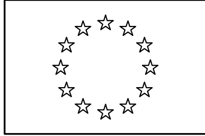

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European Financial Integration Report 2007

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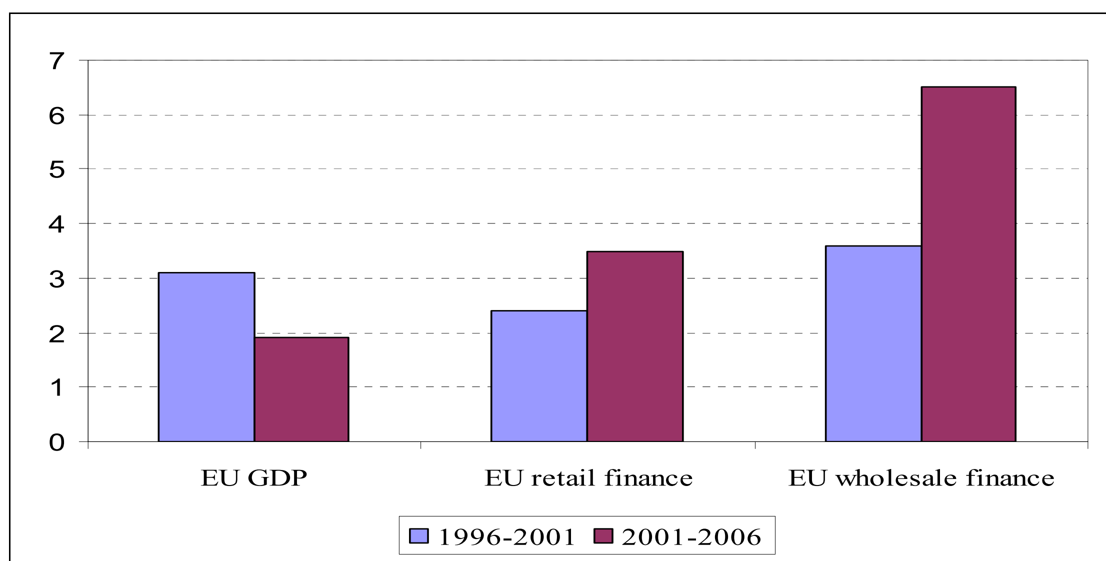
1. INTRODUCTION

1. Financial markets are of great significance to the EU economy, as they play a critical role in mobilising savings and in allocating them to investment. Financial intermediation itself contributes to GDP growth. In 2006 financial intermediation generated EUR 663 billion, which accounts for 5.8% of EU GDP[1]. Moreover, in the period 2001-2006 growth rates of the economic output[2] of the financial sector have been substantially higher than the overall growth rate in the EU (see Chart 1.1). Most strikingly, wholesale finance expanded at three times the rate of the EU economy.

Chart 1.1: Average real growth of GDP and financial services in the EU-25, in %



Source: CEBR (2007).

2. The EU is one of the main actors in international financial markets, together with the US and Japan. Chart 1.2 shows that Europe has a dominating position in the world foreign exchange markets, with a market share of 60% in 2006 (in terms of average daily turnover), while the US and Japanese market shares were 18% and 8% respectively. EU banking groups own 52% of all global banking assets, while EU insurance groups account for 38% of global premiums. Chart 1.1 in the annex shows that premiums in Europe have been higher than in the US since 2004. The US however, clearly dominates in the area of stock market capitalisation (39% against 26% in the EU-15). This demonstrates a fundamental difference between the EU and US financial system; while the US financial system is primarily market-based, the EU financial system is strongly bank-based. Nevertheless, the importance of equity finance is growing. This may partly be reflected in the relative size of European equity markets, which

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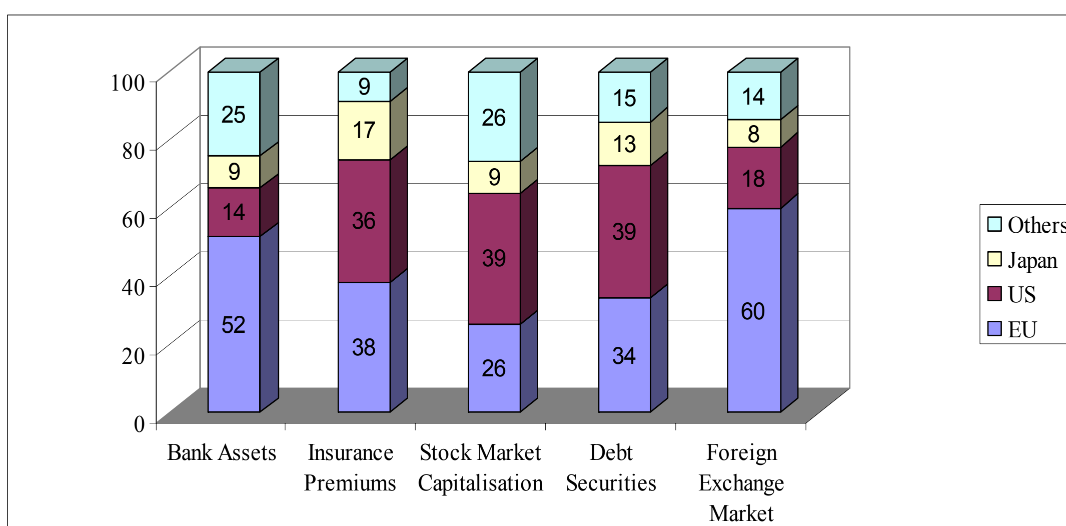
[1] CEBR (2007).

[2] Defined as gross value added by financial intermediaries, i.e. profits made by firms and salaries and bonuses paid to employees in one year – from CEBR (2007).

rose from 67% of the US market in 2005 to 82% in 2006[3]. The value of equity market capitalisation in Europe totalled $16.1 trillion at end-2006, compared to $19.6 trillion in the US (see chart Chart 1.2 in the annex).

3. Financial integration is an important catalyst for economic growth. This report therefore tracks the recent progress in financial integration, and highlights the main achievements of the EU in the field of financial services policy during 2007. In June this year, the European Parliament stressed the importance of such analyses, and called for extending the examination of the economic effects of the Financial Services Action Plan (FSAP) measures in the light of the Lisbon Strategy and the financing needs of the real economy[4]. This report (partially) answers this request by analysing the state of integration in the EU financial sector, including the effects of the FSAP. The full evaluation of the economic impact of the FSAP on the EU financial services sector is being undertaken by the Commission – the report is scheduled for release in early 2009[5].

Chart 1.2: EU-15 contribution to world financial activity in % (2006)



Sources: BIS (2007a), IMF (2007a) and SwissRe (2007).

4. Integration of EU financial markets is progressing across the board, although at a very different pace depending on the product, the end-user and the market. Progress of integration is reflected in the average annual growth of intra-EU trade in financial services, which stood at 14% in the period 2000-2005[6]. However, while wholesale markets are generally characterised by a high level of integration, retail financial markets remain nationally fragmented. Progress in integration is also reflected in the growing number of cross-border mergers and acquisitions. For example, around 30% of the total number of mergers and acquisitions in the EU banking sector in the period 2001-2006 have been cross-

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3 IFSL Research (2007).

4 European Parliament (2007).

5 For more information see: http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm

6 CEBR (2007).

border within the EU[7]. While it is acknowledged that integration can strengthen competition, it is difficult to assess the impact of the ongoing M&A process on the competitive structure of EU financial markets. Finally, financial integration offers better opportunities for financing and risk diversification. However, it also leads to structural changes in the financial system, e.g. increasing cross-border financial linkages and new financial instruments, and therefore calls for adequate safeguards to ensure financial stability.

5. The report is organised as follows. In chapter 2 the degree and evolution of financial integration is analysed. The developments with respect to competition between intermediaries, markets and infrastructures markets are discussed in chapter 3. Next to this, chapter 4 explores the extent to which integration fosters efficiency and innovation. As the integration process can also influence the way in which the EU financial system deals with risks, the issue of financial stability is addressed in chapter 5. The annex presents the main achievements of the EU in the field of financial services in 2007 as well as additional information on financial integration indicators.

[7] Based on ECB (2006a) and Commission calculations. Data for 2006 covers the first half year.

2. FINANCIAL INTEGRATION

1. There is no widely accepted definition of financial integration. Generally a perfectly integrated market is regarded as a market where prices for similar products and services converge across geographical borders and where supply and demand can react immediately to cross-border price differences. An integrated market should enable all market participants (consumers, financial institutions, etc.) to buy and sell financial instruments and/or services, which share the same characteristics, under the same conditions, regardless of the location of origin of the participant. If the latter is the case, this should result in more opportunities for risk diversification, better allocation of capital, and higher economic growth.

2. In order to assess the current state of play of EU financial integration two groups of indicators have been analysed: (i) price-based indicators and (ii) quantity-based indicators. The first category measures differences in prices or the return on assets, and thereby provides a check to see to what extent the "law of one price" holds. The degree of integration can be measured also by examining how prices react to regional and global news or events. In an integrated financial area, one would expect portfolios to be well diversified, and therefore react stronger to global rather than local shocks. Quantity-based indicators are used to investigate the extent to which market players are active beyond national borders. When there are no, or hardly any, constraints, one would expect a relatively high level of cross-border activity.

2.1. Financial markets: equity, bond and money markets

3. Over the last years, EU financial markets have shown substantial growth and have become much more liquid. The sector has been more productive than the economy as a whole, in particular the wholesale finance market which had an annual growth rate in gross value added of 6.5% between 2001 and 2006[8]. Collectively, the euro area and the UK provided for 30% of global financial stock growth in 2005 (against 20% for the US)[9]. This confirms that the EU is emerging as a major player in the global financial landscape.

4. Europe has made considerable progress in creating a single market for wholesale financial services. Financial services providers, large clients and institutional investors essentially operate on a pan-European scale and in several markets integration has led to rapid development in terms of quality and quantity of services offered. Markets for inter-bank lending, government bonds, investment banking and derivatives are almost completely integrated. In addition, equity market returns are increasingly correlated showing rising cross-border portfolio diversification. Nevertheless fragmentation of the underlying

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8 CEBR (2007).

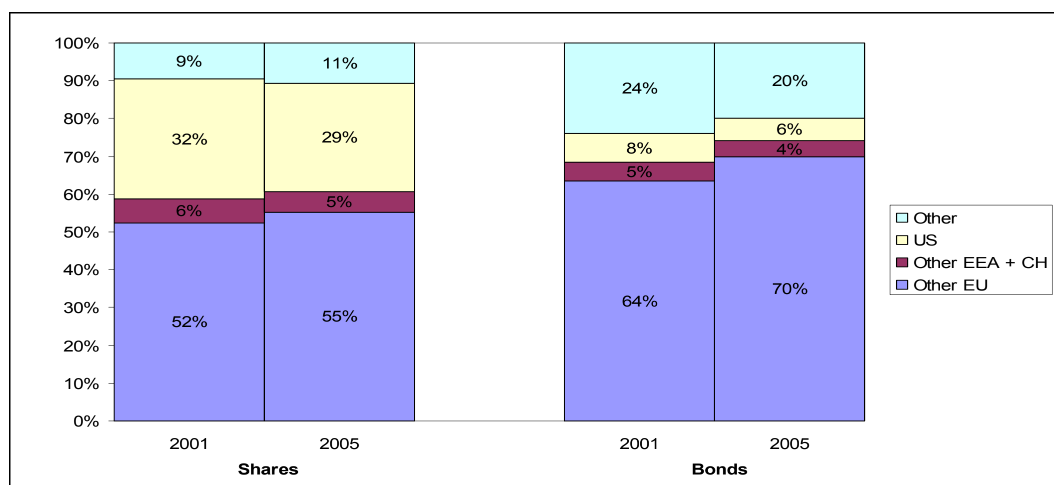
9 McKinsey&Company (2007). Data on financial stock include equity securities, private debt securities, government debt securities, and bank deposits.

infrastructure and high costs related to cross-border transactions are hampering further integration, especially for equity markets.

5. Integration in equity markets has advanced at a good pace. The cross-country dispersion of the equity returns in the euro area has dropped significantly since 2000; in the period 2004-2006 the average difference between the index returns narrowed from around 3% to 1.5% (see chart 2.11 in annex). The role of euro area events in explaining equity volatility has increased in comparison to that of global shocks reaching nearly 40% in the period 1999-2006 (see chart 2.9 in annex). Integration has even been stronger in the government bond markets in the euro area, where near perfect integration has been achieved with the introduction of the euro. Yields of bonds in other EU-15 Member States have also converged to a common level, while yields in the whole EU-25 are still more diversified (see chart 2.3 in annex). The corporate bond market shows sign of increasing integration since the variance of total yield spread explained by country effects is close to zero (see chart 2.12 in annex). The money market in the euro area has reached full integration since the introduction of the euro. The rates in the EU as a whole are also moving to a common level with EU-15 showing a stronger degree of convergence than in the EU-25 (see chart 2.4 in the annex). In terms of interest rate convergence, the unsecured market is somewhat more integrated than the secured (repo) market (see annex 2.13 and 2.14 in annex).

6. From an investors' perspective, integration should allow for free trading on any European stock exchange. However, EU investors still demonstrate a home bias concerning equities, although the value of the bias has substantially declined over the years. Indeed, the percentage of total foreign equity investments done in another EU country has increased slightly between 2001 and 2005 (from 52% to 55%), which might suggest that the declining home bias has been matched by an increasing regional bias in the EU. In most EU countries this regional bias ranges from 50% to 70%, however in the Baltic States and Malta investors from other EU countries account for more than 90% of all foreign investments (see chart 2.1 in the annex). The US was the largest third country foreign investor in EU equities with a market share near to 30%. Also the home bias of the bond portfolio investor has declined substantially in the EU; in 2005 within the portfolio of long term debt securities owned by foreign investors in the EU, on average 70% was owned by investors from other Member States (see chart 2.2 in the annex). This "regional bias" in the EU bond market has been higher than in the equity market, which reflects the fact that the bond market has reached a quite advanced stage of integration (see chart 2.1 below).

Chart 2.1: Foreign investment in the EU capital market by origin of investors



Source: IMF (2007b). European Commission's calculations.

7. As far as the euro money market is concerned, the introduction of the euro brought about a sharp convergence of interbank *interest rates*, leaving the remaining variation between Euro zone interbank rates (1-month and 12-months EURIBOR) to fluctuate between 0.5 and 1 basis points in the period 2003-2007 (see chart 2.13 in annex). The home bias also has been significantly reduced. According to the ECB[10], the geographical counterparty breakdown of unsecured transactions in 2006, shows that 25% of the counterparties originate from the same country, while 55% is from another euro area country[11]. In case of secured transactions, the degree of home bias can be approximated by the origin of collateral used to secure transactions. The share of national collateral amounted to about one third of the total while the share of collateral issued in other euro area countries reached about 61% (and increased compared to the previous year).

2.2. Financial institutions; banking and insurance

8. Although market structures differ, both banking and insurance markets show signs of increasing integration. In insurance, greenfield operations are limited, and EU market integration has mainly happened through cross-border merger and acquisitions and the creation of pan-European groups. As for banks, it has become feasible and increasingly common to operate through branches (see Chart 2.6). Nevertheless, cross-border provision of services mainly occurs in the wholesale segment.

9. The cross border flow of interbank loans has also increased within the euro area, up to the level of approximately one third of total loans in 2006 (see chart 2.2). This chart also shows that the proportion of cross-border loans to non-bank clients is relatively small, and remained less than 5% of total loans during the

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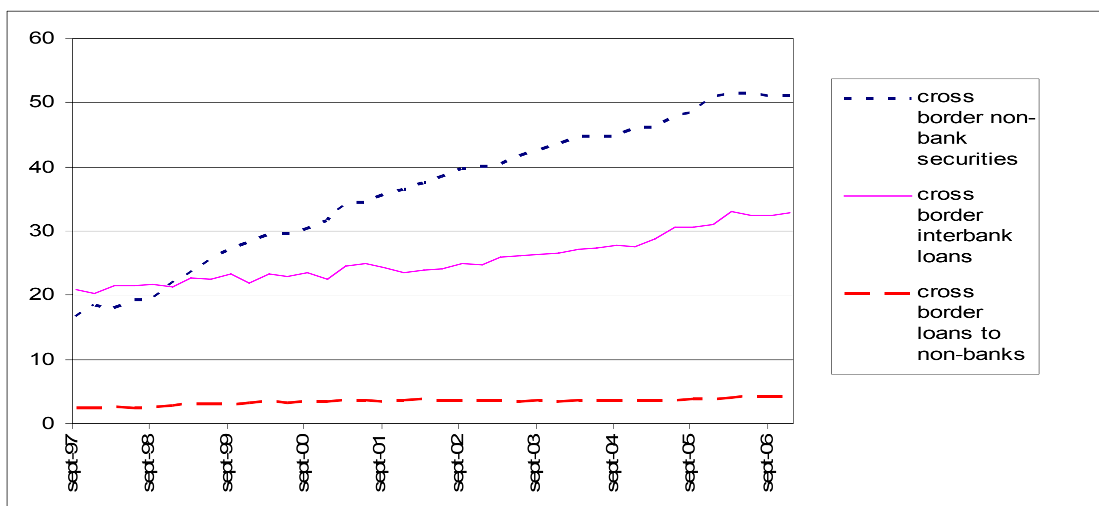
[10] See ECB (2007e).

[11] In 2003 figures were 31% for national counterparties and 52% for other euro area countries. See ECB (2005).

period 1999-2006. The low number of cross-border retail loans suggests that there are certain constraints hindering further integration in this market segment.

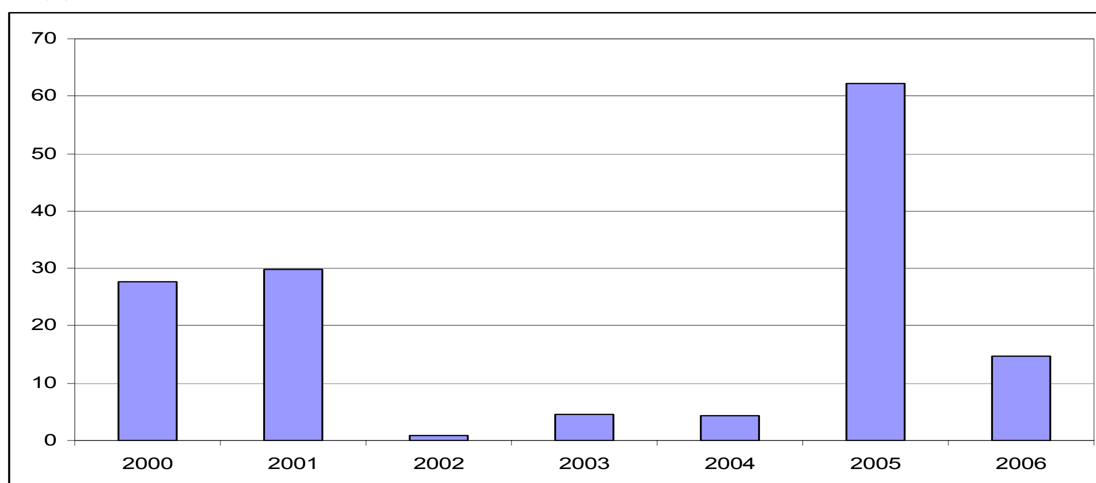
Chart 2.2: Cross-border holdings of euro-area banks (% of total holdings)



Source: ECB (2007d).

10. In the 1990s, consolidation operations in the EU banking sector have been predominantly of a domestic nature. However European cross-border merger and acquisitions activity picked up in 2005 following the slowdown registered in the period 2002-2004 (see chart 2.3 below and chart 2.5 in the annex). Despite a marked decrease from the previous year, in 2006 the level of the intra-EU cross border remained quite relevant[12]. In 2005 more than 46 banking groups were undertaking significant cross-border activities in up to 15 EU Member States. The 14 largest EU banking groups already accounted for almost one-third of total EU banking assets.

Chart 2.3: Cross-border banking M&As in the euro area, percentage of total deal value



Source: ECB, Financial integration indicators.

[12] The picture does not change when looking at the EU25 instead of the euro area. See ECB (2007a).

11. An interesting issue is to what extent European banks´ activity is targeted towards other European countries. Not surprisingly a large proportion, or 23 % of total business, is "regional" cross-border, i.e. carried out in other Member States (see chart 2.7 in the annex). Intra-EU bank activity is considerably higher than in other regions, e.g. within the NAFTA (United States, Canada and Mexico) or within the Asian-Pacific region.

12. The development of the insurance internal market has been significantly influenced by the specific characteristics of the market, i.e. the differences in the products marketed and the relevance of the "physical" distribution channels, particularly for certain typologies of product. The breakdown of the European insurance market shows that in 2005 on average EU national markets consisted of 82% national enterprises, i.e. with their head office in the country, while 14% were EU/EEA branches[13]. However, domestic companies generally account for more than 90% of total premium income.

13. The figures mentioned above might indicate that integration of the European insurance market is lagging behind. However capital ownership is much more widely spread across European shareholders, i.e. as mergers and acquisitions have created large pan-EU insurance groups. In this respect, the 20 largest European insurance groups collected more than €725 bn across the world and more specifically €523bn in Europe, which represents more than 50% of the total premium income in Europe in 2005. These 20 leading groups operate essentially in Europe where 72% of their premium income is collected. It is worth noting that the consolidation has occurred not only at cross-border level but also at cross-sectoral level with conglomerates playing an increasing leading role among big financial players (see chart 2.10 in annex).

2.3. Financial infrastructure

14. The integration of the securities infrastructure is a necessary condition to achieve a fully integrated EU securities market. The benefits of integrating the post-trading infrastructure could be substantial; according to a recent study by the Commission[14], a fully integrated EU post-trading system could lead to a lowering of transaction costs of up to an estimated 18%, which could, in turn, result in an increase of up to 0.6% in the level of GDP in the subsequent 10 years[15]. In spite of the potential benefits, integration in the post-trading market has thus far lagged behind that of securities markets. Indeed, while securities markets are becoming increasingly European, the post-trading infrastructure largely remains fragmented along national lines.

15. One reason why post-trading arrangements have not adapted to the new market reality is the existence of fundamental barriers to their integration[16]. These barriers and the complex market structure for handling cross-border transactions that has emerged in order to overcome them translate into higher costs and

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[13] CEIOPS (2007). Data include reinsurance companies.
[14] See European Commission (2006b).
[15] See European Commission (2006c).
[16] See Giovannini Group (2001) and Giovannini Group (2003) for more details.

(potentially) higher risk for cross-border investors. Several studies have tried to compare the post-trading costs of domestic versus cross-border transactions[17]. These studies generally conclude that, in the EU, an investor pays, on average, between 2 to 6 times more for a cross-border equity transaction than for a domestic one. Moreover, in spite of being internally efficient, an analysis of the different national systems reveals that they differ substantially in terms of costs, which suggests that there is room for further improvement.

16. Integration within the market for Large Value Payment Systems (LVPS) has been remarkable boosting integration in particular of the money markets. In response to the launch of the single currency, two pan-European platforms were established, which have substantially contributed to consolidation and efficiency in the euro area[18]. Further consolidation in the LVPS industry has led to a situation in which there are now four LVPS in the euro area[19]. Currently the largest volumes and values of payment orders are carried out through these multilateral payment systems, which have a market share of around 80%[20]. Of these four systems, TARGET handles the largest value of payments. In 2006, it processed 83.2 million national and cross-border payments, with a total value of more than €533 trillion, i.e. around 90% of the total value processed by all large-value Euro payment systems[21].

2.4. Retail markets

17. Despite significant progress towards a single market for wholesale financial services, enabling European service providers, institutional investors and large corporates to operate on a pan-European scale, retail financial markets remain fragmented and lag behind. This lack of integration can be partly attributed to barriers that are normally "demand-driven", i.e. language and cultural preferences[22], which keep retail consumers immobile and might be very difficult to overcome. Moreover customer mobility is also discouraged by the insufficient level of information and high transaction costs due to several factors like the fragmentation of market infrastructures (clearing and settlement and payments systems), legal and tax differences. Nevertheless some positive developments towards integration can be detected; price homogeneity is

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17 See European Commission (2006d).

18 First, the Eurosystem established TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system) by interconnecting national RTGS and the ECB payment mechanism. Second, the EURO1, the Euro System of the EBA Clearing Company, was introduced.

19 The other two LVPS are: the French Paris Net Settlement (PNS) and the Finnish Pankkien on line Pikasiirrot ja Sekit järjestelmä (POPS).

20 This means that 20% of cross-border payments are still made via corresponding banking.

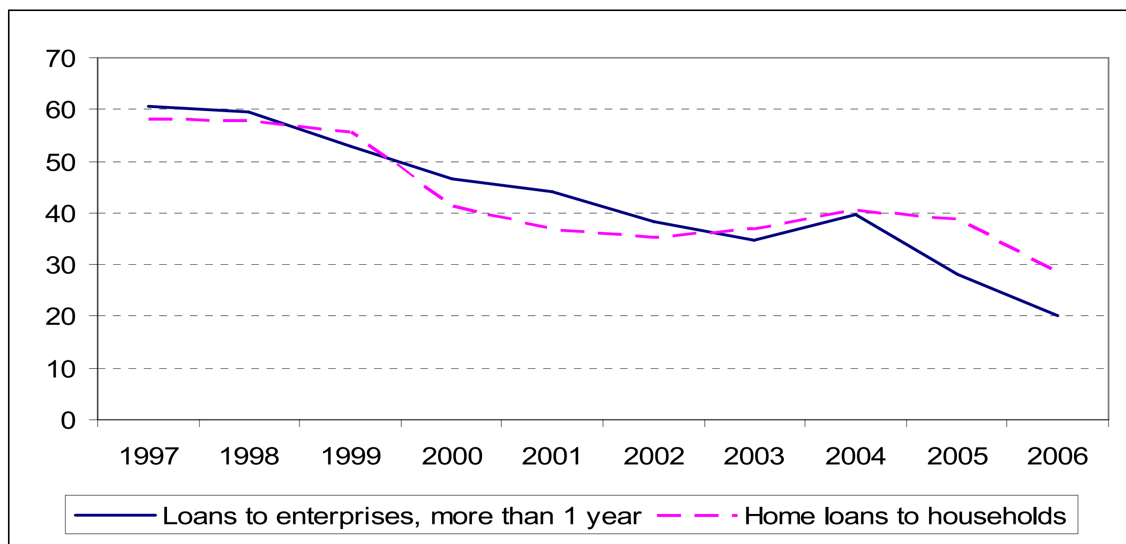
21 Information obtained from the website of the European Central Bank.

22 According to European Commission (2006a), only 3% of respondents indicated that they have thought about taking an insurance policy or a mortgage in another Member State in the previous 12 months. Figures are similar to those obtained in 2002.It is worth noting that the "language barriers" have outrank "lack of information" among the factors that discourage the use of financial services from other Member States. This means consumers are more informed than in the past but remain still reluctant towards cross-border buying of financial services.

increasing for certain retail products and costs of electronic payments are declining[23], particularly for cross-border trading.

18. Retail interest rates between EU Member States have certainly declined, but are still far from converging to a common level (see chart 2.4 hereunder). The coefficient of variation ranges from 20% for loans to enterprises with a maturity of more than one year to 28.4% for mortgage loans to households.

Chart 2.4: Convergence of retail banking interest rates (coefficient of variation)



Source: Eurostat database, based on annual data.

19. Fees for the most common banking products, such as current accounts, still differ substantially among Member States. While the overall picture of the EU retail market is that of nationally fragmented markets, with small cross-border flows and large price differences, there are some signs of progressing integration. Price discrepancies in the overall euro area banking community keep decreasing compared to banks in other regions (such as North America and Asia Pacific). Chart 2.5 hereunder shows that euro area banks continue to price in a narrower range, which appears to be reinforcing the trend towards convergence. Next to this, retail prices in banking have been declining in the euro zone in the period 2006-2007 (see chart 2.6 in annex).

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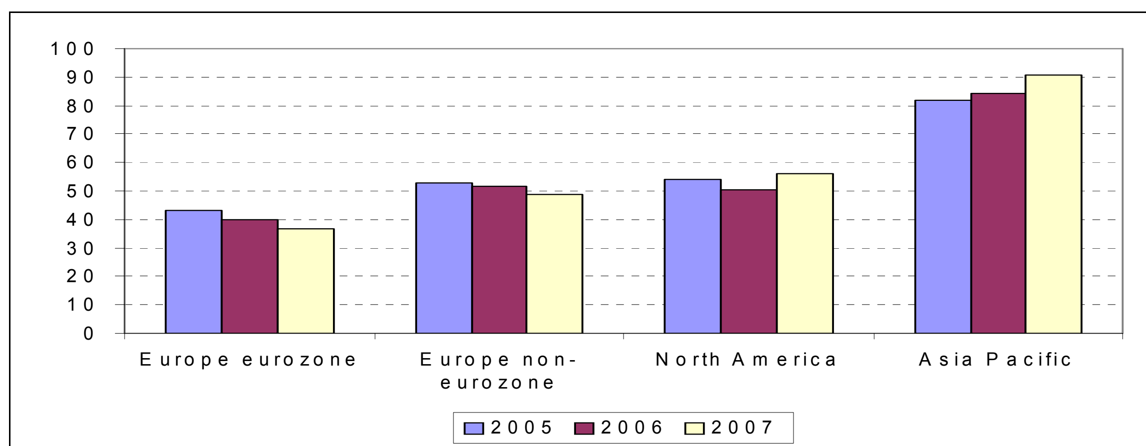
[23] According to Capgemini (2007) in 2007 prices for electronic payments decreased by 3% but they are still 21% higher than in the rest of the world. Price is defined the aggregated cost of current account, debit card,internal and external wire transfers, direct debit.

Chart 2.5: Price discrepancy among banks in different geographic regions (in %)



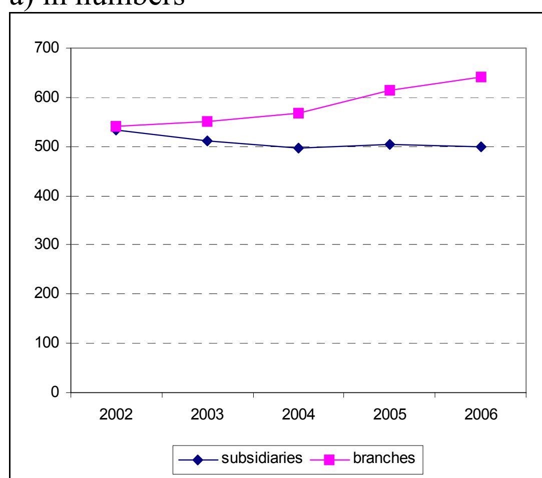
Source: Capgemini, (2007).

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 2005-2007. 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.

