European Financial Integration: Finally the Great Leap Forward?

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1) Introduction

Ten years ago, Story and Walter (1997), in their detailed study of European financial integration, concluded that a 'European financial area under a common regulatory framework and authorities still lies ahead' (313). More recently, Charlie McCreevy, internal market commissioner, said that Europe has made 'real progress' on financial integration (McCreevy 2006). Grahl and Teague (2005) claim that 'The financial integration policies launched by the EU are a remarkable success' (Grahl & Teague, 2005: 1018). In fact, since 2000, following the Lisbon European Council summit, the European Union (EU) has seen a flurry of legislative and regulatory activity with regards to integrating financial markets and services across the continent. According to one Commission official, finance is the only area where real progress has been made on the Lisbon Agenda, which aims to make the EU the most productive economic region in the world by 2010 (interview, Brussels, 6 July 2005). The process of integrating European financial markets and services has even been compared to the 1992 Single Market project (Quaglia, 2007: 281). Interestingly, financial services were supposed to be liberalised as part of the 1992 Single Market project. Yet, in spite of the complete elimination of capital controls in the EU in 1990 and the agreement at Maastricht to create a single currency for Europe, very little progress was achieved during the previous decade. Story and Walter (1997) argued that national differences in regulatory regimes and market structures – what the authors called the 'Battle of the Systems' – represented a fierce obstacle to the liberalisation of financial services and the harmonisation of financial regulatory practices and rules across the EU.

Given the importance that financial integration represents for Europe in terms of ensuring that its economy remains internationally competitive and continues to prosper, which is essential for maintaining the EU's political legitimacy, we need to understand how the achievements in this policy area have come about. How do we explain that within a period of ten years, the EU has apparently been able to overcome national differences and interests and foster the transnational integration of financial markets and services? It is not sufficient to examine progress in policy-making, however, we also need to consider the actual effects of these supranational legislative and regulatory advances on financial services markets.

There is a difference between de jure liberalization and de facto integration. This difference has usually been overlooked by the extant literature so far. Political scientists have tended to confine their studies to European regulatory convergence and supranational legislation while economists have concentrated their efforts on measuring the degree of financial market integration in Europe. Although we acknowledge that there has been significant progress in the area of regulatory integration, we argue, however, that judging the success of the EU's regulatory integration depends – unsurprisingly – on the criteria used for
measuring success. This requires also taking into account what happens on the ground, i.e. at the market level.

In the rest of this paper, we will first look at the various criteria for measuring integration and show that there is no consensus as to whether a 'level playing field' has been achieved in European finance. The second section explores different explanations to account for remaining discrepancies between regulatory and market integration. The final section concludes on the continued existence of Story and Walter's (1997) 'Battle of the Systems', albeit one that has shifted and is more subtle than ten years ago. Consequently, the complete integration of Europe’s financial services markets will remain elusive for some time.

2) The Great Leap Forward?

The degree of financial integration in Europe has been measured in one of two ways until now. First, one measures the level of legislative and regulatory activity regarding financial services at the EU level. Hence, with the adoption of the Financial Services Action Plan (FSAP) by the Lisbon European Council in 2000 and the ensuing legislative and regulatory measures that have been adopted by the EU, one concludes that European markets for financial services are finally being integrated. This is the point of view usually adopted by political scientists, who are preoccupied with explaining the recent flurry of legislative activity at the EU level. The problem with this analytical focus is that it assumes that financial market integration directly follows from supranational legislative activity. It also assumes that regulatory convergence between member-states actually follows from EU legislation, which is not necessarily the case as Story and Walter (1997) remind us. As any student of public policy knows well, there is usually a gap between the intent of a law or regulation and the actual policy outcome. Distortions arise at the policy implementation and enforcement stages.

The second measure of financial integration examines the degree to which markets are actually converging. At the simplest level, this is done by looking at the level of internationalization, however defined. Looking at European markets, analyses have tried to figure out whether prices for financial services are converging and their movements correlated across national markets. This is the focus that economists have adopted with respect to European financial integration. The problem here is that little regard is given to policy convergence and supranational legislation at the EU level. Many of the analyses look at data that cover the 1990s and early 2000s, with no consideration for the FSAP. A lot of the focus is actually on the introduction of the euro. In sum, there is a need to integrate both regulatory and market measures of financial integration in order to understand the extent to which Story and Walter’s (1997) ‘battle of the systems’ is really over.

*European Financial Integration: Policy-making Perspective*
The FSAP proposed by the Commission in 1999 and adopted by the Council in 2000 is the starting point of Europe’s new wave of progress in terms of integrating financial services across the Union. Although the Single Market programme included financial services, there was a sense that little had actually been achieved by the mid-1990s, as Story and Walter (1997) point out. This was confirmed by an EU study conducted by a London-based private research institute (Economic Research, 1997).\(^1\) The report concluded that the impact of the Single Market was weak at best and probably negligible, little or nothing had changed except for wholesale markets. As a result, the Cardiff European Council, held in June 1998, asked the Commission to reflect upon the means to improve the Single Market in financial services. The Commission’s response was the FSAP.

The FSAP contained 42 measures relating to the integration of wholesale and retail financial markets.\(^2\) The deadline for the adoption of these measures was set for 2005, although it was moved forward to 2003 following the adoption of the Second Lamfalussy Report (see below) in March 2001. In practice, however, planned legislative measures were completed by 2005. These include several ‘heavy-weight’ changes on investment services, retail banking and prudential supervision. Maybe one of the most important elements was the extension of mutual recognition to investment services. The original directive, adopted in 1993, included enough holes to prevent any effective home country control, maintaining de facto both home and host country control (Story & Walter, 1997: 266-269). The new directive was adopted in 2004 and finally accepted the principle of ‘home-country control’ for investment services. At the same time, two directives on market abuses and prospectuses were adopted to simplify procedures for issuers offering securities across the EU. A regulation endorsing the International Accounting Standards Board’s International Financial Reporting Standards was also adopted in order to facilitate cross-country comparability of publicly-listed firms’ performance. Measures were also taken to harmonize the definition of collaterals and to unify markets for pension funds. In terms of retail financial services, the Single Market Review had been particularly critical about the little progress that was accomplished in this area. Thus, the FSAP wanted to ensure consumer protection and information in order to encourage cross-border service provision in retail banking. Another EU directive aimed at reducing prices of cross-border retail payments has also been adopted. As for the supervision of financial services, while it is generally accepted that national authorities are not to be substituted any time soon, cooperation has been strengthened with the creation of a Committee of European Securities Regulators (CESR).

