STUDY

Policy Department
Economic and Scientific Policy

The Impact of the New Financial Services Framework

Part III

Country Reports

Germany, Greece, Hungary, Ireland
Italy, Latvia, Lithuania, Luxembourg

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1 INTRODUCTORY OVERVIEW

Financial Services Regulation in Germany

Division of responsibility

1.1 Prior to 2002 Financial Services Regulation was conducted by three different organisations. The Bundesaufsichtsamt für das Kreditwesen regulated the banking sector, the Bundesaufsichtsamt für das Versicherungswesen regulated the insurance secotor and the Bundesaufsichtsamt für den Wertpapierhandel regulated securities.

1.2 In May 2002 the three organisations were merged into one integrated financial services regulation authority called the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

1.3 The main goal of BaFin is to guarantee a financial services sector of high functionality, stability and integrity. BaFin is responsible for securing the solvency of the financial services companies and so to secure the trust of investors in the industry.

1.4 Other organisations involved in the regulation of financial services are the Deutsche Bundesbank (which was superseded in its management of monetary policy by the ECB in 1999) and the Bundesfinanzministerium.

1.5 The Deutsche Bundesbank participates in ongoing banking supervision and analyses the reports and returns that the banks are required to submit on a regular basis and assess whether the banks' capital resources and risk management systems are adequate. The terms of BaFin and the Deutsche Bundesbank collaboration is set out in a Memorandum of Understanding.

Key features of banking regulation

1.6 The primary objective of banking supervision is to prevent undesirable developments in the banking system which:

(a) endanger the safety of the assets entrusted to institutions;

(b) adversely affect the orderly execution of banking transactions; or

(c) may substantially prejudice the economy generally (sec. 6 of the Banking Act).

1.7 The main legal basis for the supervision of banks is the Banking Law, which has been amended extensively on a number of occasions since the Act first came into effect in 1962. There are also a number of special laws, such as the Mortgage Banks Law (Hypothekenbankgesetz), the law relating to Mortgage Bonds and another for publicly regulated Credit Institution Bonds (Gesetz über die Pfandbriefe und verwandten Schuldverschreibungen öffentlich-rechtlicher Kreditanstalten), the Securities Deposit Act (Depotgesetz), the Building & Loan Associations Law (Bausparkassengesetz) and the Federal States' own Savings Banks laws.

Key features of insurance regulation

1.8 According to section 81 (1) of the Insurance Supervision Law (Versicherungsaufsichtsgesetz - VAG) the two main objectives of insurance supervision are:

(a) to provide adequate safeguards of the interests of policyholders and, in so doing;

(b) to ensure that the obligations arising under insurance contracts can be met at all times.

1.9 The main focus of insurance supervision is therefore consumer protection.

1.10 Insurance supervision is divided between the Federal Government and the Federal States (Länder).

1.11 On behalf of the Federal Government BaFin supervises the private insurance companies which are of material economic significance as well as the competing public-law insurance companies which operate across the borders of a Land. The Länder mainly supervise publicly-regulated companies, the activities of which are limited to the particular Land in question as well as the private insurance companies of lesser economic significance.

1.12 Since the beginning of 2002 pension funds have also been subject to comprehensive supervision under the Insurance Supervision Law. Domestic companies engaging solely in reinsurance business have up to now been subject only to limited supervision.

1.13 Insurance supervision is divided into two phases: the authorisation process and ongoing supervision.

Key features of securities regulation

1.14 The legal basis for government securities supervision is the Securities Trading Law (Wertpapierhandelsgesetz — WpHG), the Securities Acquisition and Takeover Law (Wertpapiererwerbs und Übernahmegesetz — WpÜG) and the Securities Sales Prospectus Law (Wertpapier-Verkaufsprospektgesetz — VerkaufsprospG).

1.15 Supervision of the individual stock exchanges is the responsibility of the stock exchange supervisory authorities of the Länder. The latter supervise the orderly conduct of trading on the individual exchanges in accordance with the provisions of the Stock Exchanges Act (Börsengesetz).

1.16 The key responsibilities of BaFin's securities supervision are:

(a) combating insider dealing and price manipulation;

(b) ad hoc disclosure and financial analysis;

(c) significant voting right percentages;

(d) corporate takeovers and securities sales prospectuses;

(e) rules of professional conduct and organisational requirements; and

(f) solvency supervision of financial services institutions.

