FSUG RETAIL FINANCIAL MARKET INTEGRATION

INTRODUCTION

Along with the Capital Markets Union (CMU), the most important EU level initiative in financial services is the renewed effort to promote more efficient, integrated single market in financial services that actually works for households and the real economy.

Before going on to explain FSUG's work in this area, we would like to reiterate that it is important that the CMU and retail market integration are not treated as separate initiatives. Both should complement and support each other. If retail markets are more efficient, this results in less value extraction and more efficient transmission of capital through the system to the benefit of the real economy. Likewise, improving the efficiency of capital markets and preventing dangerous behaviours in wholesale and institutional markets from emerging and being transmitted throughout the supply chain results in safer, better value financial products for households and the real economy.

To influence and inform the retail market integration work, FSUG has undertaken an exercise to:

- Collect and assess preliminary evidence of consumer detriment in EU member states – this gives us an idea of whether citizens in certain member states are denied access to better value, more suitable products and services as a result of the ineffective market integration. It is important to note that the data in this report is indicative data. Even as experts, we had difficulties in retrieving the requested data for certain products in certain countries due to the lack of trusted, independent data sources;
- Identify the barriers to market integration so that policy interventions can be targeted with greatest effect; and
- Make recommendations to the Commission on which products and services should be priorities for action.

Please note that we are not trying to investigate why markets may be failing *within* individual Member States. We are focusing on whether better deals may be available cross border and what might be preventing citizens in MS with apparently poor value options from accessing better value options from a different MS.

Structure of report and methodology

The report is structured into three sections.

Section 1 summarises the preliminary evidence collated by FSUG members on price comparisons on the following product areas: Consumer credit; Mortgage credit; Credit card purchases in foreign currencies; Life insurance; Car insurance; Investment life/ unit linked insurance; Personal pensions; Payment services; Retail investment funds;

Section 2 summaries what FSUG considers to be the cross cutting barriers to *effective* market integration – see page 17.

Note the emphasis on *effective* market integration. An increase in cross border selling/ buying of financial products and services does not *per se* mean that financial markets are integrating in a way that improves the financial welfare of citizens. There is a very big difference between an increase in market activity and effective integration.

We emphasise this point about effective integration because we have very real fears that the financial services industry will use the Retail Market Integration (and CMU) to argue that robust financial regulation and consumer protection are major barriers to consumer choice and, therefore, greater integration and a deeper single market.

Of course, FSUG supports better regulation, not more regulation for the sake of it. But, given the clear evidence of market failure and consumer detriment in many EU member states and market sectors, reducing regulation and consumer protection in an attempt to stimulate greater cross border activity is likely to have serious unintended consequences. Moreover, more choice *per se* is not the same thing as better quality choice.

Therefore, if the Retail Market Integration is to be effective it should mean:

- more citizens getting access to better value, truly innovative products and services provided by more efficient, accountable markets that behave with integrity, and firms that treat consumers fairly;
- more citizens having access to effective redress schemes; and
- a significant improvement in consumer confidence and trust in financial services.

We have identified a range of barriers to effective integration which apply to varying degrees in each of the product areas/ member states. We have categorised these barriers into three groups: market/ supply side barriers; demand side barriers; and legal/ regulatory barriers. Note that regulatory barriers can include the absence of regulatory standards, lack of harmonised rules, or failure to enforce existing regulation. Note also that many of the barriers are internal barriers. That is, behaviours and practices evident within a particular member state not only harm consumers but act as a barrier to more efficient providers from another member state entering the local market. These barriers are defined in more detail in Section 2.

Section 3 contains our recommendations to the Commission on which products and markets should be priorities for further investigation – see page 23.

In terms of methodology:

- The FSUG agreed the scope of products and services covered by the research
- It developed representative basic scenarios for each product to allow for cross country comparison (details of these scenarios can be found in the separate data Annex I)
- A product coordinator was appointed to coordinate the collection of data on products within the scope of the research
- FSUG colleagues from each of the member states represented on the FSUG submitted own country data on those products to the product coordinators

We have attached a separate Annex I containing all the data we collected with details of barriers identified.

Please note that this is very much a preliminary analysis as we do not have the resources to conduct in depth and comprehensive research across each product area in every Member State. This paper is designed to prompt further more detailed assessment by the Commission.

SECTION 1: SUMMARY OF EVIDENCE ON PRICE COMPARISONS

More detailed data on each product sector and Member State covered can be found in Annex I. In this section, we summarise some of the key findings. We must emphasise that these are preliminary findings used to prompt further consideration and detailed analysis of markets. We do not have the resources to undertake comprehensive analysis and verify data in each Member State.

MORTGAGES

For mortgages, we collected data for the most common mortgage product for the following scenarios: Maturity 20 years: €100,000/ 150,000/ 200,000 and Maturity 30 years: €100,000/ 150,000/ 200,000.

Price comparisons

The mortgage market is estimated to be valued at €6,679,807 million (EU28 countries), €4,426,959 million (EU18 countries)[1].

Based on the data we have been able to collate, there seems to be a significant variation in the average mortgage interest rates paid by EU citizens. For example, on the 20 year €150,000 scenario, this ranged from 1.7% in Germany compared to 6.2% in Romania (Euro denominated)[2]. This is a difference of 4.5 percentage points. Indeed, it appears that the average mortgage interest rate in Germany is lower than the lowest rate in every MS we looked at with the exception of Denmark.

If mortgage markets in Europe were better integrated and more competitive, the price differentials between different MS are likely to be reduced.

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[1] Source: European Mortgage Federation, as at end 2013

[2] Care must be taken as the payment of arrangement fees and so on may alter the figures

Barriers

Specific comments on barriers in individual MS can be found in Annex I. But the main barriers to integration in the mortgage market appear to be:

- different approaches to property valuations;
- different approaches to collateral instruments for loans;
- different tax rules;
- different contractual/ product structures such as rules for early repayments;
- different approaches to forced sales procedures and treatment of borrowers in financial difficulty; and
- more generally, different approaches to regulation and consumer protection.
- lack of clarity regarding property rights/ ownership/ legal registers.