A major innovation has taken place in the regulatory structure in financial services. After a relatively long consultation process (2000-2001), led by a

\(^1\) See also Hurst et al. (1999).

\(^2\) A little over half of these 42 measures ended up as actual legislation (regulation or directive). The remainder took the shape of Commission communications or recommendations (European Commission 2007: 21).
committee of ‘wise men’ under the chairmanship of a former central banker, Alexandre Lamfalussy, a new governance structure was set up in June 2001. The general idea of the Lamfalussy Process is that politicians in the Council and the European Parliament (EP) only adopt broad policy guidelines, while detailed regulations and rules are decided over by expert committees. It is a response to the perceived shortcomings of submitting highly technical legislation to the EU’s co-decision procedure. For example, the latter was made responsible for the impossibility of reaching a final agreement on central issues like the single passport for investment services (Varone et al. 2006: 4). Moreover, it was set up as a way to complement the parallel efforts undertaken under the FSAP in order to speed up the pace of reform (Grahl and Teague 2005). The new four-level system is based on the ‘extensive use of comitology and consultation with market practitioners and end-users’ (Varone et al. 2006: 5). This process would also make it easier to respond quickly to new developments in securities markets. So far, four directives have been adopted under the new architecture in the area of securities regulation. It has recently been extended to banking and insurance, though in the latter case the structure has not yet been set up.

According to Fonteyne (2006), the ‘supranational legislative phase of the FSAP was largely completed by 2005, but implementation at the national level is expected to take several more years’. This view was confirmed by the European Commission’s (2005a) White Paper on financial services:

Regrettably, the rate of transposition of Community law by Member States within agreed deadlines is poor. Member States need to demonstrate real commitment and deliver proper implementation on time. Enforcement mechanisms need to be strengthened and joined-up across the Member States (5).

In fact, the Commission acknowledged that its priority, in terms of EU financial integration, for 2005-2010 had to shift from legislation to implementation and enforcement. This repositioning was a direct result of findings by specialist groups (on banking, insurance, securities and asset management) set up by the Commission in 2003 to ‘take stock’ of the FSAP (e.g., Expert Group on Banking 2004: 2; Securities Expert Group 2004: 2).

As of May 2008, virtually all FSAP directives had been transposed into all EU member-states’ national laws. 60 per cent of the member states had transposed 100 per cent of all directives, while only two scored under 90 per cent.3 This was a major improvement from the assessment that took place in May 2005, whereby 35 per cent of the directives whose deadline had already passed had been

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3 These were, moreover, the newest member states, Bulgaria and Romania. See http://ec.europa.eu/internal_market/finances/docs/actionplan/index/directive_en.pdf (accessed 6 May 2008).
transposed by less than 80 per cent of member states (about 60 per cent on average).  

However, near complete transposition does not mean that rules are now the same across member states or that they are applied equally across the EU. For instance, the Asset Management Expert Group (2004) indicated that ‘Some of the legislative measures adopted at EU level have not been as effective as expected. In some instances, […] provisions which are intended to open markets have been watered down or suffer from ambiguities which hamper consistent implementation’ (14). A specific example of this situation is the Takeover Directive, which was so watered down by the EP and Council that it ended up with many opt-outs as a result. Because member states have taken full advantage of these opt-outs, the directive has been considered a failure (Financial Times, 2 March 2006). In fact, this is the major weakness of directives vis-à-vis regulations: they allow more leeway to member states in implementing EU legislation.

In the case of regulations, this particular legislative instrument was chosen as it was essential for their proper working that the provisions contained therein were applies exactly the same in each Member State. Whereas with the directives, Member States were freer to reconcile achieving a level playing field for financial services in Europe with their national particularities (European Commission 2007: 21).

On the other hand, precisely because of their greater transposition flexibility, directives are easier to agree upon by EU member states than regulations. Therefore, the political imperative to complete FSAP measures by the initial deadline of 2005 may explain in part why most of the agreed-upon legislative

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5 Directive 2004/25/EC.


7 It is interesting to note that the Commission, in its first FSAP evaluation, recommended that regulations as opposed to directives should be used more often in the future: ‘Where possible, use regulations in order to ensure a level playing field in financial services and avoid Member States adding extra measures (‘goldplating’)’ (see Recommendation 6 in European Commission 2005b: 24). However, in a revised version of the Commission’s FSAP evaluation, following comments from governments and interest groups on the first report, Recommendation 6 was weakened as follows: ‘Assess the appropriate use of regulation or directive on a case-by-case basis’ (European Commission 2007: 22). This new wording is justified as follows: ‘responses varied from those who strongly endorsed the use of regulations as a means to ensure that each member state’s application of the legislation was identical, to the opposite end of the spectrum, with one national authority [emphasis added] calling for directives to be the only instrument used’ (European Commission 2007: 21).
instruments took the form of directives.\(^8\) This perceived need to complete the FSAP as planned may also explain why some of the measures adopted by the EU are considered to be less effective than expected (European Commission 2007: 28).