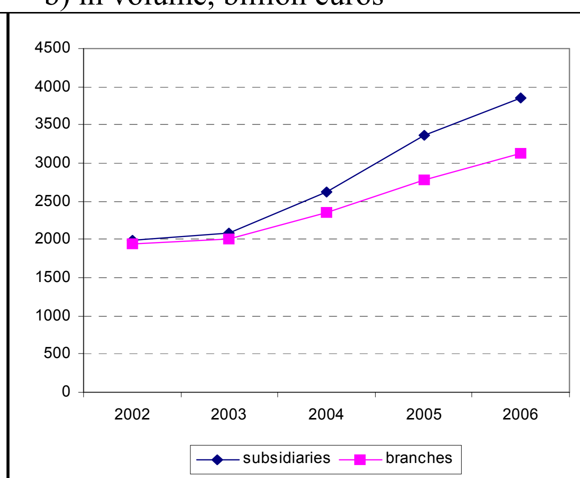
20. The *increasing number of cross-border bank branches* (see chart 2.6a) can be seen as an indication that the integration process in retail banking has advanced; ownership of local banks – through subsidiaries – is no longer the only alternative for entering into another country's retail market. It has become feasible and increasingly common to sell cross-border banking services under a foreign bank name and subject to home Member State regulation and supervision. However, in terms of volume[24], subsidiaries remain the most important form of cross-border EU banking establishment (see chart 2.6b).

Chart 2.6: Intra-EU bank branches and subsidiaries (in numbers and in volume)

a) in numbers



b) in volume, billion euros

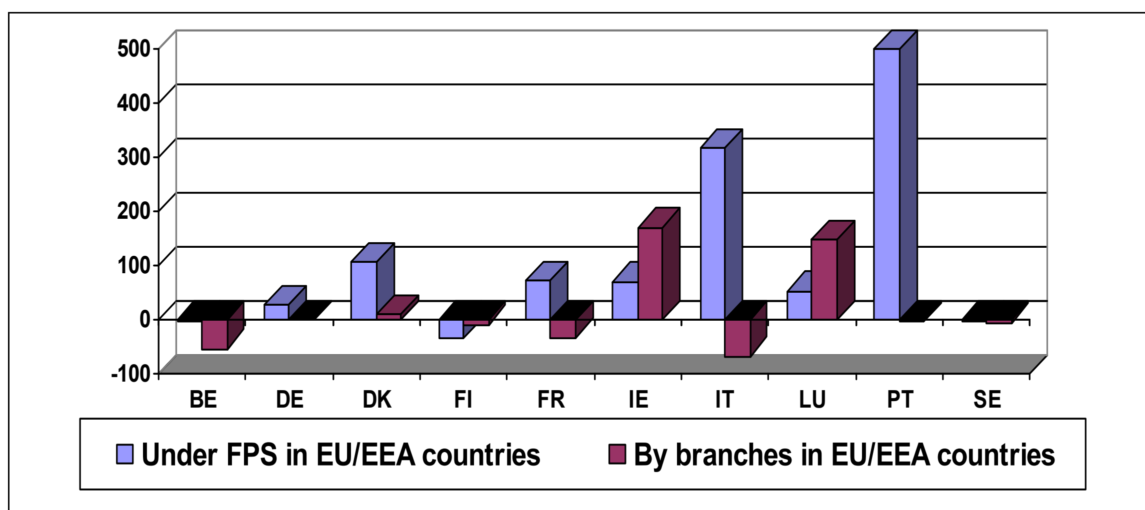


Source: ECB (2007a).

[24] The prevalence of subsidiaries can be also observed in terms of market share. In 2006 EU subsdiaries accounted for 10.5% of EU25 market (total assets of credit institution) while EU branches' share was 8.5%. See ECB (2007a).

21. Due to the low level of standardization of insurance products, prices are difficult to compare and no (reliable) price-based indicator is available. Moreover the market structure is characterized by large companies operating on an EU-wide basis through subsidiaries and with a very limited direct cross-border provision of insurances services, especially in the retail segment (see chart 2.8 in annex). Nevertheless we can observe, in most of the Member States where statistics are available, an increase in premiums provided on a direct cross-border basis and a decrease in premiums issued by branches established in another Member State (chart 2.7 below). These figures might witness a trend in the insurance distribution models towards substituting (or at least complementing)[25] the branch network with distance selling channels. Exceptions are provided only by those countries where the level of premiums under free provision of services has been historically high.

Chart 2.7: Percentage increase of gross premiums written, issued on a direct cross border basis and by branches established in another Member State. (2005 as a percentage of 2003 data)



Source: CEIOPS data, Commission Services calculations.
Note: Data include life, non life and composite enterprises.

22. While the large value payment systems have reached a high level of integration, the retail payments segment is fragmented and still tailored to national circumstances. While one would expect that the incentive to reap economies of scale and scope would give rise to consolidation activities, the current market structure in the EU does not differ substantially from the period before the introduction of the euro. For example, in the period 1998-2006 the number of retail payment systems in the euro area declined from 19 to 14, which on average is still more than one payment system per euro area country.

23. The lack of integration in the market for retail payment systems is also reflected in the variation in the level of fees between Member States. For example, merchants in Member States with high fees have to pay banks three or four times higher merchant fees on payment card transactions than merchants in

[25] According to CEIOPS (2007) in the period of 2003-2005 the number of EU/EEA branches in Europe has increased of around 20%.

Member States with low fees[26]. An important explanation for the lack of integration is the fact that procedures, instruments and services offered to EU consumers and SMEs still diverge between Member States. The introduction of the Single Euro Payment Area (SEPA)[27] aims at removing these barriers and creates a single market for payments throughout the euro area. This should strengthen European integration and provide consumers and economic actors with higher service levels and more efficient and cheaper payment services.

2.5. Conclusions

24. Financial integration in the EU has progressed although the speed and scope of that process has not been the same across all market segments (in terms of product and market participant). The most recent data confirm that a situation of almost complete integration has been established in the unsecured interbank deposit market and government bond markets. Equity markets and corporate bonds market show a rising degree of integration as witnessed by the decreasing relevance of "country" effects in explaining price changes. Further integration in these markets will greatly depend on progresses in integrating securities settlement systems (in particular for equities).

25. Retail markets show a slower path of integration; direct cross-border activity involving individual customers remains modest and price indicators witness significant variations across Member States in prices of payment services and other key retail financial services like consumer credit and current accounts. Fragmentation of retail markets can be partly explained by the insufficient level of integration in infrastructures (payments and clearing and settlement) and regulatory frameworks (i.e. taxation). Market integration is also limited by EU consumers' language and cultural preferences that make them more confident dealing with products distributed locally through traditional channels (branches, subsidiaries, intermediaries).

26. Notwithstanding that retail markets integration is far from reaching its potential some positive developments can be detected. Price convergence for certain products (home loans) has increased and, more in general, retail prices have been declining. Moreover, signals of a dynamic pattern towards integration are provided by the increasing use of distance selling channels and the expansion of large cross-border services providers operating on a pan-EU level through subsidiaries and branching.

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[26] See European Commission (2007a).

[27] SEPA is an area in which consumers, companies and other economic actors will be able to make and receive payments in euro, whether between or within national boundaries under the same basic conditions, rights and obligations, regardless of their location.

3. MARKET STRUCTURES AND COMPETITION

1. Integration is an important driver for strengthening competition in EU financial markets. One of the outcomes of increased competition can be consolidation and increasing concentration within a market, as firms try to benefit from cost savings through both economies of scale and scope. End users may also benefit from this increase in scale, as market contestability forces parties to pass on any resulting cost reductions. However, increasing concentration can also lead to market power, which may trigger firms to engage in anti-competitive behaviour. It is therefore of utmost importance to get a better picture of developments in both market structure and the level of competition. It should be stressed that, given the existing fragmentation in many markets, most notably retail financial markets, that market structures are primarily analysed at the national level.

3.1. Main developments in market structures

2. European banks have continued to restructure their business in search of improved efficiency and competitiveness. During the period 2001-2005 the total number of EU credit institutions decreased by 12 per cent while assets increased by 33 per cent, see Chart 3.1 in the annex. This reflects an ongoing trend towards the creation of large credit institutions. As a result of consolidation and organic growth, a relatively small number of banking groups now own a significant and growing share of total EU banking assets. According to a mapping exercise carried out by the European System of Central Banks a relatively small group of EU banks with significant cross-border activities is holding a sizable and rising share of total EU banking assets, i.e. in 2005 46 banking groups accounted for 68% of total EU banking assets.

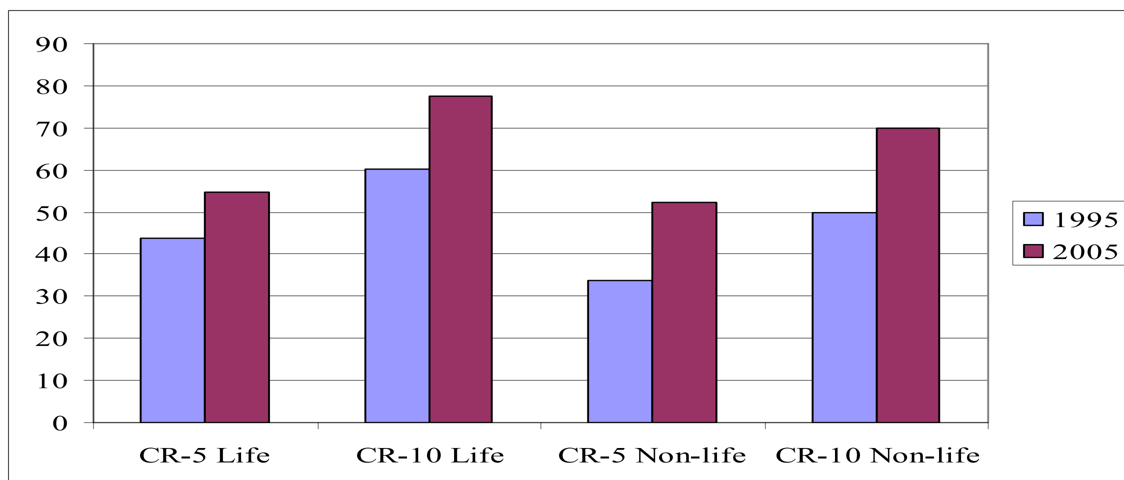
3. Table 3.2 in the Annex shows that concentration in the EU banking market has increased by 16.9% over the period 2001-2006, as the weighted average of the Herfindahl-Hirschman Index (HHI) rose from 504 to 589. However, 2006 was the first year since 2001 in which the concentration level declined (from 601 to 589). The weighted average is far below the threshold of 2000, which is generally regarded as an indication of a highly concentrated market. Nevertheless, there are a number of banking markets where the HHI is close to, or over 2000, i.e. Belgium, Estonia, Lithuania, the Netherlands and Finland. Moreover, the market share of the 5 largest banking groups in these Member States is almost twice as high as the EU weighted average. Larger Member States (such as Germany, Spain, France, Italy, and Poland) on the other hand show relatively low concentration levels. The concentration ratio in a great number of EU-10 countries has decreased in the period 2001-2006.

4. The number of insurance companies operating in the EU has also been declining for several years, mainly driven by merger and acquisition activities in this sector. In 2006 around 5300 companies carried out insurance activities in Europe[28]. The structure of the EU insurance market is characterised by a small

[28] CEA (2007).

number of groups holding a large part of the market and a large number of small and medium sized firms that hold a very low market share. This is also reflected in the concentration ratios in the EU-25 insurance market. In the life sector, the average market share of the five largest insurance groups attained 54.7% in 2005, as compared to 43.9% in 1995 (see chart 3.1). The non-life sector is slightly less concentrated, with the five-firm market share standing at 52.4% .

Chart 3.1: Concentration ratios Life and Non-life sector (in %)



Source: CEA (2007).

5. The structure of the EU insurance market is somewhat similar to that of the banking market. Here too, the largest insurance markets are less concentrated. In these markets, the market share of the 5 largest insurance groups lies between 40% and 50%, while in smaller markets such as the Baltic and Nordic countries this share is more than 85%. Moreover, it is argued that – mainly as a result of the liberalisation policies – the concentration ratio in many of the EU-10 countries has declined over the last decade. However, the eastern European markets are still dominated by large insurance companies; the top 5 companies generally have a market share of around 80% in both the life and the non-life market[29].

6. The EU stock market is also highly concentrated. Measured by trading activity, the market share of the five largest stock exchanges in Europe exceeded 90% in 2006. The London Stock Exchange (LSE) stands out with a 39% share of total EU turnover (see chart 3.2). Moreover, together the LSE and Euronext account for nearly 60%. The stock market concentration level is almost identical in terms of market capitalisation, as the five largest stock exchanges have a market share of 85% (see Chart 3.4 in the Annex). This high level of concentration may be explained by the fact that financial exchanges exhibit network externalities, as higher participation of traders on both sides of the market positively affect market liquidity, and increases traders' utility.

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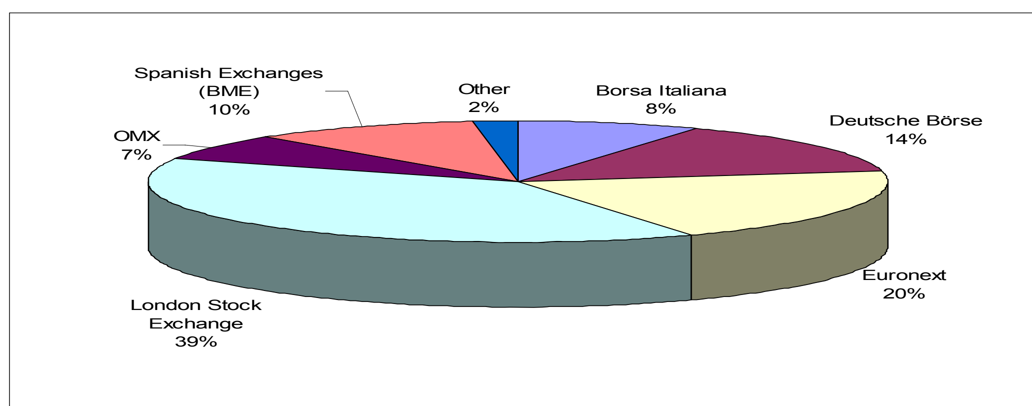
[29] CEA (2007).

Chart 3.2: Market share of EU stock exchanges in 2006 (by stock turnover)



Source: FESE (2007a).

7. In each Member State the post-trading infrastructure is also highly concentrated with a single Central Securities Depository (CSD) and Central Counterparty (CCP) – where applicable- serving the market in almost all Member States. Although economies of scale and scope are compatible with perfectly contestable markets, it is questionable whether this is currently the case for CSDs/CCPs. The latter is mainly due to the existence of network effects coupled with high sunk costs (investments are very specific and therefore not easily recoverable) and high switching costs on the demand side.

8. As for retail payment systems, the recent sector inquiry into retail banking[30]has confirmed that these banking infrastructures are highly fragmented, with little or no competition at the EU level. Also, payment card markets in many Member States are highly concentrated, with national debit networks sometimes accounting for up to 90% of all card transactions. In the downstream markets, competition is strong among banks that issue payments cards, while acquiring (i.e. the part of the payment which relates to the member of a card scheme that has a contractual relation with a merchant) often remains a monopolistic or nearly monopolistic activity. Chart 3.6 in the Annex shows the market structure in the EU markets for credit and debit cards in 2004. As can be seen, the HHI index in most Member States is (much) higher than 2000, reflecting the highly concentrated nature of these markets.

3.2. Which type of consolidation: along national boundaries or across borders?

9. Consolidation can be driven by the goal of increased efficiency as larger firms may want to exploit economies of scale and scope. Mergers and acquisitions may also be the most effective way to expand market share in saturated markets or acquire market share in foreign markets. The latter especially applies to retail markets, where proximity to the consumer and an established reputation are important factors for attracting customers. Generally it can be argued that the

[30] European Commission (2007a).

consolidation process in the EU keeps going, although in a different manner depending on the product, the end-user and the market.

10. A comparison of consolidation activities within banking and insurance, shows that insurance groups are substantially more internationally oriented than banks. Moreover, the reinsurance market should be seen as a global market, with the EU and the US as dominating regions (see chart 3.3 in the annex). Over the period 1990-2006, cross-border M&As in the insurance industry accounted for 30% of the value of all M&As in the industry, while for banks this was 11%[31]. Table 3.1 shows the geographical dispersion of the premium income of the top 15 European insurance groups in 2005. The table shows that these insurance groups indeed have a foreign bias, as ten out of the fifteen groups earn most of their premium income in foreign countries. However, the relative importance of cross-border mergers and acquisitions has fallen in recent years, which could explain why the consolidation process has been accompanied by a falling market share of foreign companies.

Table 3.1: Cross-border penetration in insurance (% of total premiums in 2005)

	Total Group Premium (€ million)	**Share of home in the group**	**Share of Europe in the group**	**Share of rest of the world in the group**
Allianz	92 190	36	45	19
Axa	65 995	27	44	29
Generali	62 678	40	54	6
ING	45 758	22	18	59
Aviva	40 385	49	42	10
Zurich Financial Services	39 494	11	53	36
CNP	26 488	79	10	11
Prudential	21 929	42	1	57
HBOS	20 434	90	5	5
Credit Agricole	19 986	90	5	5
AEGON	18 882	19	26	55
Ergo	15 919	85	15	0
Winterthur	13 658	37	51	12
Skandia	13 288	36	53	12
Groupama	13 247	80	19	1

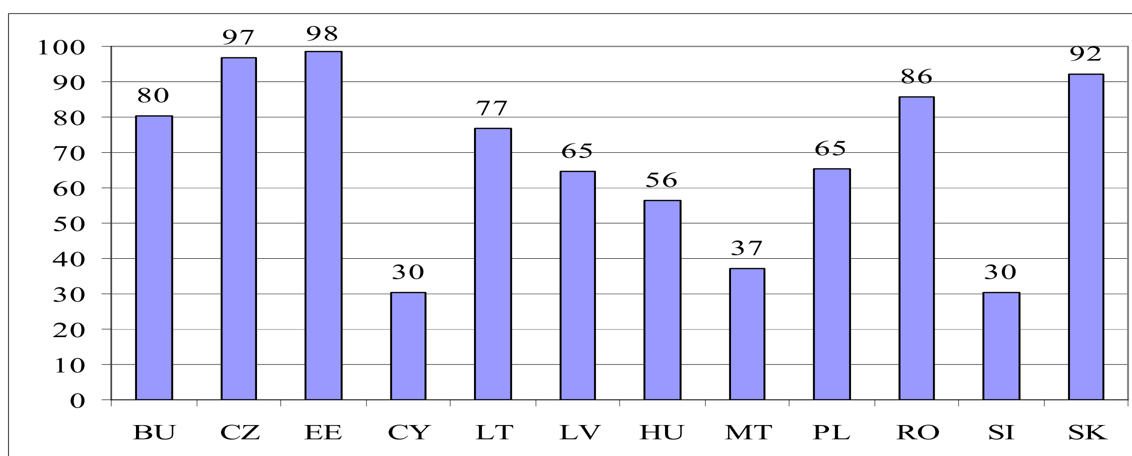
Source: Schoenmaker et al. (2007).

11. As for banking groups, much of the cross-border consolidation has concentrated around regional clusters, especially the Benelux, the Nordic/Baltic region and the Central European Member States. In the latter countries, the market share

[31] Focarelli (2007).

owned by foreign banking groups (mainly from EU-15 countries) is relatively high, reaching almost complete control of the banking sector in some countries. On average around 68% of the domestic banking sector assets in the EU-12 countries are foreign-owned (compared to 29% in the EU-15). The countries with the highest foreign ownership ratio are Estonia (98%), the Czech Republic (97%), Slovakia (92%), Romania (86%), Bulgaria (80%) and Lithuania (77%) (see chart 3.3). Table 3.2 however shows that the largest cross-border bank takeovers in Europe in the period 2004-2006 have not been biased towards specific regions.

Chart 3.3: Foreign ownership of banking assets in the EU-12 (in %, 2006 data)



Source: ECB (2007a).

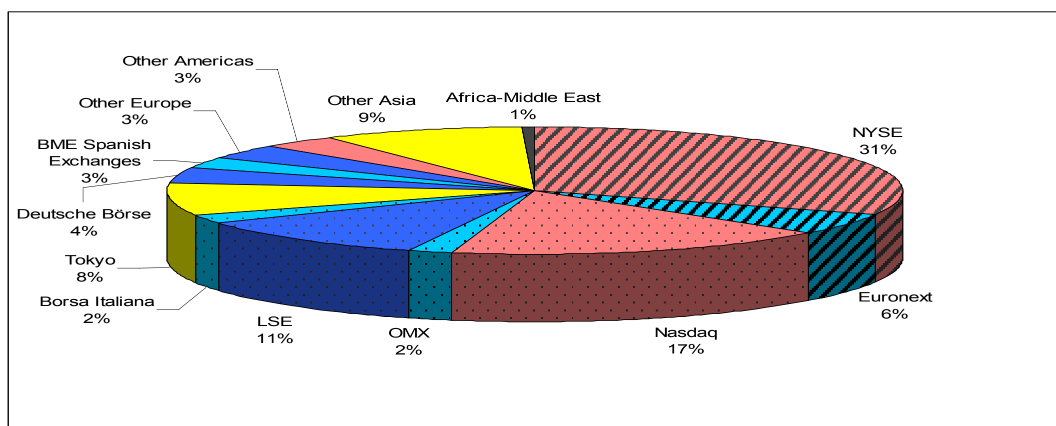
Table 3.2: Cross-border bank takeovers in Europe 1996-2006

Year	Target	Acquirer	Value (EUR million)
2005	HVB Group (DE)	UniCredit (IT)	15 371
2004	Abbey (UK)	Banco Santander (ES)	13 853
2000	CCF (FR)	HSBC (UK)	11 229
2006	BNL (IT)	BNP Parisbas (FR)	9 000
2000	Bank Austria (AT)	HVB Group (DE)	7 169
2005	Banca Antonveneta (IT)	ABN Amro (NL)	5 865
2000	Unidanmark (DK)	Nordic Baltic Holding (SE)	4 779
1997	Merita Oyl (FI)	Nordbanken (SE)	4 135
1997	BBL (BE)	ING (NL)	4 090
2006	Sampo Bank Group (FI)	Danske Bank (DK)	4 050

Source: DNB (2007).

12. Regarding EU stock exchanges, there has been an intensive regional cross-border consolidation with examples of integration with non European entities. Following the Euronext example[32], the Nordic and Baltic stock exchanges merged between 2004 and 2006 creating the OMX Nordic Exchange[33]. More recently, in June 2007 Italy's stock exchange operator Borsa Italiana decided to accept a takeover from the London Stock Exchange[34]. So far, however, many EU smaller markets have not followed the consolidation trend, in particular those in Central Europe[35] (see Annex, Chart 3.5). In 2006, the first trans-Atlantic stock exchange merger took place: between Euronext and the NYSE, strengthening the NYSE's position as the largest securities trading venue in the world (see chart 3.4). In 2007 two other consolidation deals between EU and US exchanges were announced: an acquisition of the New York-based International Securities Exchange by Deutsche Börse and a merger between Nasdaq and OMX.

Chart 3.4: Stock exchanges – shares in the global market (by turnover, 2006)



Source: WFE (2007).

13. Since the introduction of the euro, there has been some consolidation in the post-trading industry. However, most of the consolidation activities have taken place within the borders of Member States (e.g. in Italy and Spain). Nevertheless, some cross-border activity has been observed in the settlement (e.g. Euroclear and the Nordic CSD) and the clearing (the LCH.Clearnet merger) spheres. The degree of consolidation in each of these cases differs substantially (LCH.Clearnet being the most advanced and the Nordic CSD the least advanced) and is not entirely complete in either case. As for the retail payments infrastructure, the introduction of the Single Euro Payments Area (SEPA) is expected to lead to pan-European consolidation. In anticipation of the introduction of SEPA, the 2006 merger of the Dutch company Interpay Nederland B.V. and Germany's Transaktionsinstitut für Zahlungsverkehrdienst-leistungen AG already created the first truly pan-European payment processor.

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32 Merger of Paris, Amsterdam, Brussels and Lisbon stock exchanges during 2000-2002.

33 Copenhagen, Stockholm, Helsinki, Tallin, Riga, Vilnius + Iceland stock exchanges.

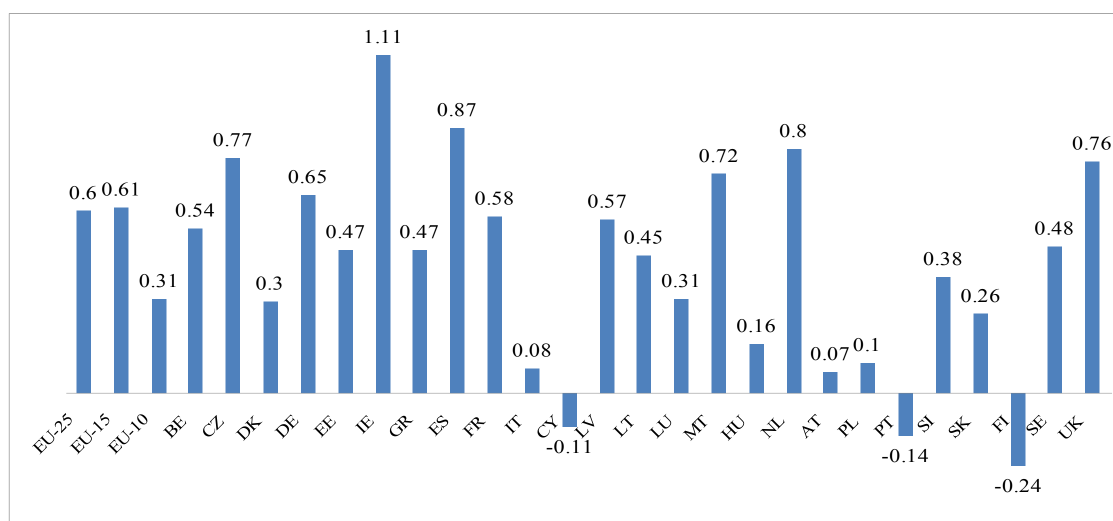
34 LSE's biggest shareholder is the New-York based Nasdaq exchange.

35 For example: Warsaw, Prague, Bratislava, Budapest, Vienna, Ljubljana stock exchanges.

3.3. Impact of financial integration on concentration and competition

14. One method to assess competition in the banking industry is by making use of the so-called H-statistic of Panzar and Rosse (1987). This test-statistic examines the relationship between a change in bank's input prices and the revenue earned. The basic idea behind this analysis is that banks employ different pricing strategies in response to changes in input costs depending on the market structure in which they operate. The H-statistic can be interpreted as follows: H is equal (or close) to zero when the competitive structure is a monopoly or a perfectly colluding oligopoly. When H is equal (or close) to 1, it indicates perfect competition and a value of H between 0 and 1 indicates monopolistic competition[36]. Chart 3.5 suggests that the EU banking markets are generally characterised by monopolistic competition. There are however substantial differences within the EU, for example between the EU-15 and EU-10 banking markets. The H-statistic relies on rather strict assumptions, i.e. it is assumed that: (1) banks are operating at their long-run equilibrium, (2) the performance of the banks is influenced by the actions of other market participants, (3) the cost structure is homogeneous and, finally, (4) the price elasticity of demand is greater than unity. Given these peculiarities and the data constraints, it should be stressed that this indicator only presents a partial picture of the competitive structure. Further research is therefore needed to draw any firm conclusions on competition in the EU banking market.

Chart 3.5: H-statistic in banking (1986-2005)



Source: Bikker et al (2006).
Note: H is equal (or close) to zero when the competitive structure is a monopoly or a perfectly colluding oligopoly. When H is equal (or close) to 1, it indicates perfect competition and a value of H between 0 and 1 indicates monopolistic competition.

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36 Monopolistic competition refers to a market structure in between the two extremes of perfect competition and monopoly. It is a market structure in which several or many firms offering heterogenous products and services. As a result, each firm has a certain degree of control over the price of its products and services.

15. Another way of assessing competition is by examining characteristics and actual behaviour of firms in a specific segment of the banking market. The recent sector inquiry into retail banking[37] suggests that European retail banking markets in general are mildly concentrated, at least at national level. Moreover, from the clear overall trend of rising pre-tax profitability it is inferred that retail banking profitability has risen over the long-term. However, the competitiveness of a market can not be measured by structural and performance indicators alone. The relevant question is whether the market is contestable, i.e. whether entry is possible and new entrants constitute a competitive fringe. Taking account of these principles, the sector inquiry identifies a number of competition concerns:

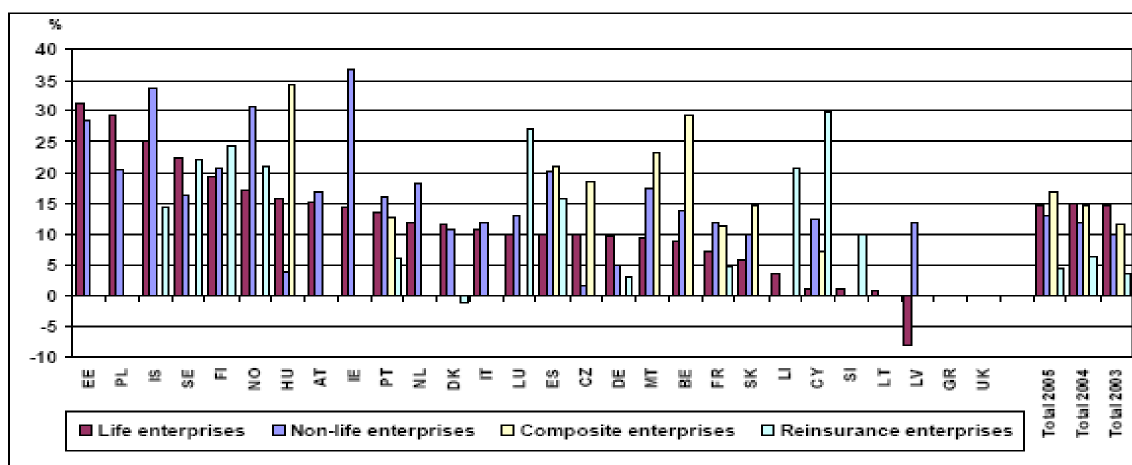
- barriers and discriminatory rules in payment cards and payment systems markets;
- high payment card fees, including interchange fees and merchant fees in some payment card networks. It is shown that merchants in Member States with high fees have to pay banks three or four times higher merchant fees on payment card transactions than merchants in Member States with low fees;
- close co-operation between banks which may restrict competition; and
- possible product tying practices.

Given these concerns, it is argued that (additional) action by competition authorities may be needed to strengthen competition in a number of Member States.

16. As for the insurance sector, the market structure can be described as a 'partly integrated market'. Consumers and smaller businesses are usually confined within their national market, while on the supply side, large companies, in some cases belonging to pan-European insurance groups, compete at a multi-domestic level. Chart 3.6 gives an indication of the profitability of the EU/EEA insurance sector. The aggregate return on equity (ROE) for life was 14.7%, almost unchanged since 2004. The return on equity in the non-life sector increased from 11.9% in 2004 to 13.1% in 2005. In 2006, the premium growth in the life sector seems to have slowed compared with the preceding years, although some EU 12 countries experienced high growth (see Chart 3.7 in the Annex). On average the weighted gross premiums increased by 1.7% from 2005 to 2006. Growth in the non-life sector was somewhat higher, as the weighted average gross premiums increased 4.1% from 2005 to 2006.