CONSUMER CREDIT

For consumer credit, we investigated two borrowing scenarios – borrowing EUR500 using a credit card and a car loan for €10,000 (full details can be found in Annex I).

Price comparison

The EU consumer credit market is estimated to be € 1,069 billion (2014).

Consumer credit

There appears to be an even wider variation in the costs for consumer credit than for mortgage credit. It should be emphasised here that we are talking about credit cards.

Note that for credit cards we should be especially careful with price comparisons because the methods of repayment and APR calculation are often not comparable and can account for a considerable share of the differences within and between member states. So these findings should be taken as indicative.

For a consumer borrowing, €500 the average cost ranges from APR 13.49% in Belgium to APR 43% in Slovenia– nearly 30 percentage points difference. Moreover, within Member States, there seems to be a very wide variation between the cheapest and most expensive credit. For example, the difference between the cheapest and most expensive in Romania is 22 percentage points (in local currency terms), 15 percentage points in Spain – yet it is only 1 percentage point in Slovenia, 2 percentage points in Belgium[3], and 5 percentage points in Netherlands and Slovakia.

Car loan

For the car loan, the variation in average costs is also very large. Borrowers pay on average around 2.2% in Belgium but nearly 13% in Greece. Again, we see a significant variation in costs within Member States. In a number of Member States, we see a very small price variation – Belgium, Slovenia, Poland. But, in others, the variation is significant. For example, in Romania the price variation is 11 percentage points, while in the UK it is an unbelievable 50 percentage points. We also

[3] There is an upper price cap in Belgium

see several examples where the cheapest deal in several Member States is more costly than the most expensive deal in other Member States.

Barriers

More details on the range of barriers can be found in Annex I. The main barriers identified appear to be:

- Proof of residence (official document from the public administration that proves that you reside in the country/city)
- Availability of credit data (lack of a credit history in another member State), or credit data asymmetry
- Fear of impossible debt recovery procedures for a person residing abroad
- Concerns about difficult dispute resolution mechanisms in case of problems
- Language barriers
- Market/ country segmentation
- Other administrative reasons (for example, specific information requirements unique to individual countries - similar to “proof of residence” but a bit broader)
- Tied products/conditions
- Taxation, competition and national budget (financial products in one country are tied to special tax benefits/conditions that cannot be applied to other consumers across border)
- National regulation regarding responsible lending and prudential regulation – for example, the difficulty calculating the default risk of lending abroad makes it difficult to comply with prudential regulations

PAYMENT SERVICES

According to the European Central Bank (ECB) payments statistics, the total number of non-cash payments in the EU, across the different types of instruments, increased by 6.0% to 100.0 billion in 2013 compared with the previous year. Card payments accounted for 44% of all transactions, while credit transfers accounted for 27% and direct debits for 24%.

For payment services, we looked at a number of services:

- Annual fees on credit cards
- Credit transfers – cost per transaction in national and foreign currency (online and offline)
- Direct debit costs – cost per transaction

Price comparison

<u>Credit cards</u>

The average annual fees on credit cards vary significantly – from €9 in Romania to €114 in Slovakia. It is interesting to note that there is even a considerable variation between countries which border each other. For example, the average fee in Belgium is €25 compared to nearly €46 in France.

Credit transfers

In many countries we looked at there is no charge levied for credit transfers. In those countries where a charge is applied, the average charge is €1.10 in Romania and €1.38 in Italy for on-line transactions.

For offline transactions, in a number of countries a charge is not levied. In those countries where a charge is levied, average charges range from €1 in Slovakia to €3.58 in France.

A special issue is represented by cross-border transactions made by consumers from outside the Eurozone. They are charged with tens of euros for a credit transfer (Romanian example – 50 EUR for a credit transfer of 79 EUR), because of charging SWIFT fees. But even in case of using SEPA channel, they are charged with 10 EUR or even more.

Direct debits

Data on direct debits was difficult to obtain. In several countries – Belgium, Germany, Slovenia and Spain - there is no charge for direct debit. In those countries where a charge is levied, average annual charges range from €0.20 in Spain to €5.45 in Romania (see Annex for list of member states where charge is levied).

Barriers

More detail can be found in the Annex. To summarise, the main barriers include:

- Payment services tied to a bank account
- Limited competition – for example, in several MS, only banks offer credit cards and deferred payment cards
- Mis-use of the Anti-Money Laundering Directive to restrict access to an account
- Structural barriers eg. payment infrastructures are mainly domestic and not inter-operable
- Geoblocking

CAR INSURANCE

For car insurance, we looked at two scenarios – for a 20 year old driver and 50 year old driver. It is important to note that it is very difficult to undertake a meaningful comparison of car insurance prices across countries. The quotes depend on many factors, including the exact model of car, coverage of insurance, the amount of excess, the occupation of the driver, the postcode, whether the car is kept in a garage or on the road, how many years the driver has had his/ her license, years of no-claims bonus/accident-free driving, and so on. But, it is likely that the biggest driver of price differentials is the different amounts of personal injury compensation awarded in different member states[4]. Moreover, with insurance we have to factor in the different approaches in member states. In some member states, a mutual model prevails. In other member states, a more individualistic, risk based model prevails leading to much higher prices for groups considered to be a higher risk.

[4] See, for example, http://ec.europa.eu/civiljustice/news/docs/study_compensation_road_victims_en.pdf (p31)

However, the inherent practices do not mean that consumers would not benefit from a more effective single market. As we have also found, there is also a large price dispersion within countries suggesting that markets may be uncompetitive and would benefit from more effective competition.

