# 4 Financial Services

**What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?**

**The assessment of the financial services test examines the costs and benefits of EMU entry for the UK financial services sector as well as those associated with remaining outside the euro area. The assessment is based on the evidence of four years' operation of euro financial markets since the start of EMU and the City's relative performance, and the detailed analysis of longer-term trends in the EMU study *The location of financial activity and the euro*.**

**Key points:**

- **Inside or outside EMU, the competitive strength of the City should mean that the UK continues to attract a significant level of wholesale financial services activity. The international nature of the City's markets and the foundations of its competitive position imply that the achievement of sustainable and durable convergence to safeguard stability in EMU is less of a determinant of the likely success of wholesale financial services activity than it is of other aspects of the UK economy. Entry might strengthen London's position as a leading financial centre. To the extent that the euro proved to be a factor in the location of wholesale financial services activity, entry would remove any unease firms might have about locating in a financial centre outside the euro area. Entry could also improve the UK's ability to compete for the new, contestable business that can be expected to arise from EU enlargement, an ageing EU population and the continued development of euro financial markets. Changeover costs arising from entry for the sector would not be significant.**
- **Entry would improve the competitive position of the UK's retail financial services sector if other barriers are also removed. Benefits to the retail financial services sector from entry would include lower costs on euro area transactions, the possibility for a more optimal allocation of investment portfolios and potential scale economies for investment funds. Assuming markets are competitive, these benefits should be passed on to consumers and offset the one-off changeover costs for the retail financial services sector that would arise from entry.**
- **The dynamic effects of the single currency can be expected to be gradual. With other changes, the euro will encourage integration of retail financial services in the Single Market over the longer term and, importantly, greater competition in the sector. Being outside the euro area would mean that these effects would be more muted in the UK sector although the barriers are regulatory and legal rather than related to currency. The business case for greater cross-border merger and acquisition activity could strengthen as retail financial services firms seek to make the most of new opportunities in a single market with no currency barriers. Outside the euro area, the business case for UK retail financial services firms to capitalise on these opportunities could be weaker.**
- **Compared to wholesale financial services activity, realisation of these gains for retail financial services is more conditional on the achievement of sustainable and durable convergence and the safeguarding of stability, just as it is for other UK business sectors that serve the domestic market.**
- **The UK's influence over EU financial services policy should remain strong whether inside or outside the euro area. Concerns prior to the start of EMU that the UK's influence would diminish outside EMU have not been realised: the UK has had an influential say over EU financial services issues. In part because of the position of the City as the major international financial services centre in the EU and the transaction of a significant proportion of euro business in London, the UK's influence should remain strong in or out of EMU. The Government is aware that it will need to be more vigilant in the face of any risks that might arise while the UK remains outside EMU and will be fully engaged in the debate about the future regulatory framework for EU financial services. Using its strong influence, the Government will work with the UK's financial services sector to ensure that the UK's competitive advantage in many retail and wholesale financial services activities is safeguarded and, wherever possible, enhanced.**

**The overall conclusion of the financial services test is:**

- **Over the four years since the start of EMU, the UK has attracted a significant level of wholesale financial services business. The strength of the City in international wholesale financial services activity should mean that it continues to do so, whether inside or outside EMU. EMU entry should enhance the already strong competitive position of the UK's wholesale financial services sector by offering some additional benefits. Again, while the UK's retail financial services sector should remain competitive either inside or outside the euro area, entry would offer greater potential to compete and capture the effects of greater EU integration that would arise from the single currency and other efforts to complete the Single Market, in particular the Financial Services Action Plan (FSAP) – benefits which are postponed while the UK is not in EMU. Overall, the financial services test is met.**

**Policy requirements:**

- **Ongoing efforts are required to increase EU financial services integration through the FSAP and other measures. In the longer term, this should add to competitive pressures in the UK financial services market as well as providing opportunities for UK financial intermediaries in the euro area.**

## THE IMPORTANCE OF FINANCIAL SERVICES

**4.1** The financial services test asks:

*What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?*

**The 1997 assessment**

**4.2** Compared to the 1997 assessment, this assessment has the benefit of over four years' experience of the euro on which to draw. The 1997 assessment concluded that EMU offered considerable benefits to the UK financial services sector whether the UK was inside or outside the euro area. However, the benefits and the opportunities would be more easily tapped from inside the euro area than outside.

**4.3** The UK's wholesale markets were expected to remain competitive following the introduction of the single currency whether or not the UK joined, because the City held a number of significant competitive advantages relative to other EU financial centres. Prospects for the UK retail financial services sector were also generally positive. Compared to other European markets, the UK sector had undergone early and significant structural reforms, with consumers feeling the benefits of innovation stimulated by competition.

**The financial services sector's importance to the UK economy**

**4.4** The financial services sector continues to play an important direct role in the UK economy:[1]

- in 2001, financial services accounted for 5.2 per cent of UK output, compared to 5.6 per cent of output in 1997;
- the financial services sector continues to be a significant source of employment for the UK economy. It provided over 1 million jobs in 2002, a level largely unchanged since 1997; and
- the sector is a significant source of overseas earnings for the economy. In 2001, financial services net overseas earnings (including insurance) amounted to around £13.2 billion. In 1997, the surplus was around £9.7 billion. The large surplus suggests that the UK continues to hold a significant competitive advantage in financial services activity relative to its competitors.