[37] Source: European Commission (2007a).

Chart 3.6: Return on equity (ROE) of the insurance sector (*)(2003-2005)



Source: CEIOPS (2006).
Note: Data is not available for LI, GR and UK.

17. Given the lack of (comparable) data we have to rely on an indirect measure for competition, i.e. overall profitability[38]. In order to assess profitability in the non-life sector we make use of the so-called 'net combined ratio'[39]which is defined as the claims and operating expenses divided by premiums. In highly competitive markets, the net combined ratios may tend towards 100%, as insurers are under competitive pressure to price their premiums no higher than the estimated coverage rate (i.e. coverage of expected claims and expenses). Chart 3.7 shows the development of the net combined ratio in 2003-2005. The aggregate combined ratio fluctuated between 92.6% and 95.3% in the period 2003-2005. According to CEIOPS (2007) there are two explanations for the historically low level of the net combined ratio in this period: (i) the moderate growth in premium rates, and (ii) an even lower growth of claims. In most countries the net combined ratio is still at a relatively low level however premium rates in some Member States have recently decreased as the result of good underwriting results.

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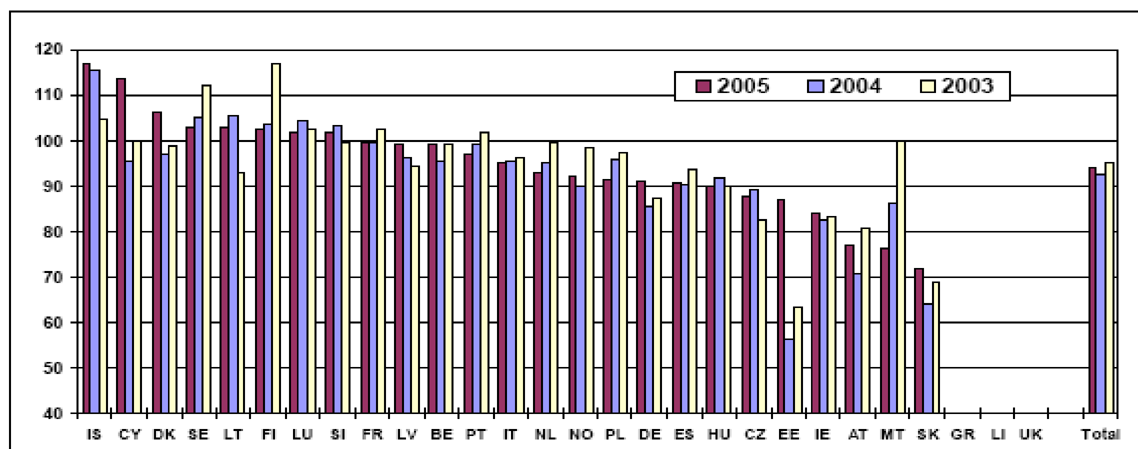
[38] According to the European Commission (2007), the existence of significant profits may be the rewardsfor taking risks, innovating, superior efficiency or better management. However, it could also be the result of having and exerting market power. High and persistent profits in mature markets together with possible barriers to competition may suggest the latter.

[39] The combined ratio suffers from a number of drawbacks. Firstly, when claims are more likely to arise and/or to be settled in the future, the matching principle of accounting is not satisfied for the combined ratio because clients "pre-pay" their insurance. Secondly, it makes no allowance for the investment income (returns) on the financial assets purchased with insurance premiums that are held until claims and related expenses are paid. Finally, the risk covered by underwriting may be different in the different lines, and therefore the return on capital demanded may also vary (see European Commission, Business Insurance Inquiry, 2007).

Chart 3.7: Net Combined Ratio



Source: CEIOPS (2006).
Note: Data is not available for LI, GR and UK.

18. Although the previous analysis can only serve to screen the market for possible issues, it seems that consumers and small and medium sized businesses would benefit from more competition in the EU insurance market. This is also confirmed by the Commission's inquiry into business insurance[40], the largest sub-sector of non-life insurance. The final results of this inquiry indicate that profitability is quite high in business insurance at the EU-25 level, but that it is also highly variable by line and geographically. The extent of variation in profitability indicates an important degree of market fragmentation and the potential scale for more efficient markets, and potentially lower prices, in several Member States and perhaps even the EU as a whole.

19. As for the EU post-trading systems, it can be argued that while they are generally efficient and safe within national borders, they interact less efficiently and (potentially) less safely across borders. This results in higher costs and (potentially) higher risks for cross-border securities transactions as compared to domestic transactions. The fragmented nature of the EU post-trading industry is also reflected in (i) the large difference between cross-border and domestic fees, and (ii) the differences in domestic fees among operators in different Member States. This illustrates a lack of integration and competition.

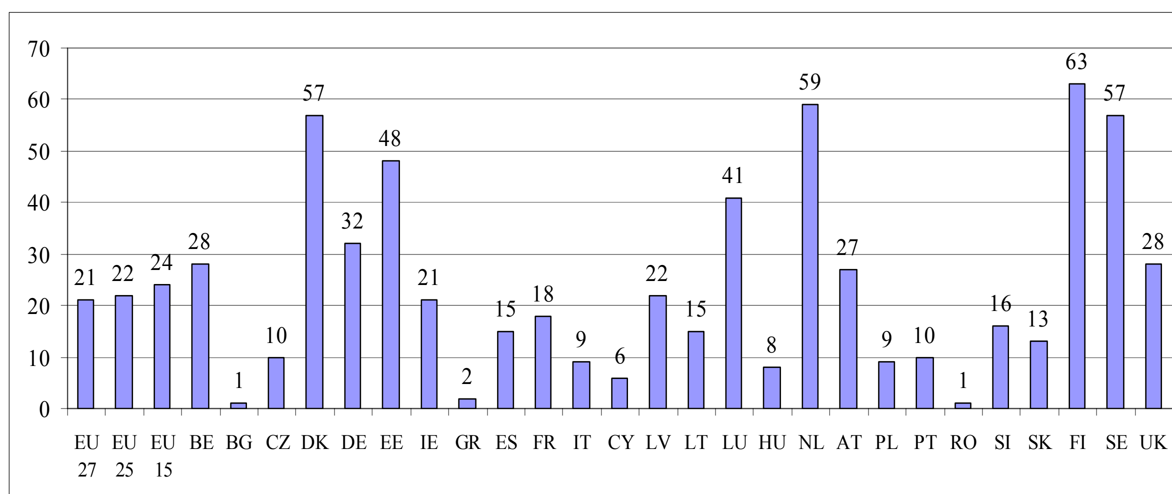
3.4. Distribution channels

20. Direct distribution channels, such as the Internet and mobile communication, can provide new ways to lower barriers to entry. These channels can offer retail services on a cross-border basis without the need for a physical presence in another Member State. By creating new entry opportunities and allowing greater customer mobility, these new direct distribution channels have the potential to make retail markets more integrated and contestable. However, direct distribution also provides a window of opportunity in other areas, such as in insurance and stock brokerage.

[40] See European Commission (2007b).

21. The usage of Internet banking has risen in recent years, i.e. the percentage of individuals in the EU-27 who regularly use the Internet for Internet banking increased from 16% in 2004 to 21% in 2006. In nearly all Member States, internet banking is growing, with particularly high levels in the Nordic and Benelux region (see Chart 4.8). It is evident that the increasing importance of direct distribution has led to significant changes in the distribution channel mix in these Member States. Currently, the Internet is most attractive channel for the distribution of standardised products, whereas more complex products are almost exclusively distributed via branches. However, this is likely to change as more and more customers become familiar and equipped with modern communication and internet services[41].

Chart 3.8: Percentage of individuals using the Internet in the last three months for Internet banking (2006)



Source: Eurostat.

22. As for insurance, distribution channels differ significantly across EU countries. Nevertheless, one could say that life insurance products are mostly distributed via bancassurance networks, while non-life insurance products are mainly distributed via agents and brokers (see charts 3.8 in the Annex). However, here too, the Internet and mobile communication can provide for new business opportunities and significantly change the distribution channel mix.

23. The need to build a distribution network may be a barrier to entry at national level. A strong independent network of agents and brokers may be beneficial in this respect. A good example is the Dutch mortgage market where foreign mortgage suppliers have quickly gained large market shares via agents and brokers[42]. The subsequent increase in competition in the mortgage market has resulted in a substantial decline in mortgage costs for consumers.

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41 Deutsche Bank (2006).

42 The two biggest foreign mortgage providers in the Netherlands are Argenta (Belgian) and Royal Bank of Scotland (UK). These providers now have a market share of 6%, against 1% in 2001. Overall, one out of every ten mortgages is currently provided by a foreign mortgage provider (source: NRC, 2007).

3.5. Conclusion

24. The number of banking and insurance groups operating in the EU has been declining for several years, mainly driven by merger and acquisition activities. As a result concentration ratios have also risen. However, concentration ratios differ across EU countries. After a relatively slow start, where cross-border consolidation in banking mainly occurred in regional clusters, European banking integration is gaining momentum. This is somewhat different from the insurance sector, where consolidation has historically had a strong international focus.

25. Substantial cross-border consolidation has also occurred in the stock market (on an European and even global scale), while the underlying infrastructures in the EU are still mostly fragmented. Consolidation activity in the post-trading and retail payments industry has thus far mainly occurred at the national level and there is little or no competition at the EU level.

26. Concentration is by itself not an appropriate measure of competition, as the latter is predominantly determined by the contestability of the respective market. As for retail financial services, the available evidence suggests that consumers and SME's would benefit from stronger competition at the EU level. The recent sector inquiries into retail banking and business insurance both confirm this. In this respect, new distribution channels such telecommunication and internet services may provide opportunities to strengthen integration and contestability of retail markets.

4. EFFICIENCY AND INNOVATION

1. A well functioning Single Market in financial services, featuring effective competition, should improve the efficiency of the financial system. The efficiency gains may have different origins and can take different forms:

   – *Financial institutions* are expected to increase their operational efficiency thanks to the economies of scope and scale and rationalisation of distribution networks;

   – *Financial markets* should also become more efficient, which should be reflected by higher liquidity, lower cost of capital and converging fees for cross-border transactions compared to domestic transactions;

   – *Financial innovation* will be promoted when markets are growing and the competitive pressure is intensifying.

   The objective of this chapter is to analyse to what extent the above-mentioned efficiency gains have been delivered in the EU financial sector.

4.1. Recent financial sector efficiency trends

2. In recent years, the EU financial sector seems to have been through a favourable period in terms of overall efficiency:

   – The *profitability* ratios have been growing, giving an overall positive trend for the major cross-border banks over the period 2002-2005, albeit slowing down somewhat in 2006. The average return on equity for the euro area large banking groups increased from 17.2% in 2004 to 19.6% in 2006[43]. The return on equity in the EU insurance sector has also been improving over the last few years (see chart 3.6 in the previous chapter);

   – The *efficiency* measures of the EU banking and insurance industries have been developing favourably. In the banking sector the *cost-to-income ratio* has been declining (see chart 4.3 in the annex). The operating income has been growing at a higher rate than operating costs, which remained largely under control. Centralisation of services and improvements in IT infrastructures appear to be the main factor increasing bank cost efficiency. In the insurance sector, the gross premium per employee ratio has been growing constantly over the last few years (see chart 4.6 in the annex).

   – The *broadening of the scope* of the bond market – implying broader access to the pool of capital – has resulted in more effective financing for many companies. These efficiency gains are illustrated by the high level of lower-rated bond issues since 2001 (see chart 4.7 in the annex).

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[43] ECB (2007b).

3. Strong economic growth seems to have given a considerable positive contribution to overall profits of the EU financial services industry. The broadness of this trend, which goes across countries, is indicating that there should not be a general problem of competition. The higher profits have also been supported by the rapid growth of innovative financial products (see section 4.4 below).

4.2. Efficiency potential in the integration process

4. While the efficiency trends have essentially been favourable, the EU financial sector is still struggling with its fragmented structure, implying that it has not been able to fully take advantage of possible economies of scope and scale, when compared to the US. This means that there is still considerable potential to make efficiency gains as the integration process moves forward.

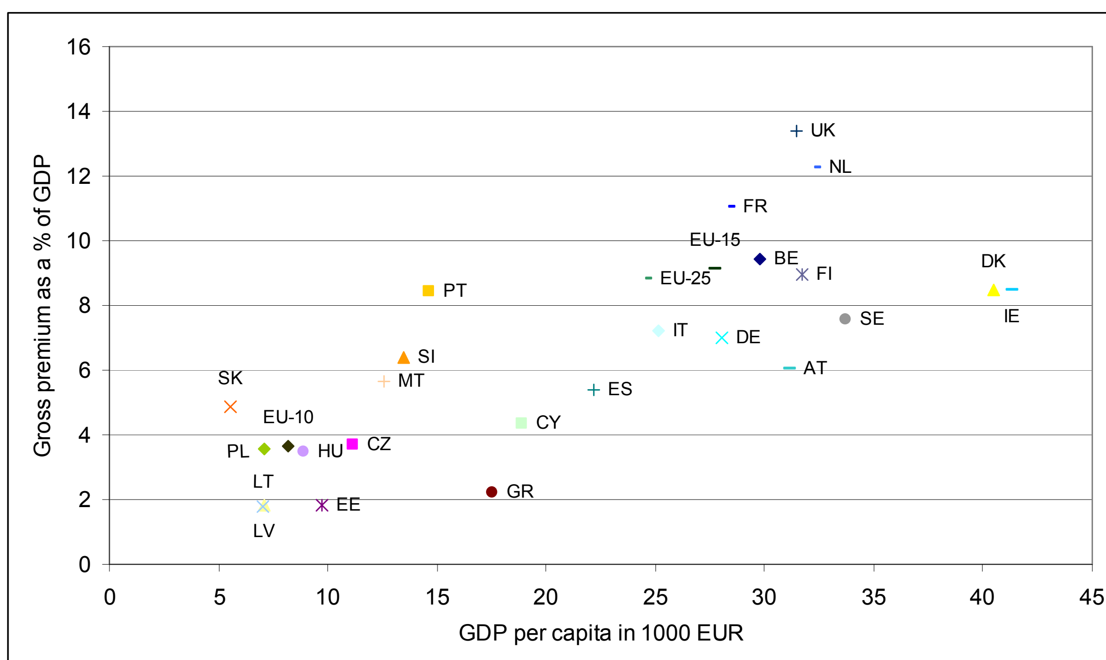
5. The following examples illustrate where significant efficiency gains can still be made in the EU financial sector, not at least at the retail level, as the integration process continues:

- Fees on the most common retail banking products, e.g. bank accounts, still vary widely between Member States, as do the cost of a standard basket of retail financial services. This is true even if the local product assortment and the varying national habits are taken into account (see charts 2.5 above and 4.8 in the annex). This is a reflection of the lack of integration in retail financial services, but it also shows the potential for significant future efficiency gains in terms of price/cost improvements for retail consumers;

- Cost levels of financial institutions also differ between Member States indicating differences in efficiency levels. For example, when comparing the total production and distribution costs of a standardised equity fund the difference between the country featuring the highest costs and the country with the lowest costs can be even threefold (see chart 4.9 in the annex). The same comparison also reveals that the differences in total costs are mostly attributable to differences in distribution costs, hinting to a low level of openness and competition in some markets;

- The insurance sector of the new Member States is underdeveloped in terms of insurance premium per capita. When the integration process proceeds and generates higher growth in these countries, a development that has already started, the demand for insurance products can also be expected to increase (chart 4.1). It can therefore be expected that it will be possible to harvest efficiencies of scale and scope in the course of the continued integration process, generating further efficiency gains;

Chart 4.1: Potential for further development of the insurance sector (2006)



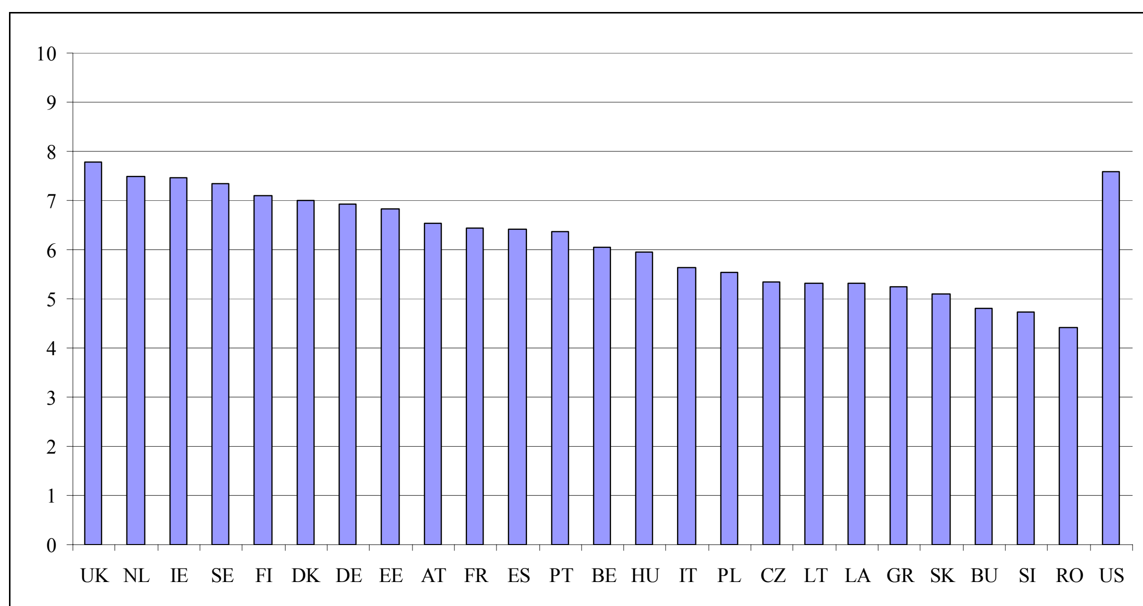
Source: ECB (2007a), CEA (2007), and own calculations.
Note: Given the unique position of Luxembourg (gross premium as a % of GDP equals 72%, and GDP per capita is € 37000) it has not been incorporated in this chart.

– The liquidity of the equity market, measured as the turnover ratio[44], can be used as an indicator of market efficiency. The turnover ratio of the biggest EU stock markets, with the London Stock Exchange as the primary example, is comparable to the ratio of the biggest US exchanges. However, the EU smaller markets offer investors much less liquidity (see charts 4.10 and 4.11 in the annex). The still relatively fragmented structure can also be a barrier to improving the overall average efficiency of the EU equity market.

– The ease with which companies can access capital plays an important role in generating new business activity and economic growth. The *Capital Access Index* (chart 4.2) examines the depth and breadth of financial systems and covers the macroeconomic environment, the strength of economic institutions, financial and banking institutions and equity and bond markets, the availability of capital and the ability of firms to access funds internationally. In Europe only the UK scores better than the US, which suggests that there is room for further strengthening the performance of the EU financial system.

[44] Annual turnover by market capitalisation.

Chart 4.2: Capital Access Index (2006)



Source: Milken Institute (2007).
Note: The Capital Access Index (CAI) ranks countries around the world in terms of the financial infrastructures that support entrepreneurial activity by providing access to capital. The maximum possible score of CAI is 10.

4.3. Creating a world class financial sector – EU global competitiveness

6. While efficiency gains in Europe are held back by the market's fragmentation, the EU financial market seems to be catching up with its US counterparts on some aspects. The EU capital markets have been growing strongly over recent years, exceeding the rate of growth in the US. In equity markets, the average annual turnover growth in years 2003-2005 amounted to 18% in the EU and 12% in the US. In bond markets, the average annual growth in terms of outstanding value of debt securities amounted to 19% in the EU and 8% in the US.[45]

7. The EU and US bond markets have become similar in nominal size: in 2006 the outstanding value of all listed debt securities in the EU was equal to 18.1 trillion euro and to 20.4 trillion euro in the US. Looking at the equity markets, the gap between the EU and the US is wider. In 2006, the turnover in the EU markets was less than 60% of the US turnover (15.4 trillion euro in the EU and 26.6 trillion euro in the US).

8. The development gap is also visible when relating the market volume to GDP. The respective ratios for the equity and bond markets are presented in Table 4.1. In 2006, the EU ratios corresponded to 80% and 52% of the US ratios for the bond and the equity markets respectively. The lower level of development may also go some way to explaining the higher growth rates in the EU.

[45] Based on WFE data (for equity markets) and BIS data (for bond markets) in US dollars.

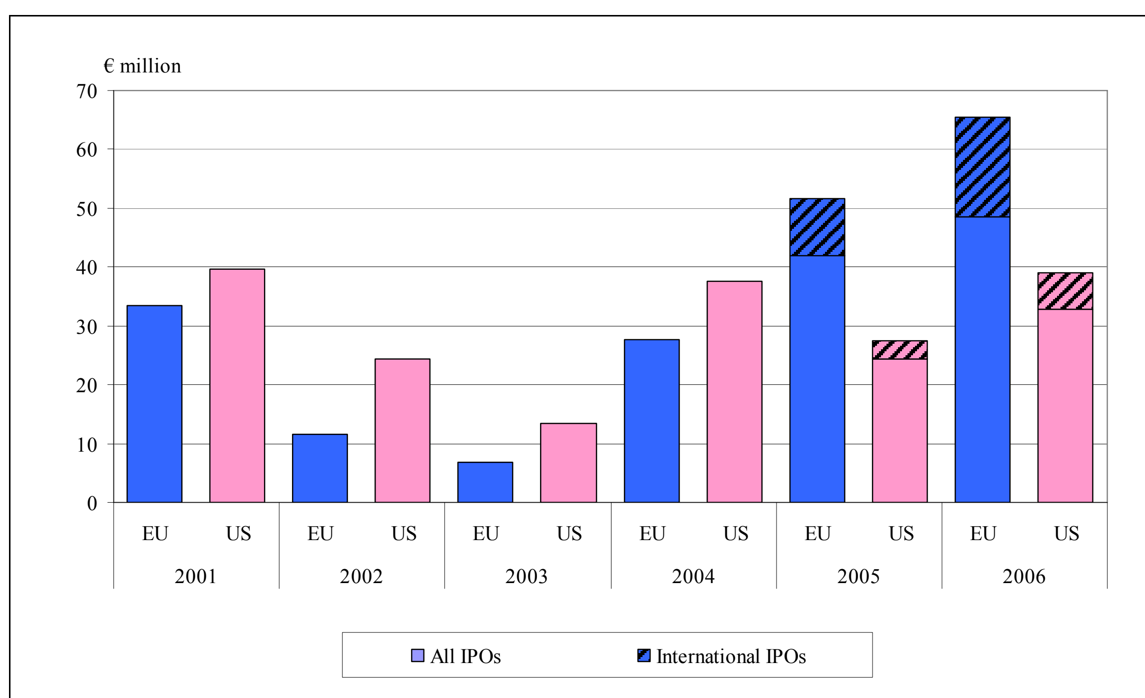
Table 4.1 Development of capital markets in EU and US

Bond markets - outstanding value / GDP	2004	2005	2006
EU	183%	172%	198%
US	238%	241%	246%
Equity markets - turnover / GDP			
EU	94%	107%	133%
US	160%	203%	253%

Source: BIS (2007a), WFE(2007a), Eurostat online database. European Commission's calculations.

9. In recent years European Initial Public Offerings grew strongly, and now exceed US levels. In 2005-2006, the EU volumes of IPO's were about three times that of the US (chart 4.3). It is noticeable that the EU exchanges attracted a large proportion of international IPOs (i.e. from companies registered in third countries). This may be linked to the increased competitiveness of the EU capital markets, but it could also be a result of the restrictive provisions of the Sarbanes-Oxley Act in the US.

Chart 4.3 Initial Public Offerings in the EU and US



Source: PricewaterhouseCoopers (2002-2007).

10. At the end of 2006, the total value of assets under management (AuM) for UCITS (the European harmonised funds) in the EU amounted to 5.8 trillion euro, while AuM of the American mutual funds amounted to 8.3 trillion euro. The EU and the US held 33% and 48% of the world investment fund market

respectively.[46] In 2003-2006, the average annual growth rate reached 15.5% in the EU and 13% in the US[47]. However, an important difference between the EU and US markets is the number of funds, which amounts to about 8 thousand in the US and over 30 thousand in Europe. This testifies of the fragmentation of the EU investment fund sector. The small average size of the European investment fund is an important drag on the European fund industry's competitiveness. Studies have estimated at up to 6 billion euro per year the potential economies of scale savings of the sector.[48]

4.4. Financial innovation – through new products and scope

11. Effective competition combined with sufficiently large markets will promote the creativity of market players and financial innovation – both through the use of new services and by widening the scope of existing markets. There is a range of factors which can drive financial innovation:

12. The continued search for *higher returns* in a low yield environment appears to be the primary factor driving innovation in financial markets. For instance, rapid growth of hedge funds or private equity funds in recent years (see Charts 1.12 and 1.13 in the annex) was linked with increased investor appetite for better risk adjusted returns. The development of new types of securities, such as high-yield Asset Backed Securities (ABS) has also been stimulated by the search for higher returns.

13. Innovation is driven by investor demand for *more flexibility* and *easier trading*. These can be achieved through various means, for example by developing new distribution channels or by designing new products. In terms of new distribution channels, the development of financial services sales via the Internet corresponds to investor/customer need for more cost effective and convenient access. Internet distribution has become popular for an increasing range of financial services, from banking services and investing in funds to using online brokers to invest directly in stock markets. As far as new products are concerned, the development of Exchange Traded Funds (ETFs) can be regarded as an illustration of the desire for more flexibility (see chart 1.14 in the annex). Contrary to traditional investment funds, ETFs offer investors the possibility of intraday trading (like any other share), usually at much lower costs.

14. Financial institutions are also driven to innovate as they seek to *limit risk* which has led to the development and use of financial derivatives and securitisation. In 2005 alone, the securitisation growth rate in Europe was 30 per cent (chart 4.4). Securitising assets can be used to both improve liquidity or to reduce the cost of funding through repackaging assets. The originator may also aim to remove certain assets from their balance sheet by selling the exposure and thereby saving the cost of holding a higher level of regulatory capital.

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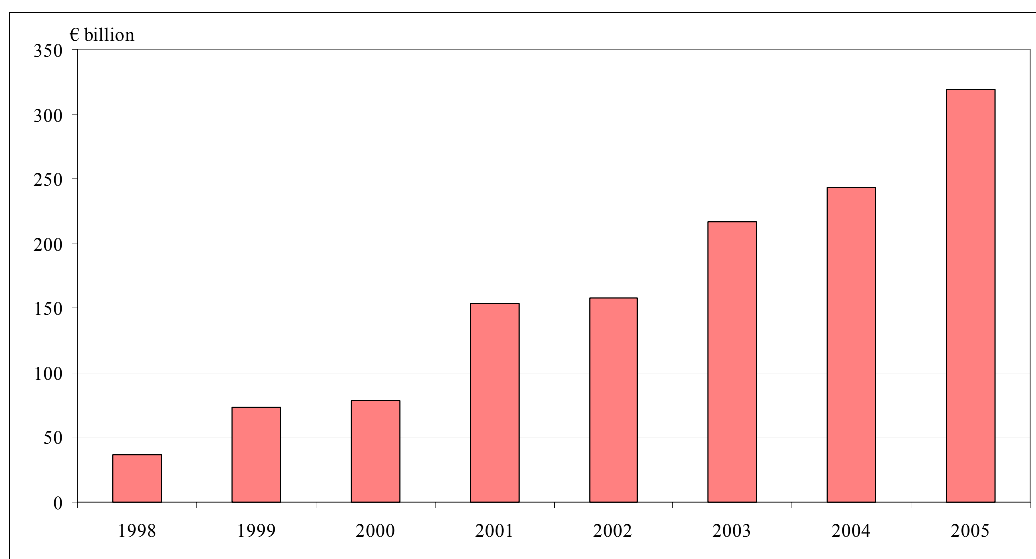
[46] EFAMA (2007a).

[47] Annual growth measured in local currency, EFAMA (2007a).

[48] See Invesco (2005); CRA International (2006); ZEW (2003).

Chart 4.4: Growth of securitisation in Europe



Source: European Securitisation Forum (2007).

15. Apart from the positive aspects, such as bringing liquidity to the markets, enhancing price discovery and risk diversification, financial innovation can be a source of concern in terms of financial stability (see chapter 5 for more detail). The rapid development of new instruments and practices requires appropriate reactions to adapt the regulatory and supervisory framework.

4.5. Conclusions

16. The efficiency indicators of EU financial institutions have been improving in recent years. This has resulted primarily from favourable economic conditions and thereby higher profits. There is still significant potential for increasing efficiency in many segments of the EU financial sector. Fragmentation (in particular on the retail side) or relative underdevelopment (in new Member States) prevents economies of scale and scope from materialising in a number of markets.

17. Over the last few years the European equity, bond and investment fund markets grew faster than their US counterparts. The EU has been particularly strong in new listings, attracting the bulk of international IPOs. This may have resulted from increased competitiveness of EU financial markets, but also from the catching up process linked with lower level of development of European markets and the adverse impact of the Sarbanes-Oxley Act on the US market.

18. Innovation has been progressing quickly in the EU financial sector as illustrated by the expansion of new products, distribution channels and market practices. The financial market turbulence in summer 2007 confirmed the link between financial innovation and stability.

5. FINANCIAL STABILITY

5.1. The impact of financial integration on financial stability

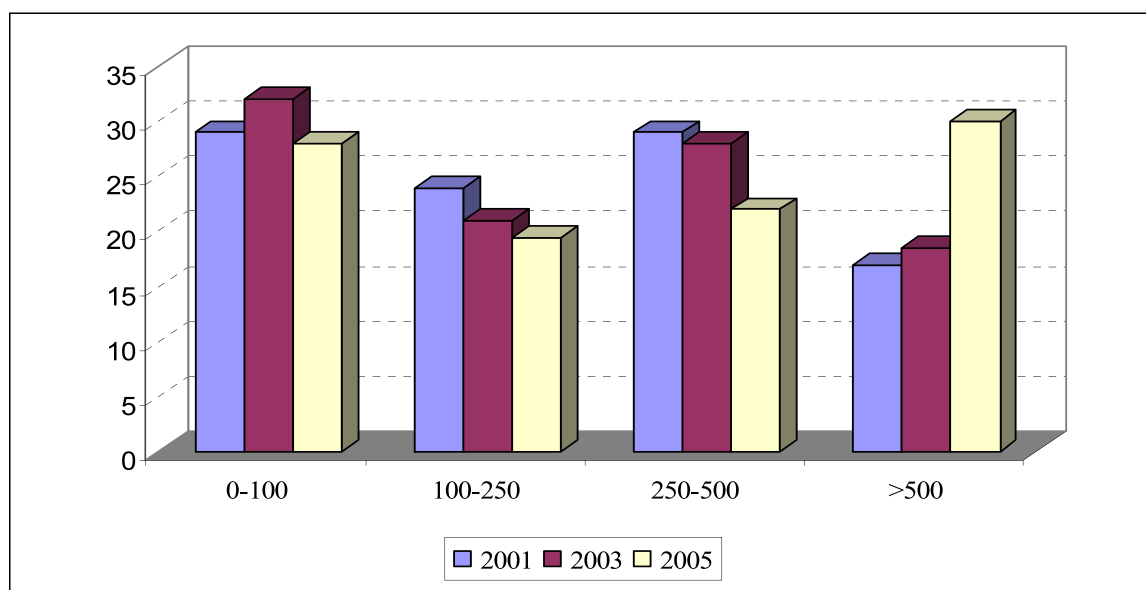
1. The advance of integration also impacts on financial stability; the greater availability of financial instruments and the increasing possibilities to invest in different regions promote risk diversification. This is positive. Moreover, deeper and more liquid financial markets are in a better position to absorb shocks.