But even if directives (or regulations for that matter) are transposed in a similar fashion across member states, it does not mean that their language is not ambiguous enough to allow their actual implementation to differ from one country to another. A good example of this is the Banking Directive.\(^9\) Article 19 of the directive allows competent national authorities to block mergers and acquisitions (M&As) of banks in order to ‘ensure sound and prudent management of the credit institution’. A well-known example of this prerogative is the efforts deployed by the Italian central bank to thwart the acquisitions of two Italian banks by Dutch ABN Amro and Spanish BSCH in 2005, without any justifiable reason other than to prevent foreign banks from acquiring domestic banks. Freixas et al. (2004) argue that the Banking Directive,\(^10\) though making it possible for banks to offer their services anywhere in the EU, still allows host-country regulators significant discretion in imposing specific rules and procedures (regarding M&As, consumer protection, reporting, taxation, etc.) to protect the national interest, which more often than not has had a tendency to favour incumbent domestic banks. This is why they conclude that ‘as long as host-country regulation applies, then integration will be impeded’ (484). On the issue of cross-border M&As, following the above-mentioned Italian case, the Commission proposed a new directive in September 2006 that would amend the Banking Directive (as well as other similar directives dealing with insurance services) in order to ‘improve clarity and transparency in supervisory assessment and help to ensure a consistent handling of M&A request across the EU’.\(^11\)

It is clear that the FSAP has been a huge success on the legislative front, with all 42 (21 of which were legislative) measures adopted by 2005, as originally planned. However, in order to get to a complete picture of Europe’s financial integration, one needs to look beyond the mere fact that a regulation or directive exists but also consider its content, its implementation and enforcement, as well as its impact on markets. Before the FSAP in 1999, there were several initiatives by the EU to integrate the provision of financial services across the member states. But those legislative attempts had only limited success (Story and Walter 1997). Although a complete review of all of the FSAP’s legislative measures is

\(^8\) According to European Commission (2007: 21), of the 42 FSAP measures, 21 were directives while three were regulations.


\(^10\) The reference here is to an earlier version of the directive: Directive 2000/12/EC.

beyond the scope of this paper, the above analysis clearly shows that the current endeavour to foster the integration of European financial markets is fraught with the same difficulties as before in terms of implementation and enforcement. The Commission is aware of these shortcomings and is making continuous efforts to remedy the situation, but it takes time and depends on the willingness of the member states, which maybe more difficult when it comes to retail financial services than wholesale ones.

As a result of the FSAP, the Lamfalussy Process and the legislative activity that followed at the EU level, several scholars have studied the process of European financial integration in terms of regulatory convergence that has taken place since 2000 (Bieling 2003, 2006; Mügge 2006; Quaglia 2007, 2008; Posner 2007; Story 2005). Their goal has been to explain the resurgence in EU legislative activity with respect to financial services. For instance, Quaglia (2007) finds that markets, supranational institutions and member states all mattered to bring about greater European integration in the area of financial services' regulation and supervision. Changes in financial markets and technology created the impetus for integration while the European Commission, the EP and the European Central Bank (ECB) set the policy-making agenda for the member states. Posner (2007) also recognizes the crucial role played by the introduction of the euro and United States’ rising financial competitiveness in fostering ‘the sudden acceleration of EU financial integration’ (139). However, going a little further than Quaglia (2007), he argues that the impact of these two factors was in fact dependent on the cumulative effects over time of ‘small’ actions by EU civil servants, member-state governments, transnational firms and other relevant groups.12 According to him, it is these effects – which created a new consensus for financial reform – that made it possible for external shocks, such as the euro’s arrival and America’s emerging dominance of world capital markets, to bring about institutional change. For his part, Mügge (2006) argues that ‘competition politics’ between large, transnational financial firms and smaller, national firms explain the outcome, whereby the former prevailed over the latter in obtaining the harmonisation of rules and regulations at the EU level. Bieling (2006), using a different conceptual approach, comes to a similar conclusion. Finally, Story (2005) agrees that globalization exercises pressures for convergence and that the introduction of the euro has added to these pressures; however, ‘there is continued divergence in the national structures which endure, restructure and shape them’ (220). As such, he concludes that the ‘battle of the systems’ in the EU is still alive.

These studies, by political scientists, tend to agree on the economic and political pressures that led to the surge in supranational legislative activity regarding the integration of financial services in the EU. They also point out the important role

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12 Posner (2007) writes: ‘At any given moment in time, opportunistic policy entrepreneurs may draw on these preformed coalitions, studies and political frames to advance their agendas. Gradualist actions thus refashion the political landscape in ways that contribute to incremental institutional change and simultaneously create the conditions for external stimuli to produce rapid transformation’ (146).
played by policy entrepreneurs like the Commission. The problem is that they seem to believe that European financial integration is now a done deal. Market integration will necessarily follow from the new EU regulations and directives. The only exception is Story (2005), who says that structural differences between member states remain. The problem is that none of these studies consider what is happening on the ground. They do not look at the actual degree of market integration, which economists do. For example, European financial market integration has move forward in the case of securities and wholesale banking while the status quo remains in the area of retail banking. The above-mentioned studies also fail to examine whether EU legislation relating to financial services is in fact implemented and enforced by the member states. It is not because a directive has been adopted by the EU that it will automatically be implemented or enforced. Furthermore, the studies fail to look at the legislative texts themselves to see what kind of loopholes have been left as a result of political compromises. The EU has a tradition of adopting directives that have a tendency to formalize the status quo, especially with regards to financial services.

*European Financial Integration: Market Perspective*

We will therefore now look at market-centered accounts of European financial integration. Mainly realized by economists, these accounts of financial integration in the EU do not necessarily converge. As elsewhere, much depends on the measures adopted. Several perspectives can be identified. Basically, those looking at wholesale-market integration consider that integration is very advanced, even if it is not certain that this is due to European integration. Instead, those focusing on retail finance or on cross-border mergers continue to underline the remaining barriers to integration. To put it bluntly, we can distinguish a simple-integration school from a strong-integration school. For the former, integration is essentially defined by increasing cross-border financial flows of any kind. The latter are more demanding: they consider that real integration must entail convergence not only of prices and rates, but also of business models, governance, refinancing practices, etc.