[1] More detailed evidence on the UK financial services sector and its performance relative to other countries is provided in an annex to the EMU study *The location of financial activity and the euro.*

**4.5** The financial services sector also has an important wider role in the UK economy. A well functioning and efficient financial sector contributes to increased investment, productivity and growth – issues that are at the core of the investment test and the growth, stability and employment test. Financial markets:

- lower the cost of capital, as large and liquid markets lead to lower risk premia. The investment test examines this important issue and the potential for EMU to lower the cost of capital;
- allocate capital to where it earns the highest returns, raising growth;
- increase information flows to investors and consumers, allowing them to manage risk and allocate capital to where they believe returns are highest;
- add to economic efficiency by lowering transaction costs; and
- can exert financial discipline on companies, maximising returns for shareholders.

**No room for complacency**

**4.6** The importance of the financial services industry to the UK economy and its dynamic nature mean that there are no grounds for complacency in this assessment. The severity of the global equity market downturn since 2000 has created a level of uncertainty not seen in the financial services sector for many years, and there are as yet few signs of a rapid recovery in market sentiment. Other significant long-term forces are also shaping the sector – the EMU decision adds to the already complex environment for the UK financial services sector. It has some direct and, perhaps more importantly, indirect effects on existing trends, with potential long-term implications for both the UK's wholesale and retail financial services sectors.

**The structure of the test**

**4.7** The assessment of the financial services test is structured as follows:

- **The future drivers of EU financial services** answers the question: **What are the drivers shaping the development of the EU financial services sector?**

  Five key drivers are assessed, drawing on the EMU study *The location of financial activity and the euro*.

- **The assessment of UK wholesale financial markets** answers the question: **What would be the costs and benefits of entry for UK wholesale financial markets?**

  London remains by some distance the leading wholesale financial centre in Europe. The factors which have resulted in this position and the potential impact of EMU membership on wholesale markets are considered.

- **The assessment of UK retail financial services** answers the question: **What would be the costs and benefits of entry for UK retail financial services?**

  The potential impact of EMU on the UK's well developed retail financial services sector is analysed, considering both the short-term changeover costs and the long-term benefits including greater competition.

- **Regulation and influence** answers the question: **Would the UK be better placed to influence the course of financial market regulation inside or outside the euro area?**

  The UK has a strong influence over EU financial services regulation, in part reflecting the position of the City as the major international financial services centre in the EU and the transaction of a significant proportion of euro business in London. The potential impact of EMU membership on the UK's influence over EU financial services policy is assessed.

- The **Conclusions** bring together the analysis to assess whether the financial services test has been met.

## THE FUTURE DRIVERS OF EU FINANCIAL SERVICES

**4.8** This section examines the drivers shaping the development of the EU financial services sector identified in the EMU study *The location of financial activity and the euro*. Against a backdrop of changing financial structures in the euro area, these five drivers have implications for the EU financial services sector going forward:

- a changing **business environment** in the EU, most notably driven by the regulatory approach reflected in the Financial Services Action Plan (FSAP);
- the increasingly **global nature** of the financial services industry;
- on the **supply side**, the continued effects of technology, in particular on firms' location decisions;
- new **business strategies**, for example in response to the opportunities created by greater market integration and new technology; and
- **currency**, in this context the euro and its impact on financial centres' development.

**Changing financial structures in the euro area**

**4.9** The 1990s saw a marked increase in demand for equity-backed investments in the euro area and a gradual shift from a bank-based to a market-based financial structure, outlined in the analysis of endogenous convergence in the assessment of the convergence test. The increasing appetite of euro area investors for equities encouraged privatisation and other equity issues targeted at retail investors, as well as merger and acquisition (M&A) activity funded by share issues rather than cash.

**4.10** The severity of the downturn in global equity markets since 2000 has clearly dented investor confidence and put on hold the trend towards an equity-based culture in the euro area. A strong recovery in investor confidence is unlikely in the short term and, at this stage, it is not clear how the recent downturn might shape perceptions of equities as investment vehicles over the longer term. A shift in the EU from a bank-based to a market-based financial structure should however continue, encouraged by the trend towards disintermediation and the securitisation of assets and, at some point, the return of investors to equity markets.

**4.11** An ageing EU population and EU enlargement will also have important effects on EU financial services. Less state support for pensions and the closure of some company defined benefit schemes will mean citizens are encouraged to turn to capital markets for retirement incomes. Member States are exploring options to switch from unfunded pay-as-you-go state pension schemes to funded schemes that invest in assets such as equities. Demand for institutional asset management services should increase as a result.

**Business environment is a major driver**

**4.12** The FSAP will be a major influence on the size, structure and competitive position of the EU financial services sector. The Government has strongly supported the FSAP's objectives and will continue to seek outcomes that are compatible with both the strengths of London's way of doing business and the achievement of economic reform in Europe. Dismantling further the policy-induced barriers in the Single Market will offer a variety of benefits to both corporate and personal consumers of financial services as well as financial intermediaries, flowing from increased competitive pressures in domestic markets.

**4.13** Greater cross-border activity should be encouraged, for example through greater cross-border M&A activity and increased cross-border trade in retail financial services. Both will help to promote integration in the EU's retail financial services sector. Estimates of the overall gains from full Single Market integration in financial services vary. But, according to recent estimates produced for the European Commission already highlighted in the assessment of investment, such gains could amount to an increase in the level of EU GDP of around 1.1 per cent in the long run.