Key features of financial conglomerate regulation

1.17 BaFin, as the integrated financial supervisor for German financial conglomerates, is the sole national authority, which is a useful simplification since German financial conglomerates are very varied in nature. Some are predominantly concerned with insurance, some with banking, while at the same time some operate purely nationally and others are active throughout Europe and beyond.

The Implementation Process and the General Effects of FSAP in Germany

Stakeholder views on implementation

1.18 Overall the implementation process of the FSAP was viewed positively by the German respondents to our survey. They felt that the general construction of the Lamfalussy procedure guaranteed that greater consideration would be given to the views of industry in the preparation of legislation.

1.19 Criticisms included the observation that steps two and three of the Lamfalussy procedure require documentation that is excessively detailed making the outcome too bureaucratic and prescriptive.

1.20 Some respondents felt that the Commission attached exaggerated importance to the harmonisation of rules while not giving enough weight to cultural differences between countries. The rules for the harmonisation of retail sectors were especially criticised.

1.21 In general respondents to our survey thought that the implementation of the FSAP had been carried out more rapidly and more thoroughly in Germany than in other Member States.

1.22 Most respondents to our survey were of the view that the legal framework had become more prescriptive as a result of the FSAP.

2 THE GERMAN BANKING SECTOR

Headline Overview

Number of players

2.1 The structure of the German banking sector is quite distinct from those of most other countries as it is divided into three tiers:

(a) The first tier (administrating nearly 50 per cent of all assets) is mostly owned by local authorities. The Landesbanken are the head institutions of Sparkassen, usually organised on a provincial basis. Sparkassen do own the Landesbanken, because they are legally obliged to do so.

(b) The second tier, with around 20 per cent of all assets, consists of the Volksbanken (cooperative banks) that, like the Sparkassen, have a local focus. Even though they are not profit maximisers, cooperative banks are owned by their members.

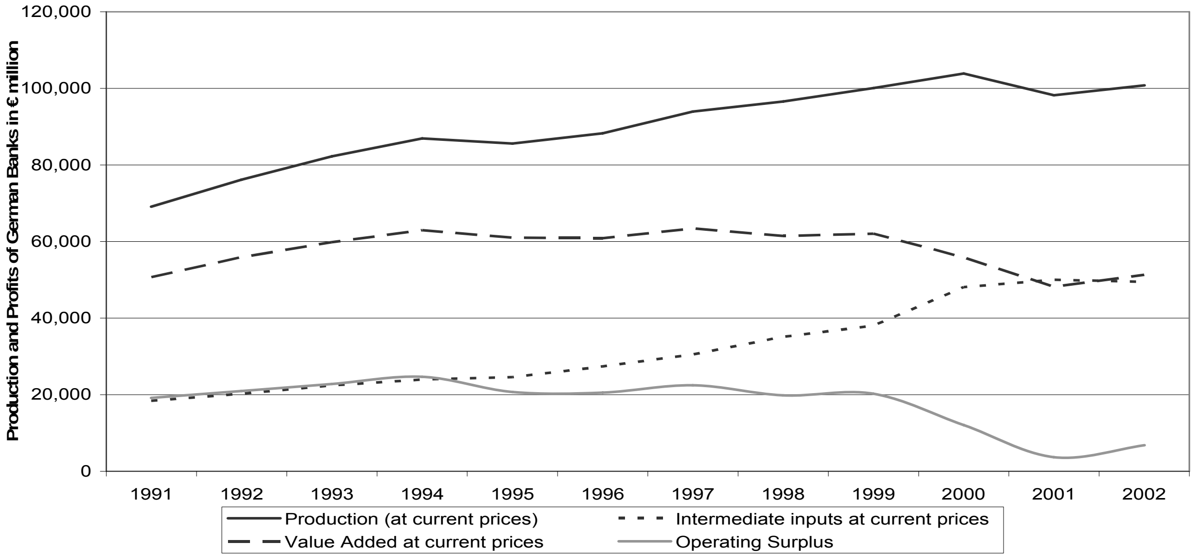
(c) The last tier consists of private banks, which control less than 30 per cent of assets.

2.2 The first two tiers are virtually separated from the rest of the banking market, although they still compete. The ownership of Sparkasse and Volksbanken cannot be transferred to private investors. The city of Berlin has been prevented from selling its Sparkasse to a private investor by a court ruling that only publicly owned banks can use the name "Sparkasse". The Stralsund authority attempted a sale of the clients of its Sparkasse to private interests, leading to a political storm preventing the transaction from completing. Volksbanken are also prevented from transferring their ownership.

