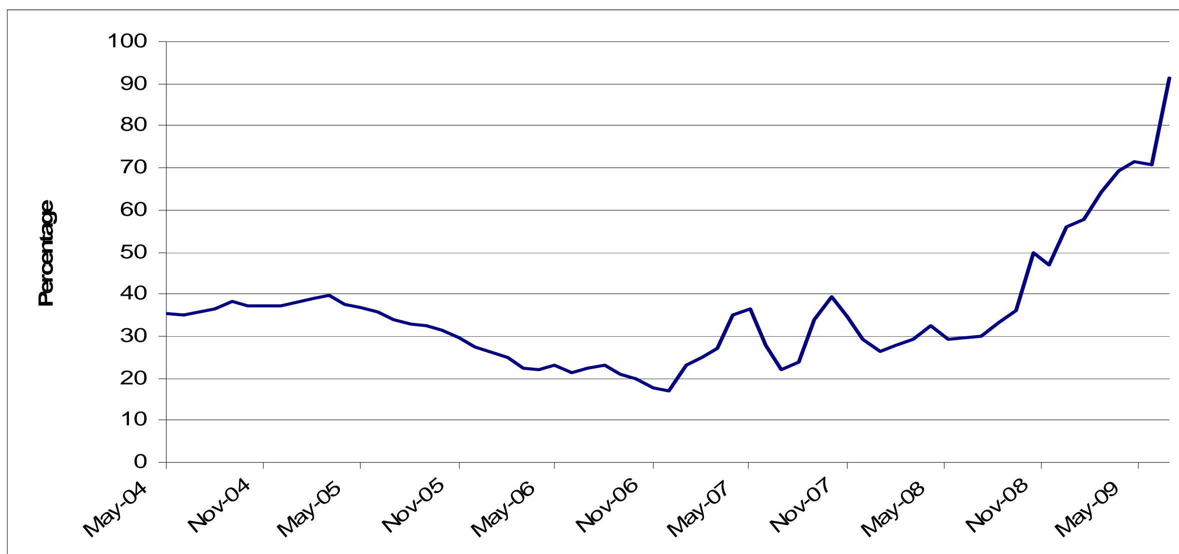
ANNEX II: STATISTICAL INDICATORS

1. Geographical counterparty breakdown in euro-area money markets (2006-09)



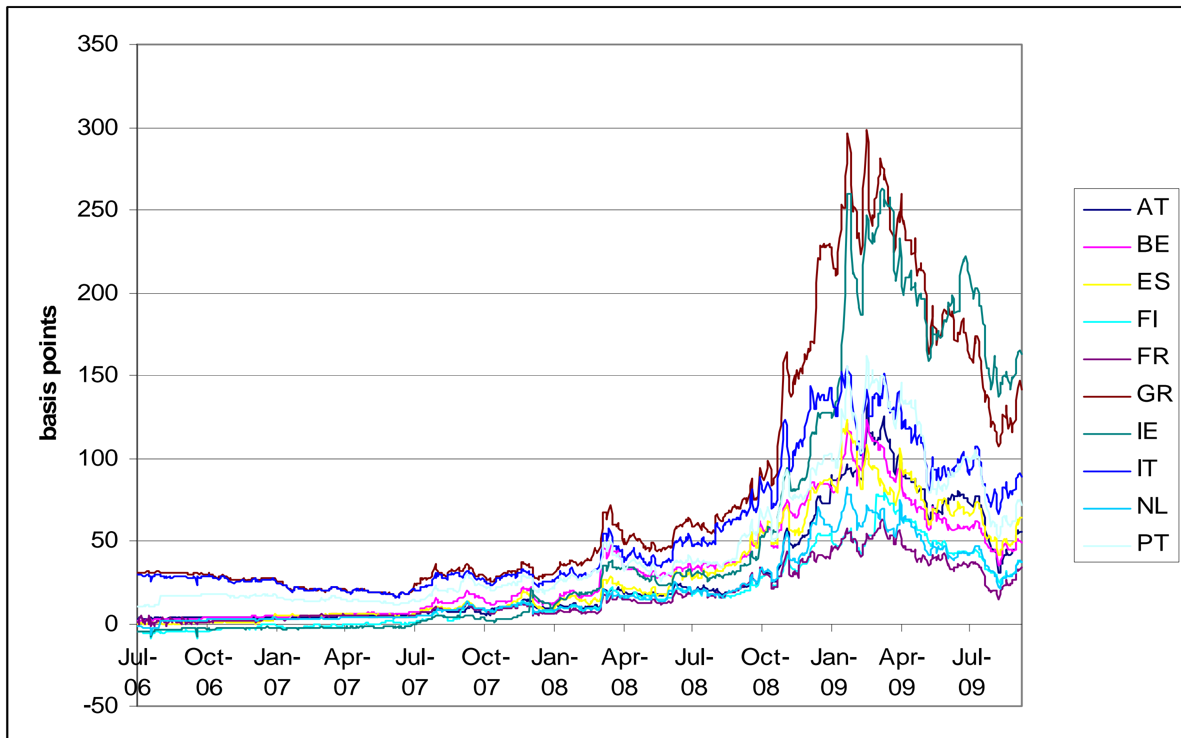
Source: ECB (2006-2009). Data on the Repo Segment refers to the geographical breakdown of the collateral. The data represented herein refer to the second quarter of each respective year.

