The single European market: survey of the UK financial services industry

In February 1988, the City Liaison Committee[1] *commissioned a survey by the Bank of England on preparations within the UK financial services industry for the completion of the single European market. The survey, which was carried out in the period February to November 1988, was based on a written questionnaire and on a series of follow-up interviews with a sample of respondent firms.*

The primary purposes of the survey were to raise awareness within the UK financial services sector of the planned completion of the internal market in Europe, and to promote a dialogue about it between financial institutions and the authorities. Partly by means of the survey, it was hoped to build up a body of data on related issues, to ensure that the UK authorities were fully aware of the concerns of the UK firms, and therefore better able to advance UK interests most effectively in the development of European Community legislation.

This article[2] *is a synthesis of the Bank's report on the replies to its written questionnaire (some four hundred responses were received from a wide range of suppliers of financial services) and on its bilateral discussions with fifty-three of these institutions.*[3] *The article concentrates on major themes emerging from the survey and is mainly, and deliberately, a synthesis of market views. It concludes with a Bank assessment on certain key issues.*

General perceptions of the single market for financial services

The Bank's survey revealed a diversity of opinion among market practitioners about the likely effects of the move to create a single European market in financial services, and hence different views on the most appropriate corporate response. Few firms perceived the single market process as an entirely new phenomenon; most expected it rather to give added impetus to current trends in European (and global) financial markets. It was generally accepted that any major effects would occur only gradually over a period of years, not as sudden or dramatic changes in the demand for financial services, or in the nature and organisation of the firms supplying them.

The survey indicated that financial institutions in the United Kingdom were generally positive about the likely effects of '1992'. Firms broadly accepted the view that the creation of the single market would boost general economic activity in Europe to levels which would have taken significantly longer to achieve without it. Most firms expected an increase in competition for business, but on balance thought there would be more opportunities for UK financial institutions as a result of the single market process.

Responses suggested that the psychological impact of the single market programme on the overall business environment could prove to be at least as important as the direct impact of any legislative changes. Increased awareness generally was expected to prompt many firms to reassess European markets and their strategies towards them. This might result in consumers and suppliers of financial services discovering hitherto unexploited opportunities as well as identifying new opportunities arising specifically out of the creation of the single market.

Firms generally expected that the Community legislation aimed at opening up markets and reducing restrictions on foreign participation would draw markets closer together. However, the development of anything like a true single market for most financial products was thought unlikely for some years. It was expected that a genuine single market would develop first in major corporate financial products; firms acknowledged, however, that the market for much wholesale business was already global and would be unlikely to be affected significantly by the changes in the European Community. At the other end of the scale, the majority of practitioners surveyed judged that the retail financial markets in Europe would remain fragmented for many years, despite the removal of a number of basic legal restrictions on market entry.

(1) The City Liaison Committee, chaired by the Governor of the Bank of England, brings together the chairmen of the main City associations on an *ad hoc* basis to discuss strategic issues of City-wide importance.
(2) Prepared by Nicola Harrington in the Bank's Financial Markets and Institutions Division on the basis of the Bank's single market survey report.
(3) The full report (dated May 1989) is available from the Bank's Information Division.

Impact on consumers of financial services

Institutions naturally expected their strategies to be heavily influenced by their customers' needs. The effects of the single market on consumers of financial services were expected to be highly diverse. It was generally thought that the requirements of the large/multinational corporations would not change markedly since such organisations would continue to satisfy many of their financial needs in the international wholesale markets. Respondents thought that the most significant changes would be in the finance requirements of the small and medium-sized corporations. Many such firms, it was thought, might feel a need to restructure as a consequence of market developments, either to exploit new opportunities or to defend existing business, and would thus need corporate financial services and assistance in mergers and acquisitions. A number of the institutions surveyed saw this group as perhaps the most homogeneous and potentially susceptible to a Community-wide approach in some areas of business. Small and medium-sized corporations had not hitherto been a prime focus of attention, despite the fact that they represent a major part of the market, but many more financial institutions seemed to be developing an interest, and competition for this segment of business was thus expected to increase significantly.