Price comparison

For the 20 year old driver scenario, there appears to be a huge dispersion in prices. In Slovakia, the average premium is €287 compared to €7,719 in the UK (seven thousand seven hundred and nineteen). Indeed, the maximum premium found in the search for the UK was over €16,000. Of course, the insurance company in this case is clearly not competing for business

For the 50 year old driver scenario, the dispersion is not so large but it is still significant. The average premium in Slovakia is €135 compared to €725 in the UK and around €750 in Poland and The Netherlands.

As mentioned, the within-country price dispersion is large in many member states. The ratio of the most expensive to the cheapest quote is smallest for the 50-year-old driver in Greece (1.92) and largest for the 20-year-old driver in the UK (6.77). The ratio is typically around 4. This is indicative of an uncompetitive market.

Barriers

Only 1% of European citizens have bought a general insurance product in another member state, and only 3% would consider doing so[5]. Yet around 40% of general insurance products are bought online, so in principle there could be more demand for cross-border transactions.

Many barriers are common across general insurance products. It is likely that suppliers are reluctant to sell across borders because of:

- The cost of adapting to different regulatory regimes and national laws, particularly contract law.
- Difficulty in assessing local risk.

For consumers, the problems that exist at national level are magnified when trying to buy in a different member state:

- Language, both at point of sale and in claims handling
- Problems in comparing offers
- Perceived difficulty of complaining or obtaining compensation cross-border.

[5] ec.europa.eu/internal_market/...retail/.../eb_**special_373**-report_en.pdf

The European Consumer Centre (ECC) Germany attempted to buy general insurance products (including motor) cross-border in four countries: Germany, Austria, France and Great Britain[6]. The study found that, of 144 companies tested, it was possible to conclude an online insurance contract with only 14 of them. Barriers included:

- Inability to input a foreign address
- Requirement to create a user account, not possible with a foreign address
- Requirement to be subject to tax in the same country as the insurance company
- For motor insurance, requirement to input a domestic license plate number
- The geographical scope of the contract, only covering claims arising from incidents in the country where the insurance company was located.

To these practical difficulties we can add the example from Spain, where it is necessary to have a Foreign Identification Number to buy insurance products, for citizens not having a Spanish postal code.

The ECC also contacted 567 insurance companies in the four countries, only 32 replied and just 3 of these offered cross-border general insurance.

LIFE INSURANCE

For the life insurance product we used a scenario based on the monthly premium paid for €100000 insurance for 40 year old person for 25 years.

Price comparison

We see a significant variation in the average premiums charged between different member states. In Slovakia, the average premium paid is €10 per month and €12.40 per month in Spain compared to GBP£65 per month in the UK, and €114 in the Netherlands.

Barriers

More details can be found in Annex but to summarise, the main barriers are:

- ‘Downsizing’ may result in ineffective coverage of market;
- High loadings result in higher premiums – especially in bancassurance;
- Low profit margins means it is not an attractive product to market;
- Existing insurance regulation – including Insurance Block Exemption – is not working effectively;
- Diverse coverage of insurance guarantee schemes;
- Dominant distribution models in member states can prevent new entrants establishing a presence; and
- Lack of information on basic exclusions, complex policy wordings undermine demand side.

[6] http://www.eu-verbraucher.de/fileadmin/user_upload/eu-verbraucher/PDF/Berichte/Resume_final_EN.pdf

PERSONAL PENSIONS

Personal pensions take different forms in EU countries and even within each EU country, personal pension schemes are organized on different basis. Even as a DB, DC, mixed DB/DC investment based individual retirement savings accounts or insurance based contracts, they possess similar features and follow a similar ultimate objective.

Price comparisons

For this exercise, we looked at the average annual charges on accumulated savings. Note that these costs relate only to the product costs. There may be other distribution costs involved such as costs of providing financial advice which we have not included.

There is a significant price dispersion on personal pension costs between member states. In Slovakia, the average annual charge is 0.8% per annum[7] compared to 2.46% in Poland. Other studies suggest that the range of total expense ratios (TERs) is actually greater – 0.65% to 3.45% with an average of 1.75%[8].

Moreover, there is also a significant price dispersion within certain member states. For example, in Germany the difference between the cheapest and most expensive we found is around 2.5%.

Costs are very important for personal pensions (and investments). Higher costs can severely reduce the amount of income available to households in retirement. For example, an increase of 1% per annum can reduce the pension pots of regular savers by up to 25%[9]. Another way of looking at this is that an increase of just 0.5% per annum means that the saver has to contribute an extra 11% into his/her pension of offset the effect of the charges. Higher charges therefore can have a disproportionate impact on lower-medium income households.

High charges will have an even bigger impact on retirement incomes in an era of lower investment returns[10]. Furthermore, poor investment performance compounds the impact of high costs on retirement incomes. Studies have found that savers are actually left with negative net real returns once charges and inflation is taken into account[11].

The industry argues that costs are not the most important issue and that investment performance has a bigger effect on retirement incomes. However, savers cannot rely on past performance to predict *ex ante* future relative performance. Therefore, it is critical that costs are controlled to ensure that savers obtain good value when saving for retirement.