Typically, the evolution of stock market size and cross-border financial flows clearly point to financial internationalization. This is often compared to and matched by certain measures of financial openness based on regulatory data (e.g. Quinn, 1997). Measures based on wholesale-market indicators tend to confirm the strong-integration thesis. Existing studies confirm that the liberalization at the national and European level has gone hand in hand with increasing internationalization of business. The data compiled by Lane and Milesi-Ferretti show that important changes have taken place (Lane & Milesi-Ferretti, 2007) in this area, too. Figure 1 shows that there is a clear trend in the evolution of cross-border business in finance in Europe since the mid-1990s.
On average for the old EU-15 member states (except Luxembourg, for which data are lacking over the period covered), the volume-based measure of financial integration has been multiplied by eight between 1970 and 2004. Here again, clear differences can be identified. Ireland has had by far the greatest degree of internationalization for almost ten years (not pictured on Figure 1), while Italy – despite significant growth – has consistently had the lowest figure in the EU since the early eighties. The UK outperforms the EU average by far, while France is close to that average, while Germany is below.

In sum, it is clear that all EU members have witnessed and promoted internationalization in financial transactions. Internationalization is today very strong, even compared to other parts of the world, despite some disparities among member states.

Other measures appear to be in contradiction with the simple integration thesis. In particular, many studies have underlined the relative resilience of retail finance, while others – and in particular the Commission – have stressed the relative rarity of cross-border mergers in finance compared to other economic sectors. Studies of market integration certainly offer a mixed picture. With respect to retail financial services, markets remain fragmented on a national basis. Baele
et al. (2004) find, for example, that interest rates for consumer as well as corporate loans have not converged across the EU; however, there is some degree of convergence in mortgage rates. It is in the securities markets where integration has really taken hold across Europe (see Securities Expert Group 2004). Baele et al. (2004) find that there is a high degree of integration in these markets since the introduction of the euro, as measured by the convergence in returns across EU member states. A study by Fernández de Guevara et al. (2007) confirms these results. For their part, Adjaouté and Danthine (2004) observe an increase in the importance of sector rather than country factors in influencing equity returns in Europe. This supports the idea that country diversification is becoming less important vis-à-vis sector diversification, which is evidence that equity markets across the EU are more integrated (see also Galati and Tsatsaronis 2003). These studies support the argument made by Fonteyne (2006) that the EU has made substantial progress when it comes to creating a single market for wholesale financial services while retail financial services remain fragmented.

Turning to cross-border mergers and acquisitions, the situation is not straightforward, either. In theory, the liberalisation of capital controls and the introduction of the euro, as an omen to greater financial deregulation across the EU, should have pushed financial services firms to consolidate their positions on the European market. In reality, the results have been mixed. For instance, Berger et al. (1999) found that, in spite of an EU banking directive that allowed banks to operate with few restrictions across the Union since the early 1990s, there were few cross-border M&As involving banks in the 1990s. However, this does not mean that there was little consolidation. In fact, the number of banks, defined as credit institutions, in the EU-15 decreased from 12,256 to 7,444 from 1985 to 2003, according to Dermine (2006: 66). But this consolidation took place mainly within member states’ borders. For the period 1997-2004, Dermine (2006) shows that nearly half (47 per cent) of the banking M&As in the European Economic Area (EEA) involved institutions from the same country. In terms of transaction value, the percentage climbs to 77 per cent. In a report published in May 2004, an Expert Group on Banking set up by the European Commission to take stock of the achievements of the FSAP confirm these findings:

Consolidation in the number of banks has taken place mainly at national level. Cross-border mergers and acquisitions have been relatively limited, though in some cases they have led to the emergence of regional banking groups, such as in the Benelux and Nordic countries. Despite progress in cross-border integration in wholesale markets, domestic consolidation has prevailed in the retail

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13 Securities markets involve the trading of short-term debt and monetary (money market), shares of companies (equities market), and bonds (government-bond and corporate-bond markets).

14 According to a more recent study by Lannoo (2008), this situation has not changed.
sector where no pan-European bank has yet emerged (Expert Group on Banking 2004, 6).

With consolidation taking place mainly within the member states, the concentration level of the banking industry increased significantly in many countries (Expert Group on Banking 2004; Dermine 2006).\textsuperscript{15}

These findings about domestic consolidation seem to confirm the argument presented above that if firms are to be competitive internationally, they need to have a strong market position at home to begin with. Otherwise, any attempt at internalisation is likely to end up in failure. In addition, larger firms with more power and greater efficiency domestically are in a better position to handle foreign competitors. Given the uncertainty associated with the introduction of the euro and the liberalisation of financial services at the EU level, banks acted carefully by building up some muscle at home in order to be better able to fight the European battle, in terms of ability to invest and absorb potential shocks to earnings resulting from the internalisation (or Europeanisation) of their operations. Therefore, cross-border consolidation in the EU may be just a question of time. Recent large cross-border M&A transactions may be a sign of things to come.\textsuperscript{16}

Another possibility is that financial services firms decide to expand abroad through greenfield investment (i.e. by setting up subsidiaries and branches) rather than via M&As. The existence of an EU banking passport allows a bank located in one member state to offer its services in another without having to obtain the authorisation of the local regulator. Hence, banks are free to open branches in any other EU member state. Nevertheless, this choice of internationalisation path still remains limited. For instance, the Expert Group on Banking (2004) found that ‘the total market share of branches and subsidiaries of foreign institutions amounted to 15.2% in 2002’ (6). Thus, local banks retained their dominance over the domestic market, in spite of the introduction of the euro and an EU directive allowing for cross-border banking.

A different way of looking at integration, however, is to look for effective convergence between market structures across the EU, in terms of corporate financing and governance. For instance, many authors concentrate on stock market capitalization. According to Rajan and Zingales (Rajan & Zingales, 2003a: 129):

\textsuperscript{15} However, it does not appear that this has had a negative effect on competition according to Expert Group on Banking (2004: 7). A new study by the European Commission (2007b), however, concludes otherwise.

\textsuperscript{16} In November 2004, Banco Santander Central Hispano (BSCH) of Spain bought Abbey National of the UK for €15.6 billion. In June 2005, UniCredito of Italy agreed to buy HVB of Germany for €15.4 billion. In April 2007, Barclays of the UK announced its takeover of ABN Amro of the Netherlands for €66 billion, though Royal Bank of Scotland, Fortis and Santander (BSCH) eventually won the takeover battle in November 2007.
In the two decades since 1980, the stock market capitalization to GDP ration went up more than thirteen times while the proportion of investments financed through equity issues went up sixteen times.

