Competition in the Financial Services in Europe today

Outline for the speech of Mr Jean-François PONS *

3rd annual conference on Retail Banking in Europe

Paris 4 and 5 March 2002

INTRODUCTION

- In modern economies:
  - Financial services play an important role for economic growth and citizens' welfare.
  - The greater the mobility of money - with adequate safety - the easier it is to finance the economy and the better the response to households needs (credit, investment, savings, insurance).
- At European level :
  - The financial sector represents 6 % of GDP
  - Money mobility goes with the dismantling of barriers between Member States, i.e. the creation of a real Single Market for financial services, where competition will play to the benefit of households and the European economy.
  - To reach that goal, very ambitious programme to harmonising rules, to allow for the creation of European actors and European-wide markets, as well as to ensure competition. Single currency represents a "quantum leap" in 12 Member States.
- Today, I would like :
  - First, to make some brief remarks on the relationship between regulation and competition ;
  - Secondly, to underline how European competition policy has played its part in line with the objective of the Single Financial Market ;
  - Finally, to give an assessment of the degree of competition and European integration in the financial services sector today and in the near future.

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* *The views expressed in this presentation are purely those of the writer and may not in any circumstances be regarded as stating an official position of the European Commission.*
The author would like to thank Maria Alessandra Freni for her assistance in drafting this speech.

1. REGULATION AND COMPETITION.

- Relationship between competition and regulation in the field of financial services is rather complex. Regulation is necessary to protect the interests of the players involved and to ensure the smooth and secure running of the markets. Competition is one of the objectives of financial regulation together with stability and sound and prudent management. It is generally acknowledged by academics, regulators and the players themselves that non-competitive markets are less efficient and have lower levels of innovation than competitive markets.

- From a competitive perspective barriers to entry resulting from regulation must be kept to the minimum necessary.

- Competition is also a form of regulation since it is based on specific rules and control on the part of public authorities. However, it is a form of regulation which is flexible as it is based on economic principles. Therefore, while the rules do not change, their application is tailored to the legal and economic facts of each case.

- Regulation must intervene in the case of market failure (that is to say when market forces are not able by themselves to achieve proper levels of efficiency, competitiveness and stability). A recent example of a regulatory intervention prompted by a market failure is <u>the EC Parliament and Council Regulation on cross-border payment in Euro</u> (19.12.2001) :
  A Commission survey of September 2001 showed that banks charges for cross border payments are very high and substantially the same as 1993, because banks did not put in place a good system at the European level. This regulation was adopted in 5 months. It requires banks to charge for cross border payments in the same way as national ones in order to enable to European citizens to take fully advantage of the single currency. Application by banks of high charges for cross-border payment in Euro restrict the opportunities of consumers and small business to take full advantage of the single currency.

2. EC COMPETITION POLICY: PRINCIPLES AND ACTION IN THE FINANCIAL SERVICES SECTOR.

- Historically, the banking sector has been less open to competition than other industries.

– Initially, it was due to reasons of safety. The need to safeguard depositors in order to avoid crisis of confidence led to a tight system of supervision and to a certain "solidarity" between bankers. In the banking sector the failure of a single undertaking may expose the other players to systemic risk because of the tie lending relationships existing between them and the solidarity within the financial world.

– The banking sector is also the preferred channel for monetary policy interventions. In the past, that involved meetings with the Central Banks and the adoption of a common reaction to the rise and fall of interest rates.

– Moreover, the banking sector has developed common tools to limit the risk; practices such as "tour de table" and pools do not - of course - stimulate competition.

- Today in Europe, this trend has declined and the system has become more competitive. First, the perspective of the single currency has significantly stimulated concentration between banks. Secondly banks have now diversified their activity; their core business is no longer represented by the traditional deposit taking and lending activity, but involves other products such as insurance policies, unit trust, asset management etc. Thirdly, the many banks have tried to expand their business outside national boundaries stimulating competition on foreign markets.