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[7] This is a regulated product
[8] Source Oxera for FSUG, 2013
[9] Estimates by Which? See paragraph 38 http://www.publications.parliament.uk/pa/cm201213/cmselect/cmworpen/768/76806.htm
[10] For example, the UK financial regulator reduced the intermediate rate used for personal pension projections from 7% per annum to 5% per annum see http://media.fshandbook.info/Legislation/2012/2012_63.pdf
[11] See OXERA, 2013; BetterFinance 2013, 2014

Barriers

Savers in many EU member states would benefit hugely from a more effective single pensions market. But, we have identified several key barriers that effectively restrict cross-border purchases:

- supply-side driven market supported by selective legislation (multinational companies operating on local markets exploit local information asymmetries) and higher transaction costs for cross-border purchase;
- supply-side driven market, which means that products are pushed into markets locally by global players;
- dominant distribution practices preventing better value products being sold into new markets;
- personal pensions are long term products, structured in such a way which makes switching difficult – this adds to the 'rigidity' of the market;
- competition for distribution rather than for savers;
- tax incentives for local players;
- language barriers resulting in low awareness of demand side on "better" products sold abroad;
- uncertainty about legal background of foreign products and uncertainty about future regulation in foreign country;
- non-existence of general benchmark for "good" product and particular features and thus inability to compare on risk-return to costs basis;
- trust-based product often tied to the employer recommendation or local representative (intermediary);

There are several bad practices consumers face when considering purchase of investment insurance based pension contracts:

- distribution of higher fee based "actively" managed pension products with no comparison to lower-cost passively managed peers or respective benchmarks;
- same investment strategy offered in different products by the same provider, however the products have different fees and returns
- no fee implication calculations on final pension pot;
- frequent changes in a fee policy and contract;
- no comparison of performance nor fees with peers.

INVESTMENT LIFE INSURANCE (UNIT LINKED INSURANCE)

Investment life insurance (unit linked life insurance) contract are one of the dominant products serving life insurance and saving needs. CEE countries´ consumers sign into typical investment life insurance contract in order to combine life insurance and savings into one product. There is an ongoing debate on the real value of these products when considering the high level of yearly contract terminations and cancellations.

Price comparisons

Charges on investment life insurance products appear to be very high. For example, in the case of Slovakia, a typical investment life insurance contract bought by a 35 year old consumer (average earner with good health status) paying €100 monthly premium and 30 years duration of contract (achieving 65 years of age) with no inflation indexation of premium would pay for such contract on average 5.75% per annum of accumulated value of investments (premiums). Minimum fees are as high as 4% per annum with maximum fees reaching 8.4% per annum.

The problem seems particularly bad in the Central and Eastern European countries. The fee structure effectively delivers negative value from purchased investment life insurance contracts. Investment life insurance is a clear example of bad products and practices being exported cross border into certain member states. If the single market was working for consumers, good products and practices would be exported.

By looking closer on one of the key features of investment life insurance products the complexity of fee structure often shows up as key detrimental factor.

Barriers

There are a number of key barriers identified that effectively restricts cross-border purchases:

- supply-side driven market (multinational companies operating on local markets exploit local information asymmetries);
- dominant distribution practices preventing more better value products getting access to new markets;
- language barriers on such a complex product;
- high transaction costs for cross-border purchase on the side of consumers;
- tax incentives often provided for local products or domestic consumers;
- low awareness of demand side on "better" products sold abroad;
- uncertainty about legal background of foreign products;
- uncertainty about future regulation in foreign country;
- non-existence of general benchmark for "good" product and particular features;
- average number of pages of typical contract is around 100 pages and often written using professional insurance and legal terms (jargon);
- high individualization of input parameters including health status and additional coverage causing inability to understand every aspect of the product and compare it even on local market;
- health status check often required by insurer.

There are several bad practices consumers face when considering purchase of investment insurance contracts:

- Investment directed through own preselected funds (in cases where preselected funds offer good value, this may not be a bad thing – but robust rules on conflicts of interest are needed to ensure this happens).
- Multi-layer system of charges (insurer, fund manager).
- Low transparency in cost structure.

- Projections for future value of investments made on linear basis with no investment risk modeling techniques mislead consumers that this product is "no risk" product.
- Inability to see the mortality (longevity) costs as part of the premium is used to cover mortality (longevity) risks associated with individual contracts.
- Insurers are aware of the fact that many contracts are terminated before the end of the contract and the fee structure is adjusted to exploit this fact.
- Insurance intermediaries are pushing customers to change the contract (terminate and buy a new one) after certain period which causes higher costs to consumers.

CREDIT/DEBIT CARD PURCHASES IN FOREIGN CURRENCIES

For this section, we analysed the commissions and fees paid by consumers making purchases with credit and debit cards in foreign currencies and to identify which exchange rates were used and if they matched the market rates at the time. To assess the market, FUSG members residing in different EU Member States checked some recent credit card statements to check how were purchases in foreign currencies (i.e. a different currency than the one used in the country where the person resides; for example a resident of the Euro zone purchasing an item on the internet in GBP) is reported. We also researched the published exchange rate available around the dates of the purchases and of their recording by the financial intermediaries.

Forex has three unique features:

- it is by far the largest financial market in the world (estimated at € 1,5 trillion transactions per day for the spot market alone)[12]
- it is totally unregulated in Europe
- It is the most opaque (see example above).

Very recently a few national supervisors have started to unveil severe forex market abuses. Not one supervisor has yet investigated the retail market. FSUG believes this is long overdue as consumer detriment risk can be huge in this area.

Price comparisons

Few of the cases we looked at mentioned commissions and/or fees. When they are communicated, fees and commissions happen to be extremely high, especially compared to other financial services that are regulated. For example, retail online equity broker fees are often less than 0.50 % although it is not ordinary consumer goods but investments.

In a Belgian case two different commissions are charged: Exchange charges (“frais de change”) amounting to 1.9%; Mastercard exchange charges (“frais de change Mastercard”) amounting to 0,17%, so a total of **2.07%** fees. In a Dutch case a fee of 1.35% was mentioned but the amount could not be retrieved. In a Romanian case, the fee added was 2.75%. In a UK study looking at most UK

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[12] Note we are not claiming this is the size of the retail market. We include this figure as there is no available estimate of the retail market

retail banks[13], the identified fee ranges in most cases between 2.75% and 2.99% or more.

Note there is a difference between exchange charges for EU citizens charged for purchases in and outside the EU.