Many firms surveyed believed that, in the longer run, the retail financial markets (very small businesses and the personal sector) could be the most affected by single market legislation, largely because these sectors were currently among the most restricted and fragmented. Even so, it was thought that a Community-wide market for retail financial services would be slow to develop except in a very small range of products. A number of reasons were put forward to support this view. 'Cultural' differences in consumer taste and habit were believed likely to persist, making it difficult for foreign institutions to design products to meet local preferences and still harder to find products with a Community-wide marketability. Moreover, even after the implementation of relevant EC legislation, suppliers expected barriers to the provision of retail services in foreign countries would remain: for example, many firms thought they would find difficulty in obtaining access to distribution systems. Opportunities for successful direct cross-border selling and delivery in such a diverse region as Europe were generally judged to be limited at present. On the other hand, acquisition of a large-scale retail network in a target region was considered too expensive by most practitioners, particularly since the shortage of such networks available to purchase was likely to force the price up to a significant premium over real worth. Collaboration agreements, involving the use of local organisations' marketing and distribution channels, were thought likely to present other difficulties. Only in a relatively limited range of financial activities (eg card-based products) was it considered possible to develop products for the Community market as a whole. However, a number of institutions were considering other possible ways of achieving economies of scale, for example, through centralised management control or computer processing, or development of pan-European branding.

Regional markets

Firms were not expecting to see the removal of all obstacles to market entry in the near future, but nevertheless most believed that continental European markets would become easier to penetrate. A number of firms were already assessing the business potential of various EC countries. Although perceptions varied depending on the type of business in which institutions were involved, in general France, Italy and Spain were cited as being particularly attractive markets for the sale of financial services. While French financial markets were judged more mature than those in Italy, the size and wealth of both countries attracted interest, and firms saw opportunities to exploit their competitive advantage, eg in international finance, treasury management, merger and acquisition activity and insurance. Opportunities were also perceived for a variety of retail services, provided ways could be found to overcome the difficulties referred to above.

Spain too was considered by many to be an attractive market. While not at present as large or as prosperous as France and Italy, it was thought to have the most growth potential among the Community's less advanced economies. This view was reinforced by the policy of the Spanish authorities of encouraging inward direct investment and by the relatively open nature of Spanish financial institutions and markets. Practitioners recognised, however, that there might be a risk that some financial firms would be led into ill-judged investments in the rush to share in the development of this new market.

The obvious attractions of the size and wealth of the German market were commonly cited; moreover, a number of people felt that UK institutions had certain skills and products which were superior to those offered locally or for which demand in Germany could grow significantly (eg pension fund mangement and life assurance, and some kinds of banking and securities products). However, while firms by no means intended to ignore Germany, most were aware of major obstacles to foreign penetration of that market, for example the corporate shareholding structures, long-established banking relationships, local market practices and the conservative approach of consumers. Consequently, many firms seemed to feel that they would achieve a more rapid and higher rate of return on their investment elsewhere in Europe.

Most of the smaller EC states were mentioned as having particular attractions for at least some institutions, although their small size and/or development potential suggested they were likely to receive less attention from UK firms overall at this stage. The exception, of course, was Luxembourg, which had clear fiscal and regulatory attractions, particularly for fund management and eurocurrency business, as a base for Community-wide marketing.

Opportunities and threats

On balance, financial institutions based in the United Kingdom apparently considered that the changes brought about by '1992' would result in more opportunities than threats. However, most institutions were conscious of a number of risks inherent in the completion of the internal market. Certainly, the impact of deregulation on firms already functioning in EC markets, coupled with the arrival of new operators in some sectors, was widely expected to increase the overall level of competition in the European financial services industry. Firms considered that competition would intensify among local institutions within some national markets as well as between firms of EC origin in European markets as a whole. However, there was a widely-held view that major—even the main—competitive pressures, particularly in banking, securities and insurance, would come from institutions based in Japan, the United States and possibly Switzerland. Japanese institutions were judged to be the most powerful competitive force in several sectors, partly because their strong capital bases and relatively low domestic cost structures gave them scope to adopt a longer-term corporate strategy and to price their services very competitively (helped in some measure by cross-subsidisation).

A number of other sources of increased risk were cited. In particular, institutions surveyed suggested there might be a tendency among some corporate consumers, as well as suppliers of financial services, to feel they ought to be 'in on 1992'; this could lead to corporate reorganisation based less on a realistic assessment of opportunities and threats than on a feeling of pressure to respond in some way to '1992'. The risks, it was felt, might also be increased by the arrival in some sectors of new participants in recently deregulated sectors who might be relatively inexperienced, and in a few cases even unscrupulous. It was thought quite possible that some of these negative effects, particularly of increased competition, could appear before the potential benefits began to be felt.