**Globalisation**

**4.14** Regulatory changes have been one of the main reasons behind the increasingly global nature of the financial services sector. Exchange and capital controls have been removed and changes in cross-border investment rules and foreign ownership have allowed large investment houses to build up interests globally and enter foreign markets. Combined with the effects of technology that facilitate the instant transfer of funds across the globe, the result has been a massive increase in global capital flows. Once the global economy picks up and confidence returns to markets, these trends look set to continue, subject to ongoing liberalisation of capital markets and the willingness of investors to take risks and invest across borders and currencies.

**Among supply-side changes, technology is key**

**4.15** Technology should continue to influence the structure of the financial services industry and where financial services activity is located. As competitive pressures in the financial services sector increase, retail financial services firms in particular can be expected to take advantage of the opportunities offered by technology to relocate lower value added activities to lower cost locations. In some cases, this may mean locating activity outside the EU altogether. Technology may also encourage some further concentration of activity. Where they have not done so, financial firms may continue to harness the potential of technology, gather operations at one site and offer their services widely from a single location. This reduces costs and allows internal scale economies to be captured.

**Business strategies**

**4.16** Some reversal of the trend towards building financial services conglomerates may be seen as firms focus on core activities and buy in services where they lack expertise or sufficient market presence to compete. Consolidation should continue in domestic markets, particularly in the retail banking sector where average bank size in many Member States remains small compared to that in the UK. In the longer term, greater cross-border M&A activity in the EU might also be seen as domestic merger opportunities become more limited. This may be more pronounced in the euro area.

**Currency may affect the development of financial centres…**

**4.17** The advent of the single currency has highlighted the potential for greater competition within Europe in financial services. It has been one of a number of factors that has encouraged European financial services providers, in particular investment banks, to try to establish sufficient critical mass to compete with larger US institutions. As economies of scale have dominated, so the tendency has been for activity to be increasingly undertaken by a smaller number of firms or markets and, by implication, at fewer locations. This has reinforced a trend towards greater concentration of wholesale financial services activity in fewer financial centres, though not necessarily in the euro area.

**4.18** Larger, more liquid markets have developed since the introduction of the euro, for example the increase in liquidity and average size of issue in the corporate and sovereign bond markets. Recent consolidation of EU market infrastructure (trading, clearing and settlement systems), driven largely by factors other than the euro, has added further weight to the concentration of liquidity on fewer, larger exchanges. Ongoing consolidation of market infrastructure seems likely, but still faces a number of obstacles.

**4.19** In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor Jean Dermine puts forward the view that: *"A single currency in Europe changes fundamentally the competitive structure of the corporate bond and equity markets, since one key source of competitive advantage, namely home currency, disappears. Indeed, savers will diversify their portfolio across European markets, now that the exchange rate risk has been eradicated. If access to a Europe-wide investor base facilitates placement, and if access to information on the supply/demand order flows seems essential to operate on the secondary market, operations on a large scale and at a European-wide level are likely to become a necessity, and one should observe a consolidation on the capital markets."*

**…whether those offering a range of services…**

**4.20** Looking ahead, the trend towards greater concentration still has some scope to continue, in part encouraged by the single currency, as Professor Dermine argues, but also by regulatory developments, technology and changing business strategies as already outlined. If the trend towards concentration continues, then larger financial centres such as London, Paris and Frankfurt might expect to be the main locus of international and regional wholesale business, even more than they are today.

**…or more niche markets**

**4.21** Other financial centres that have established niche markets can also expect to attract business. Scottish financial centres, with experience in institutional fund management, are likely to benefit from the expected increase in demand for fund management services that should flow from an ageing EU population and changes to pension arrangements. While smaller financial centres may continue to lose liquidity to larger financial centres, they should still have a role, albeit more limited and focused on serving the needs of their national markets and local clients.

## THE ASSESSMENT OF UK WHOLESALE FINANCIAL MARKETS

**The current position**

**4.22** In order to assess the costs and benefits of EMU entry for UK wholesale markets, it is important to establish first the current position and the reasons for it. The overview of global shares of wholesale financial markets in Table 4.1 shows that the UK remains by some distance the leading financial centre in Europe, largely due to the very high levels of wholesale financial services activity in London. Scottish financial centres also make an important contribution to the UK's position in wholesale financial activity through their significant presence in institutional asset management services. Scotland is now the sixth largest institutional equity management centre in Europe.

### Table 4.1: Global market share held by major financial centres in selected wholesale markets

| Per cent – rounded | UK | US | Japan | France | Germany | Others |
|---|---|---|---|---|---|---|
| Cross-border bank lending (Jun 2002) | 19 | 10 | 9 | 6 | 10 | 46 |
| Foreign equities turnover (Jan – Aug 2002) | 56 | 26 | – | – | 3 | 15 |
| Foreign exchange dealing (Apr 2001) | 31 | 16 | 9 | 3 | 5 | 36 |
| Over-the-counter derivatives turnover (Apr 2001) | 36 | 18 | 3 | 9 | 13 | 21 |
| Gross insurance premium income (2000) | 10 | 35 | 21 | 5 | 5 | 24 |
| Marine insurance net premium income (1999) | 19 | 13 | 14 | 5 | 12 | 37 |
| Aviation insurance net premium income (1999) | 39 | 23 | 4 | 13 | 3 | 18 |

*Source: IFSL and BIS; latest available data.*

**Location and currency**

**4.23** The EMU study *The location of financial activity and the euro* helps to explain why London has maintained its strong position in wholesale financial services activity over the first four years of EMU. The study focuses on the factors driving the location of wholesale financial services activity. It examines what makes a location such as London competitive in international wholesale financial services and what role, if any, currency might play in determining a location's competitive position.