- The peculiarities of the financial sector do not exempt it from the application of common principles and rules on competition. **Consumers must be provided with a wide variety of high quality products that are competitively priced**.

- If prices are too high, if choice is too limited or if innovation is inhibited, consumers are not getting what they need from financial markets. These outcomes are typical of the situation where there is a lack of competition or an excess of market power. The basic tools at our disposal to fix these problems are the following.

  – **Antitrust control** (Articles 81 and 82) that prohibits restrictive agreements and concerted practices as well as abuse of dominant position.

  – **Merger control** (Merger Regulation n.) that is aimed at preventing that excessive concentration takes place.

  – **State aid control** (Articles 87 and followings) that ensures that State intervention in markets does not distort competition.

2.1. Antitrust control : recent developments.

- It took several decades before it became clear that the EC Treaty's antitrust provisions fully apply to suppliers of banking services. In 1981, in a preliminary ruling the Court of Justice got the opportunity to state this principle unambiguously. (Züchner case)

- More recently, the Commission has been investigating in to a suspected wide-ranging traditional cartel, the so called **Lombard club.**
  In 1998, Commission officials paid surprise visits to Austria's major banks. The Commission's preliminary position is that there was a highly institutionalised network of inter-connected committees where the participating banks met regularly to exchange sensitive information and, from time to time, to agree on prices and other elements of competition. The investigation is now coming to an end, and a formal prohibition decision can be expected in the near future. This investigation demonstrates the determination of the Commission to act against unlawful collusion in the banking sector.

- The Commission has also investigated **cartel cases regarding the euro conversion charges** for euro–zone currency notes.

- Shortly after the introduction of Europe‘s single currency, the euro, in January 1999, the European Commission‘ investigation has shown that about 140 banks and national banking associations in Belgium, Finland, Portugal, Ireland, Germany, the Netherlands and Austria may have engaged into **price-fixing arrangements** to either increase the exchange fees or control their decrease. It must be stressed that creation of the euro irrevocably fixed the exchange rate of the 12 EU currencies that are part of the single currency, therefore eliminating any exchange rate risk.
  Most of the banks announced to the Commission their intention to modify unilaterally their exchange fee structure so as to break with suspected cartel behaviour and to offer favourable conditions (sometimes even no fees) to the consumers. The change in behaviour by the banks ended the alleged infringements.

- However, in December 2001, the European Commission fined **five German banks** a total of € 100,8 million for fixing the charges for the exchange of euro-zone currencies. In a clear violation of European antitrust rules, the banks in 1997 colluded to charge no less than 3 % for the exchange of euro-zone banknotes to compensate for the abolition of the buying and selling 'spread' at the dawn of 1999 when the euro was launched. This behaviour caused direct and irreparable damage to consumers and also gave a blow to citizen's confidence in the European single currency. These five banks did not reduce their charges to make good vis a vis consumers as was done by other banks in Germany and in other Member States.

• **Payment systems** is an area in which the Commission is currently concentrating its attention. It gives rise to several problematical aspects for competition policy. In particular it requires competition authorities to strike a balance in order to ensure that restrictions necessary for the provision of payment services should be minimal and not allow financial operators to earn extra-profits.

  - The notifications by **Visa International** of its international payment card rules raises a number of competition issues. The cases are closely related to a complaint filed by EuroCommerce, an organisation of European retailers, among others against the Visa scheme.
    After a thorough investigation the Commission, on 9 August 2001, adopted a negative clearance decision on some specific provisions in the Visa International payment card rules. The provisions in the Visa Rules which are considered not to raise any problems under Article 81(1) EC are in particular the so-called no-discrimination rule (“NDR”) (a rule which prohibits merchants from surcharging cardholders for paying with the card) and the modified Visa rules on cross border issuing and acquiring**.** This decision is currently the subject of an appeal by Eurocommerce. Another provision in the Visa rules concerns the multilateral interchange fee (“MIF”) (a fee paid by the acquiring bank to the issuing bank, which is passed on in practice by the acquiring bank to the merchant). On this aspect, Visa has proposed amendments, involving a reduction in the level of the MIF, a change in its method of calculation to cap it at the level of relevant costs, and greater transparency as to its level and components. Previous to these proposed modifications, in October 2000, the Commission had issued a Statement of Objections on the Visa MIF. In light of the proposed amendments, the Commission published a notice in the Official