Table 1 pictures the evolution of several indicators as ratios to GDP in 1980 and 2000. The average growth is very impressive on all indicators. Stock market capitalization is by far the strongest, but all have increased significantly, while the number of publicly-listed companies has increased significantly, if you take out the deviant case of Luxembourg.

<table>
<thead>
<tr>
<th>Country</th>
<th>Bank Loan to private sector</th>
<th>Deposits Stock</th>
<th>Stock Market Capitalization</th>
<th>Equity issues</th>
<th>N. of compagnies</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUSTRIA</td>
<td>0,298</td>
<td>0,137</td>
<td>0,126</td>
<td>0,051</td>
<td>1270%</td>
</tr>
<tr>
<td>BELGIUM</td>
<td>0,52</td>
<td>0,538</td>
<td>0,693</td>
<td>0,108</td>
<td>587%</td>
</tr>
<tr>
<td>DENMARK</td>
<td>n.a.</td>
<td>n.a.</td>
<td>0,596</td>
<td>0,182</td>
<td>890%</td>
</tr>
<tr>
<td>FINLAND</td>
<td>0,072</td>
<td>0,073</td>
<td>n.a.</td>
<td>0,485</td>
<td>n.a.</td>
</tr>
<tr>
<td>FRANCE</td>
<td>0,133</td>
<td>-0,043</td>
<td>0,997</td>
<td>0,085</td>
<td>-2%</td>
</tr>
<tr>
<td>GERMANY</td>
<td>0,343</td>
<td>0,361</td>
<td>0,578</td>
<td>0,055</td>
<td>1116%</td>
</tr>
<tr>
<td>GREECE</td>
<td>0,006</td>
<td>0,059</td>
<td>0,857</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>IRELAND</td>
<td>0,754</td>
<td>0,216</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>ITALY</td>
<td>0,215</td>
<td>-0,162</td>
<td>0,633</td>
<td>0,001</td>
<td>2043%</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>-0,111</td>
<td>1,741</td>
<td>1,77</td>
<td>0,478</td>
<td>-40%</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>0,766</td>
<td>0,361</td>
<td>1,511</td>
<td>0,619</td>
<td>876%</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>0,553</td>
<td>0,051</td>
<td>0,561</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>SPAIN</td>
<td>n.a.</td>
<td>0,093</td>
<td>0,795</td>
<td>0,838</td>
<td>95%</td>
</tr>
<tr>
<td>SWEDEN</td>
<td>0,042</td>
<td>-0,119</td>
<td>1,366</td>
<td>0,289</td>
<td>166%</td>
</tr>
<tr>
<td>Average</td>
<td>0,336</td>
<td>0,283</td>
<td>0,968</td>
<td>0,302</td>
<td>421%</td>
</tr>
<tr>
<td>Cont. Europe</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>1,044</td>
<td>0,789</td>
<td>1,46</td>
<td>0,109</td>
<td>-93%</td>
</tr>
<tr>
<td>US</td>
<td>0,139</td>
<td>-0,161</td>
<td>1,089</td>
<td>0,167</td>
<td>12%</td>
</tr>
</tbody>
</table>

Source: Rajan & Zingales (2003a)
Moreover, growth has been particularly strong in continental Europe, if one considers the starting point back in the 1980s. While the gap between the US, the UK and continental Europe has not really disappeared, these data show that capital markets have been increasing in importance in continental Europe, thereby furthering internationalization. This is because market-based models will usually be more outward-oriented than others. Models based on relationship banking, for instance, are often considered less inclined to internationalization (Hurst et al., 1999: 86).

Yet, Table 1 also shows that the evolution is hardly uniform. For instance, equity issues have increased very significantly in Spain, while they have remained almost unchanged in Germany or France (O'Sullivan, 2007). The number of publicly-listed firms has increased substantially in some countries, but remained stable or increased more modestly in others.

These differences at least partially mirror remaining differences and divergences within the European financial system. Rajan and Zingales (2003a: 163-164) consider that the EU has moved towards more market-based and internationalised finance. Yet, they are worried that current “anti-market trends” may undermine ongoing transformations. Their focus is on models of finance or government-finance relations (Zysman, 1983), rather than on actual cross-border business. But this also shows that the resilience of particular models is not simply due to institutional inertia and path-dependency. These institutions have also structured people’s horizon of how the economy works.

If we focus our attention on the case of corporate governance structures, studies on the topic clearly indicate that things have not fundamentally changed since the early 1990s. At a more conceptual level, Bebchuk and Roe (1999) argue that corporate governance systems are slow to change because they exhibit path dependence. For example, corporate governance structures persist because of rent-seeking behaviour by investors, management and/or workers. According to Roe (2003), powerful, entrenched interests act as a barrier against change. In Europe, there are two broad systems of corporate governance. There is a market-based system with equity being widely dispersed amongst shareholders, which is found in the UK and Ireland. Then, there is blockholder-based system where the majority of a company’s equity (and control) is usually held by one or few investors, and where firms are mainly financed through bank debt rather than equity markets. This system is characteristic of Continental European countries. Because of the economic pressures exercised by globalisation on both states and firms, there are much-debated expectations of a

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17 In a similar manner Llewelyn (2006) speaks of ‘convergence on the shareholder value model in European banking’.

18 This situation also generally applies to the case of labour market institutions (e.g., see Gospel and Pendleton 2005).

19 This means that there is a separation between ownership and control of a company.
convergence of the two models towards the market-based system – based on the belief that the ‘Anglo-Saxon’ model of corporate governance is economically superior – or a hybrid system that combines the best practices of both systems (for details on this debate, see McCahery et al. 2002). But this does not seem to have happened in Europe so far.