Note also that – on top of hidden commissions – one most often should add a hidden spread taken by the intermediaries between the exchange rate they use and the actual exchange rate at the time of the transaction. Evidence collected by the FSUG shows that this is a very opaque area where it is impossible for the customer to find out what was the actual rate of exchange that should be used for the transaction. For example, one can check five different exchange rate sources on the internet (including the ECB site) and find five different published exchange rates for that same day.

Barriers

Generally speaking, there seems to be little competition among retail banks if any (as the above-mentioned UK study on many retail banks shows).

Specifically, we found no transparency at all on exchange rates used. The explicit or implicit (amount in foreign currency divided by the amount in credit card account currency) usually never matches the official rates that can be found on the internet. We also found that it does not match the credit card provider's conversion rate tool either.

Furthermore, consumers may not be able to obtain helpful information from the internet to help them make informed decisions. The exchange rates found on the internet are not the same (up to five different websites: five different exchanges rates!)

It is also very difficult and often impossible to know the timing and nature of the exchange rate disclosed: closing rate, opening rate, other? Even the ECB website only mentions a "reference" rate "*usually updated by 3 p.m. C.E.T. They are based on a regular daily concertation procedure between central banks across Europe and worldwide, which normally takes place at 2.15 p.m. CET.*"

RETAIL INVESTMENT FUNDS/ ASSET MANAGEMENT

We based our analysis of this sector mainly on two studies – a study focusing on UCITS funds FSUG commissioned from IODS and published in 2014[14]and one conducted by Better Finance in 2014[15].

[13] Overseas Spending Charges - Full debit & credit card breakdown (MoneySavingExpert.com, data as of November 2014)

[14] Performance and Efficiency of the EU Asset Management Industry, IODS, 2014

[15] Pension savings: the real return, Better Finance, 2014

Size of market

Number, size and fees of mutual funds
EU versus US

	Number of funds	Average Size (€ million)	Average fee (equity funds only, bps)
EU	**32.750**	**222**	**175** (2011)
US	**7.886**	**1.568**	**74** (2013)
	Q3, 2014	Q3, 2014	

Sources: Better Finance (CMU Briefing Paper)

Price comparisons

The IODS study compared the annual management charges (AMCs), subscription fees, and redemption fees on UCITS funds in 15 different EU countries over the period end 2002 to end 2012.

The study found a small reduction in AMCs but subscription and redemption charges have actually risen over the period analysed. EU investors pay higher investment fees than their counterparts in the USA. According to EFAMA (the European industry body) itself the average expense ratio of US domiciled retail equity funds was 0.95% versus 1.77 % for European domiciled equity funds in 2011.5 By 2013, the expense ratio for the US equity funds was down to 0.74%6 . EU passive funds charged considerably lower maximum management fees in recent years, at 0.61% in 2012 compared to 1.05% in 2002.

Looking at cost comparisons across the EU, we see a wide variation. For example, the AMC in Poland is 3.4% per annum, while investors in Greece were paying 2.46% per annum. This compares to 0.77% in Romania, 1.14% in the UK, and 1.17% in the Netherlands.

The level of fees in the EU is two and a half times higher in the EU in the case of equity funds, based on the most recent figures available from the industry.

The pricing of investment funds is even worse actually for individual investors as they mostly hold AIFs, and mostly via wrapper products which typically add another layer of fees. For example in France about half of retail funds are held via life insurance unit-linked contracts which typically add another contract–level fee of 0,95% on average. Therefore, the average fee charge for investing in retail equity funds for a French saver is more typically 2,75% per year (1.8 + 0.95; not counting the entry fees). It should therefore be no surprise that French unit-linked contracts retuned a strongly negative real performance since the beginning of the century despite the positive real performance of equity markets over the same period.

Investment performance

With investment funds, it is important to consider investment performance as well as charges to understand the real value produced for investors. Looking at the individual member states, compared to corresponding benchmarks, 9 categories of equity funds underperformed their benchmark while 6 outperformed. Once an adjustment was made for switching behaviour, only 3

out of 15 outperformed[16]. For this analysis, the contractors assumed the investor in the active fund switched after 5 years.

Over the ten-year period (2003-2012), the average underperformance of EU equity funds weighted by Total Net Assets was 23.6%. Applied to the total net assets of equity funds at the end of 2003 (assumed to be €1,173 bn), the theoretical loss suffered by investors is €277 bn.

The investment fund sector also scores very badly on consumer trust and confidence. The sector scored bottom of the league table in the EU Consumer Scoreboard four years in a row.

Barriers

EU investors pay more than their US counterparts, the value destruction as a result of high charges and poor investment performance is huge, and consumer confidence and trust is rock bottom. So, with regards to the investment fund sector, the issue is not just about promoting increased cross border market activity, it is about making this market work better.

Nevertheless, in theory, the retail investment market should offer the potential for an effective cross border single market. The UCITS fund is a pan-EU investment product which is passportable to all member states. As a result, fund management is probably the most integrated financial service in the EU. The share of cross-border fund assets in Europe in 2013 stood at 40% of total European investment fund assets, compared to 27% at end 2003.

But, as we see from the IODS report, there is a considerable difference in the charges paid by UCITS investors in different member states for similar funds. This suggests there is scope for a more effective, integrated market delivering benefits for investors.

However, it is important to note that the most significant barriers to an efficient single market in investment funds are not necessarily related to cross border barriers. We think in this case it is more to do with market failure within member states which act as barriers to more efficient providers entering a market.

One of the major barriers is that EU citizens are sold mostly alternative investment funds (AIFs) not UCITS funds which are still a minority of EU domiciled funds sold to individuals. UCITS are less marketed to EU individuals than AIFs (Alternative Investment Funds, as defined by the AIFM Directive) and AIF wrapper products. AIFs in the EU are all the investment funds that are not UCITS.