2. However, the market links do not only contribute to risk diversification but may also serve as channels for cross-border contagion, transmitting risks across the financial system. Integration also synchronizes economic behaviour, which may increase volatility and amplify economic cycles.

5.2. The growth of pan-European financial groups

3. One of the new features of the European financial landscape is the emergence of *major pan-European financial institutions and groups*. As chart 5.1 below illustrates – which is based on a set of around 40 large and medium-sized banking groups with significant cross-border activity – a sharp growth in total assets were reported mainly by the large banking groups. Moreover, the ECB has identified 46 systemically important banking groups, which account for 68% of EU banking assets. Many of the pan-European groups are also cross-sectoral groups, combining banking and insurance activities, e.g. Deutsche Bank, HBSC, BNP, Credit Agricole or ING. The consolidation creates new demands on corporate (risk) management, as well as on those competent authorities in Member States that are in charge of financial supervision and oversight.

Chart 5.1: Distribution of EU cross-border banks according to asset size



Source: ECB (2006a).
Note: x-axis depicts the assets in Euro billions, the y-axis depicts the share of each category as a percentage of total banks.

4. One challenge is the supervision of group-wide risks. Often internationally active financial conglomerates establish centralised risk and capital management units. The dominant approach is to adopt a so-called ‘hub and spoke’ organisational model. The spokes are responsible for risk management within business lines, while the hub provides centralised oversight of risk and capital at the group level. Centralisation implies that strategic decision-making is transferred from the functional or sectoral entities of the group to the holding level. During this process, the legal structure will increasingly diverge from the operational structure of the group. As a consequence, it becomes harder to attribute activities to the legal entities on which the division of supervisory responsibilities is based.

5. The increasing size and pan-European structure of many financial institutions also means that any institutional failure is easily transmitted across borders. This changes the nature of *crisis planning*. More cooperation across sectors as well as across borders is necessary. In recent years, a number of Memoranda of Understanding have been set up to improve co-operation between authorities, both within and between countries.

5.3. The internationalization of capital markets

6. Market links are also created by capital flows related to the foreign ownership of interest bearing instruments, equities and different types of derivative instruments. Capital market internationalisation goes far beyond EU borders. In terms of portfolio investment assets, the United States is the most important partner for the eurozone outside Europe, followed by off-shore financial centres, see chart 5.1 in the annex. Some of these centres have special legal and economic relations to the EU, being Overseas Countries and Territories. Some off-shore centres are also important locations for reinsurance companies and hedge funds.

7. One particularly important structural change in the financial markets is the increasing use of *credit risk transfer (CRT) instruments*, such as credit risk derivatives and structured finance. They enable the originating bank to transfer credit risk to other parties in the financial markets, primarily institutional and private investors. If this is done via securitisation, an independent intermediary, called an SPV or circuit, transforms the packaged risk tranches into securities. The market for these instruments has grown substantially in recent years, both worldwide and in Europe. During the four year period 2001-2005, the global outstanding amount of credit risk default swaps has multiplied more than tenfold. In Europe, the volume of securitisation more than doubled during this period, see chart 4.4 in chapter 4.

8. The development of CRT-instruments significantly influences the functioning of the financial system: (i) it provides opportunities for more effective risk management; (ii) it improves credit availability and (iii) allows more efficient allocation of risk to a wider range of entities[49]. However, the rapid growth and

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[49] BIS (2003).

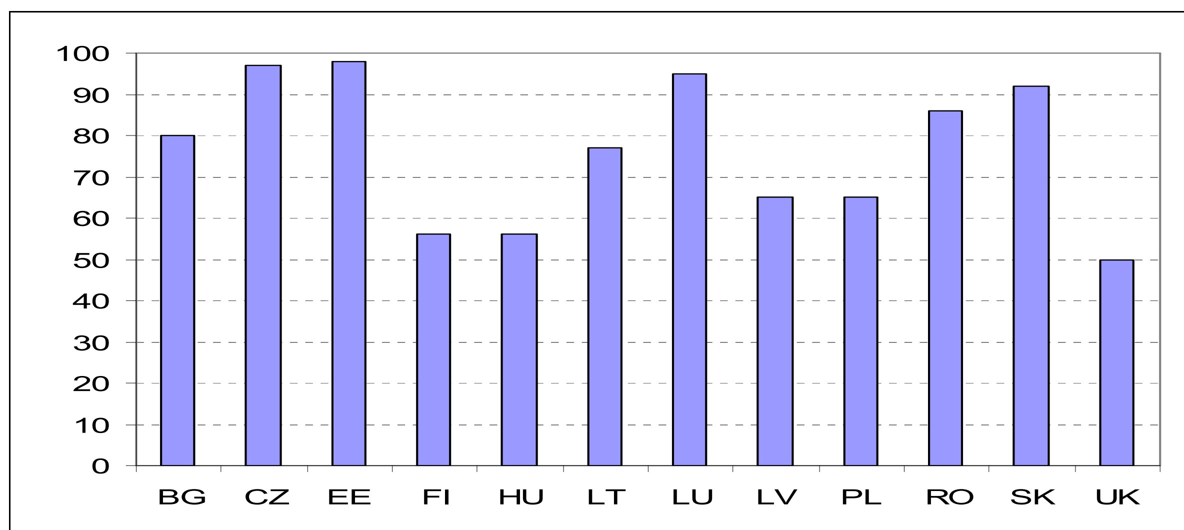
considerable size of this market also makes transparency and effective risk management crucial - investors must be able to locate where the risks are located in the financial system. Key players in the financial market also need to be aware of their risk exposures and have adequate reserves. The international financial turmoil caused by the US sub-prime crisis was an illustration of this.

9. In recent years, the assets of *hedge funds* have increased substantially in Europe, see chart 1.12 in the annex. Generally hedge funds are considered to have a positive influence on market efficiency and financial stability. They contribute to market diversity and may also dampen market volatility by providing increased market liquidity. The financial stability aspect under debate is whether a major hedge fund failure might potentially disturb the functioning of the wider financial system. So far, this has not been the case. European regulation provides important safeguards to avoid this eventuality. EU regulated entities that are trading or financing counterparties of hedge funds are requested to limit and to be aware of their risk exposures whilst setting aside capital accordingly.

5.4. The enlargement and some financial stability issues

10. The significant presence of foreign banks in many Member States, especially the new Member States, is a structural change linked to the enlargement of the European Union. Chart 5.2 below lists the Member States where 50% or more of the banking sector is in foreign hands.

Chart 5.2: Foreign ownership of bank assets (% of local assets, 2006 data)



Source: ECB (2007a).

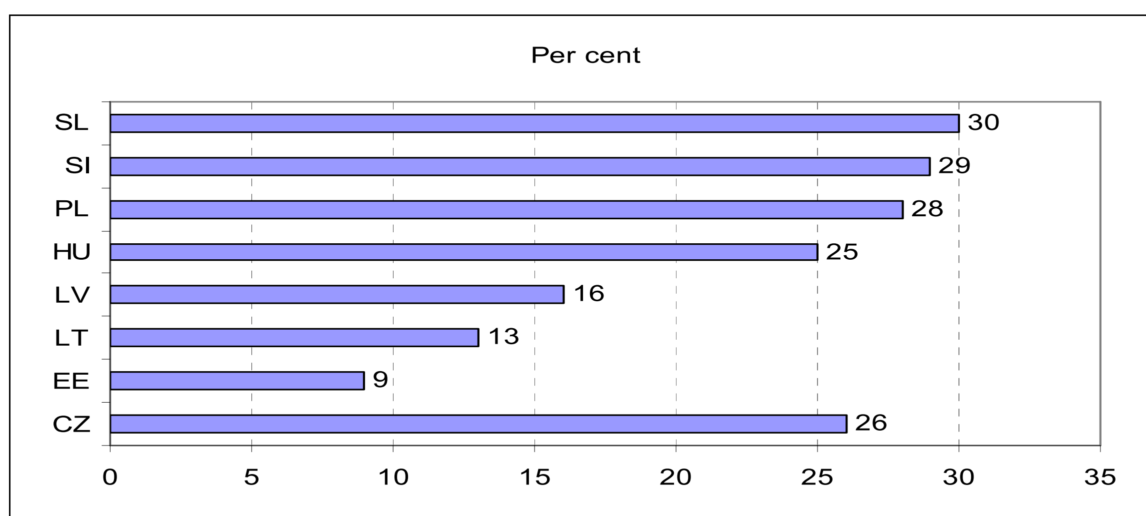
11. Many major EU banks that have established themselves in former Central/Eastern Europe have received an increasing proportion of their profitability from their new business in these countries. In addition, European investors have benefited from the rallying stock market in the new EU Member States, with considerably higher returns than in the EU as a whole. All in all, this development has increased the margins and reserves of financial institutions and investors, thereby strengthening financial stability.

12. Generally, the foreign presence is enhancing efficiency by improving the pricing of risk and by transferring expertise to new markets. However, as national authorities merely have a mandate for financial stability in their own national financial system, cross-border links can give rise to potential conflict of interest issues and possible co-ordination problems.

13. One example is the emergence of *systemic branches*, i.e. foreign-owned branches with an important market share in the host state. While the responsibility of supervision of these branches belongs to the home state of the parent company, the responsibility for market oversight, and ultimately the responsibility for the stability of the financial system, belongs to the host state where the branch is located. Yet, from a legal and operational perspective, the branches are considered as being part of the same financial institution, regardless of their geographical location.

14. One by-product of the rapid market growth in the New Member States in Central and Eastern Europe has been the strong growth of private sector credit. At the end of 2006, private sector credit amounted to between 50-85 per cent of GDP in Estonia, Latvia, Lithuania and Hungary, see chart 5.2 in the annex. Even though the high credit growth in these markets largely can be seen as a "catching up" process with levels of private sector credit in the old Member States, the high indebtedness also causes some concern, especially as a high proportion is denominated in foreign currency, see chart 5.3. A large proposition of the foreign currency loans can be expected to be unhedged, making households and companies directly exposed to currency risks.

Chart 5.3: Foreign currency loans, in % of total loans to households and non-financial companies (end 2005).



Source: ECB (2007c).

5.5. Conclusions

15. The progress of financial integration has multiplied the market links between Member States and across financial sectors. The financial stability impact of

these links is often positive; they enhance risk distribution. However, these links may also create new channels for financial contagion.

16. One type of link is created through ownership. In recent years, pan-European financial groups – which are often financial conglomerates - have gained a dominating position amongst EU financial institutions. While these institutions increase the competitiveness of the EU, which reinforces financial stability, a potential failure of one of these institutions may have a significant effect on the wider financial sector.

17. The increasing integration of the capital markets, within and beyond the EU, has created new market links. Different types of risk transfer instruments, as well as hedge funds, improve the risk distribution in the market, which strengthens financial stability. However, at the same time, the extensive risk distribution makes it more difficult to locate and value the underlying risk. This could result in increased uncertainty and market volatility.

18. The enlargement of the European Union has created several new and important market links. In many New Member States more than half of the banking market is in foreign hands with ownership dominated by old Member States. Many households in the new Member States also benefit from low-interest loans in foreign currency. Lower capital costs and transfer of knowledge are other positive factors. At the same time, foreign ownership raises new challenges, e.g. the handling of systemic branches and foreign currency risk exposures.

19. Financial integration changes the structure of the financial landscape. This is not in itself positive or negative for financial stability. Whether financial integration leads to risk distribution or contagion depends on the quality of risk management, legal framework and supervision, including the quality of cooperation across borders.

6. CONCLUSIONS

1. The EU financial services sector is still characterized by an uneven level of integration of wholesale and retail financial markets. Despite significant progress in delivering a single market for financial services in recent years, retail financial services integration does not appear to have reached its potential and competition seems insufficient in some segments. In a global context, the competitiveness of the EU financial markets has been increasing over the past years. Continued (and enhanced) monitoring of competitiveness is essential to strengthen the position of the EU in this respect.

2. The lack of integration of retail financial markets is reflected in significant price variations and relatively low volume of cross-border transactions. This is due to cultural and consumer preferences, which may imply that retail markets will predominantly remain local, but also to differences in regulatory frameworks. Several initiatives have been launched to remove the persisting regulatory barriers as well as to enhance consumer confidence and mobility. The planned introduction of the Single Euro Payments Area (SEPA) in 2008 will progressively make cashless payments in euros as easy, efficient and safe as it is today within a single country. It will also foster greater competition in EU payments markets. Proposals will be made to facilitate customers' mobility between banks, in particular by ensuring that there are adequate national switching arrangements in place. In the field of mortgage credit, a Commission White Paper will make recommendations to enhance product diversity throughout the EU. Regarding investment funds, proposals to enhance the functioning of the UCITS framework are planned for early 2008. In order to improve the functioning of the internal market for retail insurance, in-depth analysis of this market may be needed. As a first step, a detailed analysis of the national rules that impede the free flow of insurance services will be undertaken.

3. The Commission's sector inquiries into retail banking and business insurance have proven to be helpful tools to strengthen and deepen the knowledge of competition in the EU. The inquiries have shown that not all markets are sufficiently contestable and end-users can benefit from enhanced competition at the EU level. Differences in fees for financial services among Member States (e.g. fees on current accounts) suggest that not all Europeans have benefited from financial integration to an equal extent. In this respect, the role of distribution channels in enhancing the contestability of (retail) markets will deserve further attention. In particular, new distribution channels, such as the Internet and mobile communication, may provide new business opportunities and foster integration of the retail financial markets.

4. The adoption and implementation of the Financial Services Action Plan (FSAP) has been the main catalyst for accelerating the integration of wholesale financial markets. Although integration of the corporate bond and equity market is at a relatively high level and has been increasing over the past years, it has not yet reached its full potential. Implementation of the last elements of the FSAP regulatory framework, in particular the Markets in Financial Instruments

Directive and the Transparency Directive, will introduce more competition, remove some barriers to integration and provide incentives for innovation in the EU capital markets. Further integration, in particular in the equity market, is however hindered by the persistent fragmentation of national securities clearing and settlement systems. Trading and post-trading infrastructure providers have established a Code of Conduct on Clearing and Settlement in 2006. The Code contains commitments in three areas: (i) price transparency, (ii) access and interoperability, and (iii) service unbundling and accounting separation. The Commission is actively monitoring the implementation of the Code in order to ensure progress in this area. Moreover, to analyse the overall effects of integration in wholesale markets, the Commission Services intends to investigate developments regarding the cost of capital in the coming year.

5. The emergence of a pan-European financial market requires a pan-European approach to financial stability monitoring. A harmonised EU prudential framework lays the foundation. The Basel II rules introduced by the Capital Requirements Directives and the recently proposed Solvency II Directive provide the incentives for sound risk management on a group-wide basis. The legal framework needs to be complemented by strong regulatory cooperation and convergence across borders and sectors. The Commission's review of the Lamfalussy process puts forwards some suggestions in this regard. Ensuring the optimal functioning of supervision in the event of a cross-border financial crisis is a related issue that deserves further attention. Moreover, given the blurring of distinctions between different sectors, complementary analytical work on developments regarding financial conglomerates may be needed.

6. The US sub-prime crisis and its impact on Europe have confirmed the importance of the ongoing revision of the EU prudential framework. The recent turmoil has clearly demonstrated the impact of interconnected global financial markets. The latter stresses the importance of financial services regulatory dialogues between EU and its major financial partners. It is also of crucial importance that risks are properly identified, located and managed. The Capital Requirement Directive, MiFID and the draft Solvency II Directive, once they are fully implemented, will help addressing some of the issues at stake. The role of credit rating agencies as well as the impact of structured finance will require careful study. Other relevant work streams are related to bank liquidity, large exposures and the calibration of regulatory capital between the banking and trading book.

7. The Commission Services intend to continue to build on the present structure of the report. Further work is envisaged with respect to identifying and examining the linkages between the different building blocks of this report, i.e. integration, competition, efficiency, innovation and stability in a context of globalised markets.

ANNEX I: Policy achievements in 2007

1. 2007 has been a year of consolidation of financial services policy, with the main emphasis on implementation of existing "acquis". The financial turbulence, originating from the US sub-prime crisis, and its consequences for financial services policy, was discussed by the ECOFIN Council in October. The outcome was a work programme, which runs until the end of 2008, aimed at reviewing, along with the EU's international partners, how to further improve transparency, valuation process and risk management in financial markets.

2. In July, the European Parliament adopted a report on financial services policy[50], as follow up to the Commission's White Paper on Financial Services Policy[51]. The report is supportive of the contribution made by financial services policy to EU markets, and of the White Paper's emphasis on consistent implementation and enforcement of EU rules in the Member States. It calls for more specific analysis of the effects of financial services legislation, particularly on identifying the beneficiaries of the outcome of such legislation. It addresses specific remaining challenges for EU financial services policy making, including market concentration, the role played by hedge funds and private equity, citizens' access to finance, financial literacy and the inclusion of users in policy making, systemic risks and the global impact of EU policies. The report also gives considerable attention to the architecture of financial regulation and supervision in the EU.

Financial market supervision

3. During 2007, consensus has grown that some evidence-based, practical improvements are needed in the operation of the current EU supervisory framework. The Economic and Financial Committee (EFC) reported in September on issues concerning *cross-border banking crisis mechanisms*[52]. Based on the EFC recommendations, the ECOFIN Council agreed to take further steps, at the EU and national level, to develop the *arrangements for cross-border financial stability within the EU*[53]. The recent turmoil in the financial markets also prompted a policy debate in the EU. Although it is widely acknowledged that it is too early to draw any definite conclusions on how legislation and supervision should respond, some tentative reflections have steered a first exchange of views on a possible policy response at EU level.

4. There has been some intensive work in 2007 on *supervisory convergence and on the functioning of the Lamfalussy system.* The FSC has carried out a major review on long term supervisory issues and in October, the Inter-institutional Monitoring Group (IIMG) published its final report[54] which addressed in detail

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[50] PE 384.621v03-00/ A6-0248/2007.

[51] COM (2005)629.

[52] ECFIN/CEFCPE(2007)REP/53990.

[53] See http://www.eu2007.pt/NR/rdonlyres/B1ECF5C7-D202-49EB-B88A-9001ADE8747A/0/20071009_2822ReuniãodoConselhoAssuntosEconómicoseFinanceiros_EN.pdf

[54] See http://ec.europa.eu/internal_market/finances/committees/index_en.htm

the functioning of the Level 3 Committees. The Commission published a Communication on the Review of the Lamfalussy process on the 20th of November 2007[55]. This review focuses in particular on the workings of the "Level 3" Committees, and suggests practical, achievable improvements to enhance supervisory co-operation and convergence. The ECOFIN Council adopted its conclusions on the Lamfalussy Review on the 4th of December 2007.

5. A directive tightening the *procedures to be followed by Member States' supervisory authorities when assessing proposed mergers and acquisitions* in the banking, insurance and securities sectors[56] was adopted by the Council and the European Parliament in April 2007. This will improve clarity and transparency in supervisory assessment and help to ensure a consistent handling of M&A requests across the EU.

Prudential legal framework

6. In July 2007, the Commission adopted its proposal concerning the taking-up and pursuit of the business of Insurance and Reinsurance, to introduce a new solvency capital and supervision framework for insurers and reinsurers (*Solvency II*)[57]. The aims of the Solvency II proposal are to improve consumer protection, further better regulation, deepen market integration and increase the international competitiveness of European insurers. The proposal is now under consideration with the European Parliament and Council.

7. The start of 2007 marked the date from which EU Member States were to apply the Capital Requirements Directive[58]. In a number of countries, however, it was not transposed on time, and infringement proceedings have been launched. Meanwhile, the CRD Transposition Group, comprising the Commission and the Committee of European Banking Supervisors, have dealt with hundreds of questions on how the Directive should be implemented in practice, and has published these in an online database[59].

8. The transposition date for the *Markets in Financial Instruments Directive (MiFID)*[60] elapsed on 31 January 2007. The deadline for implementation was the 1st November. Considerable work was undertaken in 2007 to prepare a forthcoming Commission report on the adequacy of the level of *pre- and post-trade transparency in classes of financial instrument other than shares*. The Report, required by Article 65(1) of MiFID, is planned to be adopted in the first quarter of 2008. The Commodity derivative review, also required under Article 65 of MiFiD will also be finalised by end 2008.

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[55] COM(2007)727.
[56] Directive 2007/44/EC.
[57] COM(2007)361.
[58] Directives 2006/48/EC and 2006/49/EC.
[59] See http://ec.europa.eu/internal_market/bank/regcapital/transposition_en.htm
[60] Directive 2004/39/EC.

Retail financial services

9. The Commission published a *Green Paper on Retail Financial Services*[61] in May 2007, setting out its vision for future EU policy on retail financial services. A consultation on the Green Paper culminated in a public hearing on 19 September. A number of follow-up measures were announced in the Single Market Review (SMR) in November[62].

10. In June, the Commission published the *report of the Expert Group on Customer Mobility in relation to Bank Accounts*[63], on those obstacles that customers encounter when switching bank accounts at national or EU level or when opening bank accounts cross-border. In the context of the SMR, the Commission announced measures to address these obstacles.[64]

11. Before the end of 2007, the Commission is due to publish a *Communication on Financial Education* in which it will propose some practical facilitative actions to raise awareness of the issue and to promote best practice in Member States.

12. In March, the Commission *clarified the rules applicable under the UCITS Directives*[65] concerning the financial instruments that are eligible for inclusion in EU investment funds, and the marketing of funds in another Member State. Policy proposals to follow up on the Commission's *White Paper on Investment Funds*[66] are expected to be made in early 2008.

Financial Market Infrastructure

13. On 7 November 2006, trading and post-trading infrastructures signed a *Code of Conduct on clearing and settlement*[67]. The Code aims to enhance transparency and increase competition in the post-trading sector. In June 2007, in fulfilling one of the commitments under the code, the group produced detailed rules for access and interoperability; the "*Access and Interoperability Guideline*".

14. Work continues on the industry-led Single Euro Payments Market (SEPA) initiative to make cross-border payments in euro as easy as domestic payments. In April, the European Parliament adopted the proposal for the *Payment Services Directive*[68] (PSD) on which the ECOFIN Council had already agreed in March. The PSD provides the legal foundation for SEPA and has been formally adopted on the 13th of November 2007[69].

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61 COM(2007)226.
62 COM(2007)724, SEC(2007)1520.
63 See: http://ec.europa.eu/internal_market/finservices-retail/baeg_en.htm#report
64 SEC(2007)1520.
65 See http://ec.europa.eu/internal_market/investment/legal_texts/index_en.htm
66 COM(2006)686.
67 See http://ec.europa.eu/internal_market/financial-markets/clearing/communication_en.htm
68 COM(2005)603.
69 Directive 2007/64/EC.

Corporate environment

15. June 2007 saw the adoption of a *Directive on shareholders' rights*[70]. This Directive introduces minimum standards to ensure that shareholders, no matter where in the EU they reside, have timely access to complete information and means to exercise their voting rights at a distance.

16. In July, the Commission published a Communication setting out its vision for *simplifying EU rules on company law, accounting and auditing*[71]. The proposed measures would remove or reduce a range of administrative requirements that are considered outdated or excessive.

17. Dialogues with third countries on accounting standards have continued, with the ultimate aim to facilitate the elimination of costly and burdensome reconciliation requirements. In July, the Commission published its first report on convergence between International Financial Reporting Standards (IFRS) and third country national Generally Accepted Accounting Principles (GAAPs)[72], particularly those used in Canada, Japan and the United States. The report described encouraging progress being made towards convergence. Further to this, the Commission brought forward in August a proposal for a Regulation establishing a mechanism for the determination of equivalence of accounting standards under the Prospectus and Transparency Directives[73]. On 15 November the SEC decided to abolish the reconciliation to US GAAP (Generally Accepted Accounting Principles) for foreign issuers using IFRS (International Financial Reporting Standards) for their financial statements covering years ended after 15 November 2007.

18. In the Auditing field, the Commission has been working on two issues: the consideration of International Standards on Auditing (ISAs) and assessing public oversight systems of third countries, with the help of the European Group of the Audit Oversight Bodies (EGAOB).

19. In January, the Commission published an external report on the *possible reform of auditors' liability regimes in the EU*[74], which was followed by a public consultation.

International

20. In 2007, the Commission continued its policy of strong bilateral contacts with selected countries in the area of financial services regulation, namely through *"regulatory dialogues" with the US, Japan, Russia, India and China.* Some of the key issues discussed in the context of these dialogues included accounting standards, auditing co-operation, the implementation of Basel II in the banking

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70 Directive 2007/36/EC.
71 COM(2007)394.
72 COM(2007)405.
73 See: http://ec.europa.eu/internal_market/securities/docs/transparency/draft_reg_equivalence_en.pdf
74 See http://ec.europa.eu/internal_market/auditing/liability/index_en.htm

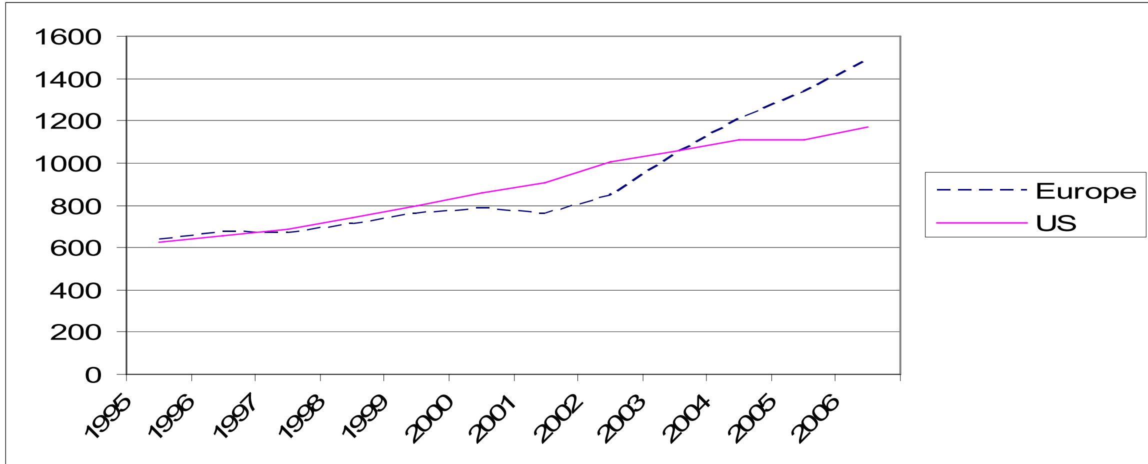
area, capital markets regulation, EU-US mutual recognition of securities, Solvency II and reinsurance regulation, and the free movement of capital.

21. Among the successful outcomes of these dialogues, one can take the example of the new, easier rules for deregistration of foreign issuers with the US SEC. With the support of the Member States, securities regulators and EU issuers, the Commission sent detailed comments on the proposal issued by the SEC in order for the new rules to be workable for EU industry. The US SEC took the concerns on board. Under the final rule, it becomes possible for companies to terminate SEC registration if the percentage of their average daily trading volume in the U.S. is less than 5% of their average daily trading volume worldwide. So far about 30 EU companies have deregistered or are in the process of doing so.

ANNEX II: Financial Integration Indicators

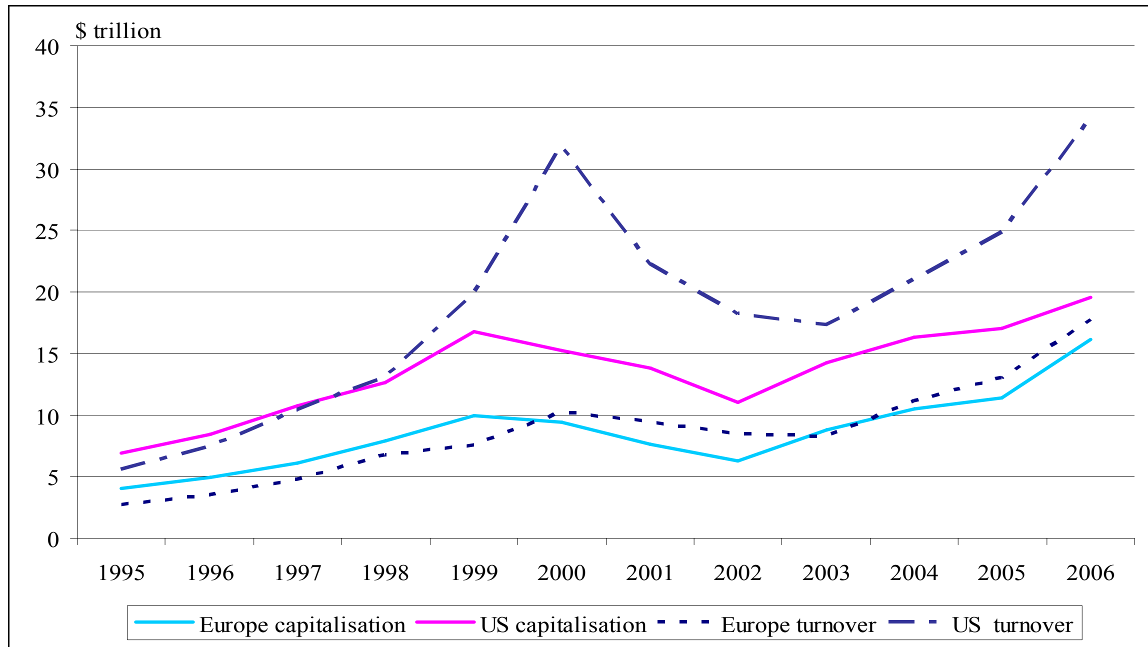
1. FINANCIAL STRUCTURE

1.1. Life and Non-Life Premiums ($ billions)



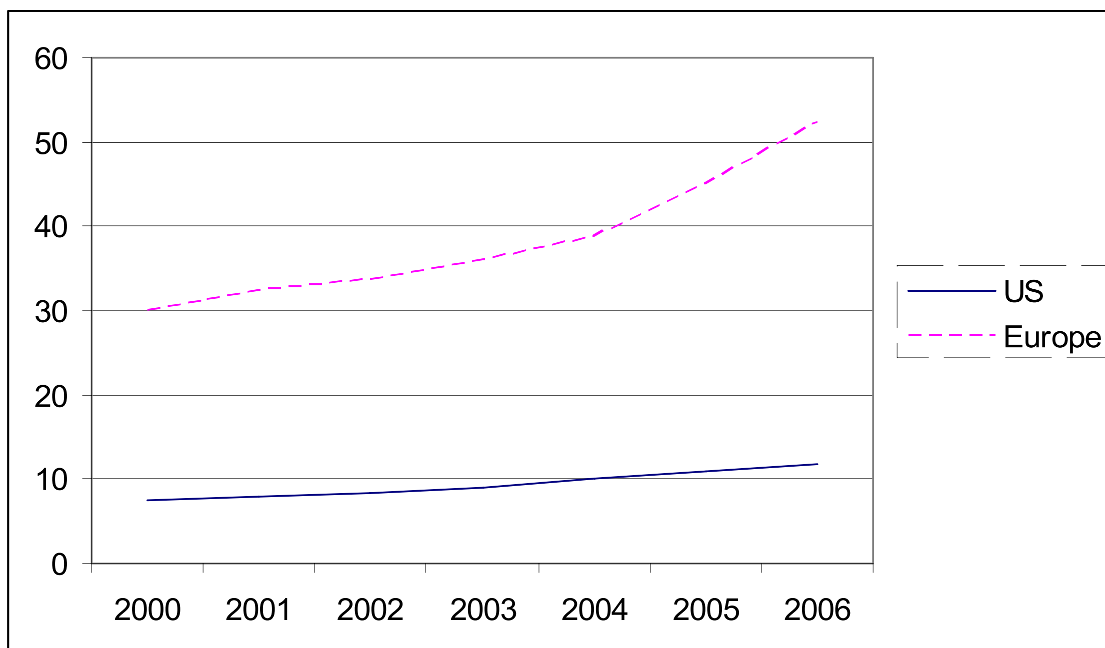
Source: IFSL Research (2007), Swiss Re (2007).

