PRIME MINISTER

OBSTACLES TO A FREE MARKET IN FINANCIAL SERVICES IN THE EC

You asked me to look out two earlier papers on obstacles to a free market in financial services within the EC.

Not attached. Can I see attachments MT

I attach copies of the two papers which I think you have in mind. The first describes "hidden exchange controls" in Germany; the second, obstacles to a free market in financial services in general.

I have also spoken to Michael Scholar. He has re-read both papers and believes that they continue to represent the broad picture as known to the Treasury (although they were originally prepared before the Madrid Summit.)

He believes his earlier conclusion - that the measures in Germany could be defended as principally of a prudential and supervisory nature rather than hidden exchange controls - remains valid. The evidence is the similarity between internal German and Euro-deutschmark interest rates.

BHP

BARRY H. POTTER
25 April 1990
c:\economic\market (kk)

Germany has some restrictions on the issue of foreign currency bonds for purposes of monetary control. Why do we not have the same? MT

OBSTACLES TO A FREE MARKET IN FINANCIAL SERVICES IN EUROPE

The purpose of this note is to identify potentially removable obstacles to free competition in financial services in the European Community which are likely to remain once the main directives currently under discussion are implemented.

General issues

2. The "ideal" free market is one in which it is just as easy for a UK firm to sell its products (by local establishment or cross- border sale of services) in Milan or Athens as it is in Manchester. In practice of course a variety of cultural, linguistic and economic barriers will inevitability prevent achievement of this ideal and for the foreseeable future individual member states will insist on retaining controls on the way financial services are sold for consumer protection reasons.

3. We can classify obstacles to a free market into three broad types:

(i) Governmental: which in turn may be broken down into regulation, such as restrictions on overseas investment or the type of service which may be sold; and taxation, which may be used to discriminate in favour of domestic instruments;

(ii) Institutional or structural obstacles: which include restrictions on market access imposed by domestic producers through cartel arrangements, through cross shareholdings or through their dominance of distribution channels;

(iii) Cultural or consumer obstacles. Language differences are the most obvious barrier; but consumers may also have strong preferences for particular types of product and may be suspicious of unfamiliar products and companies. They may also prefer to buy from a company with a local office. National arrangements such as the nature, extent and financing arrangements of pension provision may also condition the demand for particular savings products. (These problems should be less severe in wholesale than in retail markets).

4. This list also provides us with a rough order of "tractability". Cultural obstacles are most intractable and there is almost certainly little to be done here. Regulation and taxation should certainly be on the agenda to the extent that they discriminate by country or currency. But we may well want to go further and say that regulatory arrangements which restrict freedom of services in ways which cannot be justified on consumer protection grounds should also receive attention even when there is no discrimination involved, because they fragment the European market. (We would presumably be more reticent about domestic tax arrangements.)

5. Institutional arrangements are a difficult grey area. For example, most European countries do not have "independent" channels for distributing financial products and this is a real obstacle to effective cross border marketing of financial services. (The UK by contrast not only has a significant sector giving independent financial advice, but requires such advisers to give best advice across available products which will in principle include products marketed into the UK from other Community countries.) However this may well be beyond the powers of the Commission, unless some restrictive practice on the part of the banks (or whatever) which dominate the distribution outlets can be proved.

6. For the sake of completeness we should note that even within an "ideal" single market a fourth kind of barrier would remain in the form of economic factors. There will always be costs attached to breaking into new markets (advertising, local establishment etc) or extending sales across a wider geographical area, even where costs of meeting local regulation are reduced to a minimum. Inherent economies of scale may also act as an effective barrier to entry.

Progress towards the single market

7. Annex 1 provides a brief summary of the progress being made in each main sector.

8. Freedom of capital movements (subject to a safeguard clause to protect monetary and exchange rate policies) has been agreed for eight of the largest member states from the middle of 1990 with the other four countries following at the end of 1992. But a variety of tax and regulatory distortions on capital flows are likely to remain (detail below).

9. Freedom of establishment (subject to local authorisation requirements) is guaranteed in principle by Article 52 of the Treaty of Rome, and this has been reinforced for banks and insurance companies by directives agreed in the 1970s

10. Freedom to provide cross border services on the basis of home country authorisation is closest to realisation for certain unit trusts. Insurance of large commercial non-life risks will follow in 1990 on the basis of a directive already adopted. Agreement is near on banking, and rather more distant for non-bank securities firms. Progress on life assurance and "mass risk" non-life insurance is expected to be very slow. It could be well into the next decade before significant advances are made.