2. Convergence of 3-month money market rates in EU countries outside the euro-area (coefficient of variation in %)



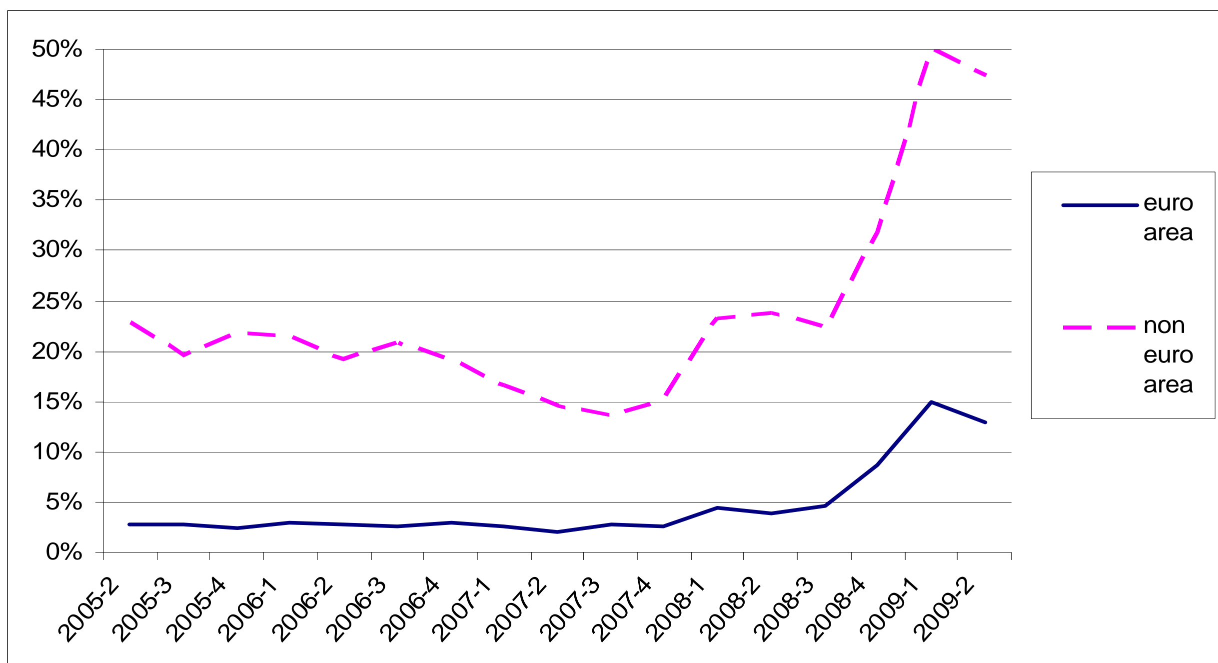
Source: Eurostat (2008), Commission services calculations. HU not included.

3. Ten-year government bond yield spread vis-à-vis the German bond



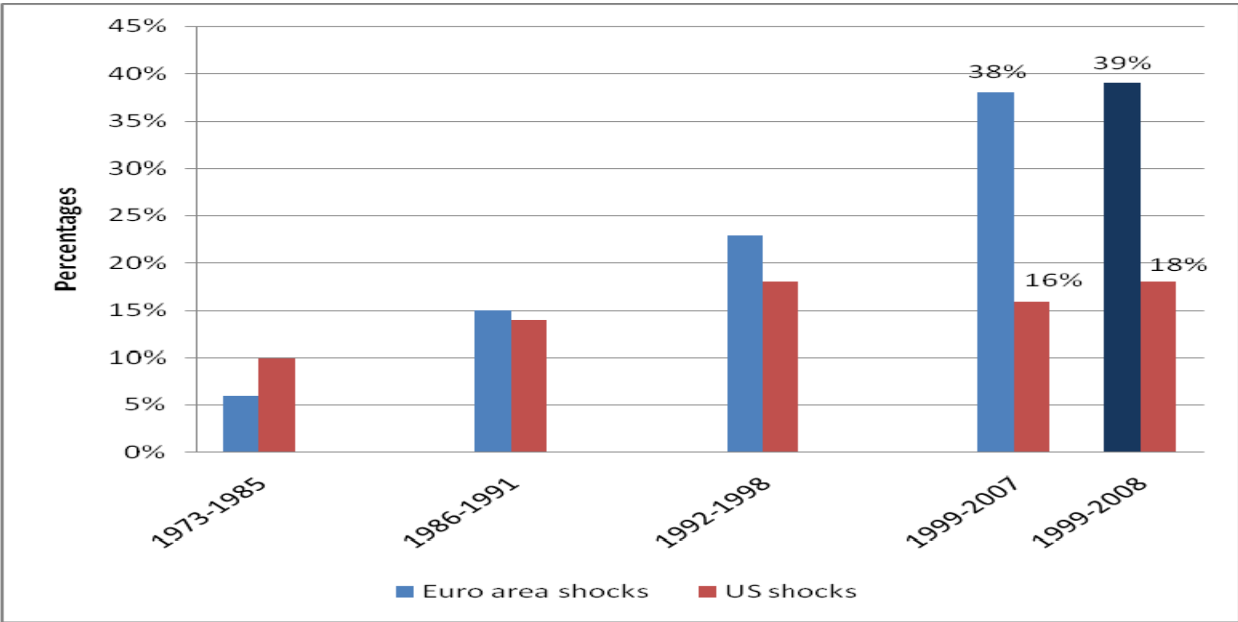
Source : ECB (2009b). Data covers the period until September 2009.