According to Culpepper (2005), who looks at financial institutional change in France, Germany and Italy since 1990, only France has seen its corporate governance system change. In spite of regulatory changes, the German and Italian systems have basically remained the same institutionally. In the case of Italy, Culpepper indicates that even though many state shareholdings were privatized and equity markets grew after 1990 a small number of large companies continued to control the great majority of firms whose shares are traded on the Italian stock market. With respect to Germany, Culpepper finds that ownership concentration has remained largely stable since 1990. As for France, the author finds that cross-shareholdings amongst both financial and non-financial firms collapsed in 1998 and 1999. They were replaced by foreign (British and American) institutional investors. On the other hand, Culpepper notes that French law has continued to favour blockholder capitalism. For their part, Bianchi and Bianco (2006) come to the same conclusion as Culpepper regarding Italy. They also find that although there have been many legal and regulatory changes in Italy between 1990 and 2005 the governance structure of Italian firms has remained the same. In their study of recent developments in German corporate governance, Goergen et al. (2008) also find that, in spite of significant regulatory changes, the German system has fundamentally remained the same: ‘most of the characteristics traditionally associated with German corporate governance (the so-called “Deutschland AG” or “Germany Inc.”) are still in place’ (66). Finally, with regards to France, Lalone (2005) agrees with Culpepper that there have been significant changes to the country’s corporate ownership structures. However, he argues that, despite these changes, the French financial services industry continues to be dependent on the state, most especially when it comes to EU policy-making.

This section has demonstrated that there has indeed been a significant leap forward since the mid-1990s when it comes to European financial integration. Qualifying this leap with the term ‘great’ may, however, still prove an overstatement, at least for the time being. Although FSAP measures and the Lamfalussy process have put down strong foundations for the harmonization across the EU of rules and regulations concerning the provision of financial services, serious shortcomings still remain. A similar conclusion applies to the integration of financial markets: wholesale markets for financial services are well integrated across the EU while retail markets remain fragmented on a national basis. Finally, our quick review of the effects of financial integration on corporate governance seems to confirm the persisting diversity.
So how do we explain this state of affairs? Is Story (2005) right to say that the ‘battle of the systems’ is not over yet? We need to answer these questions if we are to understand where European financial integration is headed towards and what may be done to help it move in the right direction. Fundamentally, accounts of financial integration do have an underlying normative vision of finance. Everything will depend on the benchmark against which you compare a given degree of integration. It is certain that the European Commission has adopted a more political view of financial integration. Rather than focusing on the evolution of business and on aggregate figures, the Commission continues to be very interested in certain kinds of economic behavior, such as mergers, as well as retail clients and consumers. This clearly translates the more abstract goal of the actual disappearance of national frontiers in financial services. In this context, the Commission’s attitude is certainly linked to its will to demonstrate the efficiency and the “superior problem-solving capacity of multi-level governance” and, thus, the EU (Scharpf, 1999). The politicisation of financial integration may thus account at least partly for the variety of views on the state of financial integration in Europe.

3) Is the ‘Battle of the Systems’ Really Over?

Explanations of the current state of affairs vary a lot and look at everything from microeconomic to system-level factors. The first group privileges explanations based on strategies of specific economic actors and/or the interests of particular market segments. This paper does not aim at closing any debates. Rather, it attempts to explore different venues for explaining the evolution of European financial regulation and integration. Yet, we will argue that “systems” in the Story-and-Walter sense, continue to be a dominant factor in the way European finance evolves and that most, though not all, micro-features derive from the larger structure of the markets of financial services and the specific market-regulation nexus.

*Asymmetries, segmentation and politicization: the limits of existing explanations*

Microeconomic accounts of integration resort to different explanations. In particular they focus on the importance of market structures, information asymmetry and the effect of existing regulatory restrictions. Those explanations, however, tend to focus on single-factor explanations that do hardly justice to the overall evolution of European finance.

Berger *et al.* (2003), for instance, argue that specific characteristics of financial markets can also explain why some segments tend to remain local rather than global or international.

Some banking services – such as relationship lending to informationally opaque small businesses – may always be provided
primarily by small, local institutions operating in the nation in which the services are demanded. Other services, such as syndicated loans to large borrowers, are more likely to be provided by large, global institutions for which the home nations of these institutions are of much less consequence to the demanders of the services. (384)

Accordingly, the authors find that for what they call ‘concierge’ services – mainly cash management services – even a majority of multinational enterprises (MNEs) tend to use local banks rather than banks from the home counter where the MNE is headquartered. ‘These findings (...) suggest that local and regional banks may be better at delivering concierge services than global banks’ (Berger et al. 2003, 412). Degryse and Ongena (2004) argue that integration has proceeded furthest in those financial market segments where information asymmetries are smallest. That is, those agents that are tapping the securities markets for capital tend to be large corporations or governments, whose information is readily available to the public while the investors that provide this capital tend to be large financial institutions, which have vast amounts of financial, human and technological resources to analyse the information supplied by firms and governments. In the retail banking market, for example, it is the opposite. There are significant information asymmetries. It is much more difficult for banks to obtain information about the financial solvency of individuals and small businesses. This is why local proximity is important, which is usually provided by a bank’s branch network. Since building such a network is costly and takes time, one can expect that banks wanting to internationalise their activities would contemplate acquiring (or merging with) foreign financial institutions.

Another potential explanation for persisting disparities among different market segments is provided by Gruual (1999). His study shows that competition – in retail financial markets – has tended to be predominantly based on variable costs, i.e. such as interest rates on deposits or customer services, as opposed to sunk costs. This, the author argues, may explain consolidation at the national level, rather than increased EU-wide concentration (Gruual, 1999: 46-47). These asymmetries may be limited in time, however. If the internationalisation process has just recently begun to take place in the retail banking sector, it could well be as a result of the flurry of legislative activity at the EU level, which was set in motion by the Commission’s FSAP. We should not forget, however, that the EU began deregulating retail financial services – with the first Banking Directive in 1977 and the Second in 1989 – much before it did so with wholesale financial services. The latter began to be liberalised with the Single Market Programme, but integration was fuelled in particular by the euro.