Indeed, contrary to a common belief,:

- AIFs are more numerous than UCITS funds, at least at retail level[17].
- The majority of AIFs are not hedge funds and they are mostly designed for- and sold to retail investors, either directly or commonly via fund wrappers such as unit-linked insurance products. For example, there are 11,500 funds domiciled in France, out of which only 3,500 UCITS and most of the 8,000 AIFs are retail funds.
- AIFs are mostly purely national products that are not sold cross-borders.

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[16] See Annex I http://ec.europa.eu/finance/finservices-retail/docs/fsug/papers/1411-asset-management_en.pdf

[17] The European trade body counted 35,618 UCITS funds in 2013 and only 19,524 AIFs (EFAMA fact book 2014, page 314). But in France alone AMF reports 9000 AIFs for only 3000 UCITS. Therefore the number of AIFs reported by EFAMA seems too low. According to IODS, LIPPER FMI database included about 100,000 active funds in Europe as of March 2014.

- AIFs are not subject to the disclosure and investor protection rules of UCITS. In particular, AIFs are not required to disclose a KID (Key Information Document) that is comprehensive, short, simple and comparable.

This means that the majority of retail funds are held not directly but through wrappers, which typically add another layer of fees and commissions on top of the fund fees. These wrappers unlike UCITS funds are typically national only products that are not sold cross-borders. They are typically created to minimize local taxes.

Moreover, there is a real problem with lack of transparency on data relating to past performance and fees on retail funds across the EU. This makes it difficult for investors and trusted intermediaries to exert pressure on the market and promote effective competition. EU Public Authorities are supposed to collect, analyse and report on these data but have failed to provide any of it to date[18].

SAVINGS ACCOUNTS

As BEUC was undertaking a study on savings, we decided not conduct our own analysis.

[18] Article 9,1 of the European Regulations of the European System of Financial Supervision of 201 provide that the three European Supervisory Authorities (Banking - EBA, Securities & Markets – ESMA - and Insurance and Occupational Pensions – EIOPA) shall collect, analyse and report on « consumer trends ». But so far, they have failed to report any performance and price data of consumer products in their respective areas.

SECTION 2: ASSESSMENT OF CROSS CUTTING BARRIERS TO EFFECTIVE RETAIL MARKET INTEGRATION

The previous section above describes the factors that act as barriers to an effective single market within each of the specific product sectors we analysed. But it is clear that there are a number of cross-cutting factors that are common to a number of product sectors. The Commission may choose to focus on specific sectors. However, it may be that tackling some of these cross-cutting barriers could produce better results for a greater number of EU financial users – in other words, produce a greater policy 'return on intervention'.

To aid understanding, we have categorised these factors into three broad groups: market/ supply side/ structural factors; demand side factors; and legislative/ regulatory factors.

- Demand side factors (sometimes known as 'pull' factors): demand side factors can inhibit the ability of financial users to exercise positive influence on provider/ intermediary behaviour and market efficiency. These factors include consumer preferences and behavioural biases, consumer awareness, confidence and trust, language barriers and cultural issues,; and
- Market/ supply side/ structural factors: these relate to market structures, business models, distribution models, the behaviours and practices of financial providers and intermediaries, and product design;;
- Public policy/ legislative/ regulatory factors: these relate to measures aimed at promoting the interests of local providers; legislation or regulation in specific member states which may unreasonably inhibit cross border activity by affecting the ability and willingness of firms to operate on a cross-border basis; or the inconsistent application and enforcement of EU legislation and regulation.

The categorisation is based on where an intervention is targeted. For example, it affects the ability of users in one member state to identify better choices in another member state. In addition, language barriers may affect the ability of providers to sell products into different member states.. In this case, the intervention would be primarily aimed at helping financial users make choices by for example ensuring they have access to product information in their own language.

The factors for each product sector are listed in more detail in Annex I.

When deciding on which single market barriers to tackle first, we suggest that the Commission assess the likelihood of success. For example, consumer awareness and consumer confidence are obvious demand side barriers to the development of an effective, integrated single market. Most consumers are not aware that they have the right to take out a motor insurance in another Member State (see Directive on motor insurance), and that they could benefit from more advantageous prices.

On the supply side, conflicts of interest and dominant distribution structures operating within member states act as barriers to effective markets *within* member states and barriers to an effective single market *across* member states. Yet, these supply side barriers could be tackled through robust regulatory interventions, but also competition inquiries, producing real benefits for financial users within member states and across the single market.

Of course, this type of supply side intervention would lead to significant disruption of dominant business models within member states and produce loud complaints from vested interests. But,

assuming the single market became more effective, these less efficient providers would be displaced by more efficient providers to the net benefit of households and real economies.

There are also clear differences in the application of legal and regulatory standards across member states we looked at. The industry would argue that this represents a barrier to cross border activity for two reasons. Firstly, they would argue that the existence of higher consumer protection standards (or more robust enforcement by national regulators) per se represents a cost barrier to market entry. Secondly, they would argue that the inconsistent application and enforcement of different regulatory standards makes it difficult to plan on a pan-EU basis – this can have the effect of pushing up unit costs.

But we would urge caution on this. These arguments should be treated with a large degree of scepticism. Reducing consumer protection standards to a lower common denominator to stimulate greater cross border activity would be a huge mistake in our view.

While harmonising consumer standards provides for a good basis for consumer protection everywhere in the EU, competition and greater consumer choice will not resolve consumer detriment. The history of financial services shows that choice and competition have not been effective agents at making markets work from the perspective of financial users. Choice and competition are not effective substitutes for robust, properly enforced regulation.

Moreover, as explain below, some of the barriers to the single market seem to be self-imposed by the industry. That is, parts of the financial services industry choose to block new market entrants while operating abroad (see major banks and insurance companies), focus on their home markets or do not want to expand into other member states.