**4.24** The three key findings of the study are that:

- since the development of the Euromarkets in the late 1950s and early 1960s, when large US dollar deposits started to be placed with banks based in London, the competitive position of London in international wholesale financial services activity has been largely decoupled from the issue of domestic currency. London's strength and development is independent of sterling;
- London's market share in a wide range of wholesale financial services markets, including euro financial markets, has remained broadly unchanged since the launch of the euro. Wholesale financial services firms based in the UK have participated fully in euro financial markets; and
- to date, there is no sign of a relocation of wholesale financial services activity from London to the euro area arising from the UK's decision in 1997 not to join EMU. Evidence suggests that membership of the single currency has not been an important issue in determining the location of wholesale financial services activity.

**4.25** The EMU study uses economic geography and economic history to identify a number of common themes that help to explain London's competitive position in international wholesale financial activity. These include:

- **clustering forces**. London's key attractions are the critical mass of wholesale financial services activity present in London and a large pool of skilled labour drawn from both domestic and international labour markets attracted by the cosmopolitan nature of London. The fact that wholesale financial firms have access on equal terms to an efficient market infrastructure is another important attraction;
- **a supportive public policy framework**. The UK's flexible labour markets, its approach to financial services regulation and a competitive tax regime together create an attractive business environment for wholesale financial activity; and
- **a long and distinct track record**. The UK has a long history and reputation for providing international wholesale financial services, drawing on the unique international nature of London's markets and market participants.

**4.26** While London faces challenges (for example, a reputation for congestion and poor public transport, and its relatively high real estate and living costs), the presence of these attractions means that the UK is still viewed as a competitive location for international wholesale financial activity.

**London is a multi-currency market**

**4.27** London's standing as a multi-currency market further underlines why the UK's non-participation in the euro has had little short-run impact on London. Many of London's wholesale financial trades are denominated in non-sterling currencies, most importantly the US dollar. The introduction of a new currency, the euro, was therefore comfortably handled.

**4.28** The international and multi-currency nature of London's business is most clearly seen in foreign exchange markets. The UK has captured a high and stable share of foreign exchange markets. In 2001, around 31 per cent of global daily foreign exchange trading activity took place in the UK (see Table 4.2). A particular feature of London is the relatively low volumes of transactions that take place in its domestic currency – only 24 per cent in 2001. Most foreign exchange trades in London are dominated by US dollar and euro transactions, whereas in the leading financial centres in the euro area – Paris and Frankfurt – foreign exchange trades are dominated by their domestic currency, the euro.

**4.29** An implication of these findings is that the international nature of the City's markets and the foundations of its competitive position mean that the achievement of sustainable and durable convergence to safeguard stability in EMU is less of a determinant of the likely success of wholesale financial services activity compared to other areas of the UK economy.

## Table 4.2: UK share of global foreign exchange trading activity

| Per cent | 1992 | 1995 | 1998 | 2001 |
|---|---|---|---|---|
| UK market total | 27 | 30 | 33 | 31 |
| UK share of major currencies: | | | | |
| US dollar | 25 | 29 | 30 | 31 |
| Euro currencies | 26 | 26 | 34 | 35 |
| Pound sterling | 49 | 55 | 83 | 61 |
| Japanese yen | 16 | 24 | 22 | 24 |
| Swiss franc | 22 | 26 | 29 | 29 |
| Other | 14 | 18 | 19 | 20 |

*Source: BIS.*

**The impact of entry**

**4.30** In assessing the impact of EMU entry on UK wholesale markets, two direct short-term costs to the UK's wholesale financial markets, and some potentially more significant long-term implications, need to be considered. While London currently enjoys a strong competitive position, and should continue to do so inside or outside the euro area, the dynamic nature of financial services means that a financial centre's competitive position cannot be taken for granted.

**Changeover costs**

**4.31** There would be short-run changeover costs for wholesale financial services firms and markets arising from a UK decision to join EMU. Operating systems would need to be adapted to cope with the changeover to the euro (for example, converting sterling equity contracts into euro and redenominating interest payments on debt instruments from sterling into euro). These would carry opportunity costs in terms of time spent managing the changeover and financial resources diverted from other more productive uses.

**4.32** Short-run changeover costs would not be expected to undermine the long-term competitive position of the UK's wholesale financial services sector. As noted above, most UK-based wholesale financial institutions are accustomed to trading in an international, multi-currency environment. In-house IT groups and external consultancies have extensive experience in introducing new trading systems (most recently in the run up to the year 2000) and wholesale market firms already have well-developed management plans to smooth any changeover process.

**Loss of sterling markets**

**4.33** Sterling markets would disappear on entry and this would be expected to result in net job losses. The removal of sterling would directly affect institutions active in foreign exchange markets, which would see a fall in foreign exchange transactions fees. Consumers of these foreign exchange services would, however, gain. Overall, the removal of these foreign exchange transaction costs would increase economic welfare, as discussed in the assessment of the growth, stability and employment test.