And, in fact, many observers consider that the euro may have a decisive weight for all market segments in the long run, thereby leading to retail market integration as well. Galati and Tsatsaronis (2003) argue that the introduction of the euro has removed foreign exchange risk, thereby making irrelevant institutional investors’ need to match the currencies of assets and liabilities in their portfolio. This caused the pool of potential investors to increase significantly.
As a result, government and corporate bond markets became integrated across most of the EU and underwriting fees dropped as competition became more intense, with European investment banks expanding their activities regionally, if not globally, while US investment banks increased their capacity in Europe. Allen and Song (2005) also find that ‘EMU played a significant role in financial integration within Europe’ (8), with capital market integration benefiting the most. A similar kind of argument looks for the way in which more political or regulatory factors have influenced the evolution of market structures. Focarelli and Pozzolo (2001) indicate that there is a negative relationship between regulatory restrictions and banking internationalisation. Therefore, since the introduction of the euro and the liberalisation push associated with the FSAP are relatively recent, the internalisation of banks should also be at an early stage.

For his part, Boot (1999) argues that politics has been one of the culprits for the fact that there has been little retail banking integration, which is a consequence of the small amount of cross-border banking consolidation. He writes:

The domestic banks in Europe were – and are – protected as domestic flagships. A fundamental belief that financial institutions should not be controlled by foreigners has (so far) almost prevented any cross-border merger (610). $^{20}$

He adds that the wave of domestic consolidation in response to financial liberalisation and the arrival of the euro has been encouraged by member-state governments in order to ‘protect national interests’ (i.e. better defend the domestic market against foreign firms) (611). Freixas et al. (2004) argue that the Banking Directive, though making it possible for banks to offer their services anywhere in the EU, still allowed host-country regulators significant discretion in imposing specific rules and procedures to protect the national interest, which more often than not has had a tendency to favour incumbent domestic banks. This is why they conclude that as ‘long as host-country regulation applies, then integration will be impeded’ (484).

Member states’ preoccupation was not so much that American banks would take over French, German and Italian banking markets, but that capital (European and foreign) would increasingly leave for US shores, with large European firms following suit in order to finance their activities. The removal of capital controls in Europe and elsewhere around the world made this possible. Obviously, large European financial institutions, which were competing for global capital flows against US institutions, were very supportive of a process whereby European markets for wholesale financial services would be integrated and harmonized (see Mügge 2006). The greater economies of scale and lower transaction costs

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$^{20}$ The adoption of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), which follows Italy’s central bank’s efforts to thwart the acquisitions of two Italian banks by Dutch ABN Amro and Spanish BSCH in 2005, is, inter alia, a response to this argument.
that would arise as a result of these integrated markets would create a much stronger base for them to then compete globally. This explains why EU financial integration has been able to move quickly in these markets. The Commission, member-state governments and large multinational financial firms were all in agreement on what had to be done. However, this of part of the integration process (both market and legislative) did not really touch member states’ existing national corporate governance and labour market institutions.

It is really in retail financial services where member states are more reluctant to open up their markets completely and relinquish control over rules and regulation to the supranational level. This is because it touches the core of the capitalist system that has developed over time, with banks and, to a lesser extent, insurance companies being at the center of the system in Continental European countries. As mentioned earlier, entrenched interests that benefit and/or have secured rents from the existing system tend to make change slow and difficult (Rajan & Zingales, 2003b). Without an external shock that threatens the system, institutional change can only be incremental at best. Unlike wholesale markets, with the removal of capital controls and the arrival of the euro, there has been no real threat or shock to European retail financial markets as of yet. There is thus no sense of urgency among member-state governments to change their systems in the short term. After all, the globalization of capital has not really changed the way individuals and small and medium-sized enterprises (SMEs) go about their financial business. SMEs continue to obtain their financing from banks with a local presence,21 while individuals continue to deposit money at and borrow from their local bank branch. True, the arrival of the euro and internet technology make it easier to seek financial services in other parts of the EU where they may be cheaper. But once additional transaction costs are factored in (acquiring knowledge of the products, trust in the foreign institution, etc.), the added benefits are usually not worthwhile. This is what the Commission is presently working on, reducing those transaction costs to cross-border banking and insurance services. However, financial institutions with little or no presence outside a member state (given the domestic nature of their retail business) have strong incentives to limit competition and prevent the entry of larger, stronger foreign competitors. That is also why member-state governments have encouraged consolidation at the national level rather than at the European level, in order to make it easier for domestic financial institutions to face up to increasing foreign competition as barriers to cross-border retail financial services fall in the EU over time.

This politicization argument is, of course central. Yet the above explanations provide at best partial views of the politics of financial integration. While most of the above elements certainly tell part of the story, they may be missing the larger picture. The final subsection will attempt to provide such a more general framework of analysis.

21 It is of course true that a significant share of SME-investments are financed through internal financing, even though there is a great deal of variation across countries and sectors (Wagenvoort, 2003).
Towards a new political economy of European financial integration

System-level explanations should include the specific national relationship between market structures and political structures. The government-finance nexus has certainly changed over time and since Zysman’s seminal analysis (Zysman, 1983). Financial globalization, European integration or the rise of the regulatory state, just to take the most important motors of change, have clearly reshaped those relations. Yet, it is also true that national political structures continue to play a very significant role in shaping responses to those challenges. We argue that most of the differential responses to European integration can be explained by the specific market-regulation nexus of financial services. The market-regulation nexus is determined by the interplay of market structure and organization, on the one hand, and the political and institutional context, on the other.

Market structure should have a significant impact on political goals and the unity of the industry’s political representation. The more segmented a given market, the more likely there will be actors who obtain economic rents from legal barriers and the more there interests will clash with those of more pro-liberalization actors. It is true that legal or territorial segmentation has historically been based on the existence of political support for specific financial actors (Verdier, 2002: 63-71). Yet, this may weaken the role of industry as a whole as it proves unable to convey strong and unambiguous messages to political actors. The specific role of the state in finance (regulation, ownership, state banking etc.) may be another fundamental element making the development of market voice more difficult.

