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Looking at the retail financial markets and identifing a number of ''natural'' and ''policy induced'' obstacles to free trade. We use the term ''natural'' barriers to refer to those arising as a result of different cultures or consumer preferences, while different state tax policies or regulations are classified as ''policy induced'' barriers.

Keywords: EU, Financial markets, Banking regulations, Policy induced barriers, Natural barriers

Before proceeding with a review of the major barriers, it is worth identifying an ongoing problem which hinders the integration of EU markets. EU states have a poor record of ***implementation*** of EC directives. There are two problems – passing the relevant legislation AND enforcing new laws. The problem is long standing. For example, in 1996 one country was taken to the European Courts before it would agree to pass a national law to implement the Investment Services Directive. It has also been difficult to get some countries to adopt the 1993 CAD-II Directive. The European Commission website has a long list of actions being taken because some EU states have failed to adopt and/or implement a variety of directives.

Heinemann and Jopp (2002) identify ***policy induced barriers***, which, they argue, could be corrected by government changes in policies. They include the following:

- Discriminatory tax treatment or subsidies which favour the domestic supplier. For example, tax relief on the capital repayment of mortgages was restricted to Belgian lenders, which gave them a clear cost advantage. This barrier has since been removed but the European Commission had cases against Greece, Italy and Portugal because of similar tax obstacles. In Germany, pension funds are eligible for subsidy but only if a long list of highly specific requirements are met, which means that any pan-European supplier of pension products faces an additional barrier in Germany. Either the firm will not qualify for the subsidy or compliance costs will be higher than their German competitors, unless the rules imposed by the home state are very similar. If every state has different requirements, compliance costs soar, discouraging the integration of an EU pensions market.
- Additional costs arising from national differences in supervision, consumer protection and accounting standards. For example, the e-commerce laws in the EU mean all firms are subject to country of origin rules: if an internet broker is planning to offer services in other EU states, then the broker must follow the internet laws of each state. It is illegal to use a website set up in France for French customers in Germany – a new website has to be created for German customers. Likewise, the EU directive on distance marketing of financial services allows each member state to impose separate national rules on how financial services can be marketed, advertised and distributed. The myriad of different rules makes it almost impossible to develop pan-EU products which can be sold in all states.
- The ''general good'' principle is used by EU states to protect consumers, and cultural differences influence consumer protection policy. However, these rules can deter competition from other EU states: the principle is interpreted in different ways across the EU states. The outcome is 15 to 25 different sets of rules on, for example, the supply of mortgage products, which raises costs for any firm attempting to establish a pan-EU presence. There is a fine line between the use of the general good clause to protect consumers, as opposed to domestic suppliers.
- Eppendorfer *et al*. (2002) provide an example of where the principle of mutual recognition creates problems. Banco Santander Central Hispano, Nordea, HSBC and BNP Paribas all reported problems when they tried to extend their respective branch network across state frontiers because of the split in supervision: the home country is responsible for branches but the host deals with solvency issues.
- There are 15 to 25 different legal systems, each with different contract and insolvency laws, and so on. For example, trying to sell loans across EU frontiers is extremely difficult because of different definitions of collateral across the member states.
- Lack of information for customers on how to obtain redress in the event of a legal dispute or problem with a product supplied by an out of state firm.
- Conduct of business rules can be used as a way of preventing other EU firms from setting up business in a given EU state. For example, there may be a rule which does not make a contract legally binding unless written in the said state's language(s). Though there is increasing convergence on the professional markets, this is not the case for retail markets.
- Reduced cross-border information flows can also create barriers. New entrants to state credit markets face a more serious problem with adverse selection than home suppliers because they have less information. In many EU states central banks keep public credit registers, but access to them is restricted to home financial institutions that report domestic information to the central bank. The same is true for some private credit rating agencies. It creates barriers for out of state lenders and even if they do manage to enter the market, it increases the risk of them being caught out with dud loans.