1.2. Equity Markets ($ trillion)



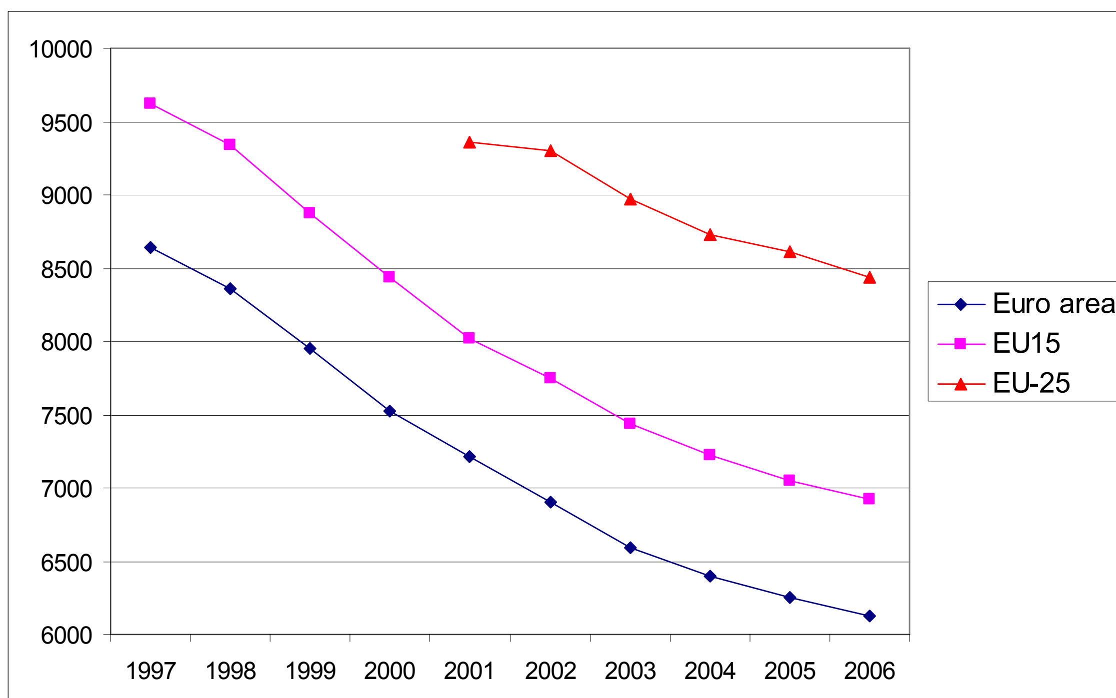
Source: IFSL Research (2007), WFE (2007).

1.3. Commercial Bank Assets ($ trillion)



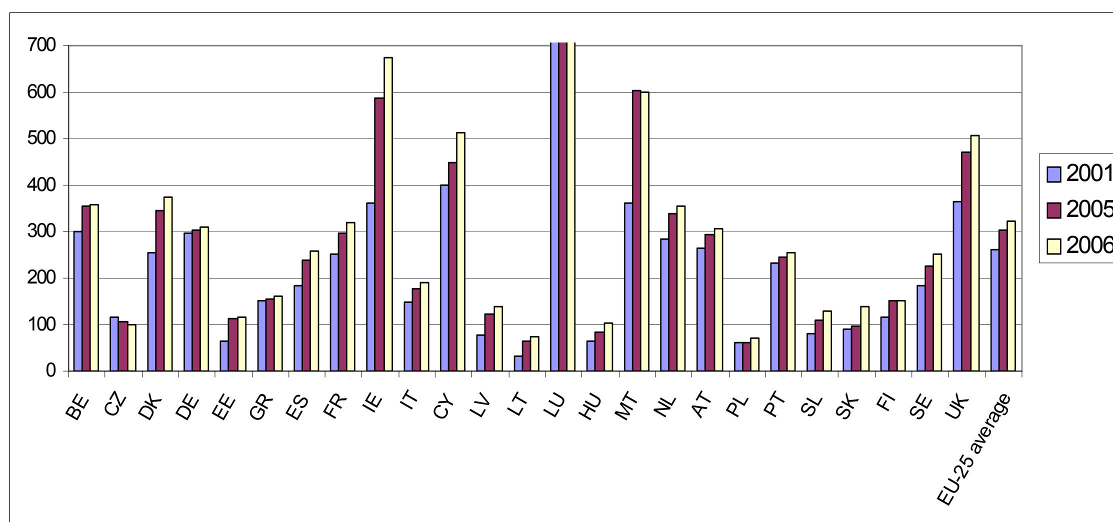
Source: IFSL Research (2007), European Banking Federation and Federal Deposit Insurance Corporation.

1.4. Number of credit institutions



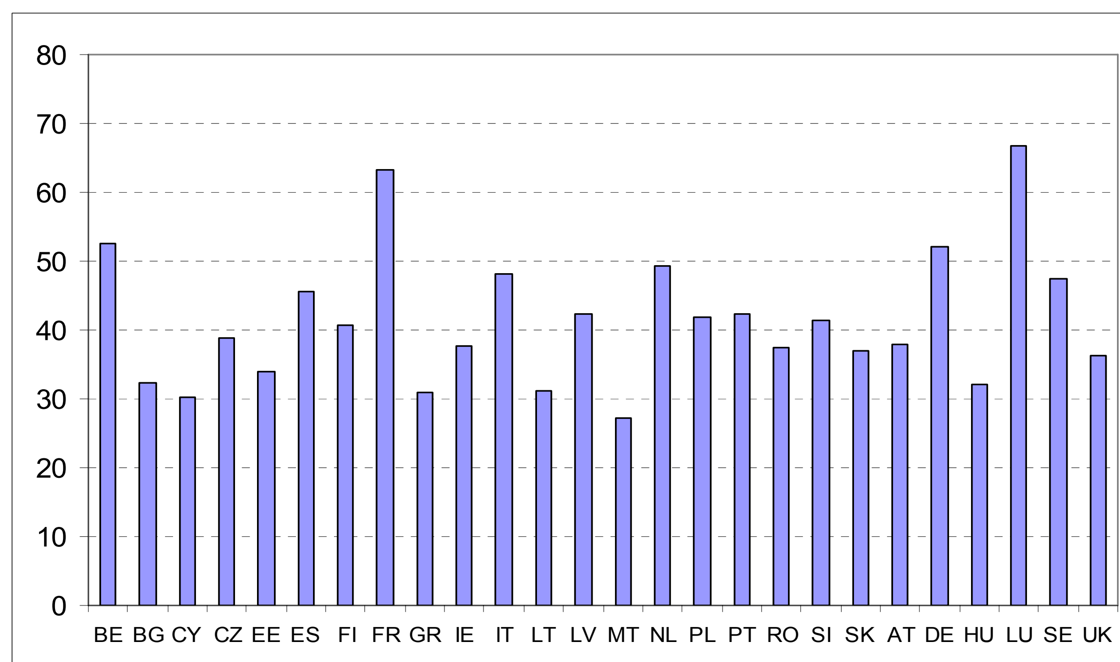
Source: ECB (2007a).

1.5. Total assets of credit institutions (in % of GDP)



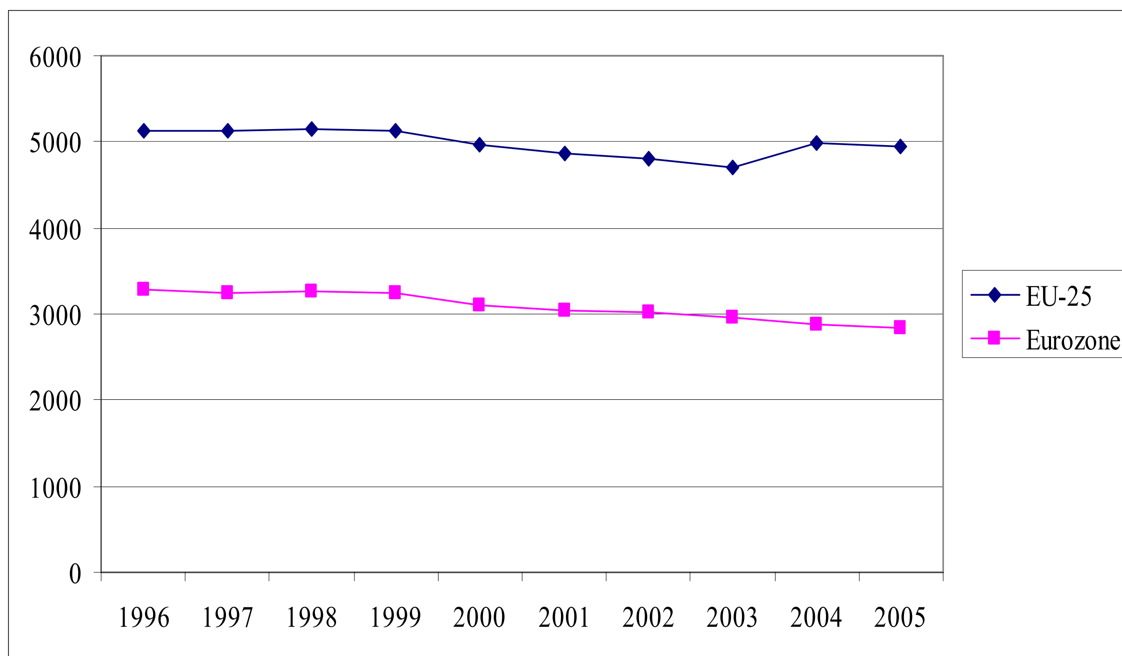
Source: ECB (2006a). Commission Services calculations.
Note: Values in LU decrease from 3194% in 2001 to 2540% in 2006.

1.6. Net non-interest income of banks (% of total income), 2006



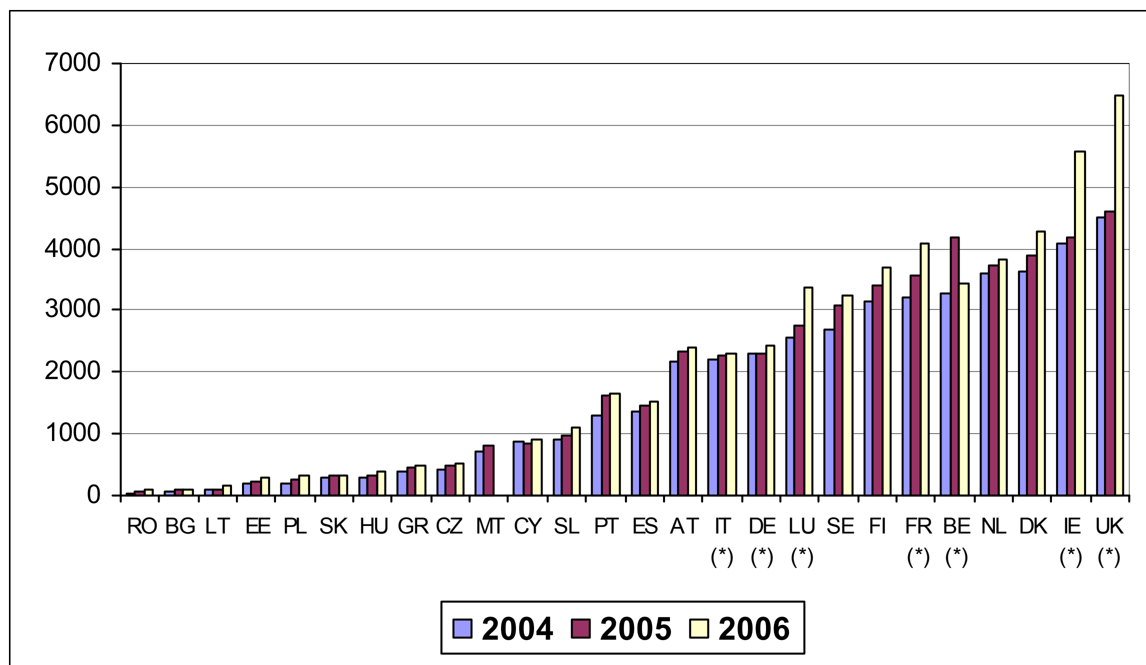
Source: ECB (2007f).

1.7. Number of insurance companies



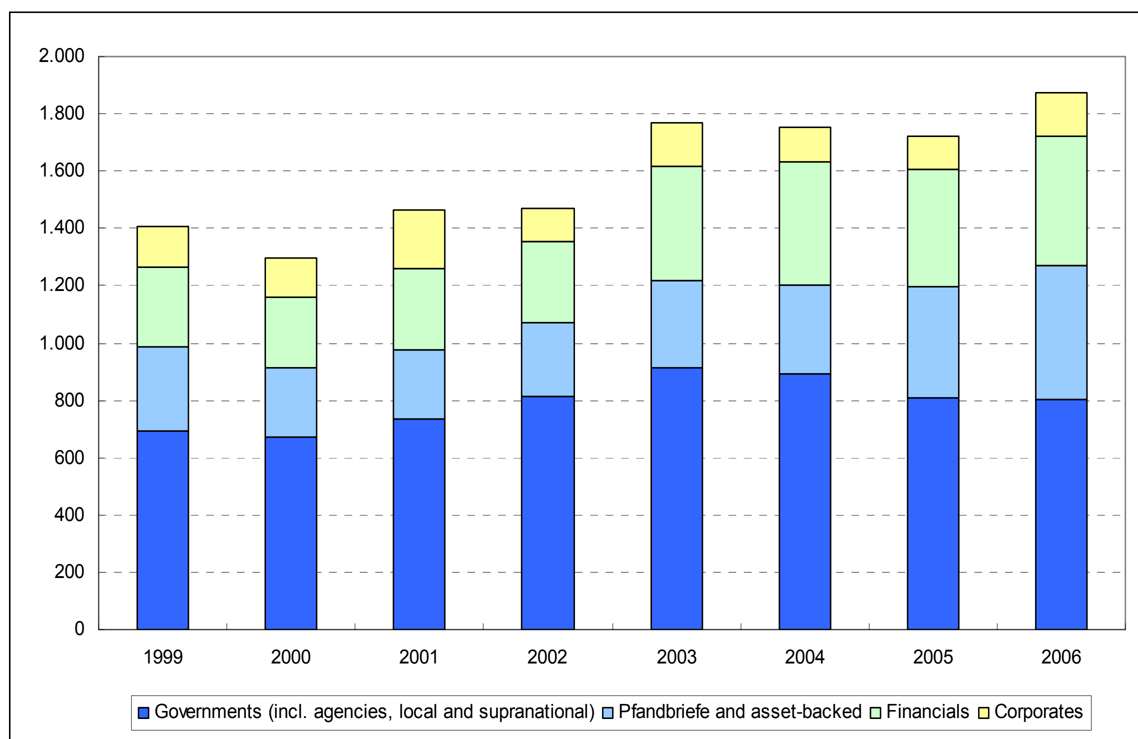
Source: CEA (2007).

1.8. Average Insurance premium per inhabitant (life and non-life, in US $)



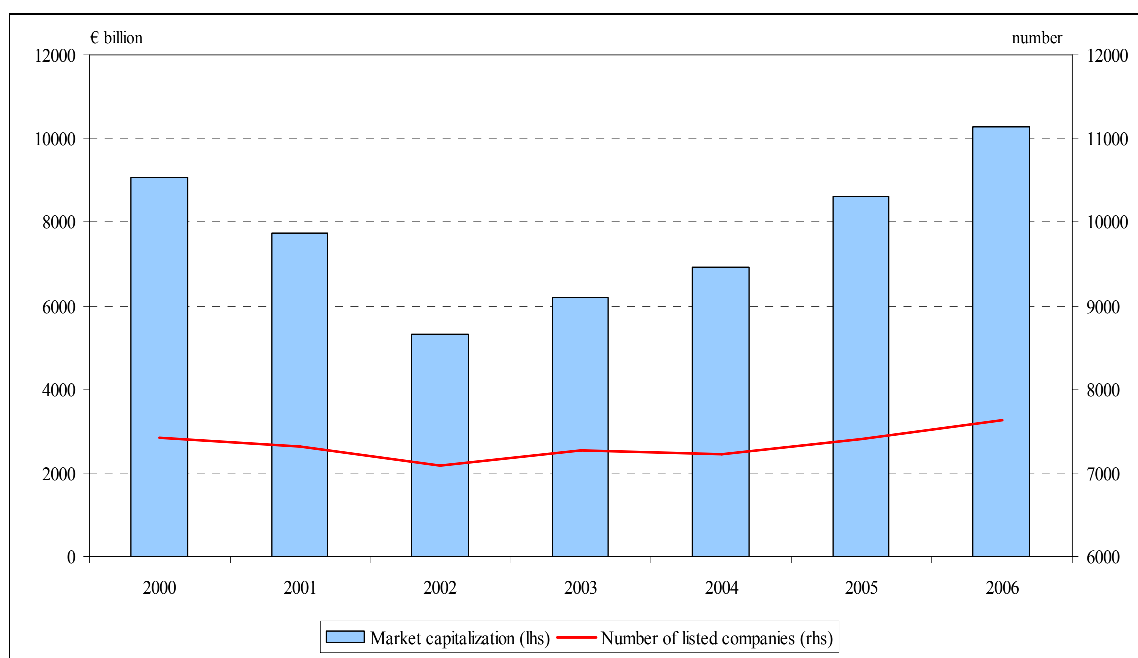
Source: SwissRe (2005), SwissRe (2006), SwissRe (2007).
* Excluding cross-border business. 2006 figure for Malta not available.

1.9. Issuance of euro-denominated bonds (in billion euros)



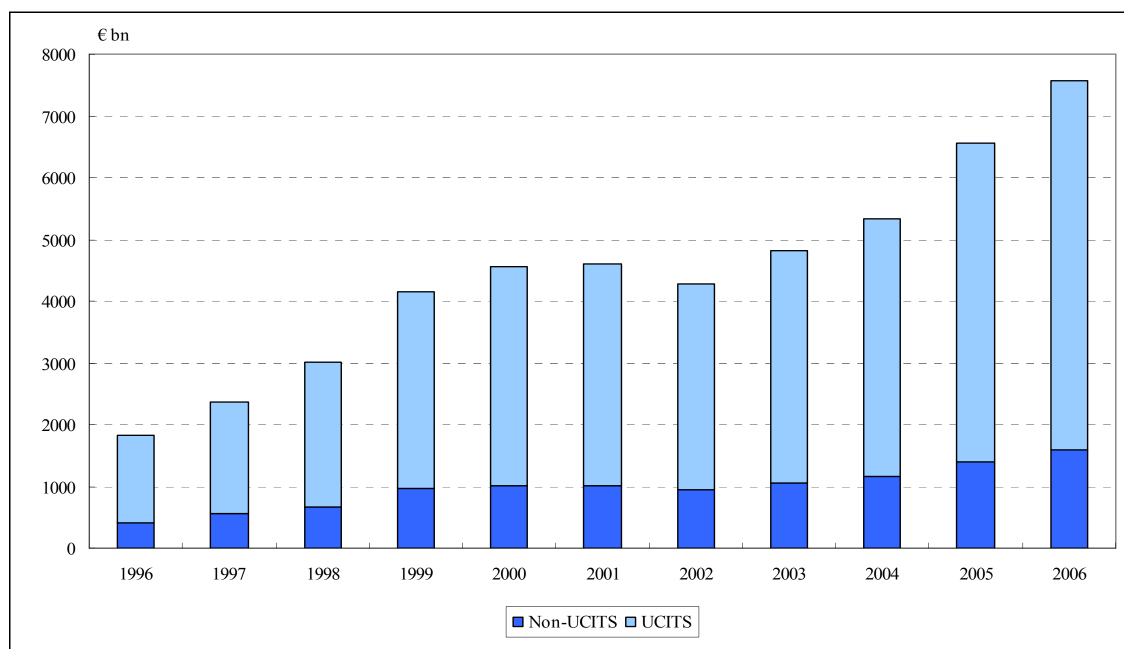
Source: European Commission (2007d).

1.10. EU equity market



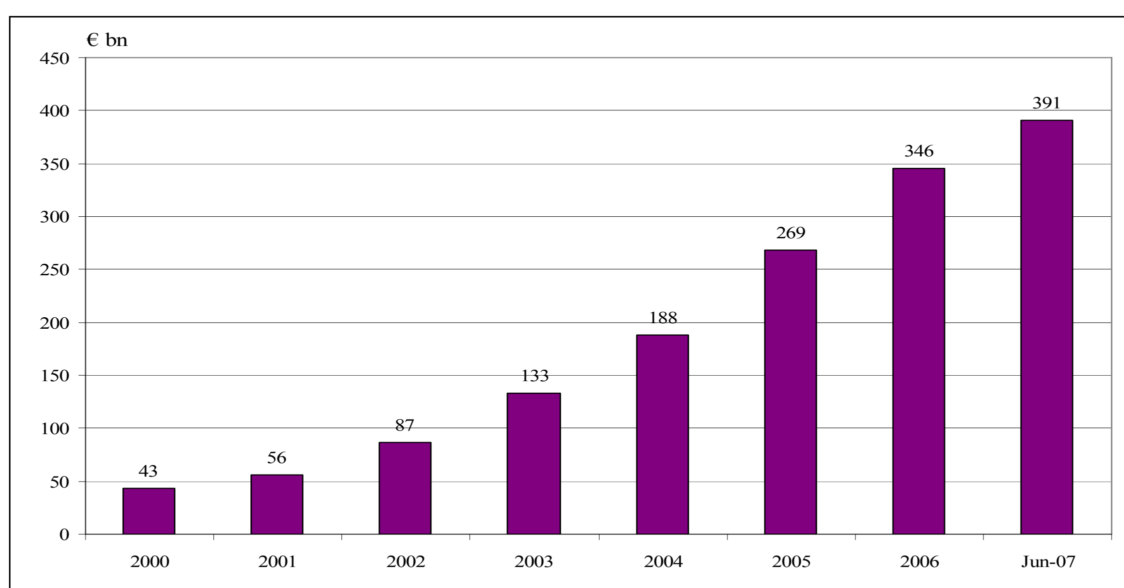
Source: FESE (2007a).
Note: The number of listed companies does not include companies listed on the Spanish Exchanges (BME) and Virt-X.

1.11. Assets of European investment funds



Source: EFAMA (2007b).

1.12. Assets of EU hedge funds

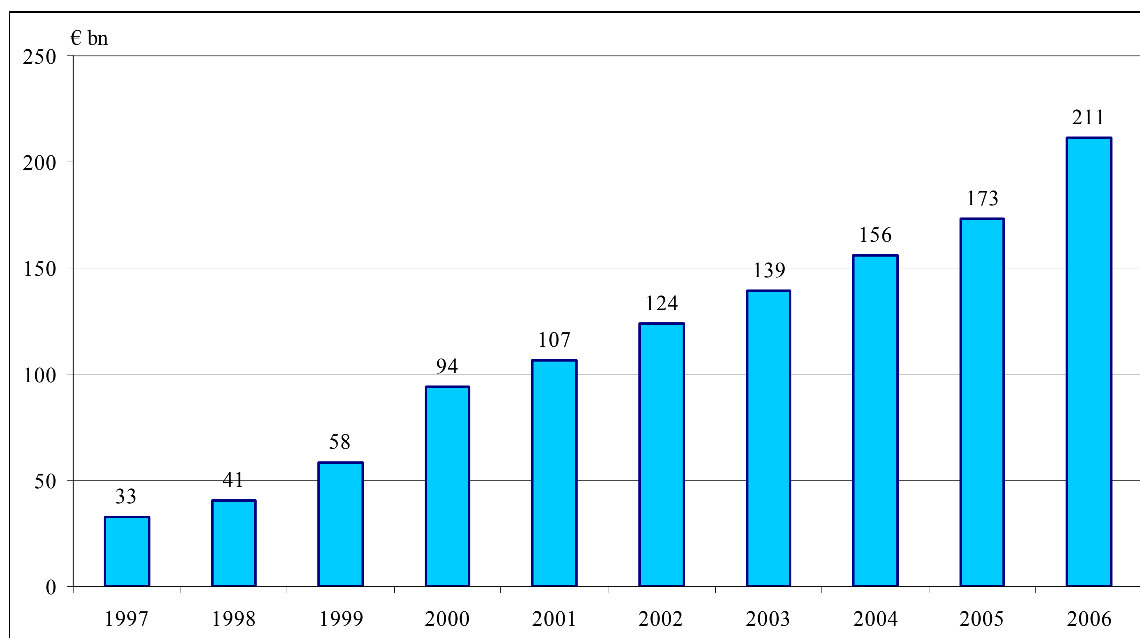


Source: various industry databases, European Commission estimates (2007)

Note: EU hedge funds means funds based (domiciled) in the EU and/or with managers residing in the EU. This includes hedge funds that are managed from outside the EU but are domiciled in the EU and hedge funds which are domiciled offshore but managed from one Member State. Note that this is not legal definition. All figures are DG Markt estimates based on data from the following industry databases:

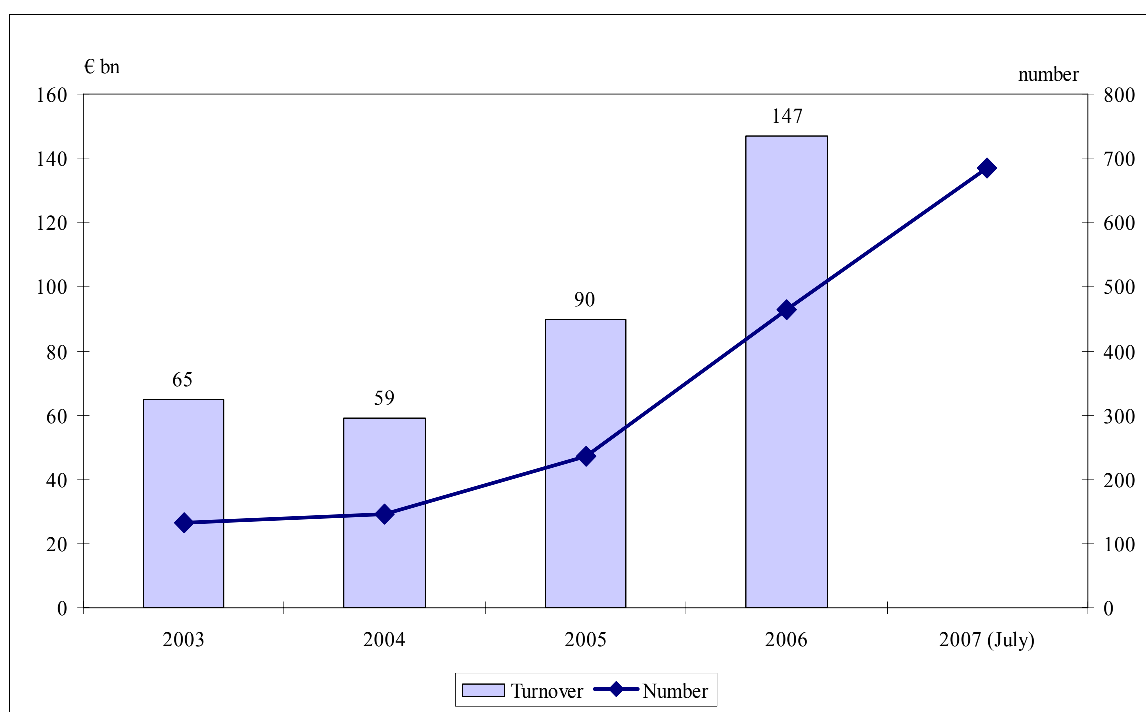
Eurohedge hedge fund intelligence : http://www.hedgefundintelligence.com/eh/archive.htm
Hedgeweek : http://www.hedgemedia.com/
Hedgeco.net : http://www.hedgeco.net/
EDHEC-Risk Asset Management Research : http://www.edhec-risk.com/
IFSL : http://www.ifsl.org.uk/research/index.html
Greewhich Van hedge : http://www.vanhedge.com/pdf/vanindex.pdf
CogentHedge : http://www.cogenthedge.com/admin/rank_providers.asp

1.13. Private equity funds – portfolio at cost



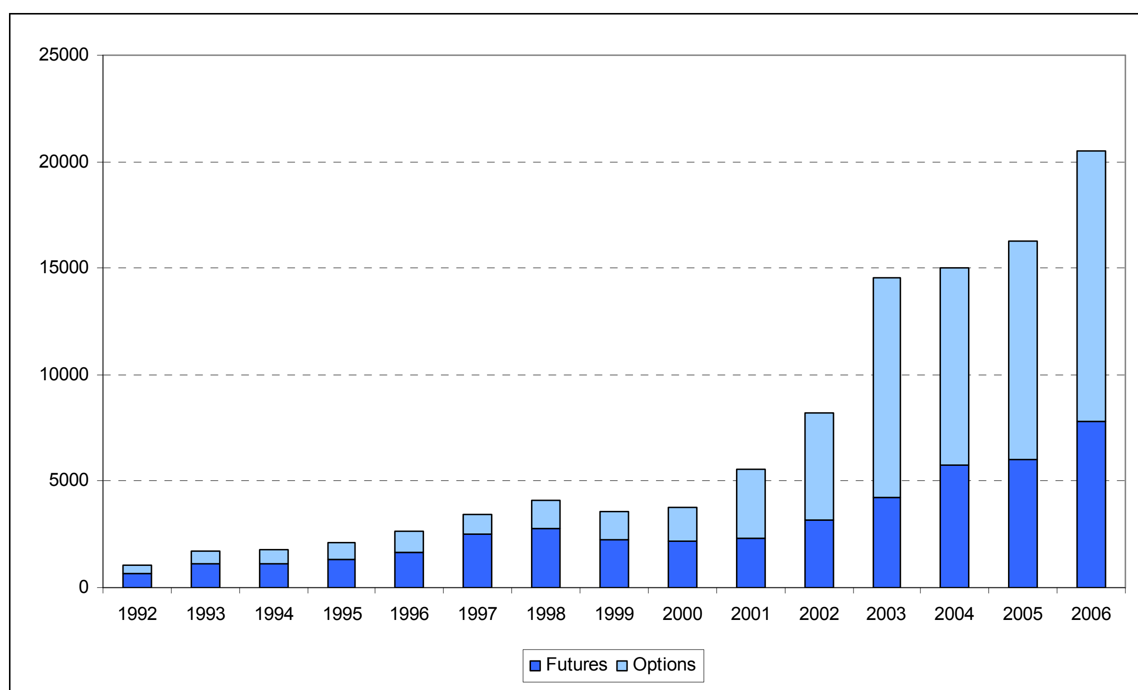
Source: EVCA (2007).