Journal on 11 August 2001, indicating its provisional intention to adopt a favourable position on the modified MIF, and inviting interested third parties to submit their observations. A number of comments have been received, and a substantive reply from the complainant, EuroCommerce. Having analysed these comments in detail to judge whether any aspect of the provisional favourable position needs to be changed in consequence, the Commission is in discussion with Visa on certain specific points. The notification from Europay raises similar issues and is also being examined.

- The recent economic and financial turmoil following the **events of September 11th** has given rise to concern also for competition policy. **Reaction to such events may lead to restrictions of competition**. With specific regard to the insurance sector the Commission is currently investigating whether the apparent reaction of aviation insurers amounts to an infringement of Article 81.

2.2 Merger control

- When we look at the consolidation process of the banking sector we can see that :

  - banks are mostly merging within national markets ;
  - very few banking mergers (only two out of 121 notifications in the last 10 years) have raised competition concerns ; this is clear evidence that markets are still far from being concentrated.
  - The **Bank Austria / Creditanstalt** merger (1997) raised competition concerns because the merged entity would have become not only the leading supplier of banking services in a number of product segments. However, Bank Austria gave undertakings to the Commission, which eliminated competitive concerns relating to the proposed merger. In particular, the group committed itself to sell its stake in Giro Credit and to reduce its participation in Österreichische Kontrollbank, a bank active in the area of export insurance and finance. In addition, Bank Austria undertook not to extend its influence in Investtkredit, a bank specialised in subsidised credits. Finally, with regard to the competitive concerns in the construction sector - arising from the fact that Bank Austria had close links with several large Austrian construction companies - Bank Austria undertook to sell its participation either in Universale or in Stuag (two of the largest Austrian construction companies).
  - The recently abandoned **Swedish bank merger** between **Skandinaviska Enskilda Banken (SEB)** and **FöreningsSparbanken AB (FSB)** also raised competition concerns. The Commission took the preliminary view that the deal would have brought together two of the leading Swedish full-service banks, creating the largest provider of retail banking services to households and SMEs in Sweden with market shares in a number of markets, in the range of 40-60%. The merged entity's large customer base together with its extensive bank branch network (over 1,000 branches) would have placed the merged entity well ahead of its closest competitors on the Swedish market. The two banks decided the withdrawal of the merger at an early stage and so the initial views of the Commission were never tested in a phase II proceeding, involving an in-depth investigation and hearing, and no discussion of remedies took place.

- In the field of merger control it is worth mentioning a particular business model known as ***bancassurance*** . This model, although not new, has gained some prominence in the financial services field recently. It involves the combination of a bank and an insurer. With State pension systems in Europe being increasingly complemented by private saving schemes, it has become vital for both banks and insurers to access as many "pension customers" as possible. A prominent example is the recent merger between **Allianz**, Germany's largest life and non-life insurance company and Dresdner Bank, Germany's third-largest universal commercial bank.
  Although the activities of the two companies presented very small overlaps, the Commission carefully examined the possible consequences of the merger given the strong distribution networks of both companies. It also looked at the new group's position on the new growth market for personal pensions. The Commission's examination led it to conclude that, while Allianz would improve its competitive position as a result of the 'bancassurance' alliance with Dresdner, there was no risk of a dominant position being created or strengthened. However, in the course of its review the Commission noted a large number of structural and economic links between the new Allianz/Dresdner group and one of its major competitors. The new entity gave appropriate undertakings to reduce its holdings and influence on other companies, enabling the Commission to clear the merger.