4. Convergence in long term government bond yield (coefficient of variation; quarterly data)



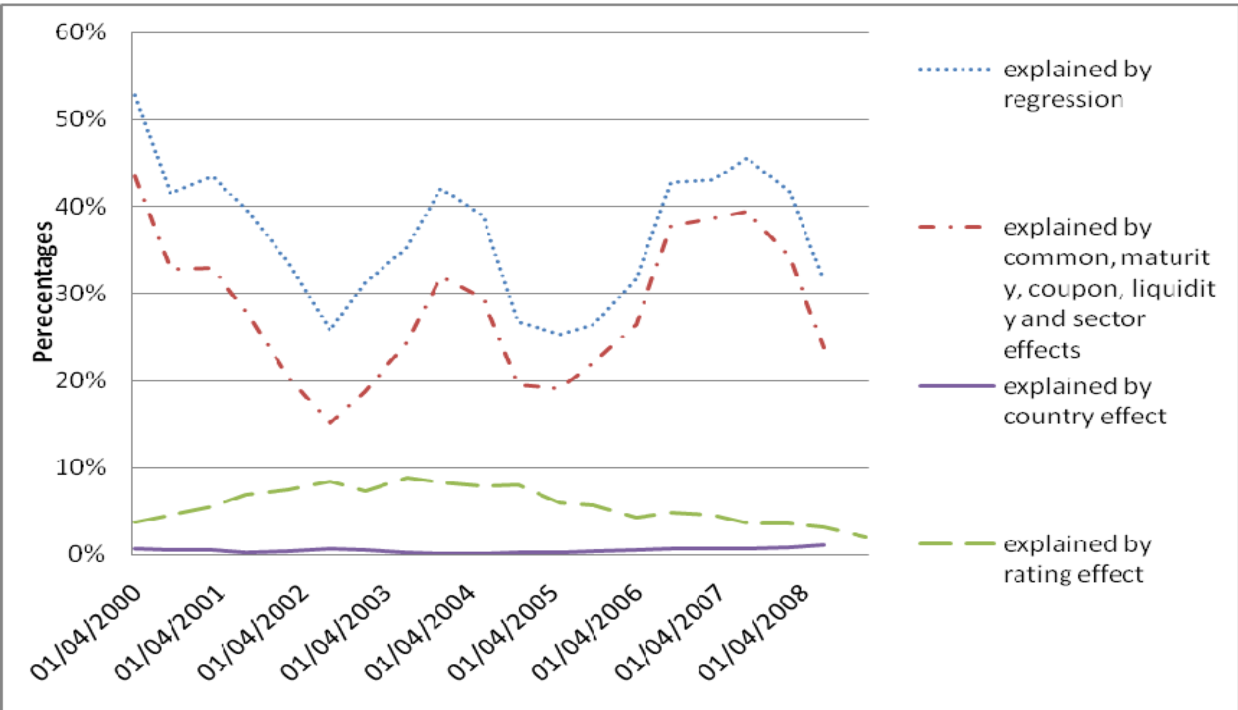
Source: Eurostat (2009), Commission services calculations.

5. Proportion of variance in local euro area equity returns explained by euro area and US shocks



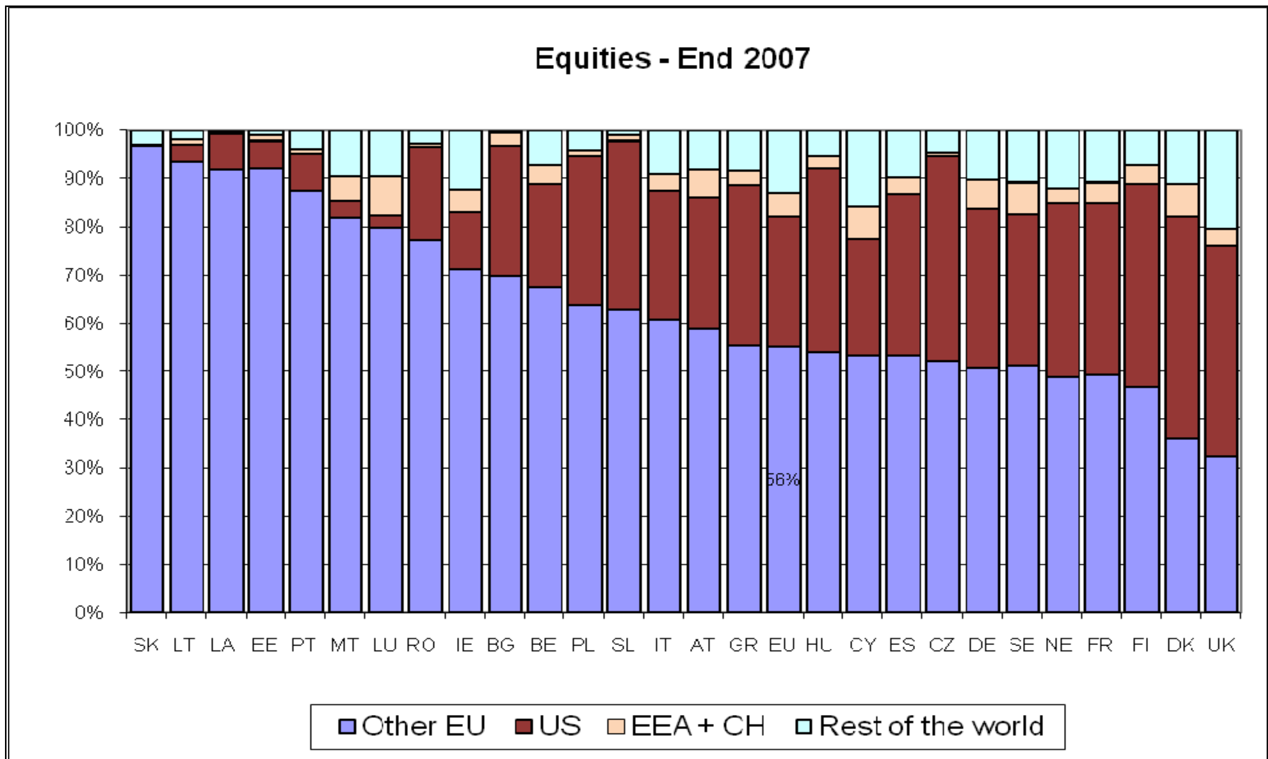
Source: ECB (2009a).