1.14. EU Exchange Traded Funds – number of funds and annual turnover



Source: FESE (2007a).

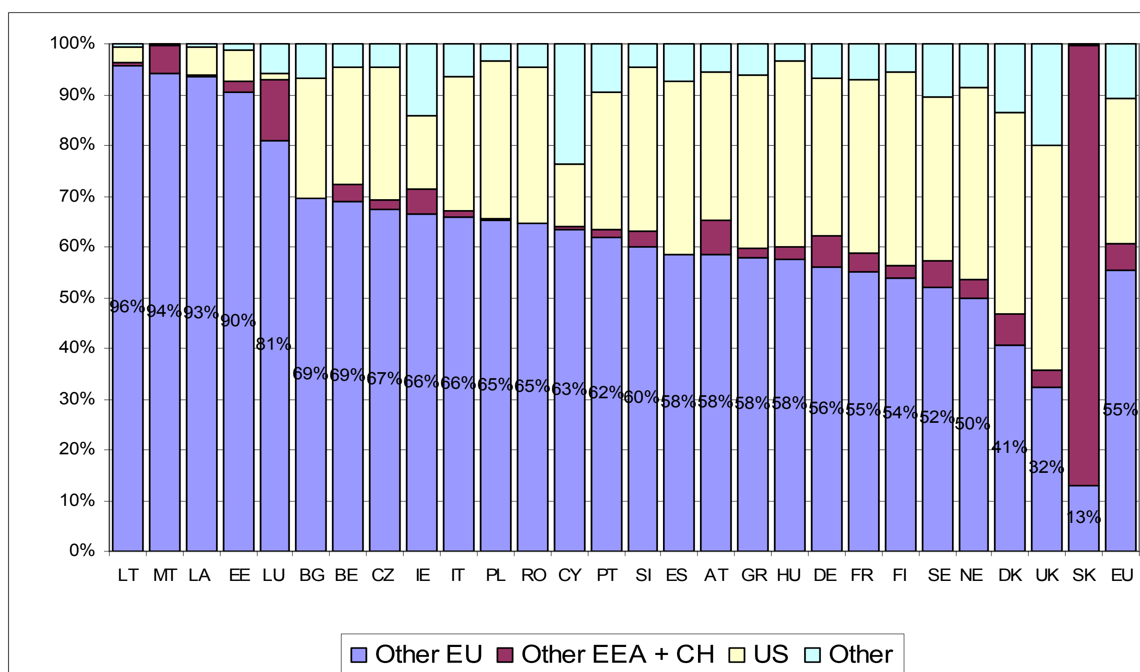
1.15. Notional amounts outstanding of interest rate derivatives traded on European organised exchanges (year end, $ billion)



Source: BIS (2007b).

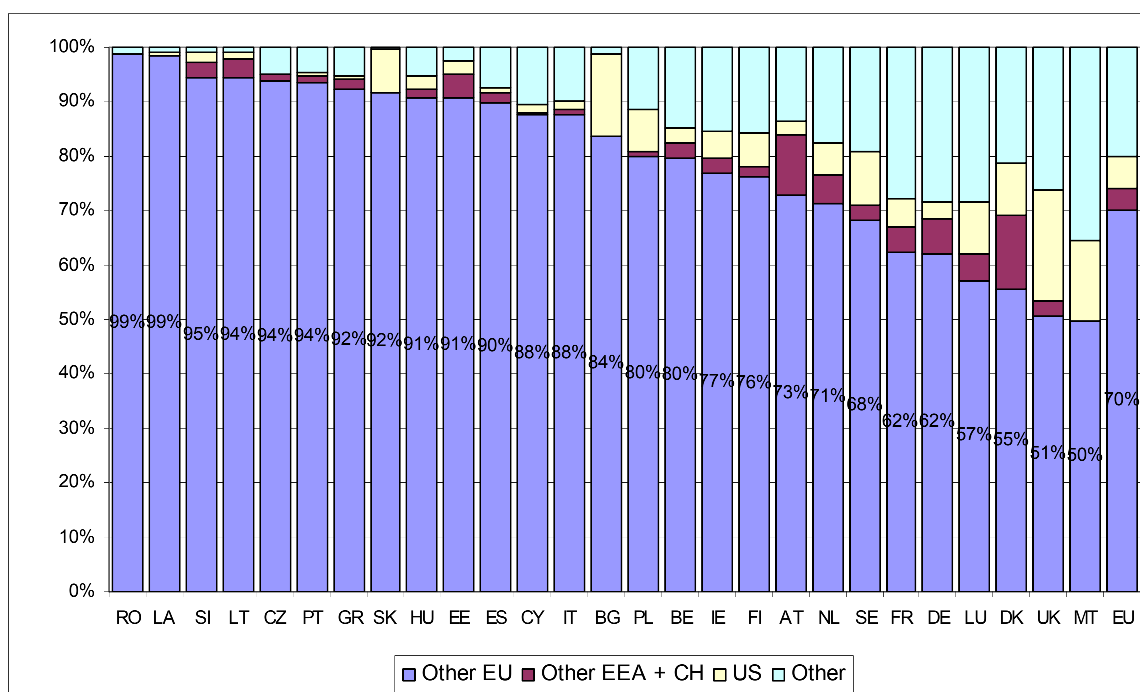
2. FINANCIAL INTEGRATION

2.1. Foreign investment in the equity markets by origin, 2005



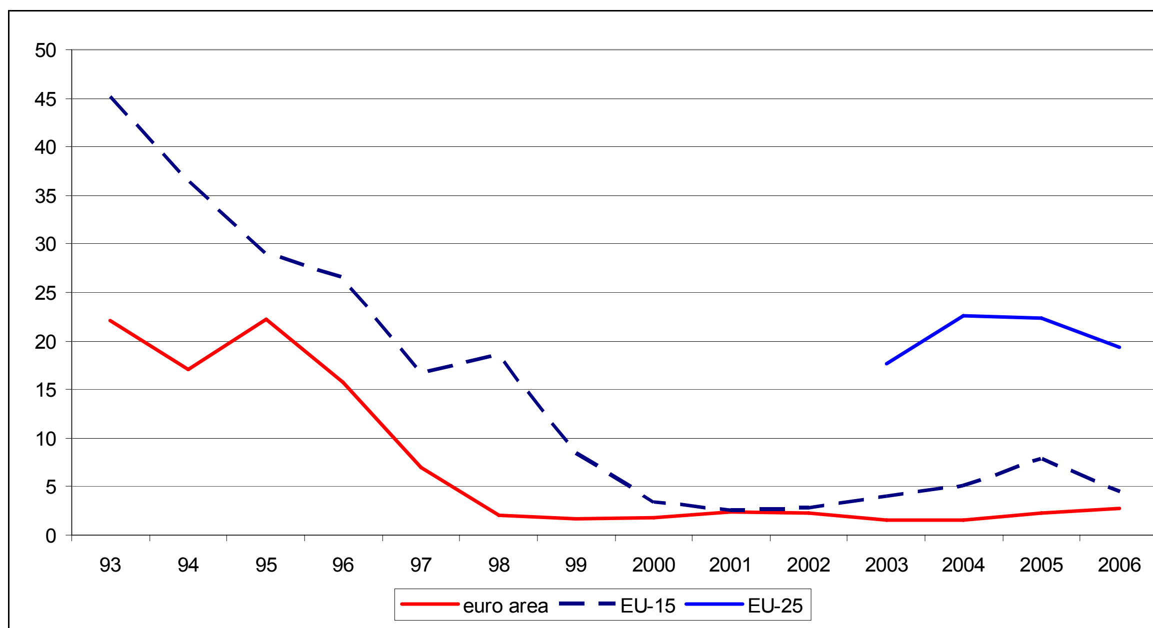
Source: IMF (2007b). European Commission's calculations.

2.2. Foreign investment in the long term debt securities markets by origin, 2005



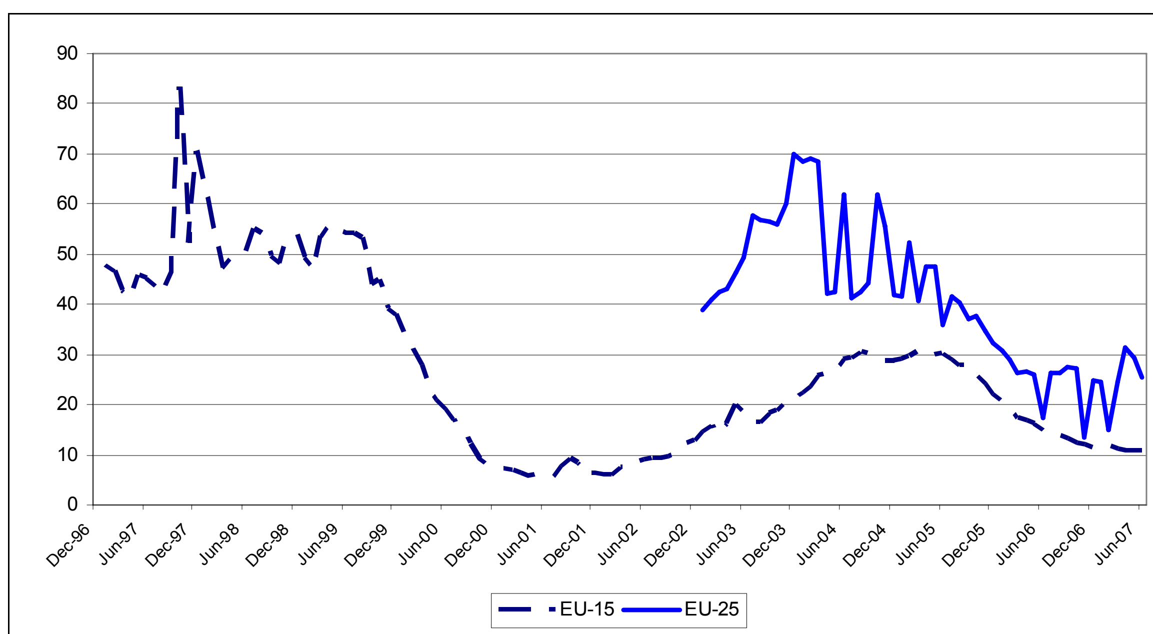
Source: IMF (2007b). European Commission's calculations.

2.3. Convergence in long term government bond yields (coefficient of variation in %)



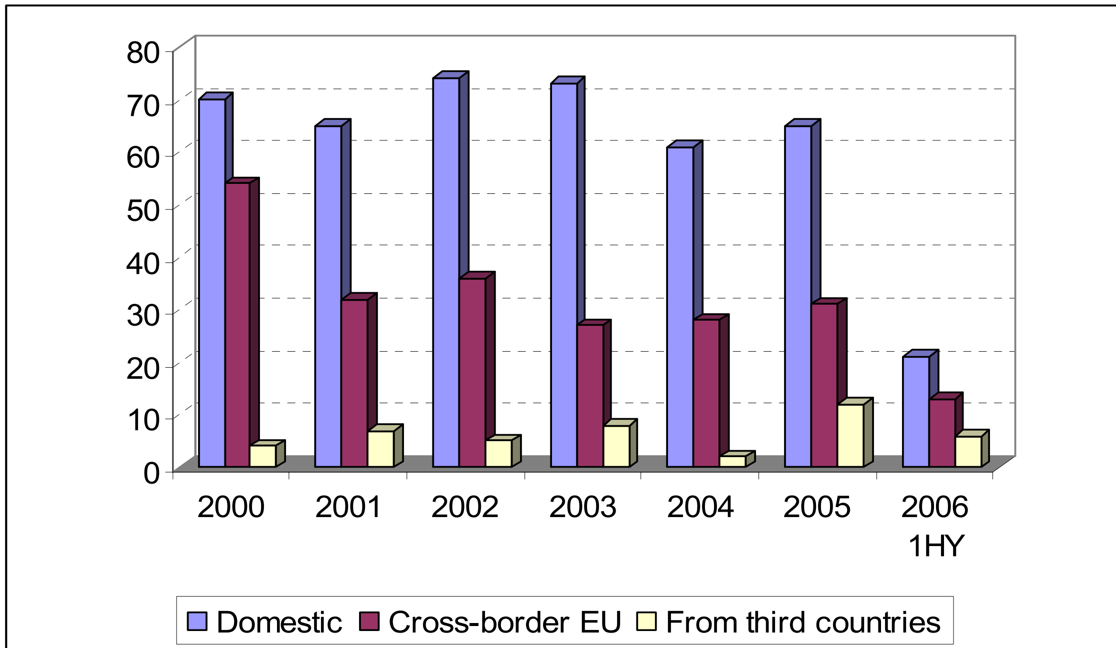
Source: EUROSTAT data, European Commission's calculations.

2.4. Convergence of 3 month money market rates (coefficient of variation in %)



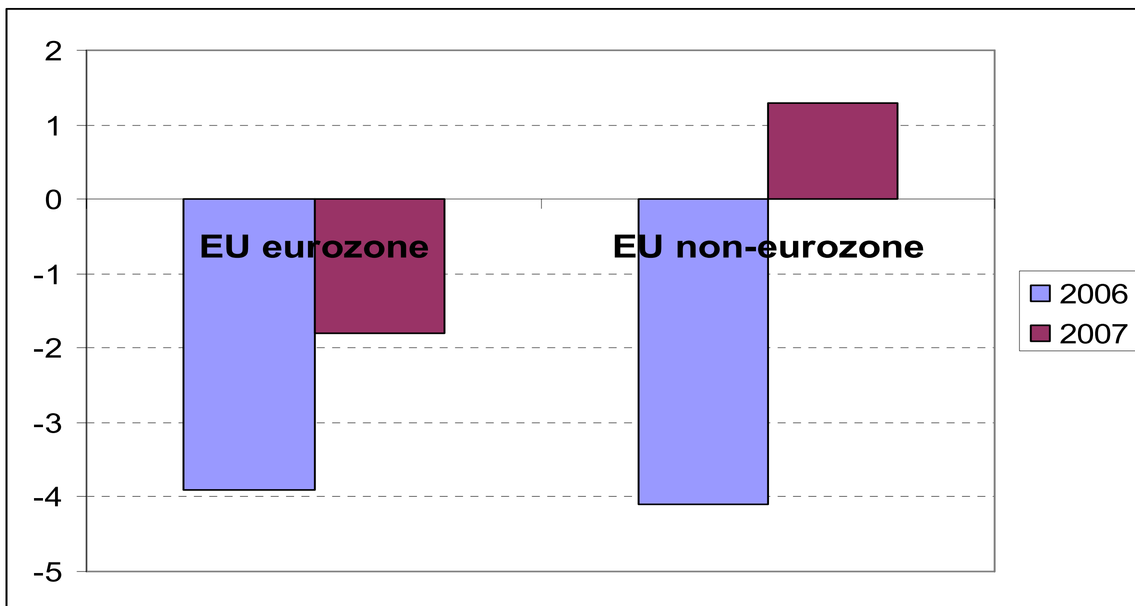
Source: EUROSTAT data, European Commission's calculations. For Euro-area Countries an average rate calculated by the ECB is used.

2.5. M&As in EU-25 banking sector: number of deals



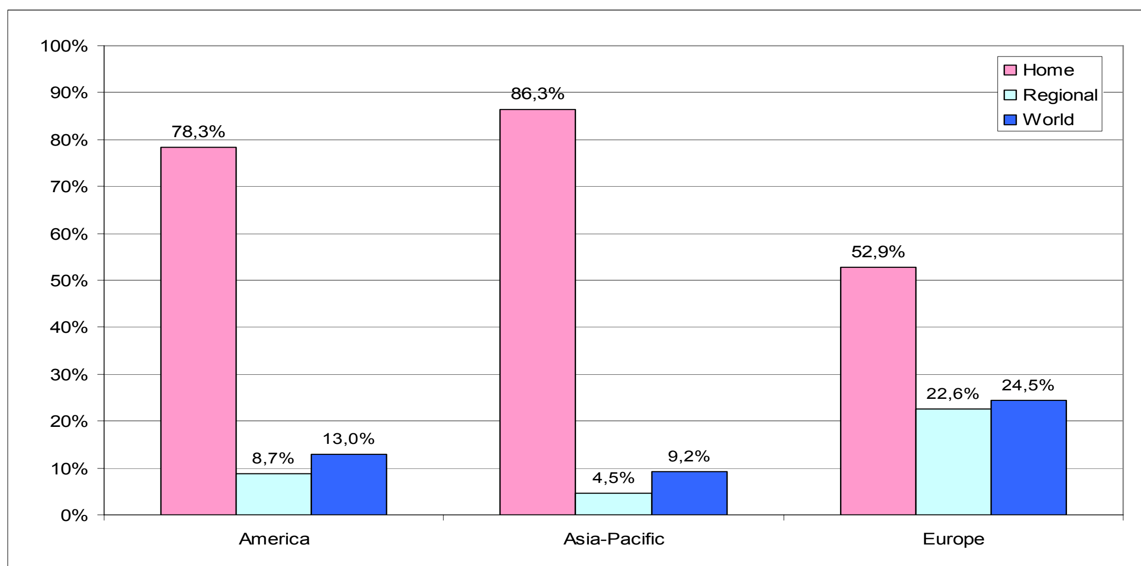
Source: ECB (2006a).

2.6. Retail prices in banking – Evolution of local profile prices. Average price change in per cent compared to previous year



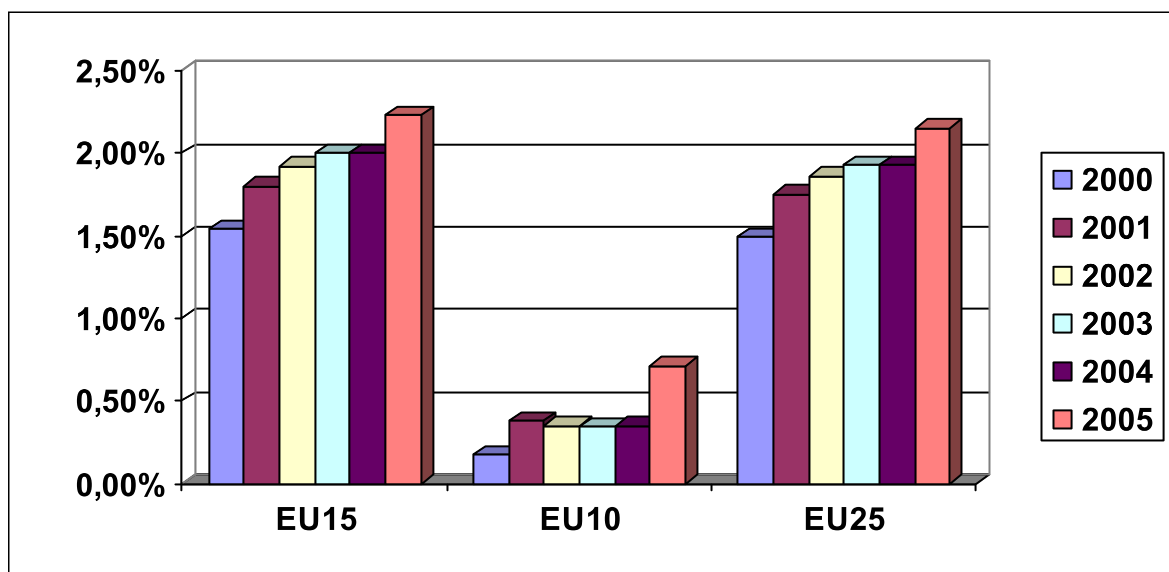
Source: Capgemini (2006) and Capgemini (2007).

2.7. Geographical segmentation of banks assets in 2005



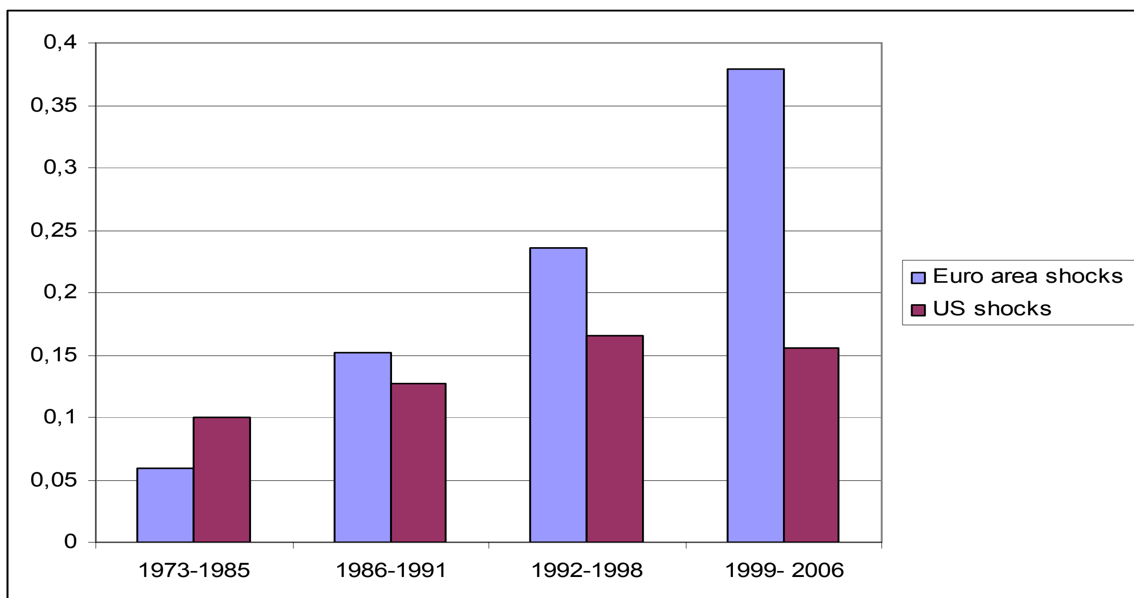
Source: Schoenmaker and van Laecke (2006).
Note: "Home" is defined as a bank's assets in its home country; 'Rest of the region' is defined as a bank's assets in other countries in the region (e.g. European countries except the home country); 'Rest of world' is defined as a bank's assets in countries outside the region (e.g. outside Europe).

2.8. Direct cross-border sales of business insurance in % of total premiums written



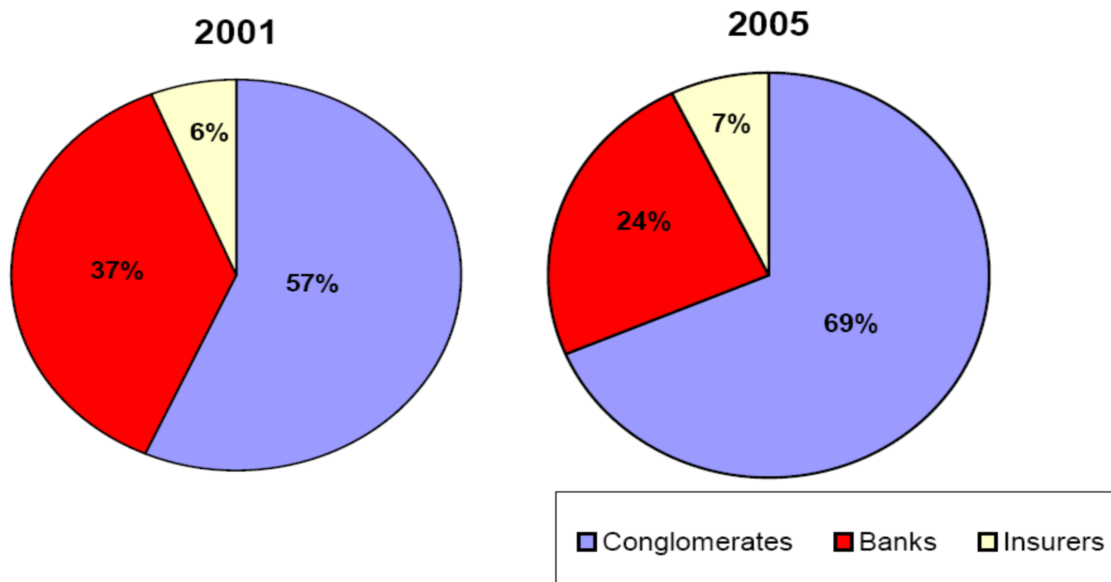
Source: European Commission (2007b).

2.9. Proportion of variance of individual euro area countries' equity returns explained by euro area and US shocks (percentage)



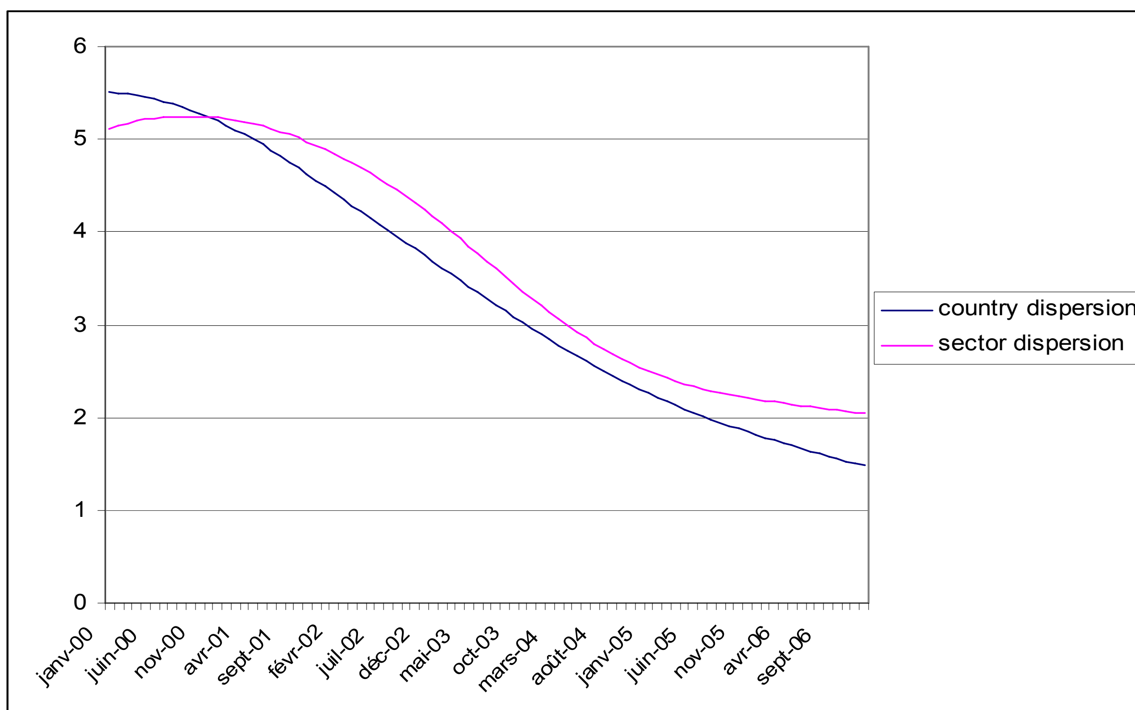
Source: ECB, Financial Integration Indicators.
Note: The chart shows the level of the variance of domestic equity returns explained by common factors while the remaining is due to local (domestic) shocks.

2.10. Balance sheet totals of 25 largest banks, insurers and conglomerates in the EU market (percentage)



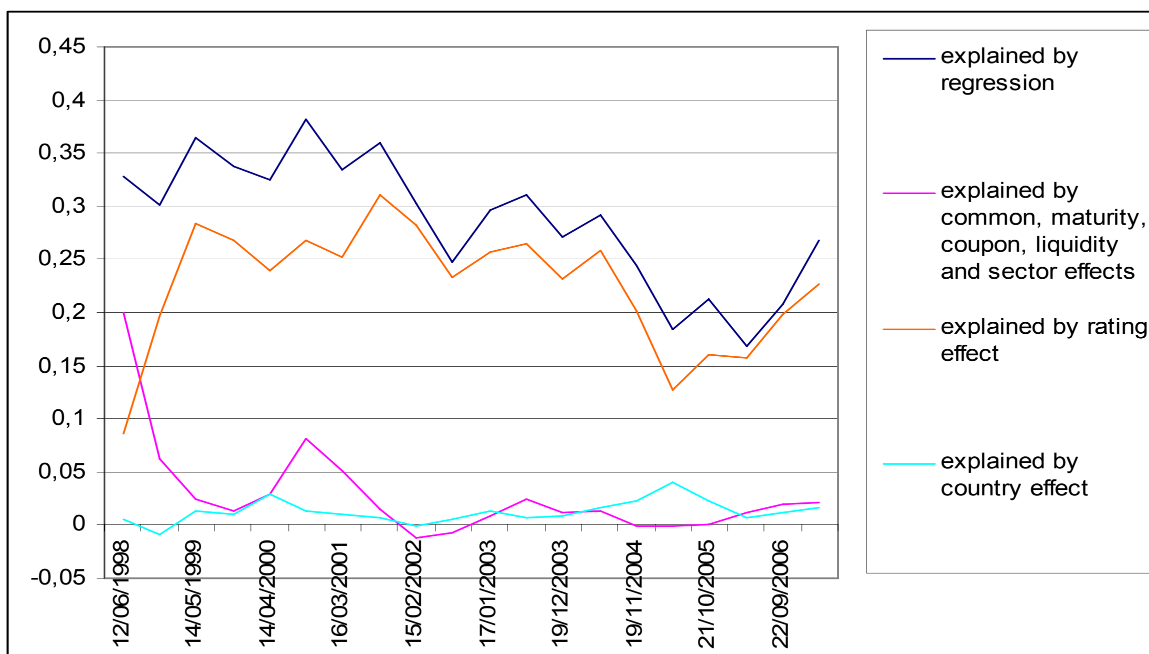
Source: CEIOPS (2007).