**Longer-term issues: perception…**

**4.34** If the UK were to join EMU, and assuming entry was under the right conditions, the positive perception of the UK as a full participant in euro financial markets should continue. Entry might strengthen London's position as a leading European financial centre, provided it did not undermine – or was not perceived to undermine – London's other advantages. It could create intangible but important reputation effects for wholesale financial services firms located in the City, and perhaps in Glasgow and Edinburgh too.

**…and foreign ownership**

**4.35** Given the high levels of foreign ownership in the City, perception effects may be important. Many international wholesale financial firms are mobile. The high level of foreign ownership in London's and Scotland's wholesale financial centres may have made them more sensitive to changes in the relative attributes of locations. Technology has already been noted for its potential to allow firms to relocate some of their activities to lower cost locations (but not necessarily in the euro area) and has increased the 'contestability' of locations.

**4.36** To the extent that the location of wholesale financial services activity might be based on membership of the single currency, then a decision not to join the single currency might imply an adverse perception for future location decisions. However, the first four years of the euro have not produced any evidence of such concerns affecting location decisions. Wholesale financial firms such as those from the US are likely to continue to place greatest weight on the locational advantages of London already highlighted, including its critical mass of financial expertise and a skilled labour force. While the same attractions would apply equally to euro area wholesale financial firms, in some cases they may be more comfortable with establishing wholesale activities in a financial centre that is part of the euro area. UK entry to EMU under the right conditions would ease any such concerns.

**4.37** A further effect of a decision to join EMU might be to encourage wholesale financial services firms who had not already done so to concentrate more of their euro-related wholesale operations in London. With most leading institutions already using London as the base for their core European time zone wholesale functions, the gains would be expected to be marginal, but could include euro area banks integrating their money market and treasury functions in London. Professor Iain Begg in his contribution to the EMU study *Submissions on EMU from leading academics* argues that: *"On balance, membership would be expected to increase the size of London offices because it would make sense to consolidate some euro-related activity (such as treasury functions or corporate finance and advisory activities) in London, but these gains could be offset by the disappearance of some foreign exchange dealing."*

**Greater business opportunities?**

**4.38** As already stressed, an ageing EU population, greater use of market-based instruments by euro area firms and investors, and the forthcoming enlargement of the EU are all likely to be important sources of new business for UK wholesale financial services. There might be some additional benefits if firms use the strategic opportunities resulting from growing euro financial markets as well as the growing international use of the euro, and transact any increase in business flows through their wholesale operations in London. But inside or outside the euro area, the UK's wholesale financial sector would expect to capture its fair share of new business resulting from any increase in demand in the euro area because of its strong competitive position.

**Markets**

**4.39** In terms of markets, apart from some relatively minor technical changes, UK entry would not affect day-to-day trading. Adding the significant weight of the UK financial services sector to that of the euro area would add momentum to existing trends in the euro area, for example further deepening and broadening euro-denominated corporate bond markets.

**4.40** Since London already provides the broadest range of international wholesale financial services, a decision to join EMU would not in itself be expected to offer access to any new wholesale instruments for UK-based institutions and investors. Entry would, however, offer UK insurance companies access to the significant *Pfandbriefe* market (bonds issued to finance mortgages or public projects, secured against mortgages or public sector loans) without facing currency risk.

**Portfolio reallocation**

**4.41** EMU entry should lead UK investors to reallocate their portfolios and diversify their risk through a greater geographic spread of investments. Evidence from the euro area suggests that euro area-wide portfolio allocation strategies have been adopted by many fund managers. This has led to a greater cross-border diversification of euro area portfolios and, other things equal, a more optimal allocation of assets for euro area investors. Were this pattern to be repeated if the UK joined EMU, UK consumers could see better returns on their investments for the same level of risk – for example savers through their investments in pension funds.

**4.42** The net effect of portfolio reallocation on capital flows is difficult to predict with any certainty. Judging from the experience of existing euro area countries, EMU entry would be likely to provoke a one-off impact on net flows, as institutional investors diversified into UK assets and UK institutions moved into euro area assets.

**4.43** Stamp duty on share transactions could reinforce any capital flow out of UK assets resulting from a decision to join EMU by putting an additional charge on trading in UK equities. At 0.5 per cent, however, its effect is likely to be very marginal. It needs to be considered alongside the full range of other factors affecting the attractiveness of the UK as a business environment, and the barriers potentially holding back full portfolio diversification in the euro area. These include differences in national regulatory environments, the fragmented nature of EU market infrastructure and the fact that small firms in particular will favour domestic stocks because they have better information on these compared to foreign stocks.

## Conclusion: what would be the costs and benefits of entry for UK wholesale financial markets?

**4.44** Inside or outside EMU, the competitive strength of the City should mean that the UK continues to attract a significant level of wholesale financial services activity. The international nature of the City's markets and the foundations of its competitive position imply that the achievement of sustainable and durable convergence to safeguard stability in EMU is less of a determinant of the likely success of wholesale financial services activity than it is of other aspects of the UK economy. Entry might strengthen London's position as a leading financial centre. To the extent that the euro proved to be a factor in the location of wholesale financial services activity, entry would remove any unease firms might have about locating in a financial centre outside the euro area. Entry could also improve the UK's ability to compete for the new, contestable business that can be expected to arise from EU enlargement, an ageing EU population and the continued development of euro financial markets. Changeover costs arising from entry for the sector would not be significant.