Turnover, employment and profitability

2.3 The bear market of 2001 and 2002 and the following downturn of the German economy had a significant impact on the profits and turnover of German banks. Throughout this period there was extensive resort to outsourcing. Intermediary goods increased from 30 per cent to more than 50 per cent of turnover.

Figure 2.1: Turnover and Profits of German banks 1991-2002



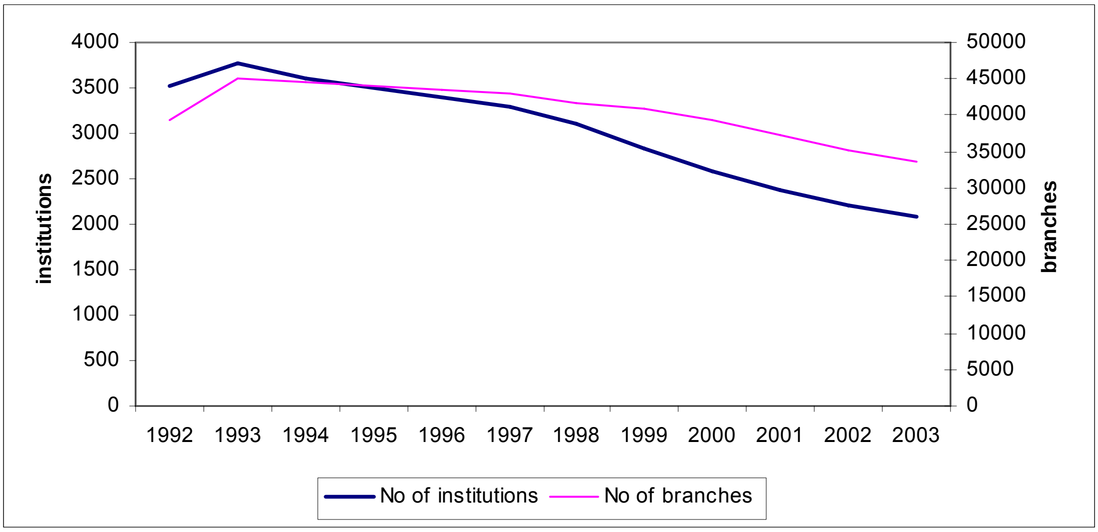
Source: Statistisches Bundesamt

2.4 Employment in the banking sector rose strongly from 1991 to 1994 (largely as a result of the increase in banking employment in east Germany), increasing from 745,000 to 779,000, but decreasing thereafter (with a brief and un-sustained increase in 1999 and 2000). The fall in employment was exceptionally marked in the years 2001 to 2004. In 2004 the banking sector employed only 94 per cent of the work force it employed in 1991 and only 90 per cent of the work force it employed in 1994.

2.5 The build up of employment in the early years was confined to the public and cooperative sector while employment in private banks was more or less steady to 1994. Thereafter the reduction in private employment was more pronounced. In 2004 the private sector employed only 82 per cent of the staff employed in 1994 while the public and cooperative sectors retained 93 per cent and 94 per cent respectively.