UK financial markets

While expecting an increase in financial market activity and competition in Europe overall, many firms tended to regard the United Kingdom as an exception in certain respects. Indeed, some believed that, since the UK markets were already open and highly competitive, and most foreign operators wishing to be here were already established, the single market would stimulate only a marginal increase in competition and total financial activity in the United Kingdom. A contrary view, however, was that increased competition would result from non-EC firms wishing to use the United Kingdom's well-established, deregulated markets as a European base or stepping stone from which to move into other Community markets. Moreover, it was argued that UK financial institutions were more susceptible to the threat of takeover than their competitors in some other European states where shareholding structures and voting arrangements, *inter alia*, made hostile takeovers virtually impossible for practical purposes. A number of firms also expected increased competitive pressures as a result of efforts by established players to diversify their activities. Building societies, for example, were coming under pressure from banks (UK and foreign) in the housing loan market, just as banks were facing growing competition in normal banking services from building societies. There was also increasing interest from large institutions in the provision of private banking services to high-net-worth individuals, which was intensifying the competitive pressures on some smaller niche operators.

Broadly speaking, those sectors of the UK financial markets which appeared most confident of their ability to handle increased competition were banking, insurance and fund mangement. This was partly because of the degree of competition which already existed in these sectors, and because of confidence in the United Kingdom's established high levels of capacity, expertise and service in these areas. UK insurance companies nevertheless saw some threats to their business, but mainly in the form of possible takeovers by large foreign institutions rather than competing products or services. The majority of securities firms apparently expected increasing pressure primarily from institutions of US or Japanese origin rather than from Community-based firms. A very few building societies saw an opportunity to compete in continental housing finance markets, but they were more concerned with the possible increase in inward competition for domestic business.

On balance, firms considered that experience of a deregulated environment meant the United Kingdom would be well placed to compete in a Community-wide market. It was felt, however, that the United Kingdom needed to make efforts to retain its competitiveness, and that the authorities needed to ensure that the regulatory environment did not reduce the attractions of the UK market. At the time the survey was being carried out, a great many firms criticised the Financial Services Act (FSA) in this context. (The FSA is discussed in more detail below.)

Corporate strategies

Responses to the survey revealed a considerable improvement during the course of last year in UK financial institutions' awareness about '1992'. By the second half of the year, when bilateral interviews were being held to follow up the written questionnaires, many more institutions appeared to have grasped the need to inform themselves of EC legislative developments, and to begin formulating a response to impending changes. Clearly some firms were much nearer to establishing a single market policy than others, but few had at that stage developed any definite European strategy. Many felt this was impossible, and indeed inappropriate, until the likely form of the relevant legislation became apparent and until their customers (particularly corporate ones) had decided upon the strategy they would adopt in the internal market. However, most of the financial institutions interviewed indicated that they did not at this stage expect to alter dramatically their basic strategy in response to the moves to complete the internal market.

There was, however, some general discussion about possible strategies for '1992'. The strategies of the largest European banks, for example, were expected to remain unchanged, and these institutions were expected to continue to compete across much of the Community in a wide range of activities. The majority of UK organisations interviewed in this group thought that, *ceteris paribus* (and leaving aside the possible long-term deterrent of a comparatively strict regulatory regime), they would retain their principal base for pan-European and wider international business in this country, perhaps with limited local representation in other EC centres. Interestingly, even some non-UK Community institutions involved in banking and securities activities felt there were advantages, at least at present, in running much of their international business out of London rather than their home base. A number of Japanese and US banks and securities houses indicated that for the time being they would continue to base their European operations in the United Kingdom, albeit with a presence in certain other Community markets.

In the main, the large firms were not expected to seek cross-border mergers with, or acquisition of, other similarly large institutions; purchases of smaller competitors or complementary niche acquisitions were thought more probable. Apart from a natural desire to retain independence, managements stressed the enormous practical problems associated with implementing large-scale, cross-border corporate combinations—for example, the difficulties of blending different financial, corporate and mangement cultures. There was a widely-held perception that such differences were often significantly greater between financial institutions (particularly banks) than between commercial or industrial organisations.

Mergers or collaboration arrangements were thought to be more likely to take place between second-tier financial institutions, which might adopt this approach for defensive reasons, to enable them to compete against larger organisations, or alternatively as a positive move to pool complementary resources (such as skills or outlets) in order to do business more effectively across Europe. Firms thought that mergers and acquisitions and co-operation agreements of this kind were most likely to succeed where there were opportunities to combine sales of complementary financial products or services. It was thought that such arrangements might in many cases involve institutions from the same country.

True niche players were expected to be the most responsive to changes arising from the creation of the single market in financial services. Firms thought that niche firms would tend to be more willing to move their base of operation in order to exploit particular opportunities, or to avoid some increase in costs, which they might be less capable of absorbing than a larger firm.

Financial institutions selling retail products and services were expected to have to continue to adopt a market-by-market approach, since it was believed that Community retail markets would remain fragmented for some time. Local acquisitions, mergers or co-operation arrangements were expected to figure prominantly among the various strategic options considered, partly because of the advantages perceived in having access to national skills and expertise, and also because firms viewed a local distribution network as critically important, particularly in retail banking and personal insurance.