11. In each case some form of European "passport" is offered but the host country retains control over the way the product is sold. In the case of UCITS the host country can impose its own (non-discriminatory) marketing rules. For credit institutions it can invoke a "public good" provision to apply local rules. Domestic conduct of business rules can be applied to investment services under the draft Directive. And in the case of insurance the directives now planned are geared towards the limited objective of removing host control of policy terms and conditions; harmonisation of conduct of business rules is beyond the horizon.

Obstacles to a free market

12. Against this background, the following are the most important areas where progress could be made towards greater openness in European financial markets.

(a) Removing regulations restricting the free movement of capital

13. EC member states which maintain formal exchange controls are generally taking steps to remove them in line with the Capital Liberalisation Directive. But disguised controls remain even in those countries such as Germany which profess to have established freedom of capital movements. Examples of such controls include:

* restrictions on investment overseas by pension funds and life assurance companies. Annexes 2 and 3 set out the available information. All countries supervise investments on prudential grounds, but some countries apply regulation of investment more strictly. Germany for example limits overseas investments by pension funds and insurance companies to 5 per cent of assets, and even these investments must be made through shares or investment trusts quoted on a German stock exchange. Liabilities in one currency must be matched by assets in the same currency. The UK imposes solvency requirements on insurance companies which allow considerable scope for overseas investment. (We do however require that 80% of sterling liabilities in the form of technical

reserves should be matched by sterling assets held in the UK.) We would stand to gain both in terms of fund management business and investment in UK companies if other countries' restrictions were relaxed. However, other countries could similarly gain if our restrictions were relaxed. UK consumers would gain in both cases.

* restrictions on investments made by other savings vehicles, trusts etc. In the UK the Trustee Investments Act which applies to certain trusts, friendly societies, charities and public sector funds prohibits investments overseas other than through UK quoted securities, and certain public sector debt. Examples from other countries are not immediately available but must be presumed to exist.

* restrictions on foreign currency borrowing It appears that Germany, which claims to have abolished all exchange controls, uses its Currency Act to prevent issues of foreign currency securities in Germany where both the issuer and the initial investor are resident in Germany. This is justified on monetary policy grounds.

14. The directive does however provide an escape clause. Article 4 states that the directive is "without prejudice to the right of Member States to take all requisite measures to prevent infringements of their laws and regulations inter alia in the field of taxation and prudential supervision of financial institutions......". It is likely that many countries would argue that restrictions on overseas (or at least foreign currency) investment by savings institutions were necessary for prudential reasons. The borderline between something which is necessary in prudential terms and something which constitutes a hidden exchange control is very difficult to draw, as was found in the recently completed extension of the OECD Codes.

(a) Removing tax measures which discriminate in favour of domestic investments.

15. Such tax distortions are widespread: they include incentives to buy domestic securities (eg PEPs); preferential treatment for income from domestic bonds, deposits or dividends; and indirect taxation of securities purchases. Annex 4 gives details.

16. The Commission declared in its explanatory memorandum covering the Capital Liberalisation Directive that such tax distortions "should be eliminated" but "a pragmatic approach should be adopted with a view to adopting national tax schemes to the requirements".

(b) Real progress towards integration of insurance markets

17. The insurance sector stands out as an area where progress towards freedom of services has been particularly slow. Insurance markets are often highly regulated on the continent. In Germany, for example, the authorities lay down policy conditions, methods of calculating premium rates and, in the case of third party motor insurance, the premium rates themselves. It is illegal for German brokers to place insurance other than transport risks with insurers not authorised in Germany, and tax reliefs on life policy premiums are only available for policies with German companies. The market is dominated by a very small number of very large local firms, and general obstacles to share purchase mean that takeover is not a practical route into the market.

18. The non-life services directive marks a small step forward but allows countries to continue to impose tight regulation of "mass risk" insurance. Even if such regulation does not discriminate directly against foreign firms wishing to enter other markets, it has the effect of fragmenting the European market, reducing potential economies of scale, and pushing up entry costs. On life services, an area in which the UK industry is relatively sophisticated and developed, almost no progress has yet been made.

19. One example of current restrictions is the principle of "cumul" which allows a Member State to prevent an insurer from offering the same class of insurance both from an establishment in that state and by service provision from an establishment elsewhere. (This does not apply to the limited class of insurance covered by the first life and non-life services directive)

20. A further problem is that the present life directive bans "composite" insurers (which offer both life and non life insurance) from providing cross border insurance. This unnecessary restriction would harm UK interests as we are the only country in which composite insurers are common.