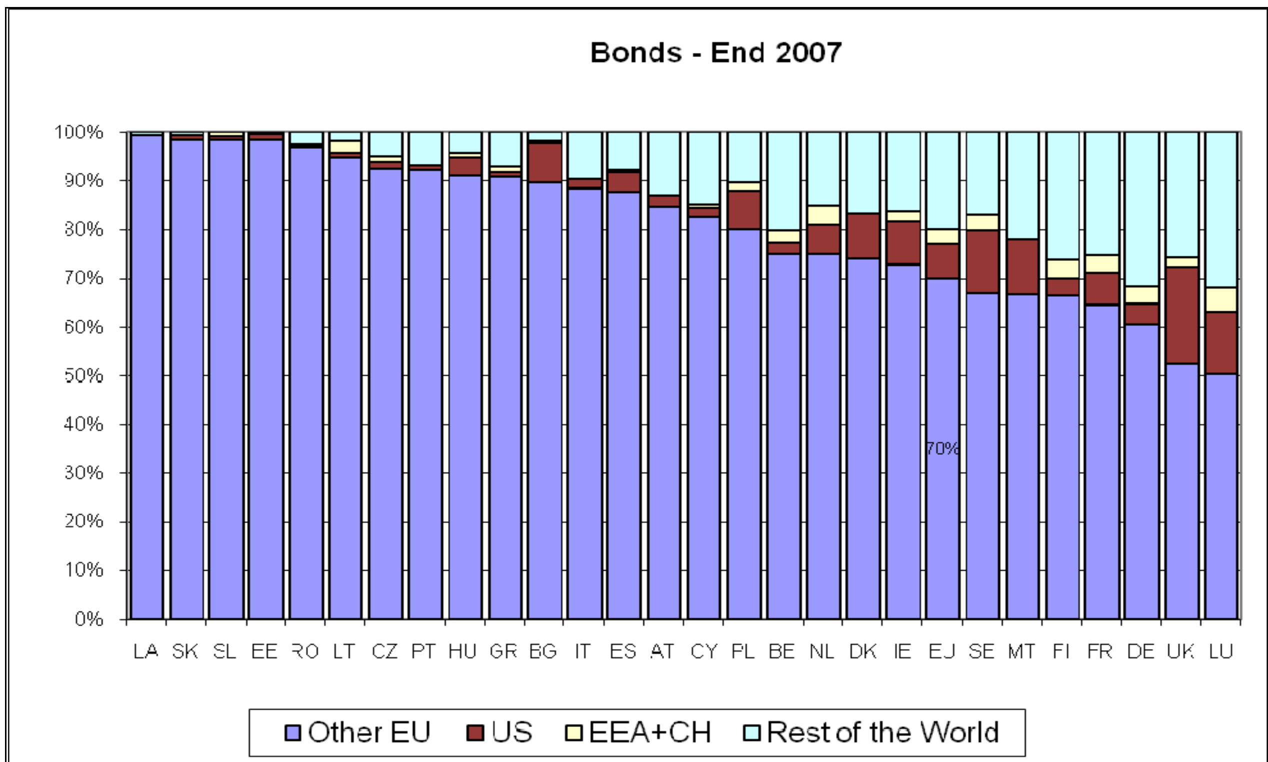
6. Cross-sectional yield spread variance of euro area corporate bonds explained by various factors



Source: ECB (2009a).

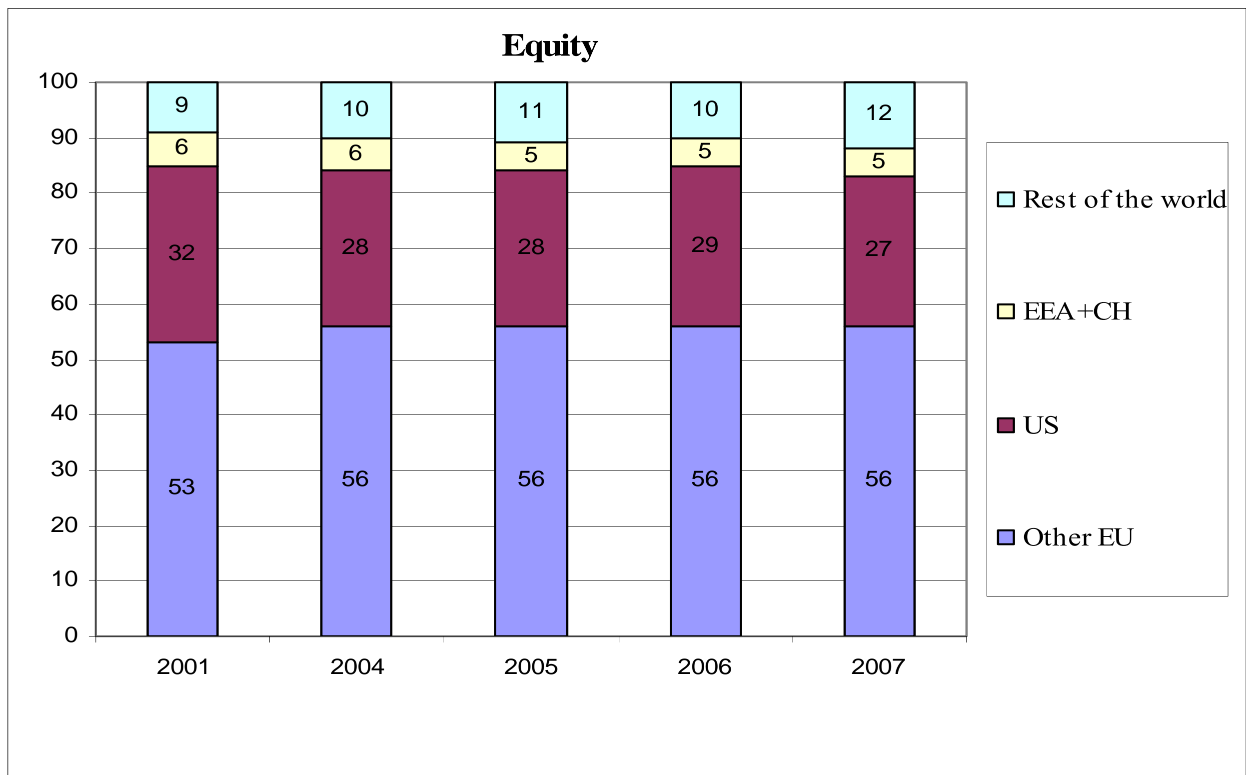
7. Foreign investment in the equity and bond markets by origin, 2007