The way in which eventual messages are conveyed depends a lot on the institutional and political context. In simple terms, the more marjoritarian a given political system, the more it will be difficult for niche actors to secure sector-specific rents. Put differently, once a pro-liberalization agenda has been adopted, its chances of success will depend strongly on the institutional and political capacities of the actors embodying the reform agenda.

In this context the more majoritarian political systems (Lijphart, 1999) are likely to favour liberalization (Rosenbluth & Schaap, 2003). On the contrary, reform may be more difficult in consensual systems, as the relative fragmentation of political

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22 Especially the territorial structure appears to be very important in this context. For instance, Verdier (2002) shows clearly how the territorial structures of banking since the early 19th century have depended on a certain degree of equivalence between banking and political structures. Local banking has been able to capitalize on its informational advantages only in so far as it possesses strong political support by decentralized political actors. On the contrary, where such support does not exist, i.e. in centralized or unitary states, local banks have quickly lost out to large national commercial banks. But differentiation may also be due to legal frontiers within financial services, such as the classical forced separation between investment services and deposit banking in the US and, to a lesser degree, in the UK. The same applies to the existence of other legally recognized specialties, as they exist in some countries with regard to mortgages, savings banks, co-operative banks etc..
power is likely to allow for a higher number of access points and thereby facilitate the access of niche and liberalization-averse actors to the political agenda.

In the context of EU-level reforms, taking into account the specific national market-regulation nexus in financial services may help to understand the pace of reform and the specific difficulties to promote reforms and to implement them forcefully. Existing disparities become more understandable. While a detailed analysis would go beyond the scope of this paper, a brief review of the three most different cases - the UK, France and Germany – may clarify our point. Looking at the different waves of liberalization, the attitude of individual countries has of course changed over time. Yet, certain differences remain, based on the specific market-regulation nexus.

As for the UK, it appears to be – unsurprisingly – a strong promoter of liberalization. Yet, this has not always been the case. Until the mid-eighties, the City of London remained more of a club with high entry and exit costs, some degree of auto-regulation and little or no outside scrutiny (Laurence, 2001; Moran, 1991). The specific market-regulation nexus was profoundly transformed, however, with the successive reforms of financial regulation between 1986 and 1997. Since the Single Market programme, the UK has promoted strong liberalization and the development of an EU-wide level playing field in financial services. In the face of strong competition from other international financial markets as well as a series of market failures, the strongly majoritarian political system facilitated radical reform at the expense of niche players.

While there still is a strong divide between so-called wholesale banks and commercial and investment banks, the two major trade associations (the British Bankers’ Association and the London Investment Banking Association) clearly agree on most objectives. Under pressure to liberalize and to increase the regulatory burden at home, UK financial services firms tried to impose the same constraints on all other players, in order to ensure that they would not be disadvantaged. The Single Market program and, later, the FSAP appeared as good ways of doing this.23

The case of France is more complicated: it has pursued a strategy of delaying. The financial system used to be strongly segmented until the early eighties. Moreover, a long-standing tradition of state interventionism and public ownership (Verdier, 2000) made market voice weak. The strongly majoritarian political system has, however, facilitated liberalization with little or no opposition from market actors. Yet, given the strong role of the state in French finance, successive governments have favoured domestic consolidation of banking and financial services in order to make domestic actors fit for EU-wide and

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23 To some extent this can be seen as a form of as promoting “redistributive cooperation” (Oatley & Nabors, 1998), where international norms may offset the comparative disadvantage created by domestic reforms.
international competition. This may explain why France was among the more reticent countries during the Single Market programme but among the promoters during the FSAP. Its defense of a single regulator in financial services places it even ahead of the UK with regards to integration and the creation of a level playing field.

Finally, the case of Germany appears as the most contradictory as it combines the general acceptance of liberalization with the persistence of strong obstacles to integration. This is mainly due to largely segmented markets in Germany and the relative autonomy and specialization of the three “pillars” of German finance (Deeg, 1999). The implementation of reforms, such as the respect of EU state aid rules, has proved difficult and politically explosive (Grossman, 2006), as regional governments have supported regional and local players at the expense of EU rules. This has revealed a divide between regional actors and the federal government, which has supported all major measures of liberalization at least since the mid-nineties.24 The continued segmentation and the high-level of cross-participations in Germany may explain the little effect that EU legislation has had so far on the organization of German markets. It remains very difficult for non-German firms to penetrate the German market, despite some significant change (Lütz, 2000). There appears to be an increasingly bipolar world in German finance with a strongly internationalized sector on the one hand and a host of more local actors on the other that remain out of reach of international markets.

**Conclusion**

This paper has reviewed evidence and arguments on financial integration in the EU. We have shown that a correct assessment of the process of financial integration and, in particular, the Financial Services Action Plan has to take into account both regulatory change and effective market integration. This has also shown that national contexts continue to bear considerable weight in this context.

In particular, we have tried to show that any explanation of the current state of affairs in financial integration in the EU needs to take the market-regulation nexus serious. This implies looking at market structure as well as at the political and institutional context. We suggest a framework that may explain more adequately the contradictions between regulatory and market integration.

In sum, Story and Walter’s (1997) ‘battle of the systems’ has shifted. The battle is much more subtle. Its underlying fundamentals have not really changed, in terms of the absence of convergence to one model of capitalism. Corporate governance and labour market systems remain basically the same in Continental European countries. The battle now takes place only in retail financial services rather than in all financial services. The US threat to Europe’s wholesale financial

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24 The arrival of a social-democrat-led government may have helped to undermine the manager-government nexus typical of the period of Christian-democrat domination (Cioffi & Höpner, 2006).
markets forced member-state governments to stop competing and start collaborating in order to prevent the United States from becoming the main pole of attraction for global capital markets. There has been no such threat in retail financial services. The only pressure for change and integration comes from the EU’s traditional desire to create a single market for products and services, with the Commission providing the policy entrepreneurship and member states moving along incrementally at a rate that depends on the nexus between the national market structure and the institutional and political context.

References