## THE ASSESSMENT OF UK RETAIL FINANCIAL SERVICES

**The UK retail financial services sector**

**4.45** The UK retail financial services sector is well developed, offers a very wide range of retail financial services products and has a high level of innovation. The assessment of the costs and benefits of EMU entry must take this into account. The retail banking sector has been through an intensive period of restructuring and consolidation in the past two decades and the sector is dominated by four large institutions. Long-term and general insurance have a significant weight in the retail financial services sector. The UK insurance sector is the largest in Europe and accounts for over 20 per cent of investments in the UK stock market. Some other examples illustrate the highly developed nature of the UK retail financial services sector:

- the UK mortgage market is the second largest in the EU after Germany;
- in terms of premium income, the UK insurance market accounts for 30 per cent of the total EU market; and
- the UK has a well-developed consumer credit market, accounting for 40 per cent of the total EU market.

**Box 4.1: Examples of retail financial services in the EU**

**Retail financial services available to EU consumers include the following:**

- **savings and lending products** offered by banks and building societies. Most EU retail savings are held in the form of deposits;
- **investment funds** such as unit trusts, or shares in an open-ended investment company (an 'OEIC') or an investment trust company; and
- **insurance products**. Life insurance or pension holdings are the second most popular form of saving in the EU after deposits.

**Impact of EMU to date**

**4.46** There are few signs that the single currency has made any significant impact on the UK's retail financial services sector. The reasons lie in the structure of the EU's retail financial services sector and remaining obstacles to the cross-border provision of retail financial services in the EU. These mean that EU markets remain segmented along national or even regional lines, limiting any benefits from greater Single Market integration that the single currency might encourage because:

- UK consumers predominantly purchase retail financial services from local providers rather than overseas providers. This includes euro-denominated products for those customers willing to take the currency risk (for example, euro mortgages offered by UK banks);
- in many instances, the business case for cross-border branch networks and M&A activity among retail banks is weak, limiting integration in the EU market along these lines; and
- national consumer and retail investor protection rules vary considerably and can make the cross-border provision of some relatively standard and simple retail financial services products difficult.

**4.47** As with wholesale financial markets, UK retail financial services would experience short run and longer-term effects from EMU entry.

**Changeover costs…**

**4.48** The short-run costs of entry into the single currency would be significant for retail financial services. The changeover costs incurred would be dependent upon the approach taken by each institution, the type and age of IT systems and the composition of the customer base. While most of the cost would relate to IT changes, for example accounting infrastructure and automated cash machines operated by banks in their branch networks, other costs would include:

- short-term cash handling costs when the move to euro notes and coins took place;
- marketing and information campaigns to inform customers about changes to their bank accounts as well as euro products and services;
- staff training costs to service customer needs and manage the changeover; and
- opportunity costs as other change programmes were deferred and management focused on the changeover period.

**4.49** Against these short-run costs, some longer-term benefits might arise through investment in upgrading IT systems to handle the euro. These could hasten efficiency gains for the UK retail financial services sector, providing the opportunity for organisations to rationalise and upgrade their product ranges and introduce improved customer service and working practices.

**...offset by longer-term benefits**

**4.50** Over the longer term, a number of dynamic benefits would be captured from EMU entry that would outweigh the short-term costs. Compared to wholesale financial services activity, realisation of any gains for retail financial services is more conditional on the achievement of sustainable and durable convergence and the safeguarding of stability, just as it is for other UK business sectors that serve the domestic market. Gains for financial services intermediaries as well as corporate and personal consumers of retail financial services from entry can be expected to come through greater competition and an increased range of products and services. Other specific benefits from EMU for UK financial intermediaries and consumers which are not available outside EMU could include:

- making the matching of UK and euro area assets and liabilities easier, and removing the need to hedge risks on transactions with the euro area. This could bring particular benefits for insurance companies with significant UK liabilities which would be able to hold a more diverse set of euro area assets without either currency risk or hedging costs. Their customers would benefit too from the more optimal allocation of investment portfolios that would result from entry;
- increasing the average size of investment funds and other retail products. As savings from the euro area were pooled, scale economies could be captured, lowering the average cost of managing an investment fund. Analysis produced for the European Financial Services Round Table suggests that if the average EU fund size matched that of the US, then annual cost savings could be around €5.3 billion. Assuming markets are competitive, the bulk of the savings would be passed on to consumers; and
- removing the psychological barrier created by national currencies. Though not expected to be particularly significant, entry could improve the perception of UK providers and products in the euro area.

**Business models leading to greater integration**

**4.51** The extent to which these benefits would be realised depends on the degree to which the single currency can in practice encourage the right business models to develop. Business models include:

- greater **cross-border trading** of retail financial services, for example over the Internet where a consumer buys a retail financial services product from a provider in another Member State;
- the ability for retail financial services products developed in one country to be sold through **local distribution** networks in other countries, sometimes with local branding. For example, 'open architecture' allows the investment funds of the US investment management company Fidelity to be sold through HypoVereinsbank's branches in Germany; and
- branch networks, where a firm creates or buys a multi-national branch network either through **cross-border M&A** or by opening branches itself. This allows firms to sell their products locally and provides them with opportunities to capture economies of scale and scope.