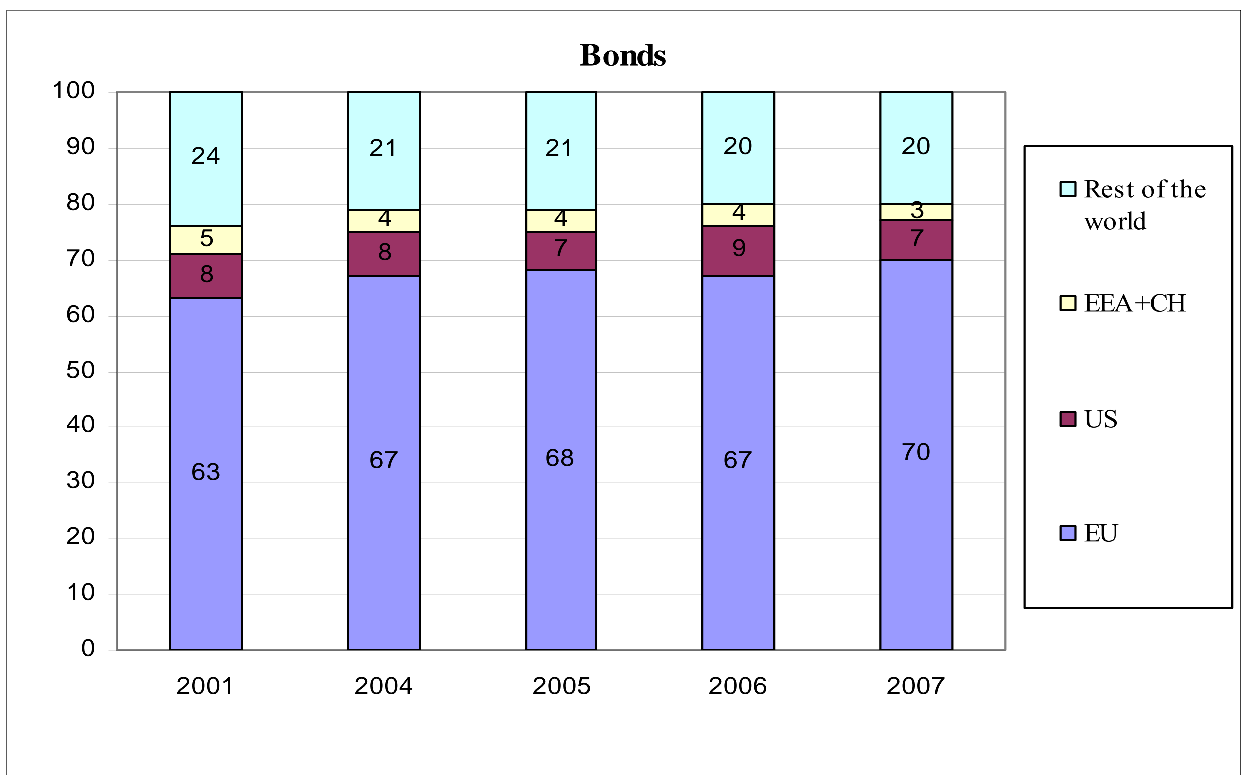




Source: IMF (2002-2009).

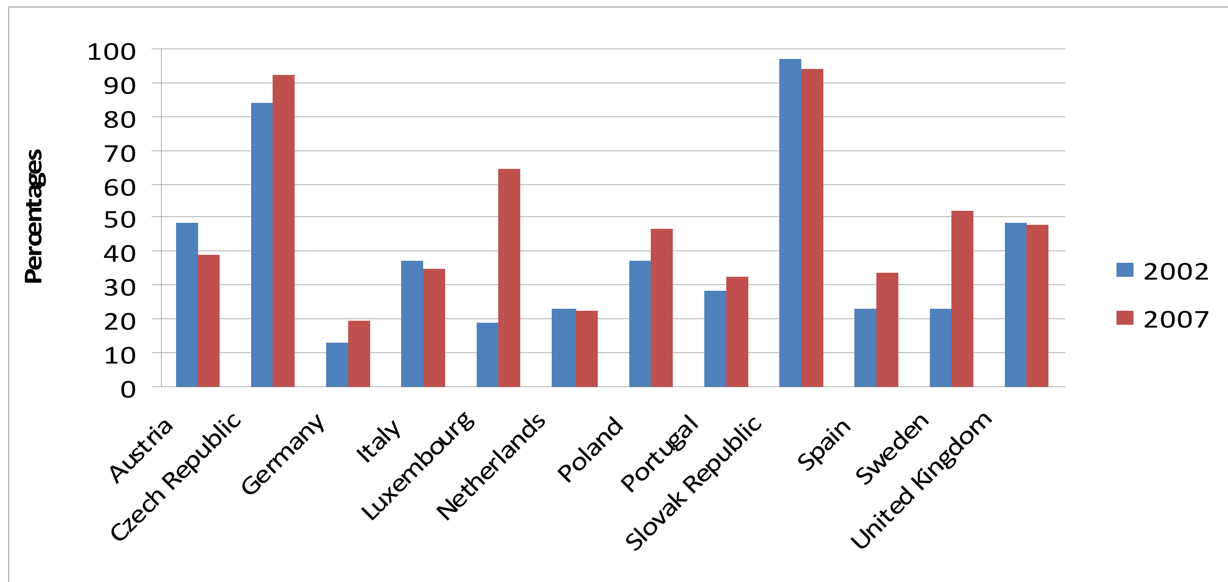
8. Equity and bond investments in EU by origin of investors, 2001-07 (percentages)