2.11. Cross-country and cross-sector dispersions in euro area equity returns (in %).



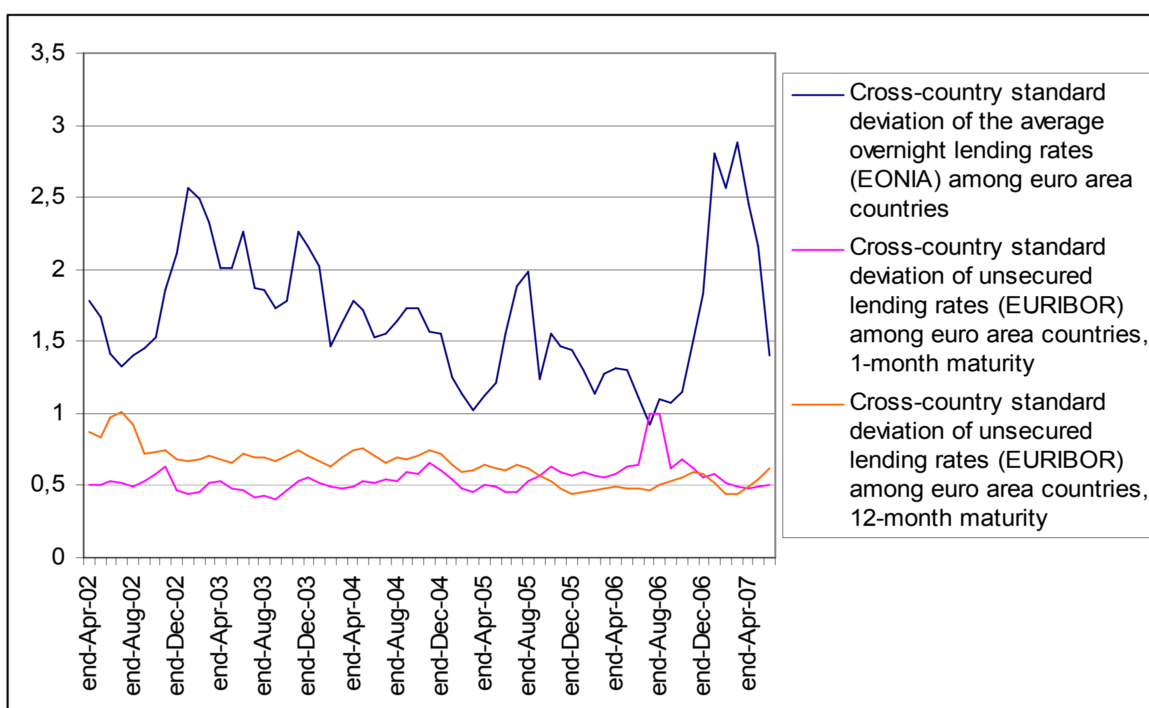
Source: ECB, Financial integration indicators.
Note: Sectors covered are: basic industries, cyclical services, cyclical consumer goods, general industrials, information tech, non cyclical consumer goods, non cyclical services, resources, financial, utilities.

2.12. Proportion of cross-sectional variance of corporate bonds yields explained by various factors.



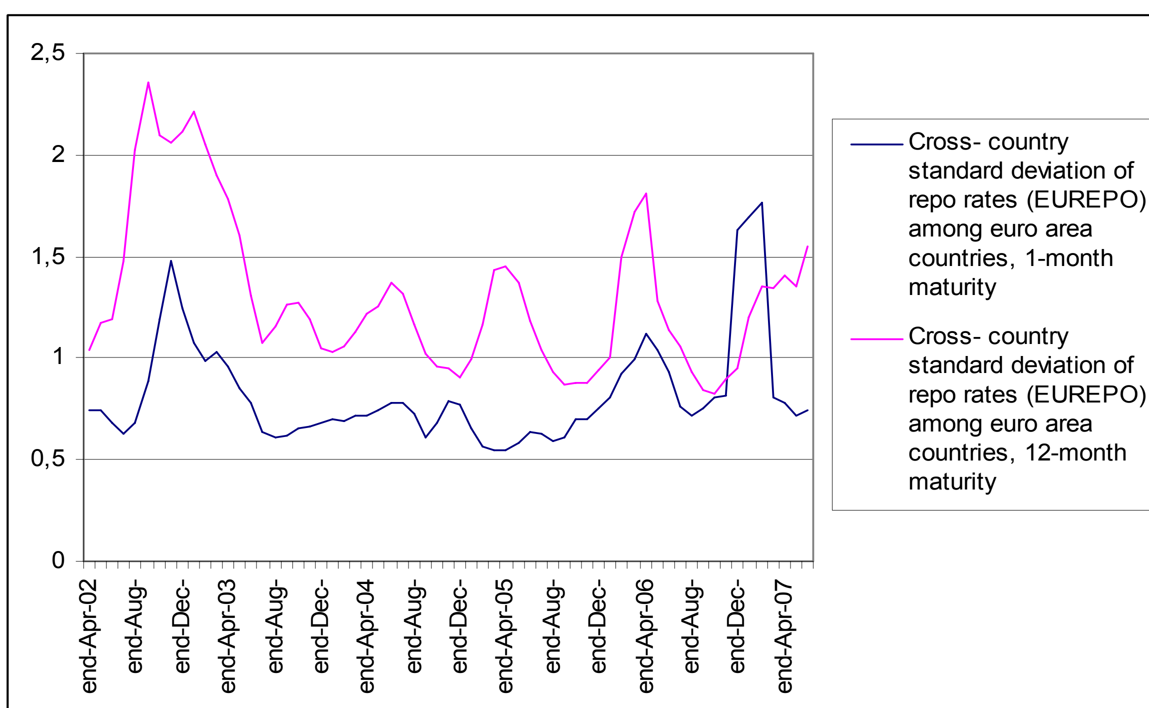
Source: ECB, Financial integration indicators.
Note: The sectors covered are the same as in chart 2.11.

2.13. Cross-country standard deviation of the average unsecured interbank lending rates across euro area countries



Source: ECB, Financial integration indicators.
Note: The wider cross-country standard deviation for the EONIA is partly related to the method used by the ECB for its computation. See ECB(2007e).

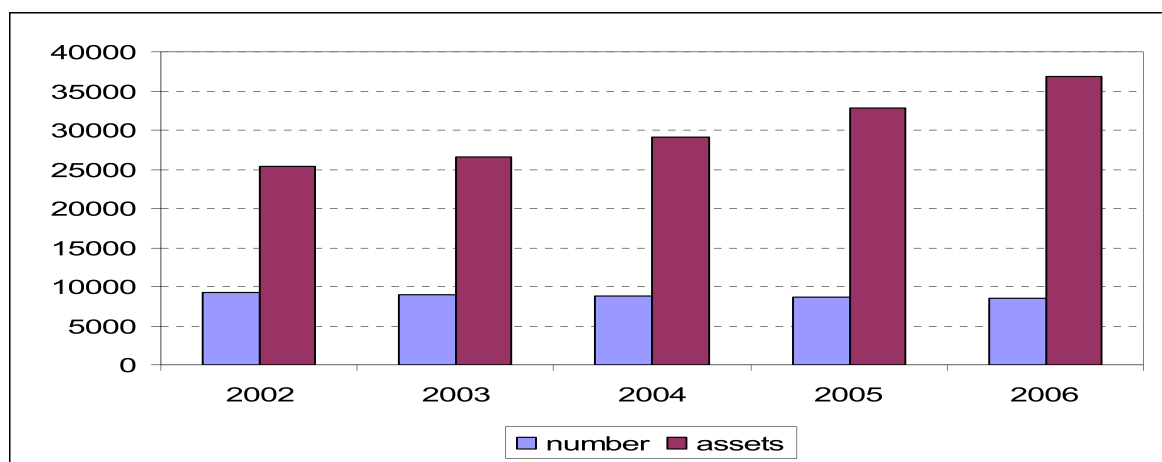
2.14. Cross-country standard deviation of the average repo interbank rates across euro area countries



Source: ECB, Financial integration indicators

3. COMPETITION

3.1. Consolidation in the EU-25 banking sector



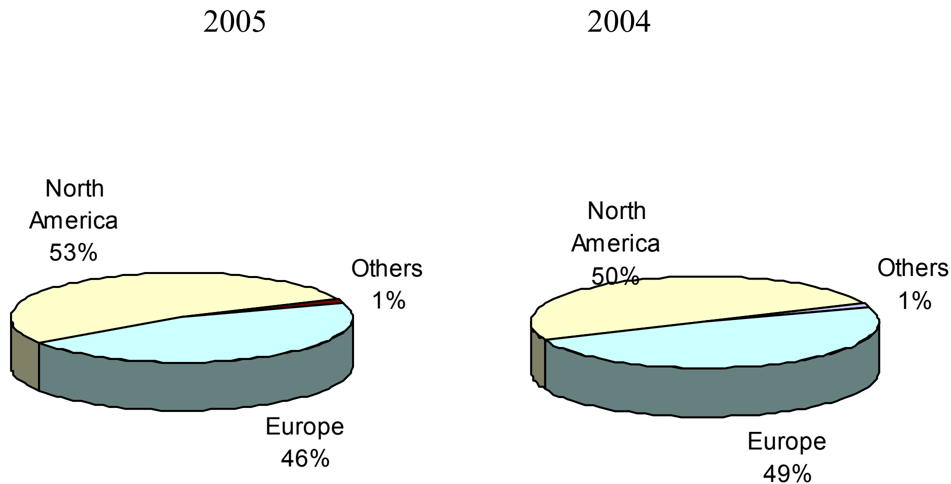
Source: ECB (2006a).
Note: Number of credit institutions and total assets (the latter in billion euros). A more detailed illustrations of the changes in the number of credit institutions can be found in chart 1.4 of the annex.

3.2. Concentration in EU-25 banking markets

	Herfindahl Index for CIs			**Share of the 5 largest CIs in total assets (in percent)**		
	2001	**2005**	**2006**	**2001**	**2005**	**2006**
BE	1587	2108	2041	78,3	85,2	84,4
CZ	1263	1155	1106	68,4	65,5	64,1
DK	1119	1115	1071	67,6	66,3	64,7
DE	158	174	178	20,2	21,6	22
EE	4067	4039	3593	98,9	98,1	97,1
GR	1113	1096	1101	67	65,6	66,3
ES	532	487	442	43,9	42	40,4
FR	606	758	727	47	53,5	52,3
IE	512	600	600	42,5	46	45
IT	260	230	220	29	26,7	26,3
CY	964	1029	1056	61,3	59,8	63,9
LV	1053	1176	1271	63,4	67,3	69,2
LT	2503	1838	1913	87,6	80,6	82,5
LU	275	312	294	28	30,7	29,1
HU	892	795	823	56,4	53,2	53,5
MT	1835	1330	1185	81,1	75,3	71,4
NL	1762	1796	1822	82,5	84,8	85,1
AT	561	560	534	44,9	45	43,8
PL	821	650	599	54,7	48,6	46,5
PT	991	1154	1134	59,8	68,8	67,9
SI	1582	1369	1300	67,6	63	62
SK	1205	1076	1131	66,1	67,7	66,9
FI	2240	2730	2560	79,5	83,1	82,3
SE	760	845	856	54,6	57,3	57,8
UK	282	399	394	28,6	36,3	35,9
Weighted Average	**504**	**601**	**589**	**37,8**	**42,3**	**42,1**

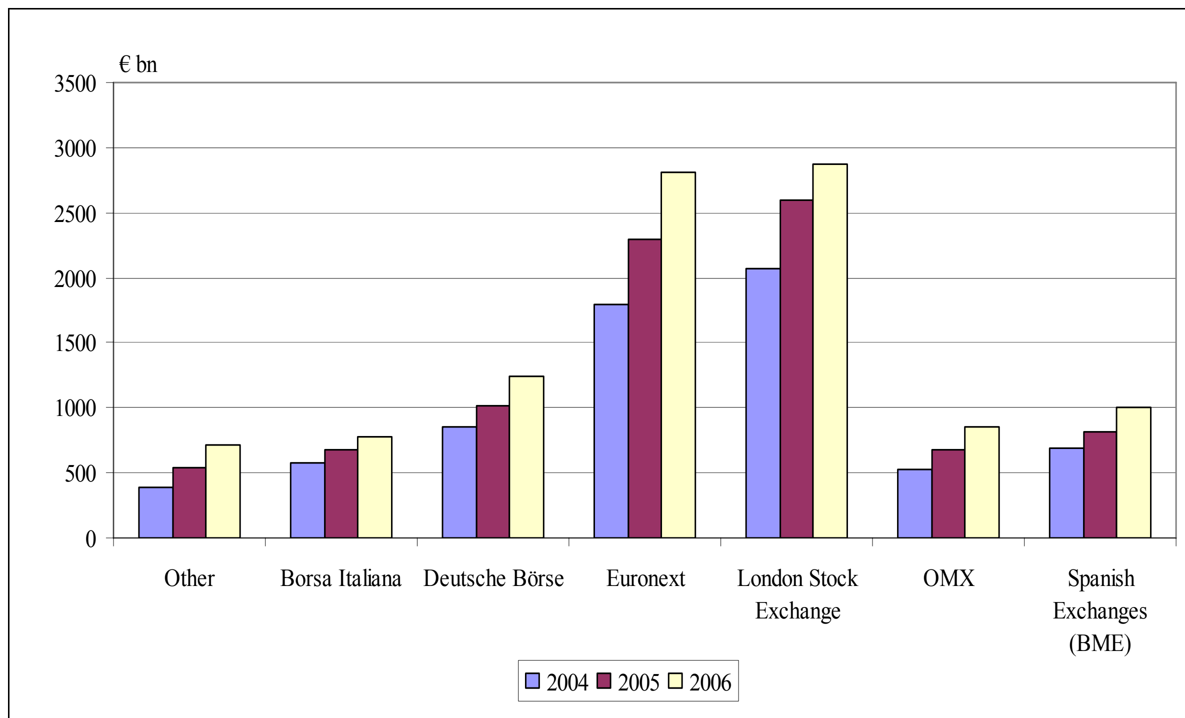
Source: ECB (2007a).

3.3. Gross global reinsurance premiums assumed by region



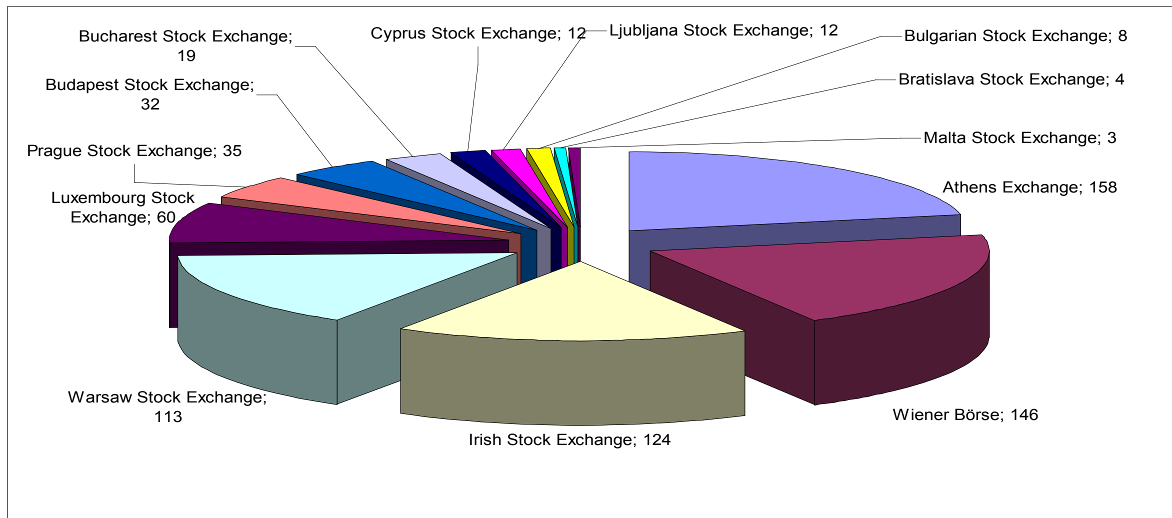
Source: IASA (2005 and 2006).

3.4. Market capitalisation of EU stock exchanges (end 2006)



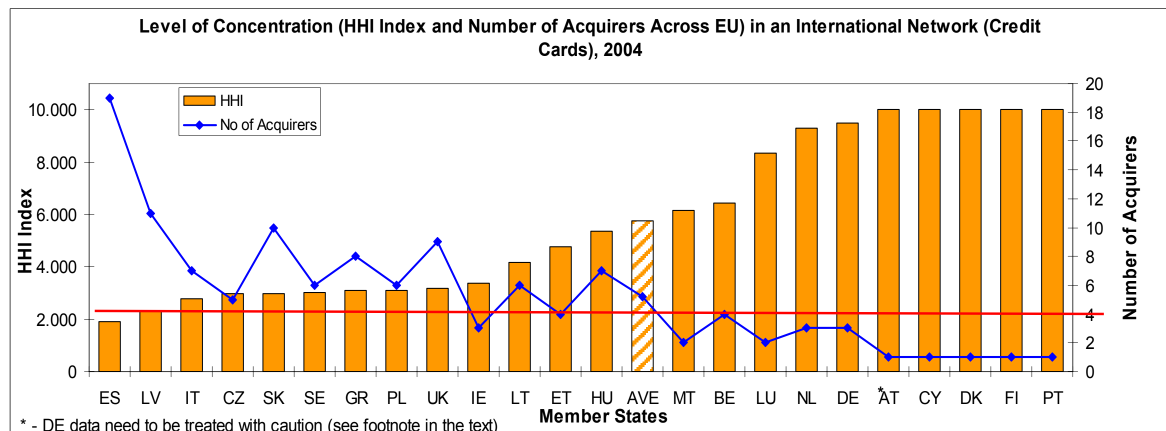
Source: FESE (2007a).

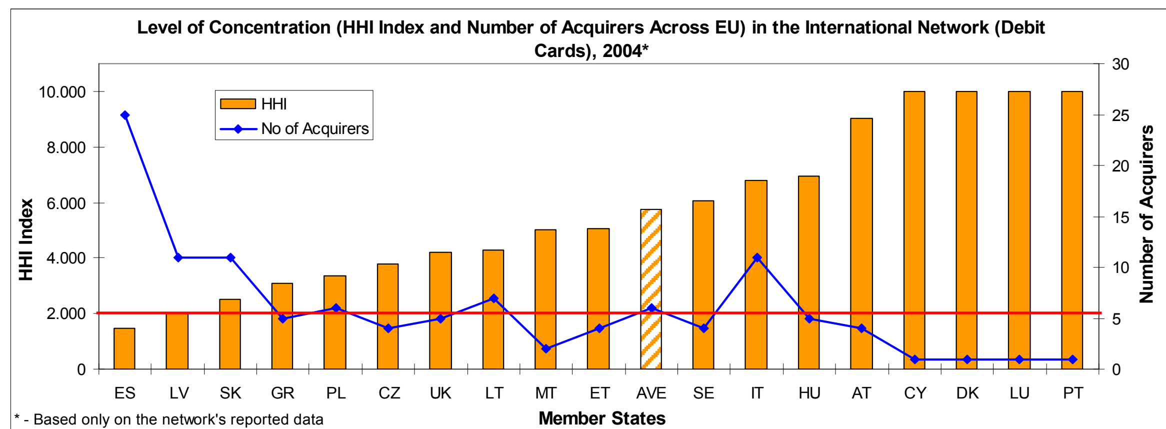
3.5. Smaller EU exchanges by market capitalisation (end 2006, EUR billions)



Source: FESE (2007a); Bulgarian Ministry of Finance (2007; data for Bulgarian Stock Exchange).

3.6. Level of concentrations in the credit and debit card market

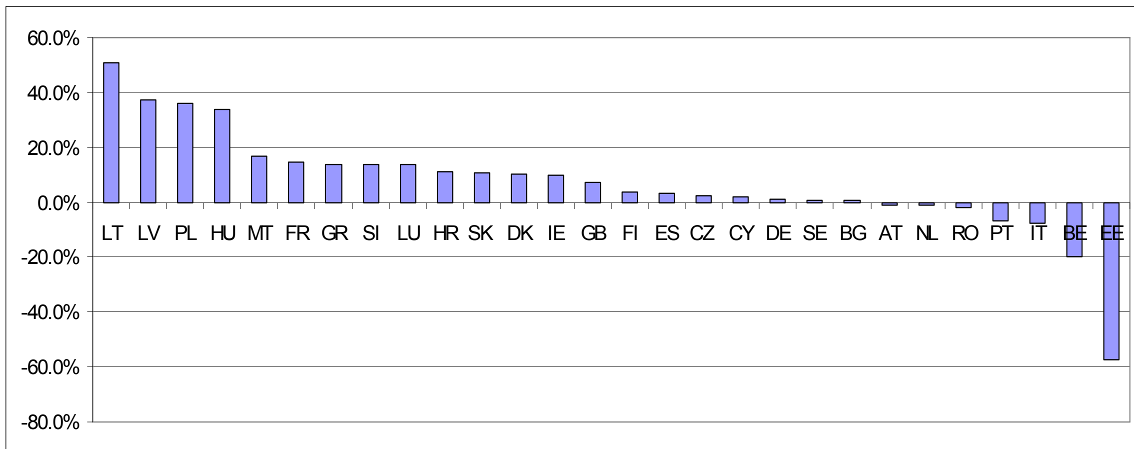




Source: European Commission (2007a).

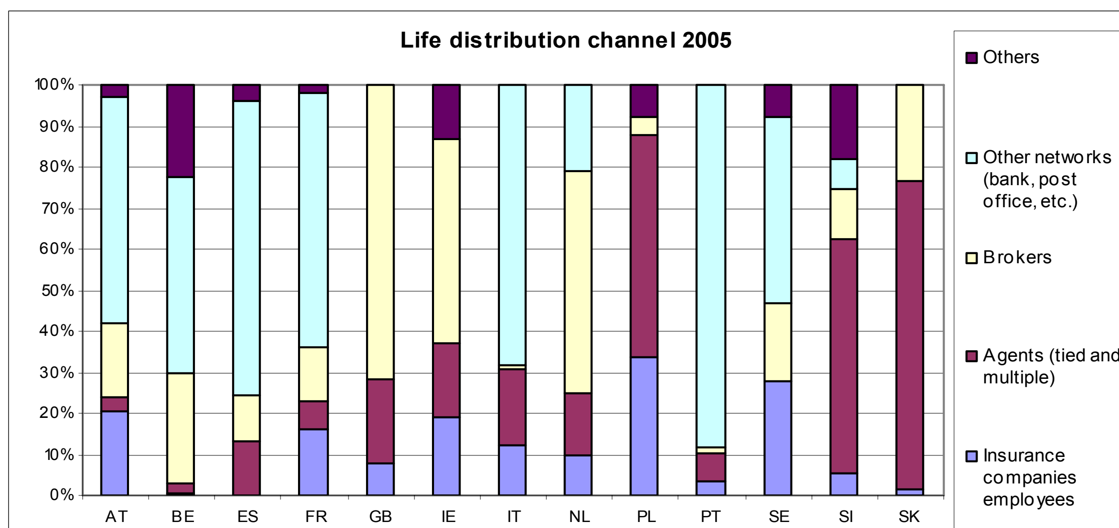
Note: The Herfindahl-Hirschman Index (HHI) is defined as the sum of the squares of the market shares of each individual acquirer. The index van ranges from 0 to 10,000, which reflects a move from a large number of acquirers with limited market shares to a monopolistic market situation. The acquirer is the payment service provider that provides payment services to the merchant (e.g. Mastercard and Visa).

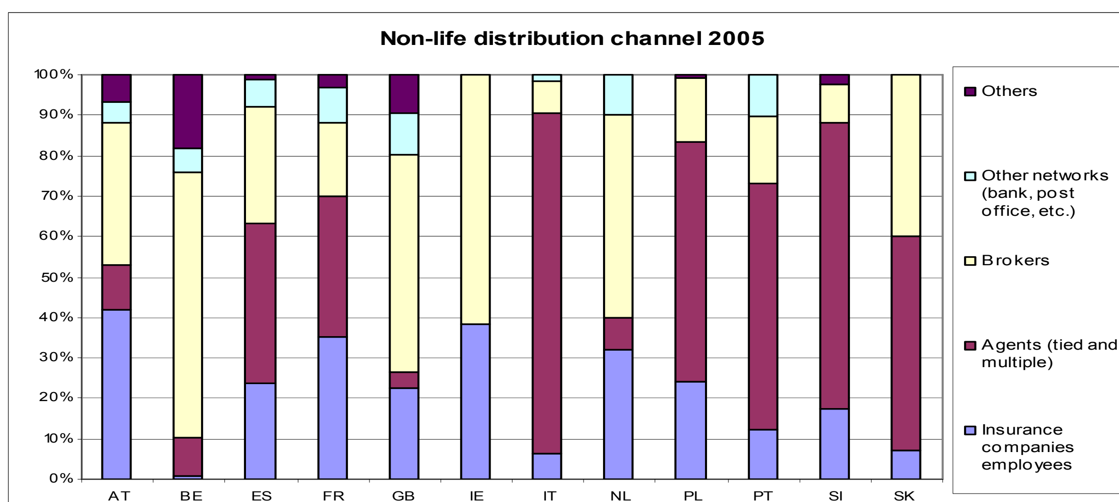
3.7. Life premium growth rate 06/05 (inflation-adjusted)



Source: CEA (2007).

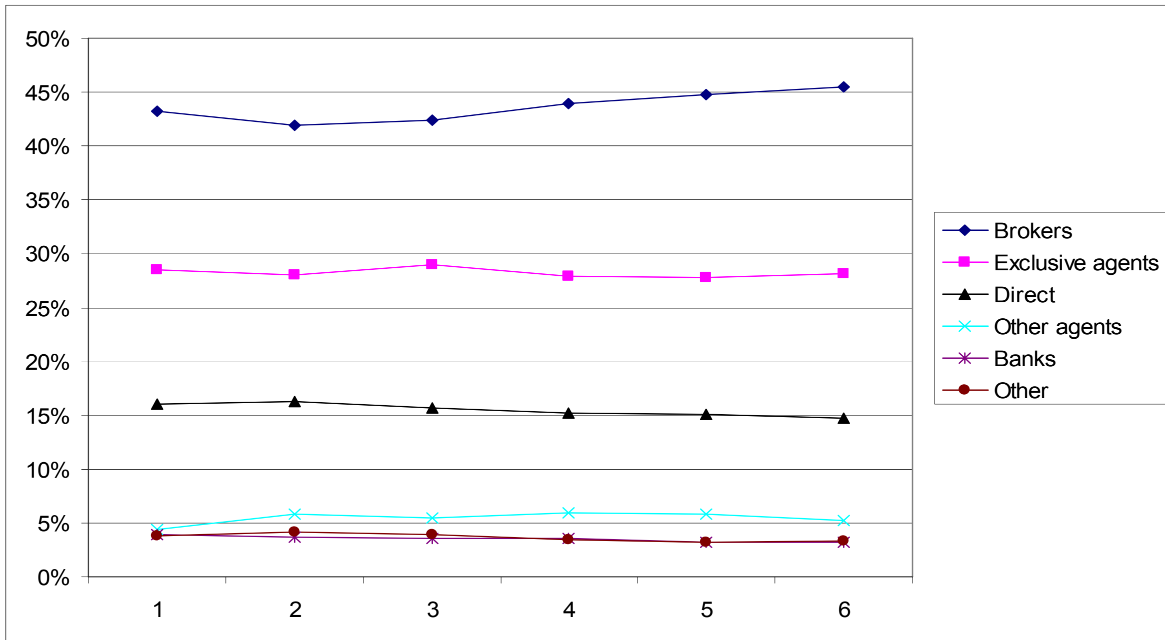
3.8. Insurance distribution channels (2005)





Source: CEA (2007). Note: The two charts include all EU countries reporting to CEA on insurance distribution channels.

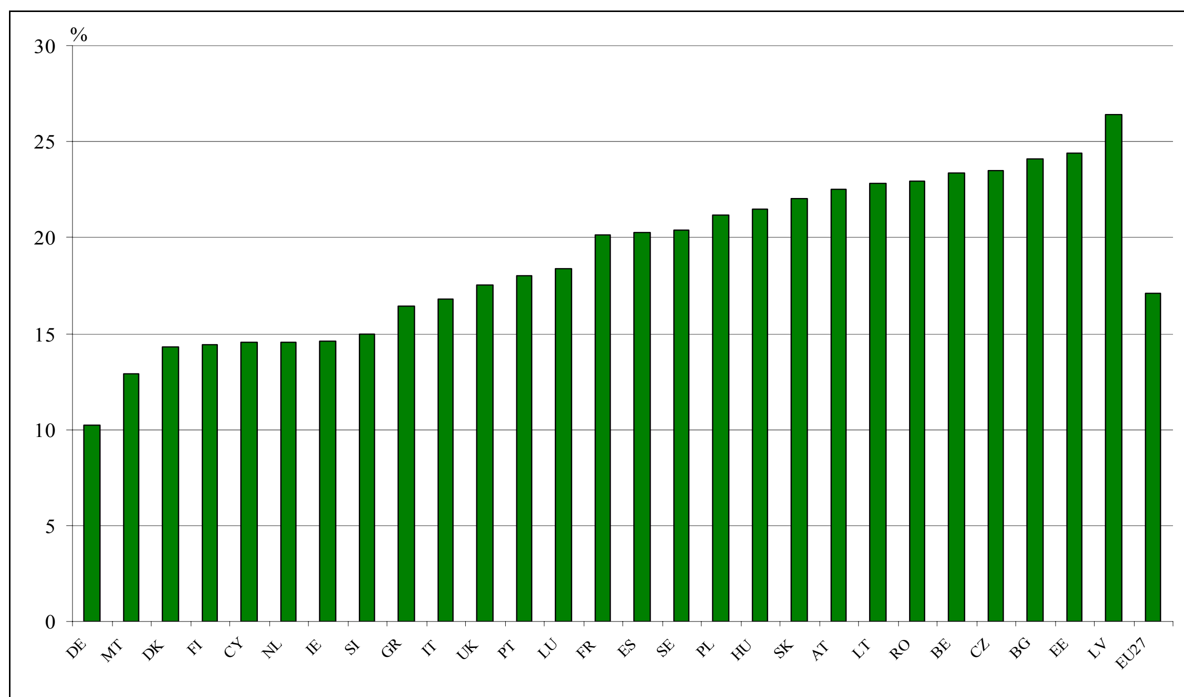
3.9. Market shares of different distribution channels in business insurance



Source: European Commission (2007c).