**M&A is the most promising model…**

**4.52** The single currency may have its greatest long-term effect on cross-border M&A activity. Retail financial services firms can be expected to take increasing advantage of the business opportunities presented by a single market without currency barriers. Thus far, the business case for cross-border M&A activity has been weak given the low levels of cost savings that can be achieved compared to domestic mergers – a key reason why, to date, most bank mergers in the EU have been in domestic markets. As these domestic opportunities become exhausted, and as rules permit them to do so, euro area firms may increasingly look across borders for their expansion plans.

**4.53** The large size of many UK institutions relative to their euro area competitors would put them in a good position to take advantage of any such opportunities. As Professor Jean Dermine argues in his contribution to the EMU study *Submissions on EMU from leading academics*: *"…the number of significant cross-border mergers in banking have been few…but it is the belief of the author that the end of domestic consolidation will force banks to search across borders for new sources of value creation."*

**…the others will see a more limited impact**

**4.54** The impact of a decision to join EMU on the other business models might be expected to be more limited, especially in the short run. Some competitive advantage might be gained from lower transaction costs and potential scale economies for investment funds. Entry could also improve sentiment in the euro area towards UK retail financial services providers and products. But as the example of Fidelity cited earlier shows, membership of the single currency need not be a crucial factor driving competition in euro area markets. In principle, UK retail financial service firms can already trade euro products across borders and offer euro products and services on competitive terms – the currency risks they face when doing so have not proved a barrier (but do increase costs).

**4.55** Either inside or outside the euro area, the key requirements for the UK's and other Member States' retail financial services sectors to be able to compete in the Single Market are likely to remain:

- their ability to access euro area customers through an efficient distribution network such as bank branches, the Internet or local advisers; and
- their ability to develop retail financial services products and brands that appeal to differing national consumer tastes.

**4.56** Establishing these delivery mechanisms and products will be closely tied to efforts to remove policy-induced barriers in the Single Market through the FSAP. Expectations of complete EU integration should be tempered by evidence from the US banking and insurance sectors, which shows that regional differences can still persist in a monetary union even in the very long run, as detailed in the EMU study *The United States as a monetary union*. Other hard-to-tackle 'natural' policy barriers will act to hamper integration and limit the full benefits of the single currency being realised, for example the persistent effects that differences in language, law and legal tradition have had on the character of Member States' national markets. EU integration will therefore be a gradual process and, in practice, complete integration even with a single currency may be impossible to achieve.

### Conclusion: what would be the costs and benefits of entry for UK retail financial services?

**4.57** Entry would improve the competitive position of the UK's retail financial services sector if other barriers are also removed. Benefits to the retail financial services sector from entry would include lower costs on euro area transactions, the possibility for a more optimal allocation of investment portfolios and potential scale economies for investment funds. Assuming markets are competitive, these benefits should be passed on to consumers and offset the one-off changeover costs for the retail financial services sector that would arise from entry.

**4.58** The dynamic effects of the single currency can be expected to be gradual. With other changes, the euro will encourage integration of retail financial services in the Single Market over the longer term and, importantly, greater competition in the sector. Being outside the euro area would mean that these effects would be more muted in the UK sector although the barriers are regulatory and legal rather than related to currency. The business case for greater cross-border merger and acquisition activity could strengthen as retail financial services firms seek to make the most of new opportunities in a single market with no currency barriers. Outside the euro area, the business case for UK retail financial services firms to capitalise on these opportunities could be weaker.

**4.59** Compared to wholesale financial services activity, realisation of these gains for retail financial services is more conditional on the achievement of sustainable and durable convergence and the safeguarding of stability, just as it is for other UK business sectors that serve the domestic market.

## REGULATION AND INFLUENCE

**4.60** A complex issue to assess is the long-term development of policy towards, and affecting, financial services in the EU. It has been argued that the UK EMU decision could affect the UK's ability to influence the course of these developments.

**4.61** Some areas will clearly remain unaffected by the question of the UK's entry decision. These include two important areas of EU policymaking:

- Directives relating to completing the **Single Market** in financial services through the FSAP are mostly agreed on the basis of qualified majority voting (QMV) in the ECOFIN Council and co-decision with the European Parliament. The UK has no veto and faces the same voting structure in relation to these measures either inside or outside EMU. All EU Member States are in the Single Market and must adhere to Single Market rules irrespective of their membership or otherwise of the single currency. Coupled with the fact that international rules regulating financial services are becoming increasingly harmonised, the scope for the UK to develop competing regulatory rules should it remain outside the euro area is very tightly constrained; and

- the UK's ability to determine its own approach to **tax policy** would not change on entry. Tax policy applied across the EU requires the unanimous agreement of all Member States whether they are inside or outside EMU. For example, the recent agreement on the treatment of withholding tax could only be reached with the agreement of the UK. That position would not change should the UK decide to join the single currency.

**4.62** Experience to date shows that cultural differences have been the usual motivating factor behind Member States' positions on financial services dossiers. The UK's decision on EMU entry is unlikely to shift such deeply held positions. If the UK was inside the euro area, there would therefore be likely to be little additional benefit to the prospect of achieving the UK's regulatory objectives – it could be argued that pressure to conform to the rules of the euro area 'club' might even lead to worse outcomes.