- It is acknowledged that it is much harder to raise venture capital in the EU than in the USA. The ***Risk Capital Action Plan*** was endorsed by the European Council in June 1998, to be implemented by 2003. The point of the plan is to eliminate the barriers which inhibit the supply of and demand for risk capital. It will focus on resolving cultural differences (e.g. lack of an entrepreneurial culture), removing market barriers, and differences in tax treatment. However, the plan is ambitious and may prove too difficult to implement.
- Domestic suppliers, especially state owned, often have special privileges. Or, the costs of cross-border operations, such as money transfers, may involve costly identification/ verification requirements. For example, on-line brokers (or any financial service) have to verify the identity of the client they are dealing with. This is done through local post offices, the relevant embassy, or a notary. Such cumbersome procedures discourage the use of foreign on-line broking/financial firms.
- The existence of national payments systems for clearing euro payments is cumbersome and costly. In July 2003, a new EU regulation requires that the charges for processing cross-border euro payments be the same as for domestic payments up to €12 500, rising to €50 000 by 2005. The goal is to create a single European payments area. Banks have done well from extra charges for cross-border payments, and one estimate is that this regulation will cause lost revenues of around €1.2 billion.
- Though the integration of EU stock exchanges continues apace through mergers and alliances, clearing and settlement procedures remain largely national. This means, for example, that on-line brokers must charge additional fees for purchasing or selling stocks listed on other EU exchanges (even if there is an alliance), or they do not offer the service. The demand side is also affected: customers are deterred from choosing a supplier in another EU state. The cost of cross-border share trading in Europe is 90% higher than in the USA, and it is estimated that a central counterparty clearing system for equities in Europe (ECCP) would reduce transactions costs by $950 million (€1 billion) per year. The cost savings would come primarily from an integrated or single back office. A central clearing house for European equities acts as an intermediary between buyers and sellers. Netting would also be possible, meaning banks could net their purchases against sales, reducing the number of transactions needing to be settled, and therefore the capital needed to be set aside for prudential purposes. Real time gross settlement would help to eliminate settlements risk. The plan is being backed by the European Securities Forum, a group of Europe's largest banks.
- There are more than 50 related regulatory bodies with responsibility for regulation of financial firms in the EU, and the number will continue to rise as new member states join. This makes it difficult for them to cooperate. This issue will remain while individual states have the right to decide how to regulate home state financial firms. Different reporting rules for companies and different rules on mergers and acquisitions are just two examples of how regulations can create additional barriers to integration. A new directive on takeovers (the 13th Company Law Directive) was supposed to be ratified by the EU Parliament in July 2001. The directive would have brought in standard EU-wide rules on how a firm can defend itself in the event of a hostile takeover bid. Hostile bids would have been easier to launch because it would require management wishing to contest a bid to obtain the support of their shareholders. German firms believed the directive did not give enough protection, and lobbied German MEPs to vote against it. The result was an even number of votes for and against with 22 abstentions, so it was not passed. Though unprecedented, it meant 12 years of work on a directive had been wasted. The failure to ratify this directive has encouraged banks to enter into strategic alliances or joint ventures rather than opting for a full merger. Recent examples include Banco Santander Central Hispano (BSCH) with Societe Generale, Commerzbank, the Royal Bank of Scotland Group and San Paolo-IMI, and Dresdner Bank with BNP Paribas.

Natural barriers identified by Heinemann and Joppe(2002) include the following:

- Additional costs due to differences in language and culture. For example, the barriers to trade caused by the e-commerce directive were noted earlier. But there are natural barriers arising from the use of the internet as a delivery channel across European frontiers. Fixed costs are created by the need for a specific marketing strategy in each EU state because of differences in national preferences, languages and culture, together with the need to launch an advertising campaign to establish a brand name. IT systems must be adapted for local technical differences and sunk costs can discourage entry. Consumer access to some products may also be limited if certain EU states are ignored because their market is deemed to be too small.
- The need to have a relationship between firm and customer, which makes location important. This point is especially applicable for many banking products. Relationship banking may be used to maximise information flows, which can in turn, for example, improve the quality of loan decisions.
- Consumer confidence in national suppliers. For example, a real estate firm may refer clients to the local bank for mortgages.

Heinemann and Jopp (2002) surveyed seven European banks and insurance firms to ascertain how important they considered these obstacles to be, using a scale from 1 (not relevant) to 10 (highly relevant). In retail banking, the most important barriers were differences in tax regimes (6.8/10) and regulation (supervision, takeover laws, etc.) 5.8/10. Consumer loyalty and language barriers came next (5.2/10 and 5.1/10), followed by unattractive markets (4.8/10) and poor market infrastructure (3.2/10).

An earlier survey by the Bank of England (1994) reached similar conclusions. About 25 firms, mainly banks and building societies, were surveyed. Cultural and structural barriers were found to be the most difficult to overcome, including cross-shareholdings between banks and domestic firms, consumer preferences for domestic firms and products, governments choosing home country suppliers, and a poor understanding of mutual organisations, which made it difficult for British building societies to penetrate other EU markets. Others included fiscal barriers due to different tax systems, regulatory barriers due to different regulations (e.g. the pension or mortgage examples identified by Heinemann and Jopp), and legal and technical barriers. Note the perception that notable barriers exist has not changed, even though the two surveys were done nearly 10 years apart.

The objective of the Financial Services Action Plan is to achieve a single financial market in Europe. However, it is open to question whether the plan will succeed. As has been documented, major barriers continue to exist. The question is the extent to which a single market can be achieved in view of the cultural, language and legal differences within the EU, especially now it has expanded.

Policy makers should concentrate on removing blatant policy induced entry barriers and accept that some markets will never be fully integrated, particularly in the retail banking and some other financial markets. The wholesale financial markets are already global in nature, and a key objective of the European regulators should be to ensure that no legislation is passed which hinders the competitive advantage of Europe's financial firms operating in wholesale markets.

The EU is a collection of 27 independent nations. From 2004, it is 76% bigger than the USA in terms of population, and has a somewhat higher GDP. If a country with just one official language has not achieved a single market in certain sectors, how can the EU, with its many different languages, cultures and legal systems be expected to succeed?

Evans (2000) is one of several experts calling for an increase in the harmonisation of rules across Europe in the banking, capital and securities markets. However, the whole point of the 1986 Single European Act was to introduce mutual recognition because the goal of harmonisation was inhibiting the achievement of internal markets. As the early history of the EU demonstrates, attempts at achieving harmonisation will be even less successful than efforts to bring about a single market through mutual recognition. However, the time has come to recognise that like any country, some markets will be easier to integrate than others.

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