Practitioners' concerns

Practitioners mentioned a number of concerns, both general and specific, about aspects of the single market process. There was a general concern about the overall impact of EC legislation, the major fear being that, in spite of its derestrictive intent, it might increase rather than reduce restrictions on business activity, particularly in areas where there had previously been few or no controls on market entry or operating standards. However, given that the United Kingdom already has one of the most developed and comprehensive financial regulatory regimes in Europe, practitioners were of the view it should benefit from some levelling-up of the playing fields in the Community financial markets.

At the time the survey was carried out, firms cited various concerns relating to particular features or principles in a number of directives; many of these problems have since been addressed. On the question of permitted activities, institutions were keen that the lists in both the draft Second Banking Co-ordination Directive and the draft Investment Services Directive should be similar, as a means of avoiding any disparity in the competitive position of institutions licensed under either directive. This point was taken on board in revisions to the draft directives. A related concern was the limit in the Second Banking Directive on credit institutions' shareholdings in non-bank institutions. While firms agreed there might be sound prudential and other regulatory reasons for this, some banks saw it as an unwelcome restriction on their activities, which could inhibit their response to changing market conditions.

There was fairly widespread concern among institutions about the complex issue of the appropriate division of supervisory and enforcement responsibilities between 'home' and 'host' country authorities. UK institutions feared they might be disadvantaged because of the differing nature and rigour of the various regimes elsewhere in Europe.

An issue of considerable concern was the possible treatment of reciprocity, a provision for which has been introduced into a number of draft directives affecting financial services. The majority of firms felt it was in the United Kingdom's interests for the European Community to remain open to institutions from third countries, and many people pointed out that possible retaliatory action from non-EC countries could prove extremely costly for the United Kingdom. On the whole, firms believed that some form of reciprocity provision was inevitable (eg in the Second Banking Co-ordination Directive and the Investment Services Directive), but generally thought this should be a reserve power. The reciprocity clause in the draft Second Banking Co-ordination Directive has since been substantially revised, and is now much more flexible and less automatic than the original draft clause.

The Financial Services Act

Concern was also expressed about aspects of UK legislation which it was felt might place UK firms at a competitive disadvantage *vis-à-vis* their continental European competitors, particularly the Financial Services Act. At the time of the survey this gave rise to widespread criticism on a number of grounds, not least the high costs associated with establishing and running compliance arrangements.

Firms criticised capital adequacy requirements for securities underwriting and trading under the FSA, and the perceived complexity of the rules for calculating these requirements, which it was felt restricted firms' flexibility to respond swiftly to market developments. More fundamentally, the principles behind the FSA were widely considered to be based on an unreasonable assumption of homogeneity between those whom it was designed to protect, with insufficient distinction between 'retail' and 'professional' business.

Notwithstanding the many negative comments, there was considerable diversity of opinion about the FSA's overall impact on the attractiveness of the United Kingdom. It was thought that some smaller organisations might be driven out, and that some institutions might be deterred from coming to the United Kingdom. However, most of the larger banks and securities firms of UK, US and Japanese origin who were already here considered that the general attractions of the United Kingdom as a base for international financial business outweighed any adverse impact of the FSA for the time being, although the balance could shift over time.

Since the time of the survey, the SIB has been working on revisions to the draft rulebook, in parallel with amendments being made to the FSA, with the aim of reducing the complexity of the regulations and requiring account to be taken of the costs of regulation in establishing an adequate degree of investor protection.

Taxation

Aspects of both UK and Community taxation gave rise to a number of concerns. The idea of a Community-wide withholding tax—which has since been shelved by the Commission—was particularly criticised by banks and securities firms. As far as the UK taxation system was concerned, firms generally recognised the relatively low corporation tax rate as favourable, but were critical of the restricted availability of tax deductions in the United Kingdom compared with elsewhere in Europe. The main general concern was the impact which differential tax treatment in the EC might have on takeover possibilities, particularly *vis-à-vis* countries such as France and Germany where accountancy practices or disclosure requirements made it more difficult to value companies accurately for takeover purposes.