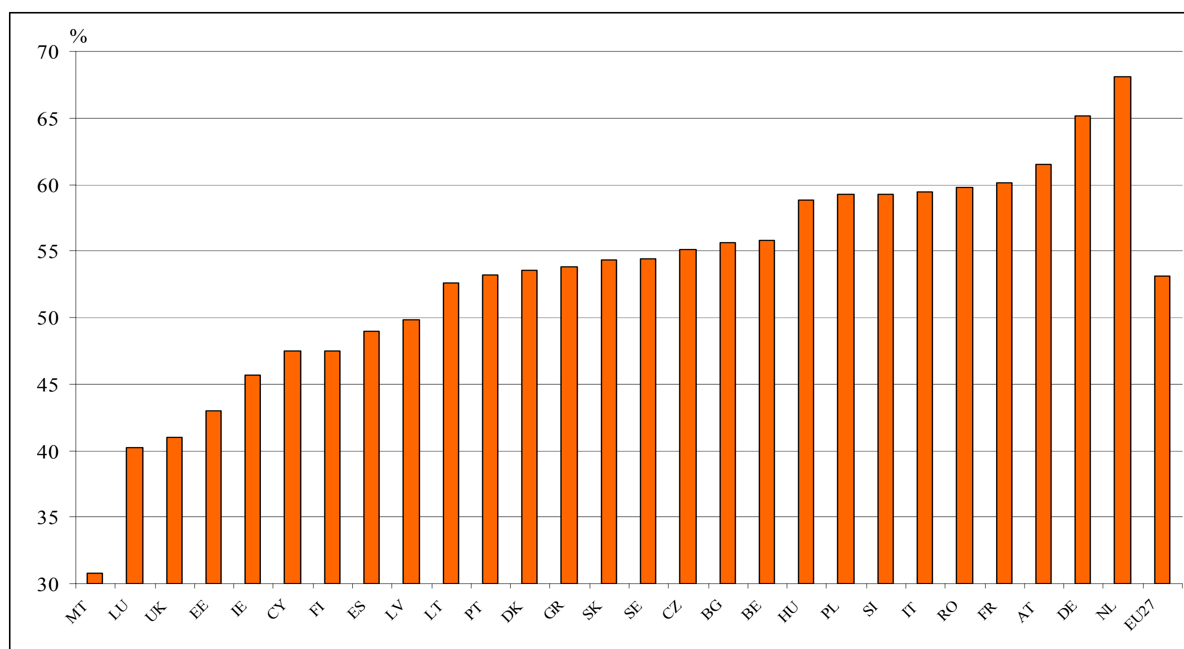
4. EFFICIENCY AND INNOVATION

4.1. Banking: return of equity (RoE) by Member State (2006)



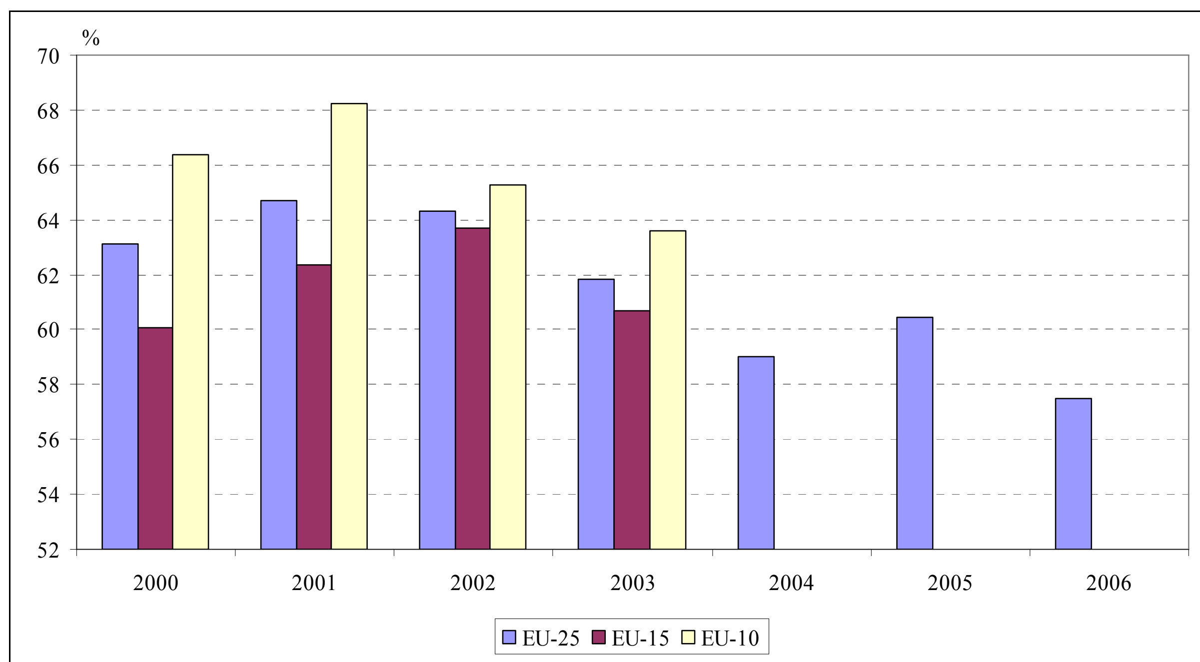
Source: ECB (2007f).

4.2. Banking: cost-to-income ratio by Member State (2006)



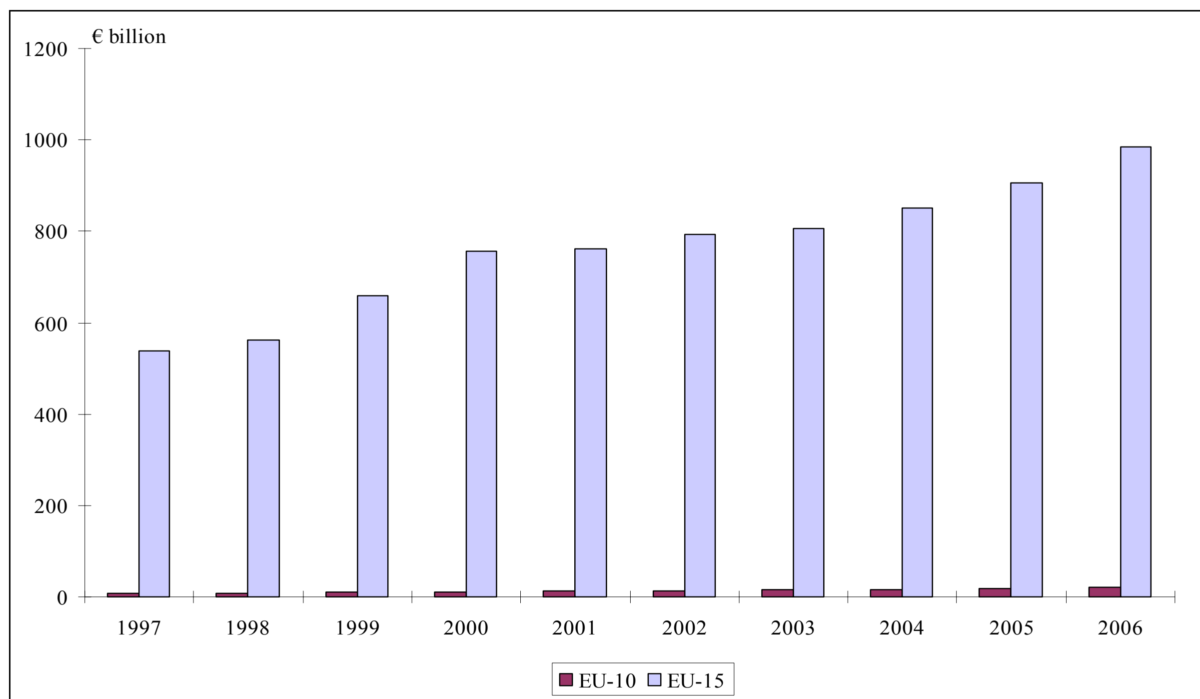
Source: ECB (2007f).

4.3. Banking: cost-to-income ratio - EU average



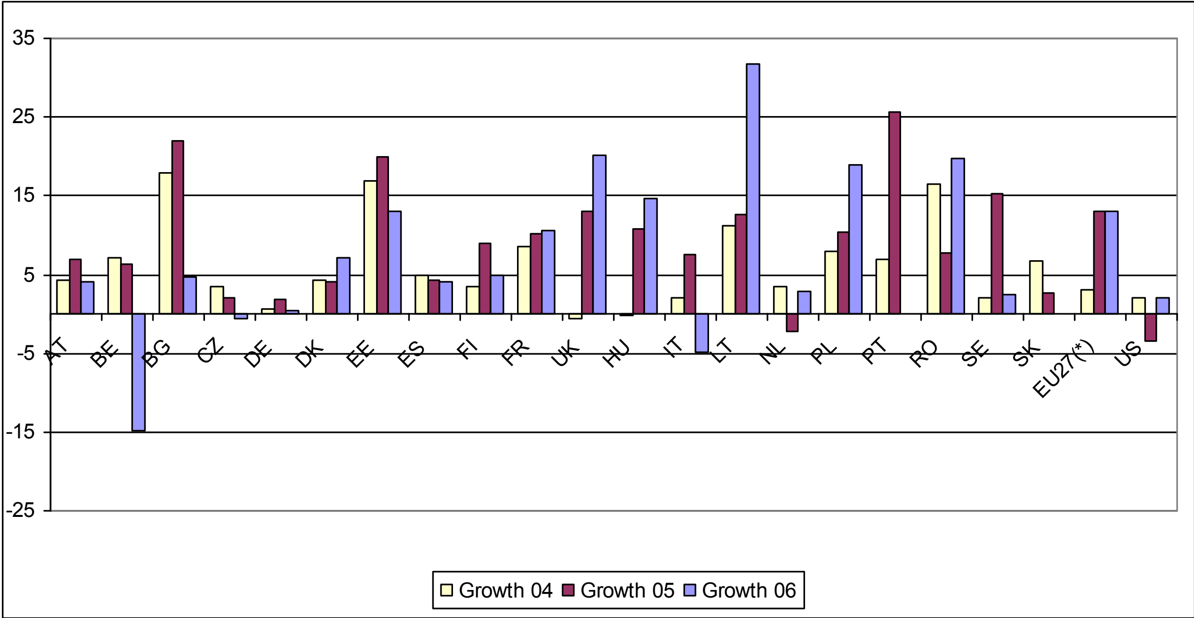
Source: BankScope (2000-2003 data); ECB, *Banking sector stability* (2004-2006 data).
Note: The cost-to-income data for 2004-2006 may not be comparable with previous years due to the change in accounting system. Moreover, the 2004-2006 data are only based on the IFRS reporting banks.

4.4. Insurance - total gross premium



Source: CEA (2007).

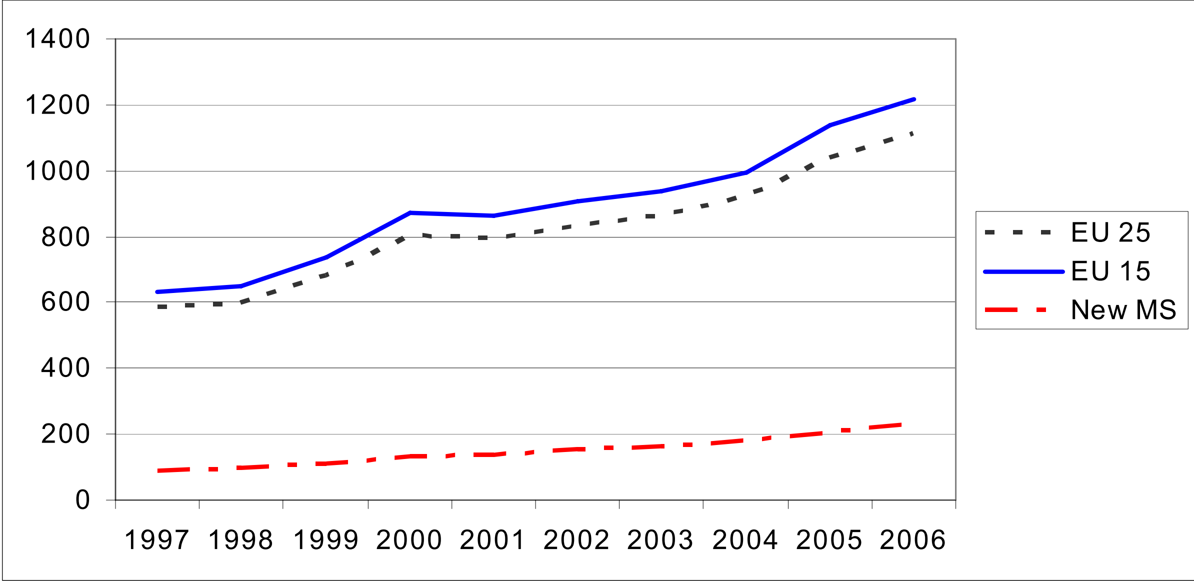
4.5. Annual growth rate of insurance premiums (2004-2006)



Source: SwissRe (2006), SwissRe (2007).

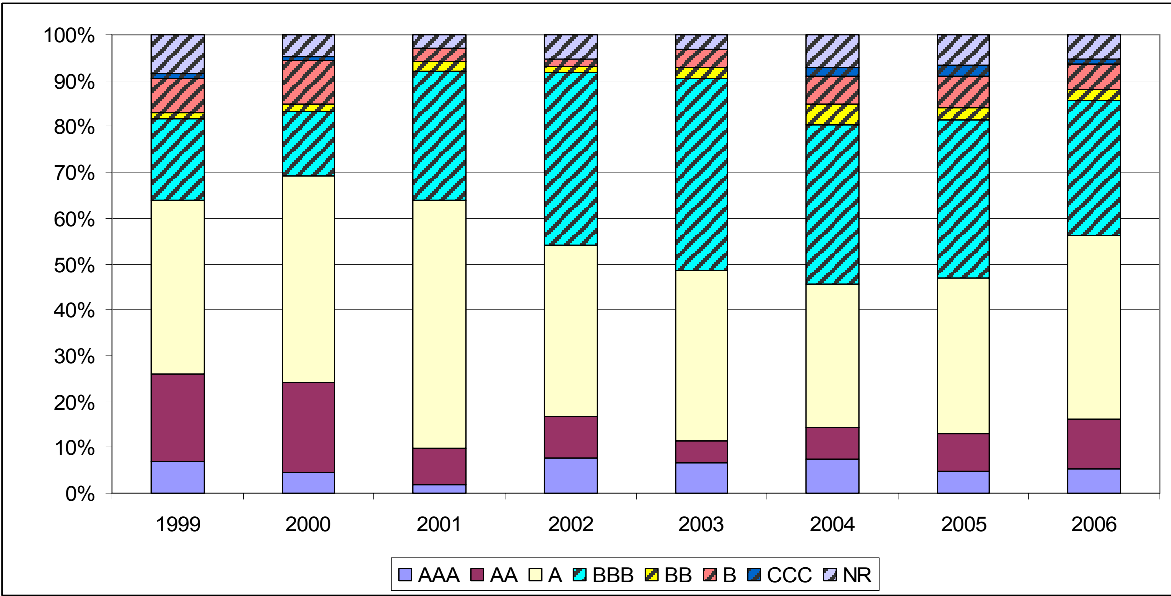
Note: In US $. 2006 figure for PT not available. (*) – 2004 figure refers to EU25.

4.6. Average premium collected per employee (in thousand euros)



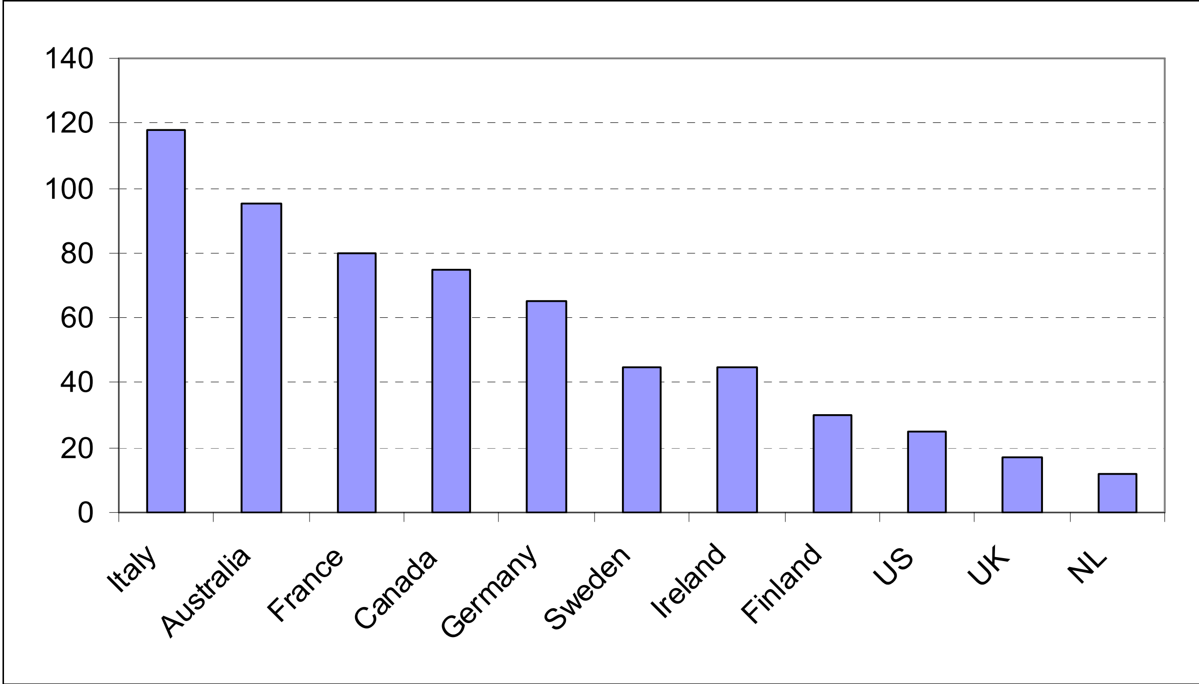
Source: CEA (2007).

4.7. Issuance of euro-denominated corporate bonds by rating categories



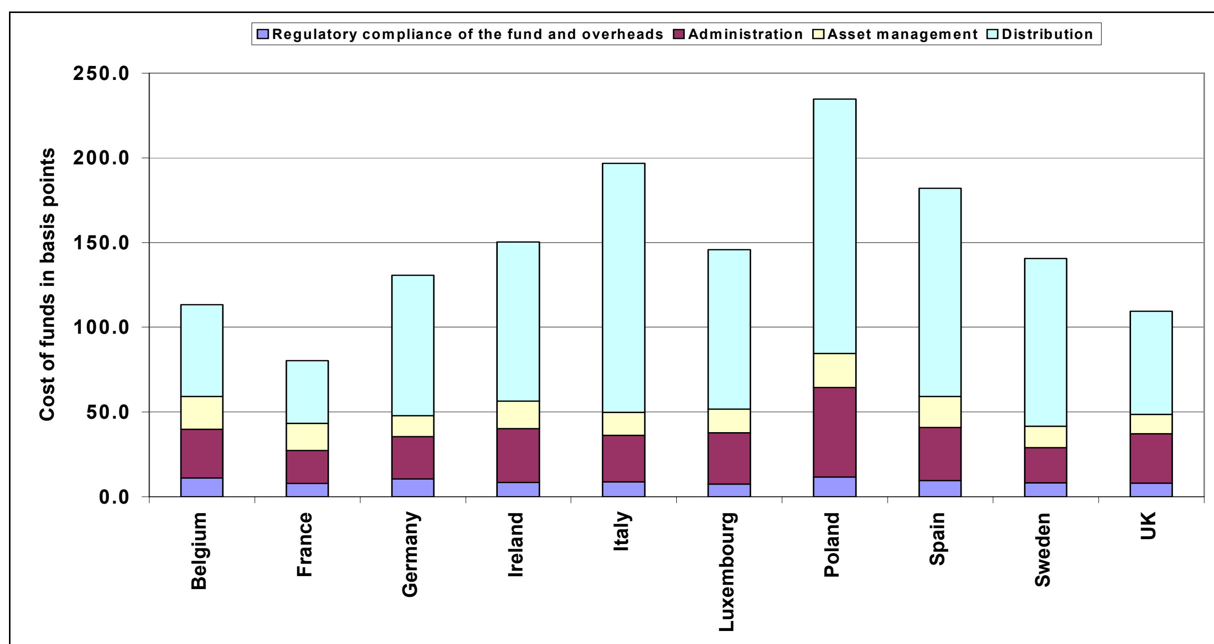
Source: European Commission (2007d).

4.8. Annual fees on a current account used by a typical median-income family, in euro (2005)



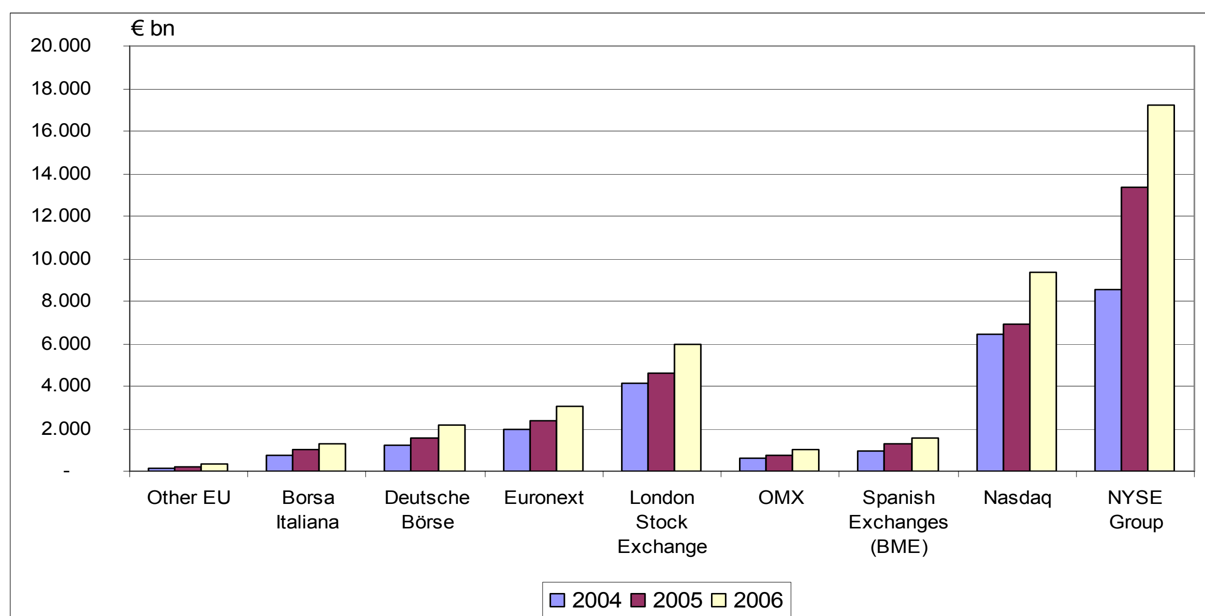
Source: Oxera (2006).

4.9. Comparison of total production and distribution costs for equity funds by Member State based on current average fund sizes



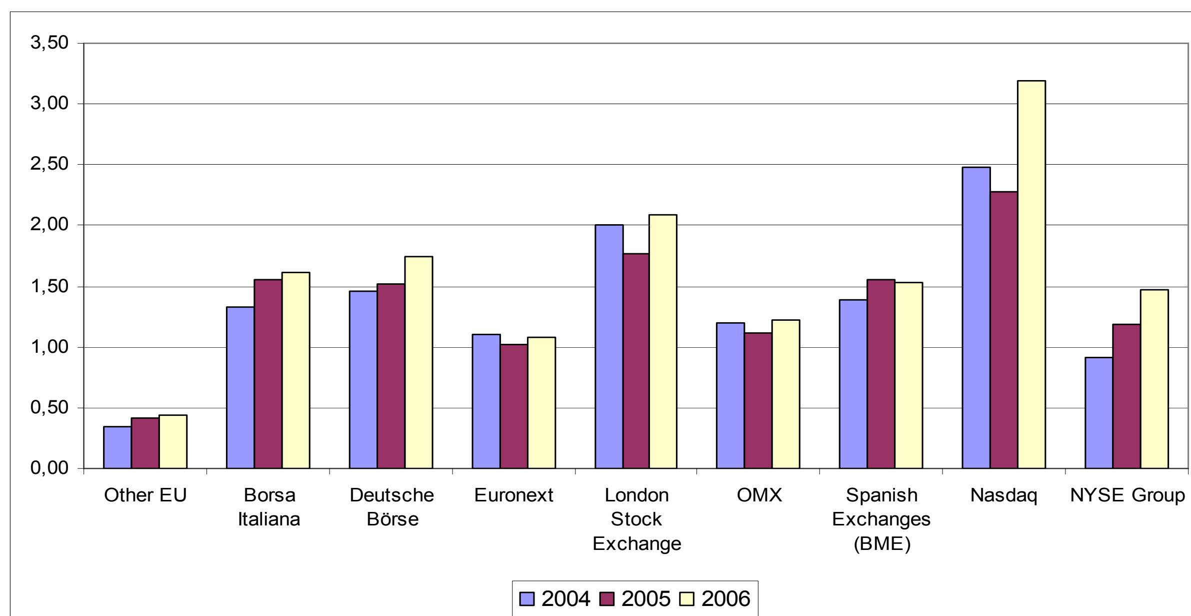
Source: CRA International (2006).

4.10. Turnover in selected EU and US stock exchanges



Source: FESE (2007a), WFE (2007), European Commission calculations.

4.11. Turnover ratio in selected EU and US stock exchanges

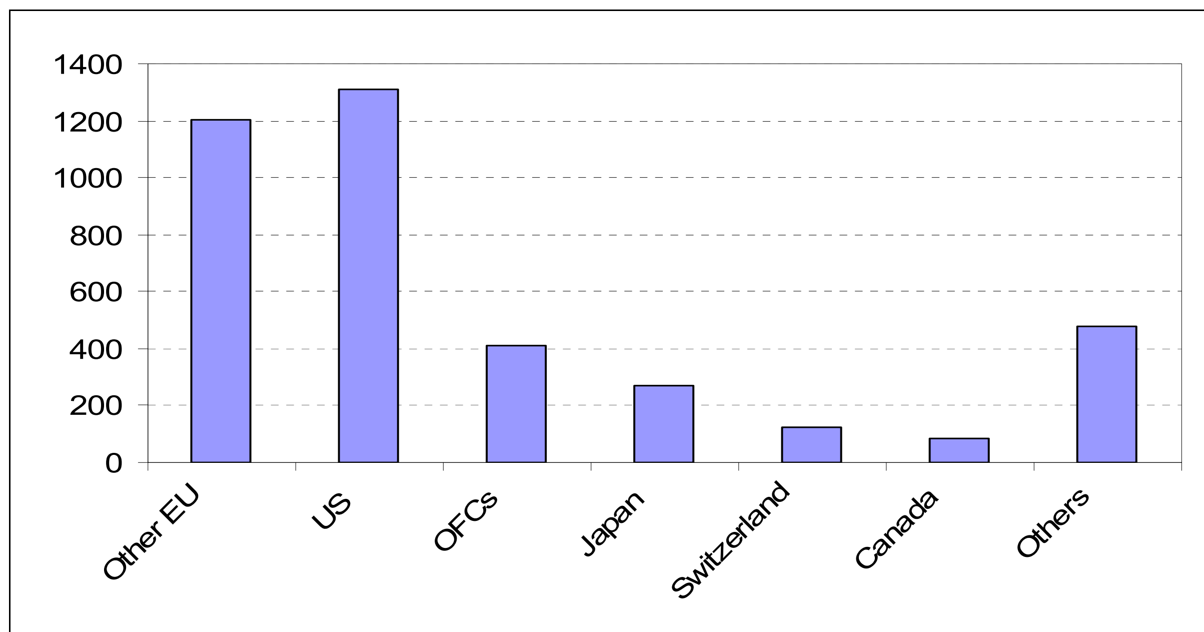


Source: FESE (2007a), WFE (2007). European Commission calculations.
Note: Turnover ratio is calculated as relation of total annual turnover to market capitalisation at year end.

5. FINANCIAL STABILITY

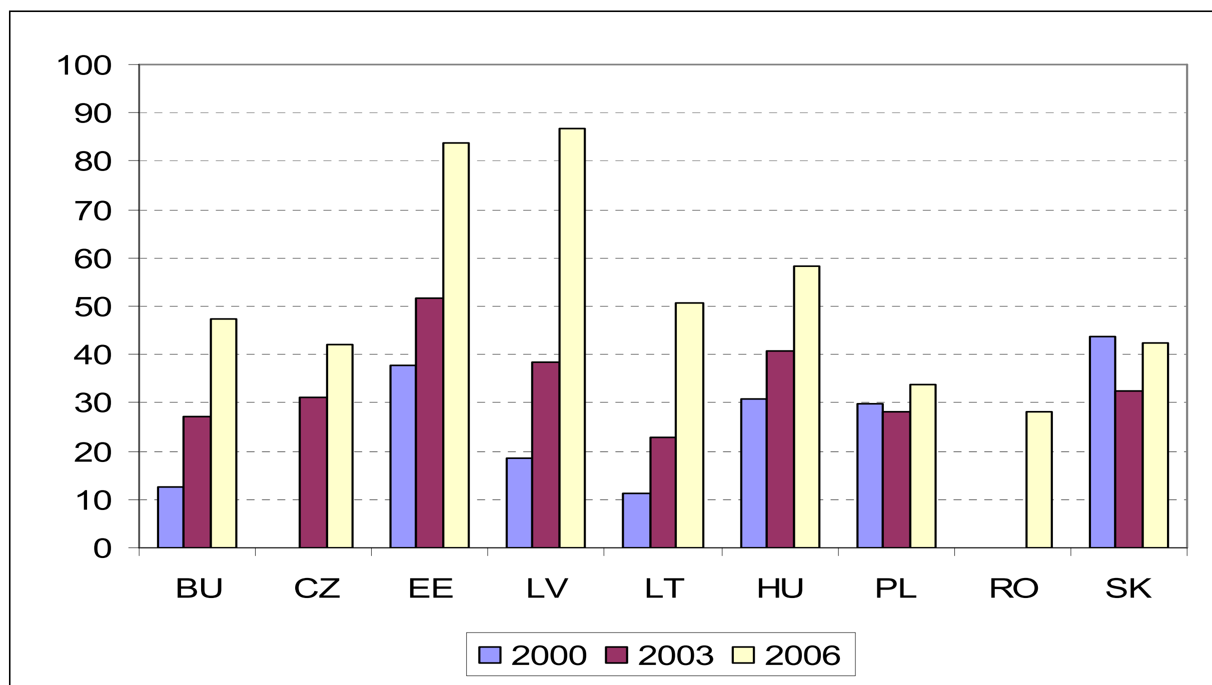
5.1. Outstanding amounts of Euro area portfolio investment assets (end-2005)

€ billion



Source: ECB (2007c).

5.2. Credit to the private sector as percentage of GDP



Source: ECB

6. ABBREVIATIONS

Member States

AT Austria

BE Belgium

BG Bulgaria

CZ Cyprus

CZ Czech Republic

DE Germany

DK Denmark

EE Estonia

ES Spain

FI Finland

FR France

EL Greece

HU Hungary

IR Ireland

IT Italy

LT Lithuania

LU Luxembourg

LV Latvia

MT Malta

NL Netherlands

PL Poland

PT Portugal

RO Romania

SE Sweden

SI Slovenia

SK Slovakia

UK United Kingdom

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.

EU15 the European Union before the 2004 enlargement

EU10 the 10 countries that became Member States in 2004

EU25 EU15+EU10

EU12 EU10 plus Bulgaria and Romania

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