There may well be a number of financial services providers who are interested in expanding their markets and operating at a single market level. But we see no justification for reducing regulatory standards to a lower level to encourage this group of providers. Reducing standards of regulation would expose their home state customers to greater risk of consumer detriment without promoting a more integrated single market. Reducing regulation would increase the level of consumer detriment and market failure in those states which have good regulatory systems. It would also undermine confidence and trust in the wider single market in financial services.

Of course, we agree that there should be consistent application and enforcement of regulation. But the emphasis should be on bringing weak regulatory systems up to the standards of the best. As we explain, market failure within a member state not only harms households in that member state, it also inhibits the development of an effective single market. In this case, the dominant distribution models can prevent external providers from entering the market with an improved business model. This means external providers have to adopt the same business model to gain entry into a new market – this just reinforces or exacerbates the existing market failure.

DEMAND SIDE FACTORS

Data from the insurance sector suggests that in theory greater number of consumers might be willing to shop for financial products cross-border. Only 1% of European citizens have bought a general insurance product in another member state, and only 3% would consider doing so[19]. Yet

[19] ec.europa.eu/internal_market/...retail/.../eb_**special_373**-report_en.pdf

around 40% of general insurance products are bought online, so in principle there could be more demand for cross-border transactions.

But, if we want to encourage a more demand led single market, then a number of conditions have to be met:

1. The consumer journey has to be made easy. The consumer journey consists of the following stages: the initial shopping around/ comparing offer stage, the purchase stage, managing the ongoing relationship with provider, making a claim (in the case of insurance), switching provider, and making a complaint and obtaining redress/ compensation in the event of something going wrong.
2. Consumers must have confidence and trust in the experience of shopping cross border
3. Consumers must have access to the necessary information/ guidance or advice (when required).
4. Better products must be available and accessible (see above).

However, there are a number of very difficult demand side barriers to overcome including language, consumer confidence and trust, and information asymmetries. These barriers exist at each point of the 'consumer journey'.

- **Language**

Language is one of the main demand side barriers. The problems consumers face at national level making decisions and buying products are magnified when trying to buy in a different member state.

- **Consumer confidence and trust**

This includes: uncertainty about legal background of foreign products and about future regulation in foreign country; lack of awareness of scope of guarantee/ deposit protection schemes and consumer protection measures; perceived difficulty of complaining or obtaining compensation cross-border; and concerns about difficult dispute resolution mechanisms in case of problems.

Moreover, trust-based products are often tied to the employer recommendation or local representative (intermediary).

- **Information asymmetries**

In theory, with the growth in internet based transactions, consumers should be well placed to get access to information to compare products. However, we found that consumers face difficulty in obtaining information about potentially better offers and comparing different offers – this is linked to the language barrier above.

More generally the complexity of contracts is a barrier at national level (for example, the average number of pages of typical contract is around 100 pages and often written using professional insurance and legal terms (jargon). This problem is exacerbated when shopping cross border.

Similarly, the high individualization of input parameters (for example, health status and additional coverage) makes it difficult to understand every aspect of the product and compare it even on local market.

While benchmark products have been used in certain member states, they are not used at the EU level.

MARKET/ SUPPLY SIDE/ STRUCTURAL FACTORS

To remove these barriers to an effective single market, policymakers would need to intervene to change market structures, business models, distribution models, behaviours and practices of financial providers and intermediaries, and product design.

- **Structural barriers to entry/ local market practices**

Practices in a local country market can make it difficult for external competitors to enter that market. For example, in the mortgage and consumer credit markets, this includes: different approaches to property valuations; and different approaches to collateral instruments for loans.

Some of the biggest barriers we found relate to local market structures. There are a number of these barriers and include:

- Intermediaries and dominant distribution models: the critical role of local intermediaries and dominant distribution practices prevent better value products getting access to new markets. Similarly, dominant providers and distribution models in local markets can prevent new entrants getting a foothold in the market (for example, investment directed through own preselected funds).Linked to the above, given that competition is for distribution not the end-user, new entrants have to compete using the same remuneration and incentive schemes as local providers to encourage intermediaries (whether local banks or financial intermediaries) to recommend or sell their products. This means that competition ends up pushing up the total cost of new products to the level of existing products undermining the potential benefits of an integrated single market;
- Product structure: failure to regulate products at a national level allows for product structures which act as a barrier to new entrants. There is a damaging relationship between product structures and the remuneration/ incentive schemes outlined above. Product features such as high front-end loaded charges or early repayment charges allow for payment of high levels of commission/ bonus payments to compete for distribution. In turn, commission/ bonus payments reinforce high or detrimental charging structures;
- Low profit margins: it is important to note that just because charges are high, this doesn't mean that providers are making large profits on selling products. The need to pay high commissions/ bonuses mean that profit margins can be low. This can deter new entrants from trying to break into a new, cross-border market.
- Higher transaction costs for cross-border purchase: this is also a demand side factor as it inhibits consumers from seeking out products outside their home market.

Other barriers in this category include payment services tied to a bank account and limited competition - for example, in several MS, only banks offer credit cards and deferred payment cards. The fact that payment infrastructures are mainly domestic and not inter-operable can represent a structural barrier to entry for external competitors.

In the payment services area, we found mis-use of the Anti-Money Laundering Directive to restrict access to an account.

We also found a number of examples of administrative practices or processes which act as barriers to single market activity. These include:

- requirement for proof of residence (official document from the public administration that proves that you reside in the country/city);
- other administrative reasons (for example, specific information requirements unique to individual countries - similar to "proof of residence" but a bit broader);
- we also found a number of practices which indicated that domestic providers are not interested in cross border business (see self-imposed barriers below)

- **Market information asymmetry**

Market information asymmetry can make it difficult for external providers to enter a new market on a cross-border basis.