More specifically, there were widespread calls for the abolition of stamp duty on transfers of shares of UK companies, whether to UK residents or foreigners, (not payable on transfers in the United Kingdom of foreign companies' shares). In the context of general insurance, there was concern about the Inland Revenue's view that accruing liabilities for outstanding claims should be discounted for tax purposes; continental European practice does not generally require such discounting. Many insurance companies also felt the absence of tax relief on compulsory equalisation reserves and on catastrophe reserves (likely to be made compulsory) placed them at a disadvantage *vis-à-vis* their competitors in some European states where such reserves were eligible for tax relief. Life assurance companies were particularly concerned that the Inland Revenue's proposed tightening of the tax regime (notably in relation to capital gains reserved for policy holders) would disadvantage them at a time when they were trying to enter new markets in the EC. However, the proposals which gave rise to these concerns were not, in the event, included in the package of measures announced in the 1989 Budget.

Unit trust operators identified a number of instances of fiscal disadvantage *vis-à-vis* certain other Community countries. They had a specific concern about differences between the tax treatment of umbrella funds based in the United Kingdom and those based elsewhere. These concerns were addressed in the 1989 Budget: the tax treatment of umbrella funds was made consistent, while on UCITS there were efforts to make UK-based schemes more competitive by removing the tax disadvantages through reduction of the corporation tax rate from 35% to the basic rate of income tax. This especially helped bond funds, the group most disadvantaged by the old system. In the context of investment management, a particular difficulty cited was the potential tax liability for overseas residents which remained despite provisions of the 1985 Finance Act designed to relieve the tax liability of investment managers acting for overseas clients—the uncertainty meant that such business could be lost to UK investment managers. Finally leasing companies felt disadvantaged compared with other EC competitors because of lower tax allowances in the United Kingdom for cross-border leasing.

The consultation process

In the course of the survey, firms were asked for their views on the efficiency of the system for consultation on single market issues between the authorities and market practitioners, and on the adequacy of information dissemination from government departments, the Bank of England, trade assocations and the EC Commission. The information and consultation processes (including the circulation of draft legislation for comments, correspondence and direct discussions between the authorities and practitioners) appear to have just about met the requirements of financial market practitioners hitherto. However, as firms have become more aware of the potential significance of the single market, the desire for material has grown and the demands on the UK authorities and the Commission have become more pressing.

Bank of England assessment

Several encouraging points emerged from the survey. As might be expected, financial institutions in the United Kingdom generally seemed to be adopting a constructive approach to the single European market and the majority were taking appropriate steps to inform themselves. At the same time, they were in the main developing strategic responses based on a realistic assessment of prospective market changes. This pragmatic approach should help to avoid the principal potential pitfalls, such as a rush of new investment based more on fear of missing the '1992 boat' than on a sound analysis of the markets.

However, this broadly encouraging picture should not lead to complacency. By no means all firms surveyed were at the same level of awareness of, or equally prepared for, '1992'. Some clearly required a more effective approach, beginning with an effort by management to educate themselves more about the single market. It was apparent that a number of firms had considered only the external implications of '1992': certainly, some of the firms with no aspirations at present to expand business elsewhere in the Community did not appear to have considered fully the potential impact on their domestic UK market.

The existing openness of UK financial markets may mean that they are less likely than other national markets to experience a sudden intensification of competition. However, in certain sectors, increased inward competition is already occurring and is likely to intensify; the growth of foreign interest in mortgage-backed credit in the United Kingdom and in securitisation of mortgage-backed assets is an example. Increased inward competition both from other EC and from non-EC financial institutions would be welcome in expanding consumer choice and in stimulating greater efficiency in the UK financial services industry. However, established UK firms should not underestimate the possible effects on their own operations and market position.

The increasing competitive pressures on financial institutions, coupled with the arrival in some sectors of new participants, will tend to raise the level of risk in the markets, although this may be seen as a normal feature of such a process of economic adjustment. However, it will increase the need for firms to ensure that their own control systems are effective. Regulatory authorities, too, will need to be that much more vigilant, although a pre-condition for the single market in such areas as banking and securities business is that there should be minimum common standards for authorisation, supervision and capital adequacy. It will be important, however, to maintain an appropriate balance between high standards of prudential supervision and investor protection, on the one hand, and the need to avoid any unnecessary or unduly complex or expensive requirements on the other. In this connection, the SIB has already initiated its review of certain aspects of the FSA, in particular conduct of business and other rules.

The consultation process between market practitioners and the authorities appears to have worked adequately thus far but needs to be strengthened to take account of the increasing demands for information and help. However, it would probably be inappropriate for the authorities to aim to produce comprehensive analyses and commentaries on every detail of EC legislation and single market opportunities (as some practitioners urge): practitioners are likely to be better placed to judge the implications and commercial opportunities in their own fields of operation. Moreover it is important that this should be a two-way process. Practitioners should further their efforts to understand the single market process themselves and can lobby for their own interests, while the UK official sector should continue to seek to meet reasonable demands for information, consultation and advice. The Bank welcomes any practical suggestions for improving arrangements.