**UK influence should remain strong**

**4.63** Other more specific examples suggest that the UK's influence on EU financial services regulation should remain strong:

- a significant proportion of euro business is done in the City. This creates a powerful argument for the UK to be fully involved in all discussions relating to regulatory or financial markets issues. One example is the UK's success in negotiating cheap and efficient access to TARGET, the Eurosystem's wholesale cross-border payments system;
- there is significant input from the Financial Services Authority (FSA) and the Bank of England to regulatory, supervisory and financial stability discussions in the EU. Examples include the Bank of England's participation in the European System of Central Bank's Banking Supervision Committee and the FSA's participation in the Committee of European Securities Regulators;
- the success of the joint UK-Germany initiative to extend the Lamfalussy process, already established for securities, to banking and insurance despite the UK's non-participation in the euro;
- the fact that EU enlargement will introduce further non-participants in the single currency, who will bring their own different financial services regulatory cultures to European negotiations; and
- the recently agreed Memorandum of Understanding between central banks (including the ECB) and banking supervisors on high level principles of cooperation in crisis situations which was the culmination of discussions on a European, rather than euro area, basis. Both the Bank of England and the FSA are parties to the Memorandum.

## Conclusion: would the UK be better placed to influence the course of financial market regulation inside or outside the euro area?

**4.64** The UK's influence over EU financial services policy should remain strong whether inside or outside the euro area. Concerns prior to the start of EMU that the UK's influence would diminish outside EMU have not been realised: the UK has had an influential say over EU financial services issues. In part because of the position of the City as the major international financial services centre in the EU and the transaction of a significant proportion of euro business in London, the UK's influence should remain strong in or out of EMU. The Government is aware that it will need to be more vigilant in the face of any risks that might arise while the UK remains outside EMU and will be fully engaged in the debate about the future regulatory framework for EU financial services. Using its strong influence, the Government will work with the UK's financial services sector to ensure that the UK's competitive advantage in many retail and wholesale financial services activities is safeguarded and, wherever possible, enhanced.

## CONCLUSIONS: THE FINANCIAL SERVICES TEST

**4.65** Inside or outside EMU, the competitive strength of the City should mean that the UK continues to attract a significant level of wholesale financial services activity. The international nature of the City's markets and the foundations of its competitive position imply that the achievement of sustainable and durable convergence to safeguard stability in EMU is less of a determinant of the likely success of wholesale financial services activity than it is of other aspects of the UK economy. Entry might strengthen London's position as a leading financial centre. To the extent that the euro proved to be a factor in the location of wholesale financial services activity, entry would remove any unease firms might have about locating in a financial centre outside the euro area. Entry could also improve the UK's ability to compete for the new, contestable business that can be expected to arise from EU enlargement, an ageing EU population and the continued development of euro financial markets. Changeover costs arising from entry for the sector would not be significant.

**4.66** Entry would improve the competitive position of the UK's retail financial services sector if other barriers are also removed. Benefits to the retail financial services sector from entry would include lower costs on euro area transactions, the possibility for a more optimal allocation of investment portfolios and potential scale economies for investment funds. Assuming markets are competitive, these benefits should be passed on to consumers and offset the one-off changeover costs for the retail financial services sector that would arise from entry.

**4.67** The dynamic effects of the single currency can be expected to be gradual. With other changes, the euro will encourage integration of retail financial services in the Single Market over the longer term and, importantly, greater competition in the sector. Being outside the euro area would mean that these effects would be more muted in the UK sector although the barriers are regulatory and legal rather than related to currency. The business case for greater cross-border merger and acquisition activity could strengthen as retail financial services firms seek to make the most of new opportunities in a single market with no currency barriers. Outside the euro area, the business case for UK retail financial services firms to capitalise on these opportunities could be weaker.

**4.68** Compared to wholesale financial services activity, realisation of these gains for retail financial services is more conditional on the achievement of sustainable and durable convergence and the safeguarding of stability, just as it is for other UK business sectors that serve the domestic market.

**4.69** The UK's influence over EU financial services policy should remain strong whether inside or outside the euro area. Concerns prior to the start of EMU that the UK's influence would diminish outside EMU have not been realised: the UK has had an influential say over EU financial services issues. In part because of the position of the City as the major international financial services centre in the EU and the transaction of a significant proportion of euro business in London, the UK's influence should remain strong in or out of EMU. The Government is aware that it will need to be more vigilant in the face of any risks that might arise while the UK remains outside EMU and will be fully engaged in the debate about the future regulatory framework for EU financial services. Using its strong influence, the Government will work with the UK's financial services sector to ensure that the UK's competitive advantage in many retail and wholesale financial services activities is safeguarded and, wherever possible, enhanced.

**Overall conclusion**

**4.70** Over the four years since the start of EMU, the UK has attracted a significant level of wholesale financial services business. The strength of the City in international wholesale financial services activity should mean that it continues to do so, whether inside or outside EMU. EMU entry should enhance the already strong competitive position of the UK's wholesale financial services sector by offering some additional benefits. Again, while the UK's retail financial services sector should remain competitive either inside or outside the euro area, entry would offer greater potential to compete and capture the effects of greater EU integration that would arise from the single currency and other efforts to complete the Single Market, in particular the FSAP – benefits which are postponed while the UK is not in EMU. Overall, the financial services test is met.

**Policy requirements**

**4.71** Ongoing efforts are required to increase EU financial services integration through the FSAP and other measures. In the longer term, this should add to competitive pressures in the UK financial services market as well as providing opportunities for UK financial intermediaries in the euro area.