(c) Need to harmonise conduct of business arrangements

21. For a European passport to become effective, greater standardisation of marketing or conduct of business arrangements will be required, extending into mutual recognition of financial techniques. Countries are able to use conduct of business rules to favour products which are produced by their own firms and to disfavour those processed by foreign firms. This applies in all areas of financial services. In the case of mortgage credit for example it is currently illegal to conduct variable rate lending in Belgium. In the case of unit trusts compliance, local marketing rules may be designed with a bias towards local firms. (Could be expanded).

(d) Overcoming barriers to takeovers.

22. Although the thrust of the single market is to open markets to cross frontier business, in practice consumer preference and the need for local market knowledge will ensure that takeover of an established local firm is one of the most effective means of market entry. A reduction in barriers to takeovers will produce a freer market. The Commission are conducting an investigation of barriers to takeover at the request of the UK. The DTI have commissioned a parallel study. We expect that these will produce examples of barriers in other EC countries.

Conclusion

A number of areas have been identified where substantial further progress could be made towards a single market in financial services and towards integration of capital markets by full implementation of existing directives, by faster progress on directives under discussion and by bringing forward new proposals to extend current single market measures. These changes should bring benefits to UK firms, but we should recognise that pressure to reduce barriers in other countries will lead to some pressure to reduce our own, with scope for trade-offs and deals.

ANNEX 1

PROGRESS TOWARDS A SINGLE MARKET IN EACH SECTOR OF FINANCIAL SERVICES

CAPITAL LIBERALISATION

Capital Liberalisation Directive approved June 1988 requires removal of all exchange controls by end of June 1990 (end December 1992 for Spain, Portugal, Ireland and Greece). Precondition for cross border provision of investment services. Commission now investigating tax and regulatory obstacles to free movement of capital.

BANKING

Banks have freedom of establishment under 1977 Directive.

Second Banking Coordination Directive aims to provide European, "passport" for defined range of activities (including mortgage credit, and securities business done by banks) on basis of home state authorisation. Close to adoption. Associated directives on own funds and solvency ratios seek to harmonise standards of prudential supervision. Other draft directives under discussion deal with bank accounts and winding up of credit institutions.

MORTGAGE CREDIT

Draft Mortgage Credit Directive seeks to require mutual recognition of a limited range of "financial techniques" in housing finance market. Likely to be overtaken by Second Banking Directive.

CONSUMER CREDIT

Draft directive currently under discussion seeks to harmonise definitions of Annual Percentage Rate (APR) of charge for consumer credit.

LIFE INSURANCE

Life insurers have freedom of establishment in Europe under 1979 Directive, but all establishments must comply with host country authorisation requirements. First life services directive adopted by Commission in January 1989 seeks to provide freedom for cross border life insurance services for "own initiative" insurance - where customer approaches the life office. Further directives are promised covering group and pensions business, and then individual life business. Progress expected to be slow.

NON LIFE INSURANCE

Non life insurers have freedom of establishment under 1973 directive, but all establishments must comply with host country authorisation requirements. First non life services directive adopted June 1988, to come into effect at end of June 1990. Provides nominal freedom of cross border services for all risks (except motor liability) but removes host country control of premium rates and policy terms only for large commercial risks. Further proposals to remove such controls on mass risks are due.

Directives have been adopted on legal expenses and credit and surety insurance (both adopted June 1987, with application by 1 July 1990). Further draft directives under discussion on accounts of insurance undertakings and winding up of insurance companies.

INVESTMENT SERVICES

Draft Investment Services Directive currently under discussion in Council Working Group. Aims to provide European passport based on home country authorisation for non-bank securities firms. Timetable uncertain.

UNIT TRUSTS

Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) adopted 1985, to come into effect October 1989. Establishes a European market for unit trust type instruments which meet prescribed conditions. Does not include "umbrella" funds, money funds etc, and allows host country marketing rules.

INVESTMENT TRUSTS

SECURITIES MARKETS

Community has already coordinated conditions for admissions of securities to stock exchange listing, listing particulars and publication of information by quoted companies. Further directives have been adopted by not yet implemented on listing particulars (adoption June 1987, implementation 1 January 1990); information on major shareholdings (adopted June 1988); and public offer prospectuses (common position December 1988). Draft proposals are under discussion on insider dealing (close to adoption) and takeover rules.

PENSIONS

There are no single market directives envisaged which address pensions directly. In most EC states employee pension contributions are paid direct to an insurance company under a group insurance scheme (rather than into a trust fund as in the UK). Hence pensions are being dealt with in the context of the proposed life services directives. Many German pensions are paid by companies on a pay-as-you-go basis.