2.3 State aid control

- With regard to State aid policy in the banking sector, it must be emphasised that the Treaty is neutral as regards ownership. However, the Treaty prohibits all State aids which distort competition insofar as they affect trade between Member States. Few exceptions are allowed. All State aid projects must be notified beforehand to the Commission for it to assess whether one of the exceptions can be applied. Non-notified aid is illegal, and can be recovered.

- State intervention by way of direct or indirect subsidies has often been prompted by <u>the need to avoid serious bankruptcy of large national financial institutions</u>. State intervention is not the proper tool to avoid systemic risk and other negative externalities related to a bank failure. On the contrary State aid distorts competition and may harm efficiency and stability of the financial system.

- The Commission's activity in this field has increased dramatically during the mid 1990's and decreased since. A number of banks, mainly French and Italian, experienced difficulties, requiring State intervention. At the same time, liberalisation and market integration have increased the competitive pressures in the financial sector and made apparent the distortions of competition among banks.
  - **Crédit Lyonnais** and **Banco di Napoli :** these cases are important because they were a real test of Commission policy and determination in the application of State aid rules to banks in difficulty.
    The consequences of wrong management behaviour supported by State intervention may only emerge after a certain time. This gives the banks in question the possibility of pursuing aggressive policies for a longer period to the detriment of competitors more soudly managed

Therefore, the Commission requires State aid to banks to be coupled with radical restructuring plans, drastic divestitures and reforms to corporate governance. Shareholders must carry the burden of the crisis as far as possible, and the bank's management and control must be reviewed. Moreover, to redress the distortions of competition significant divestments have to take place.

- **Public guarantees** are a subject having a wide scope in several EU Member States, including in the area of financial services. These public guarantees constitute in principle state aid. However, since the majority of the cases in financial services constitute existing aid (existing already before the Treaty or the accession), no action for the past is possible. However, the guarantees should be brought in line with state aid rules. As an example let me quote the German case related to public guarantees for banks (**Anstaltslast** and **Gewährträgerhaftung**).

  – These guarantees grant the **Landesbanken** and the savings banks a competitive advantage vis-à-vis commercial banks in particular by reducing their funding costs. On 8 May 2001, the European Commission adopted a decision proposing to the German Government so called "appropriate measures" in order to make the guarantee system of Anstaltslast and Gewährträgerhaftung compatible with the State aid rules of the EC Treaty. The German authorities (July 2001) fully accepted the proposal which is based on the following principles : 1) Gewährträgerhaftung will be abolished, 2) Anstaltslast will be replaced by a normal owner relationship between the owner and the public financial institution concerned, and 3) transitional arrangements will allow the financial institutions concerned to restructure their activities and organisation in view of the changed legal and economic environment.

3. COMPETITION AND MARKET STRUCTURE TODAY AND IN THE NEAR FUTURE :

3.1 MORE COMPETITION AT NATIONAL THAN AT EUROPEAN LEVEL

- Especially in the retail-banking sector (which includes account and lending facilities, mortgages, payment services) factors such as linguistic barriers, advantages deriving from proximity and local branch networks may have discouraged the entry of foreign operators. Until the adoption of the single European currency, exchange rate risk may have represented an obstacle to cross-border operation. Penetration of markets has been realised more by way of acquisition of local banks than by setting up of branches or direct provision of services.

- Consolidation is closely linked to the re-shaping of Europe's economic landscape following the introduction of the euro. We have not seen the same number of megamergers that have occurred in the US banking sector. Almost all bank mergers examined by the Commission have so far been cross-border operations, meaning operations involving companies from at least two different EU Member States or companies located in third countries generating a certain turnover inside the Community. As already mentioned just two of them gave rise to competition concerns.