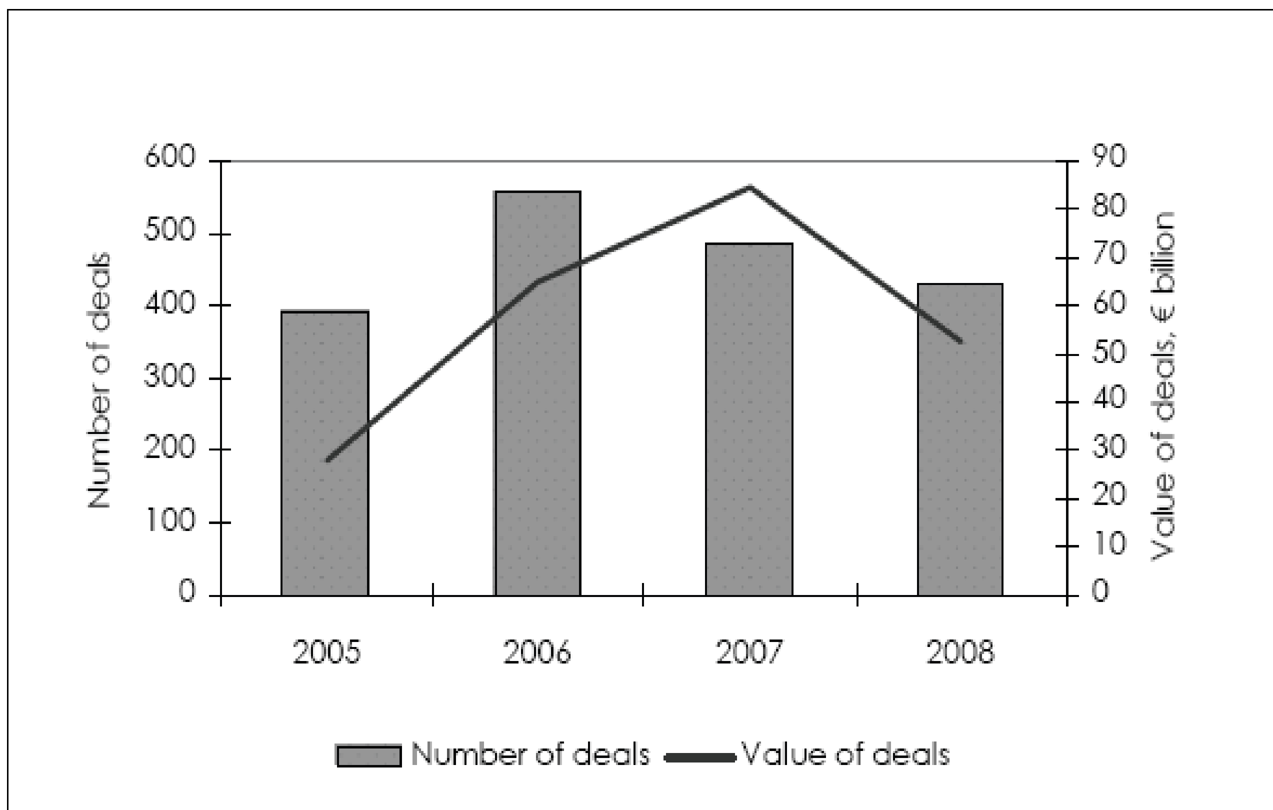
Source: IMF (2002-2009).

9. Market share of "foreign controlled undertakings" and "branches/agencies of foreign undertakings" in total domestic business (Non Life).