ANNEX 2

RESTRICTIONS ON INVESTMENTS BY PENSION FUNDS

Belgium requires pension funds to invest a minimum of 15% of assets in Government Bonds, and prevents direct real estate investment outside Belgium.

Denmark permits investment of a small proportion of the assets of company pension funds abroad, provided that the liabilities are guaranteed.

France requires pension funds to have 50% of their assets invested in French Government loans at the end of each year. In addition, exchange controls prevent investment in real estate in other countries, including other member countries.

In the Netherlands the huge civil servants pension fund (ABP) is permitted to invest only 5% of its assets abroad.

Spain requires pension funds to be invested in Spanish securities.

West Germany bans investments by pensionkassen in foreign countries other than through quotations on a German Stock Exchange or through German investment trusts, in which German investments dominate. There is also a 5% limit to the total of investment abroad. No exception is made for investment in other member countries.

Sources: National Association of Pension Funds, Bank of England

ANNEX 3

RESTRICTIONS ON INVESTMENTS BY LIFE ASSURANCE COMPANIES

All EC countries (except the Netherlands) impose solvency requirements for life insurance companies which require liabilities to be covered by "prescribed" assets. Each country imposes a different definition of prescribed assets: these have the effect of limiting investments in different categories. The main features are:

* In Holland, insurance companies are required to provide a detailed account of assets and liabilities by currency to the insurance supervisor who can make recommendations. There are no regulations.

* Most countries require matching of assets with liabilities in the same currency. Exact matching is required in France and Germany (subject to permission of the insurance supervisor). Italy limits foreign currency assets to foreign currency liabilities. **The UK requires that 80% of a liability in any currency (including sterling) should be matched by assets in that currency.**

* All countries apart from the UK impose maximum or minimum limits on investments in different categories. For example in Belgium foreign transferable assets are limited to 25% of the total. Minimum investments in government stocks are prescribed in Belgium (15%) Greece (15%) and France (34%). Maximum investments in equities are laid down in all countries except the UK, France and Holland: Limits are 20% in Germany 15% in Italy and 25% in Belgium.

* All countries including the UK impose limits on individual investments. For example in the UK an investment in a listed company must not exceed 2½% of relevant assets. In Belgium, Germany, France and Italy

a shareholding must not exceed 5% of the capital of that company.

* In France, Belgium and Italy there are requirements to <u>notify</u> the authorities of (and in some cases seek approval for) disposal of assets.

Source: Committee European des Assurances Life Assurance Committee paper "Study on Choice of Investments" 1985

ANNEX 4

EXAMPLES OF TAX MEASURES WHICH DISTORT CAPITAL MOVEMENTS

Belgium Offers tax relief on pension plan contributions where at most 10% of the funds can be invested in foreign companies and these must be quoted on the Belgian Stock Exchange. Half the value of investments in new shares issued by "innovative companies established in Belgium" may be set against income tax. Employees receive tax relief for investing in the shares of their own company. Income from investments in Belgium bonds is free of tax up to a certain ceiling.

France The "Loi Monory" of 1978 allowed investments in shares of French companies (not proceeds of sales) to be set against income tax. (Now being gradually phased out). Retirement savings plans receive tax advantages when at least 75% of the money is invested in French companies. Income from public and private sector French bonds and dividends from French companies is free of tax up to a certain ceiling. Interest on deposits in certain savings accounts (received by residents or non residents) is tax free. Very roughly a half of french savings are untaxed, and the rest are taxed at penal rates.

Ireland Offers relief from income tax for purchase of shares in Irish manufacturing companies under a Business Expansion Scheme. Employees receive relief for purchase of new shares in their employing company.

Luxembourg Interest on domestic savings amount is exempt from tax up to a certain ceiling.

Netherlands Dividends on shares in Dutch companies are free of tax up to a certain ceiling.

Spain Grants tax credits equal to 10% of the value of investments in certain companies listed on the Spanish stock exchange.

UK Provides relief from income tax for investments through the **Business Expansion Scheme** in unquoted UK companies. Investments in **Personal Equity Plans** attract tax relief on dividends and capital gains up to defined limits. Investment must be made in UK quoted companies or UK authorised Unit Trusts holding at least 75% of their assets in UK securities. Tax reliefs are available for **savings for retirement** certain forms of which are subject to investment restrictions : appropriate personal pensions must be invested in..... and contracted out money purchase schemes cannot invest in .... Income from **National Savings Certificates** deposits with **National Savings Bank** (up to £70 pa) and **SAYE savings** are tax free. Mortgage interest tax relief is only available for loans from financial institutions established in the UK.

Source: European Commission "National Tax Measures liable to introduce distortions in capital movements within the Community" January 1988, updated for UK only.