- The other cases did not present competition concerns for the following reasons:

  – there are a large number of international suppliers for the wholesale banking or for financial services related to capital markets. Customers therefore appear to have sufficient choice and, barring unlawful collusion, there are no concerns as to restrictions of competition. This conclusion was drawn for example in the merger between Schweizerische Bankgesellschaft (SBG) and Schweizerischer Bankverein (SBV), which merged their activities into UBS and at that time created the largest banking institution in Europe;

  – several banking concentrations assessed by the Commission involved companies which had no or only very minor activities in the EEA (for example Kyowa/Saitama or Bank Americana/Nationsbank);

  – in a number of cases (such as the Deutsche Bank/ Bankers Trust merger) the operations in question were largely of complementary nature since the companies lacked substantial overlaps.

- As I mentioned earlier, so far retail banking mergers have largely been domestic as opposed to cross-border. In France and Germany, in particular, few foreign institutions have made inroads into the retail banking sector. In other Member States such as Italy the presence of financial operators from other EU Member States is more marked. Several reasons may explain this evolution.

  – Risks within a single Member State seem already fairly well diversified and diversification would therefore not increase greatly by entering into a neighbouring country.

  – In addition, it may be thought that synergies and efficiencies can be achieved more quickly and more easily by domestic mergers. Last, but not least, cultural, language, legal, regulatory and tax barriers are felt to impose higher costs on international as opposed to domestic mergers.

- Finally, for a true single market, it is of utmost importance to ensure a secure, transparent and efficient restructuring of financial services, be it on a national or cross-border basis. Here comes the question of "**national champions**". If strong domestic institutions are further strengthened by government intervention, there is a risk that existing competitors will be weakened and potential market entrants will be discouraged. Such a situation could foster market segmentation and present an obstacle to the opening up of financial markets.

- **The BSCH/Champalimaud** Case. The Commission has made it clear that any intervention by Member States concerning mergers which fall within the Commission's jurisdiction must be based on one of the recognised "legitimate interests" (public security, plurality of the media and prudential rules) or notified to the Commission for its approval. The Commission established a clear reference point for any possible similar case in the future.

  – In any event, most domestic banking mergers so far have lacked Community dimension; meaning that the Commission does not have jurisdiction and the examination has to be left to the Member State concerned. Thus, the Banco de Santander/Central Hispano or BNP/Société Générale/Paribas cases did not fall under the jurisdiction of the Commission and were examined at the national level

3.2 Expected changes

- **Expected benefit from the introduction of the Euro**. In retail banking: markets at present national will gradually be widened to cover the whole Euro zone. The Euro, in combination with the introduction of new technologies, will enable banks to compete for retail deposit business in countries where they have no physical presence. On the asset side, within the Euro-zone, lending operations in any Member State can be financed from deposits obtained in any other Member State. Competition in homogenised segments of the loan market, where direct customer contact is less important (consumer credit, standard mortgage loans) should therefore intensify.

- **New technologies** have resulted in new instruments for the supply of financial services; with regard to some services location is becoming less important. New technologies together with liberalisation of some financial activities (exchanges, clearing and settlement systems) have increased the degree of internalisation of financial markets). That should lead to de-nationalisation and increased competition at national level.

- The **modernisation** of the European economy requires speeding up the processes of **liberalisation** and structural reforms in order to make our markets more efficient. On **15 February 2001** the **Committee of Wise Men on the Regulation of European Securities Markets**, chaired by **Mr Lamfalussy**, published its final report. Its terms of reference were defined by the European Union's Economic and Finance Ministers on 17 July 2000. With the aim of achieving a truly integrated European financial market, the three main elements of its terms of reference were:

  (a) To assess the current conditions for implementation of the regulation of the securities markets in the European Union;

  (b) To assess how the mechanism for regulating the securities markets in the European Union can best respond to developments underway on securities markets and

  (c) In order to eliminate barriers and obstacles, to propose as a result scenarios for adapting current practices in order to ensure greater convergence and cooperation in day to day implementation, taking into account new developments in the market.