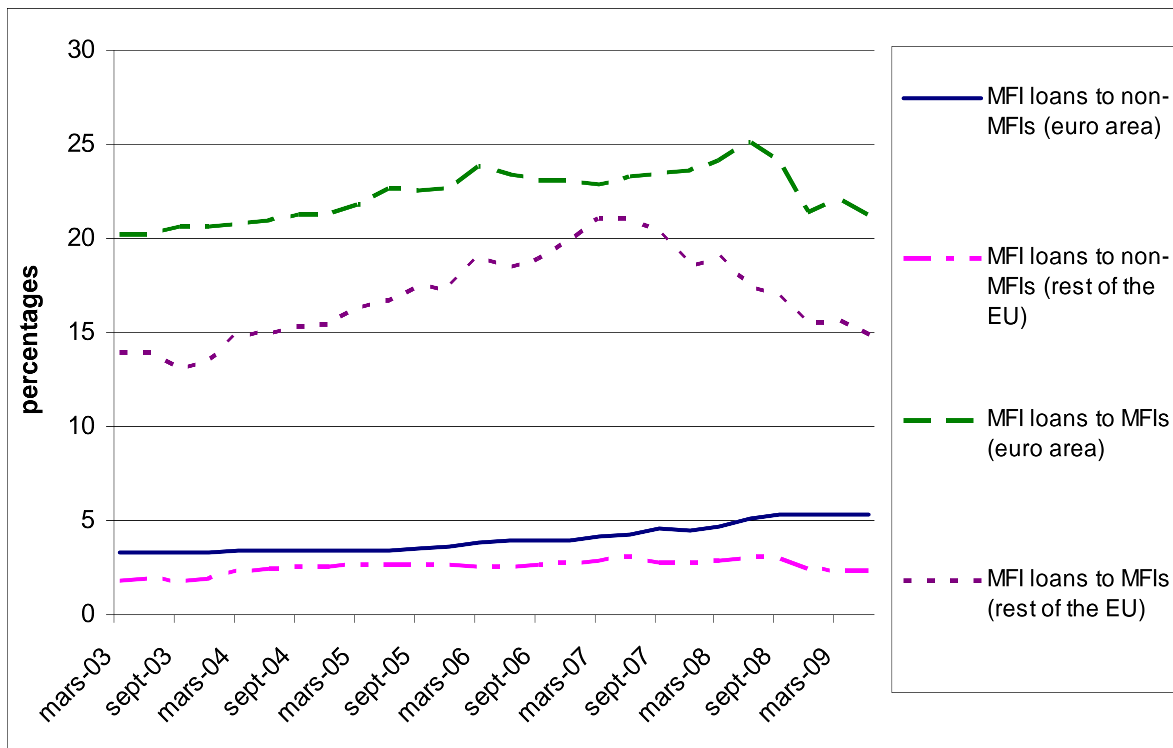
Source: OECD (2009). Data on NL refer to years 2003 and 2007; data on SK refer to years 2002 and 2006; and data on SE refer to years 2001 and 2007.

10. Number and value of EU27 cross-border deals in financial services



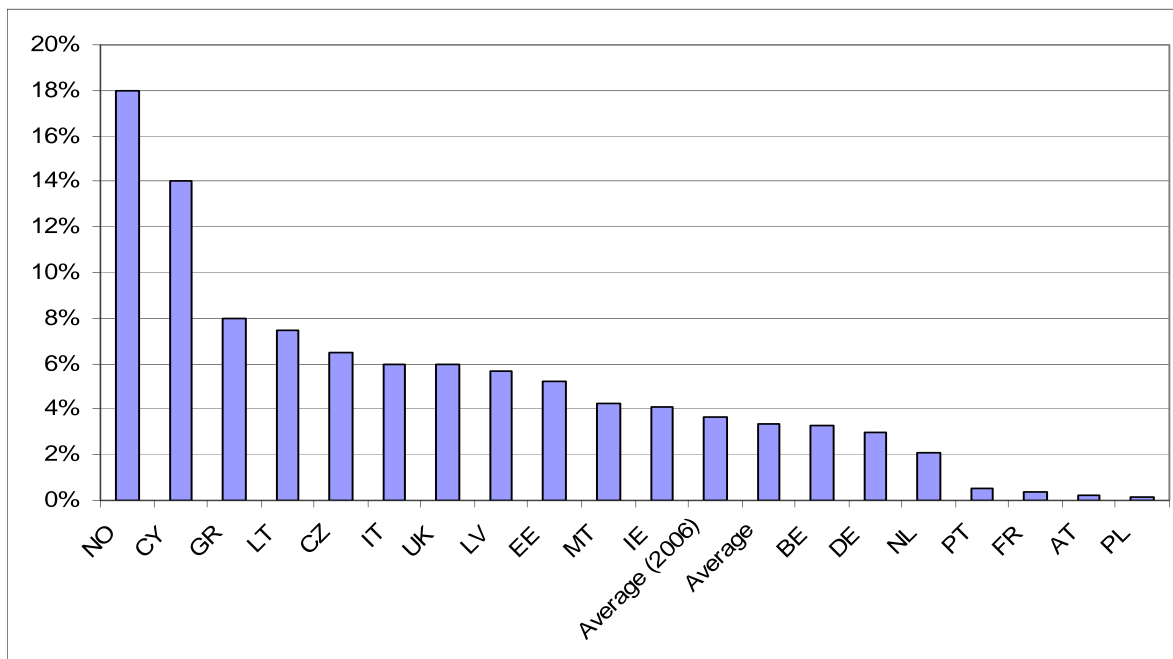
Source: City of London (2009).