For example, availability of credit data or credit data asymmetry makes it difficult to assess local risk. Difficulty calculating the default risk of lending abroad makes it difficult to comply with prudential regulations

Similarly, market information asymmetry can affect the ability of insurance companies to assess local risk.

- **Self-imposed industry barriers**

We must also recognise that there a number of 'self-imposed' barriers to an integrated single market. That is, many providers prefer to operate on a market/ country segmentation model rather than on a single market basis. Financial services tend to be a supply-side driven market, which means that products are pushed into markets locally by global players.

A good example of this is provided by the attempt by The European Consumer Centre (ECC) Germany to buy general insurance products (including motor) cross-border in four countries: Germany, Austria, France and Great Britain[20]. The study found that, of 144 companies tested, it was possible to conclude an online insurance contract with only 14 of them because the domestic insurers appeared not to be interested in cross border custom. Barriers included:

- Inability to input a foreign address
- Requirement to create a user account, not possible with a foreign address
- Requirement to be subject to tax in the same country as the insurance company
- For motor insurance, requirement to input a domestic license plate number
- The geographical scope of the contract, only covering claims arising from incidents in the country where the insurance company was located.

[20] http://www.eu-verbraucher.de/fileadmin/user_upload/eu-verbraucher/PDF/Berichte/Resume_final_EN.pdf

This wasn't a case of expecting domestic providers to actively market into another EU country. Rather it shows that even with the access opportunities provided by the internet, they did not facilitate online access.

LEGISLATIVE/ REGULATORY/ PUBLIC POLICY FACTORS

Within this category, we include: measures aimed at promoting the interests of local providers; legislation or regulation in specific member states which may unreasonably inhibit cross border activity; or the inconsistent application and enforcement of EU legislation and regulation.

The key factors we have identified include:

- The cost of adapting to different regulatory regimes and national laws, particularly contract law;
- Public policies which confer preferential treatment on local providers (for example, tax treatment);
- Taxation, competition and national budget (financial products in one country are tied to special tax benefits/conditions that cannot be applied to other consumers across border) and tax incentives often provided for local products or domestic consumers;
- Different legal standards;
- More generally, different approaches to regulation and consumer protection.
- Different tax rules;
- Different approaches to forced sales procedures and treatment of borrowers in financial difficulty;
- Fear of impossible debt recovery procedures for a person residing abroad (that is, the provider feels it cannot rely on local enforcement);
- In some insurance markets, there is a requirement to be subject to tax in the same country as the insurer
- Diverse coverage of insurance guarantee schemes;
- Existing insurance regulation – including Insurance Block Exemption – is not working effectively;
- As highlighted above, financial services is a supply-side driven market but this is supported by selective legislation (multinational companies operating on local markets exploit local information asymmetries).

SECTION 3: PRIORITY AREAS FOR THE EUROPEAN COMMISSION – FSUG RECOMMENDATIONS

We are using three criteria to select priority areas for further work:

- The scale of the consumer detriment and potential impact on financial users;
- Probability of intervention making a difference; and
- Is the issue already being dealt with effectively by another intervention (for example, by a new directive)?.

Scoring system

For each of the three criteria, we allocated each product a score of 1 to 10. Note that this is not a ranking system where products are listed in order from 1 to 10. If experts thought that two or more products deserve the same score then these products were allocated the same score.

Scale of detriment/ impact: for this factor, experts allocated a score depending on his/ her assessment of the scale of detriment caused by market failure. 1 is a low amount of detriment/ impact, 10 is a very large amount of detriment/ impact.

Probability of making a difference: for this factor, experts rated the likelihood of a Commission policy intervention promoting more effective market integration and making a difference to financial users. In this case, 1 means intervention would make little/ no difference, 10 means would make a very large difference.

Dealt with by another intervention: experts considered whether the problems identified in the sector are already being dealt with effectively by an existing EC policy intervention. In this case, 1 means that the problem in the market is already being dealt with effectively and no further intervention is needed. 10 means that the problem is not being dealt with effectively/ current interventions are having limited impact and further major interventions are required.

Below, we summarise the results of the analysis. The table contains the sum of each of the scores allocated by each FSUG member.

Sector	**Scale of detriment/ impact**	**Probability of making a difference**	**Being dealt with by another intervention**	**Total Score**	Ranking on detriment	Ranking on total score
Consumer credit	109	92	87	288	4	5
Mortgage credit	114	87	91	292	2	4
Credit card purchases in foreign currencies	91	96	92	279	6	6
Life insurance	100	100	97	297	5	3
Car insurance	82	80	82	244	8	8
Investment life/ unit linked insurance	77	67	63	207	9	10
Personal pensions	134	127	121	382	1	1
Payment services	85	90	71	246	7	7
Retail investment funds	113	115	102	330	3	2
Savings (BEUC study)	73	72	68	213	10	9

As can be seen from the table above, based on total scores, the top five priorities for further action are:

1. Personal pensions
2. Retail investment funds
3. Life insurance
4. Mortgage credit
5. Consumer credit

The ranking is slightly different if based just on the amount of detriment caused:

1. Personal pensions
2. Mortgages
3. Retail investment funds (Mortgages and Retail investment achieve same detriment score)
4. Consumer credit
5. Life insurance

It is worth noting that if the Commission wants to act to create a more effective single retail financial market in these areas, it should consider interventions to address the local market/ supply side/ structural barriers we have identified in local markets as well as – in addition to EU level interventions. As our analysis makes clear, the existence of local structural barriers and local market practices and behaviours undermines the functioning of local markets *and* inhibits the development of effective cross-border market activities.

Moreover, in addition to tackling specific product areas, the Commission should consider cross-cutting interventions. As our analysis shows, certain barriers – such as dominant distribution channels, conflicts of interest, remuneration practices, product/ pricing structures – are common to a number of product areas. Tackling these barriers through effective interventions could produce maximum impact by producing significant improvements for financial users across a number of product areas.

FSUG

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