- In its report the Committee underlined that public policy should focus on competition issues in European Securities markets and on removing impediments which make consolidation difficult. The policy objective is to facilitate competition between different stock exchanges and trading infrastructures, thereby unleashing market forces favourable to the establishment of an efficient securities infrastructure. This can only be achieved by ensuring **open access** and **interoperability of networks**. While the major force for liberalisation will come from Internal Market Directives, the parallel application of the competition rules is also crucial.

- Against that background and given that DG COMP was already examining this sector, it extended its examination by launching a formal in-depth ex officio inquiry at the end of March 2001. It is the first time that such a large-scale antitrust examination of **the clearing and settlement sector** has been undertaken.

  – DG COMP is focusing its examination on open access and interoperability. Concerns have been expressed about exclusive arrangements between exchanges and central securities depositories. As regards interconnection, efficient links between Central Securities Depositories (CSDs) would enable other CSDs to compete more efficiently on settlement services for certain types of securities and make cross-border settlement more efficient.

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CONCLUSIONS

- At the **Lisbon European Council in March 2000** the European Union set itself the ambiguous target of becoming the most competitive and dynamic knowledge-based economy capable of sustainable economic growth with more and better jobs and greater social cohesion. The commitments included the realisation of the Single Financial Market in 2005. At the **Barcelona European Council** the European Union will seek to give to that target a renewed boost.

- **Financial integration is a fundamental building-block of the integrated European strategy to achieve the objectives set at the Lisbon Council**. An integrated financial sector will lower the cost of capital for 18 million businesses in the EU, increase our global competitiveness, help develop our SMEs and drive down the cost of financial services for consumers. There will be social benefits too: better pensions, higher returns for individual investors, more venture capital available for innovation.

- Good progress toward integration has been made in certain areas.

  – Together with the final changeover to the single currency a major step has been made towards a Single Payment Area by adopting the **Regulation**, which I have mentioned before, to reduce bank charges for **cross border payments in euro**.

  – In some market segments, **financial instruments** have been **standardised** across the Union. Prices are similar. The **eurobond and corporate bond markets** are well integrated.

- But there is still major work to be done in other areas.

  – To complement the single currency, Europe's financial industry needs one set of common rules, including a single set of **accounting rules**, so that there is proper and transparent disclosure to the market. In the wake of the collapse of Enron, we can see how important this is.

  – In the **mortgage** and **corporate loans markets**, there is a substantial lack of convergence in the prices of services.

- The integration process is also far from complete in the **retail credit market**.

- For securities, **rules** on **market abuse**, **prospectuses** and **collateral** need to be adopted quickly.

- The **Investment Services Directive** needs to be reshaped for a new era of trading and cross-border investment services.

• And in some areas we have not seen any progress at all:

  - The **Take Over Bids Directive** was rejected after 12 years of negotiation. The Commission will table a revised proposal around May. Here the European Union must find an equitable deal so that there is a real "level playing field" in the Union.

  - The **Pension Funds Directive** is stalled. Yet it is vital for providing funds for an ageing population - and for agreeing prudential-risk spreading rules.

• Lisbon set a clear strategy to open the financial services market. This was taken forward in the Commission's Financial Services Action Plan. The agreement now reached on the Lamfalussy proposals offers a chance to speed up work in this area, consistent with the FSAP objectives. Reform should also focus on other aspects of the Lamfalussy report, including consultation, prioritisation and proper use of all four "levels" of decision making (framework directives, comitology, agreement among competent authorities and enforcement), The principle of subsidiarity should be respected.

• In this contest competition policy will continue to play its part. Among all the means given to the European institutions to achieve the objective of a single integrated financial market, the application of competition rules is without doubt one of the most powerful. Where we find unlawful collusion or excessive concentration or unacceptable state interference in market mechanisms, we will not hesitate to use the power granted to the Commission.

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