11. Euro area MFI cross-border loans (in percentage of total loans)



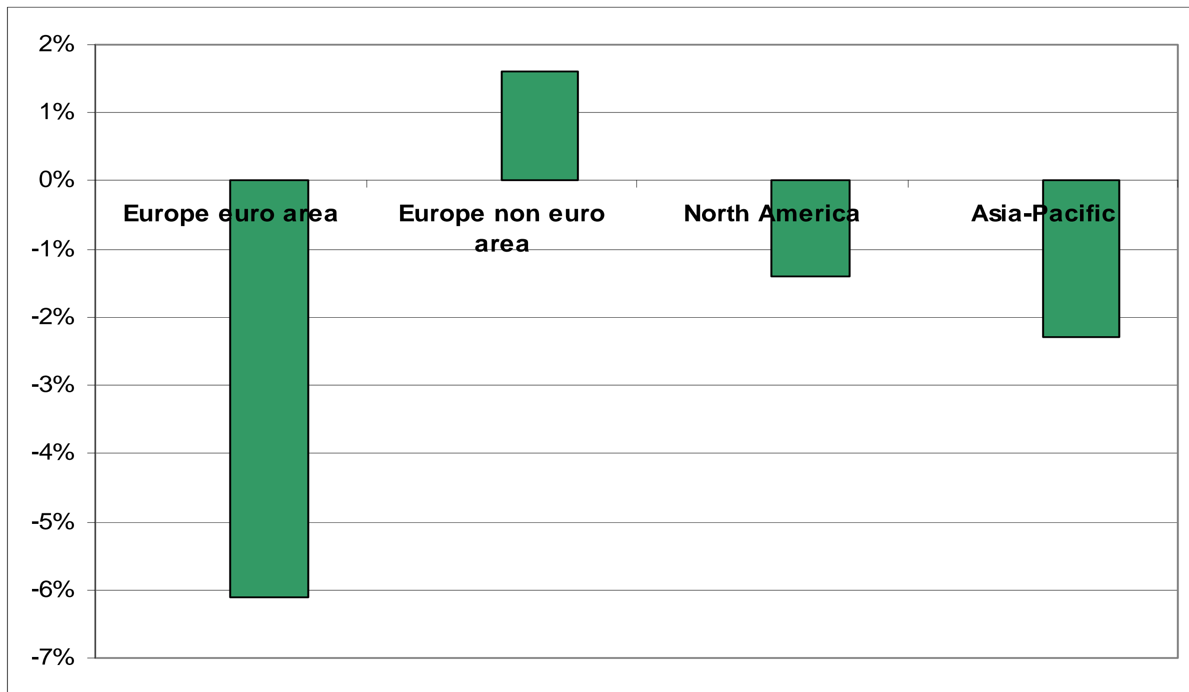
Source: ECB (2009a).

12. Share of premiums written by foreign branches in 2007



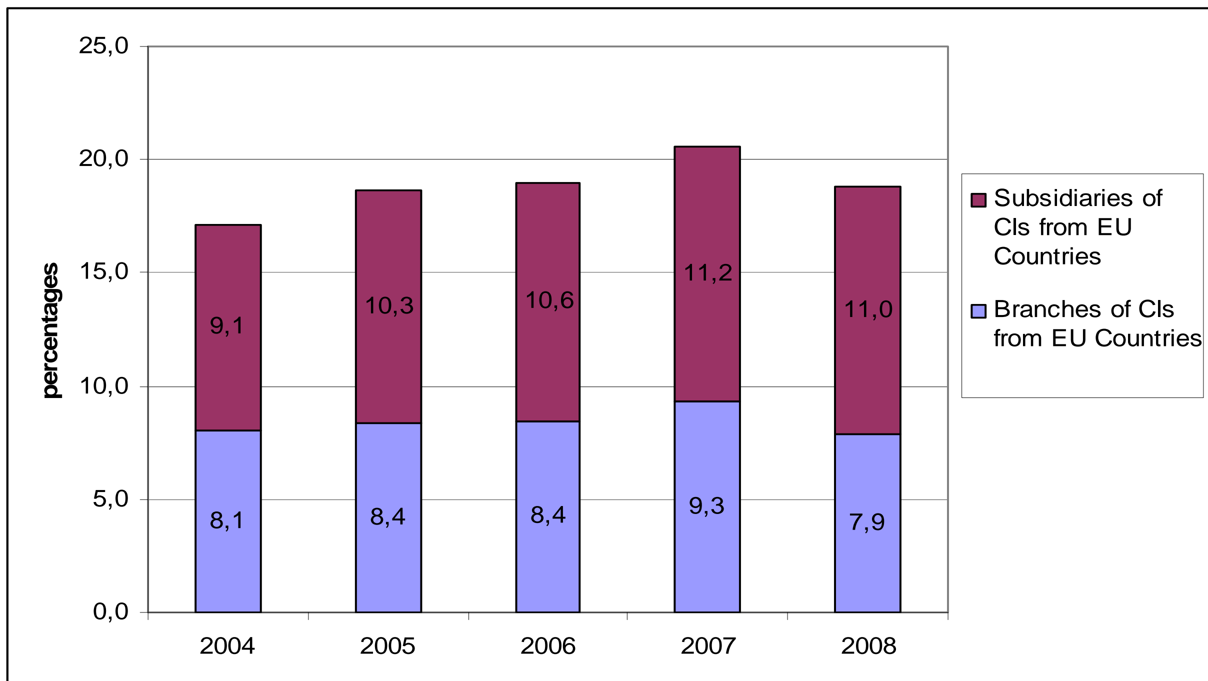
Source: CEIOPS (2008). Data refers to gross premiums written by foreign branches as % of total activity in the country.

13. Evolution of retail banking prices 2008-2009



Source: Capgemini (2008).

14. Market share of branches and subsidiaries of credit institutions from other EU countries (% of total assets of credit institutions)



Source: ECB (2009).

ABBREVIATIONS

Member States

AT	Austria	IT	Italy
BE	Belgium	LT	Lithuania
BG	Bulgaria	LU	Luxembourg
CY	Cyprus	LV	Latvia
CZ	Czech Republic	MT	Malta
DE	Germany	NL	Netherlands
DK	Denmark	PL	Poland
EE	Estonia	PT	Portugal
ES	Spain	RO	Romania
FI	Finland	SE	Sweden
FR	France	SI	Slovenia
EL	Greece	SK	Slovakia
HU	Hungary	UK	United Kingdom
IR	Ireland		

European Union

EU is used when referring to the 27 Member States of the European Union. When reference is made to other groups of Member States, this is explicitly indicated, e.g.

EU-15: the European Union before the 2004 enlargement.

Euro Area: the area encompassing those EU Member States in which the euro has been adopted as the single currency. It comprises AT, BE, DE, EL, ES, FI, FR, IE, IT, CY, LU, MT, NL, PT, SI, and SK.

EU-10: the 10 countries that became Member States in 2004.

EU-25: EU-15+EU10.

EU-12: EU-10 plus Bulgaria and Romania.

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