Number of Credit Institutions

Figure 2.2: Credit Institutions and Branches



Source: OECD

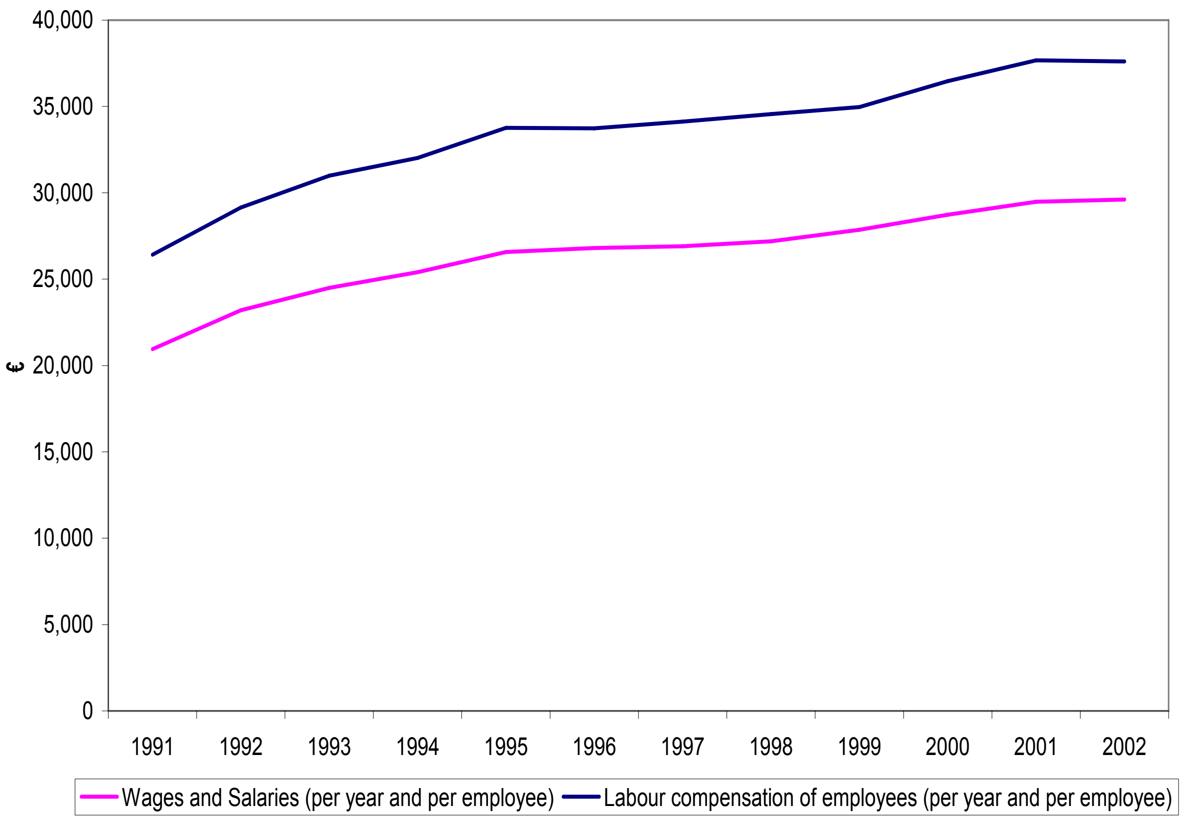
2.6 The large (perhaps even excessive) number of bank branches is itself a reflection of the constraints on the development of retail banking. The number of Sparkassen and Volksbanken may be to some extent a historical artefact, arising as a consequence of the high savings rate that typified the German economy after 1948. Together these constitute a element in the retail banking system that will naturally tend to be relatively inflexible (and probably also inefficient) compared with private banks, because they will lack the pressure of a private profit motive, the need to adapt to maintain shareholder confidence, and the connection with latest management practices that tends to be more characteristic of private ownership. There may also be issues of the quality of loans made — lacking a private profit motive, loans made may not optimize risk-return ratios, with potential consequences for the efficiency of investment. Fragmented public and co-operative ownership entrenched in the law also may make it difficult to rationalise banking facilities, to introduce domestic or international competition or to attack its high costs and low productivity. These ownership problems are largely beyond the direct reach of the FSAP and FSWP legislative measures. Radical reform in this area might even imply changes in property rights — a development that would presumably face understandable political opposition.

Table 2.1: Employment in the Banking Sector 1991-2004

	Total banking Sector	Private banks	Public Banks (Sparkassen and Landesbanken	Cooperative Banks
1991	744,800	237,000	306,100	170,450
1992	764,150	240,100	316,350	175,100
1993	773,050	239,650	321,600	178,600
1994	779,450	239,150	324,400	182,800
1995	778,250	235,750	323,300	185,850
1996	769,800	229,400	322,050	184,250
1997	768,150	229,350	321,900	182,200
1998	769,350	231,600	321,300	181,250
1999	771,650	234,550	322,950	180,600
2000	774,550	230,050	325,300	180,400
2001	769,300	232,850	325,650	178,200
2002	751,200	221,750	320,650	176,200
2003	722,000	202,900	312,400	174,700
2004	702,750	195,350	303,950	170,300
2004/1991	94%	82%	99%	100%
2004/1994	90%	82%	94%	93%

2.7 Wages rose steadily with most of the progress being made in the first half of the 1990s. Labour costs rose faster than wages, because of the very large increases in social security costs in the first half of the 1990s.

Figure 2.3: Average Wages, Labour costs

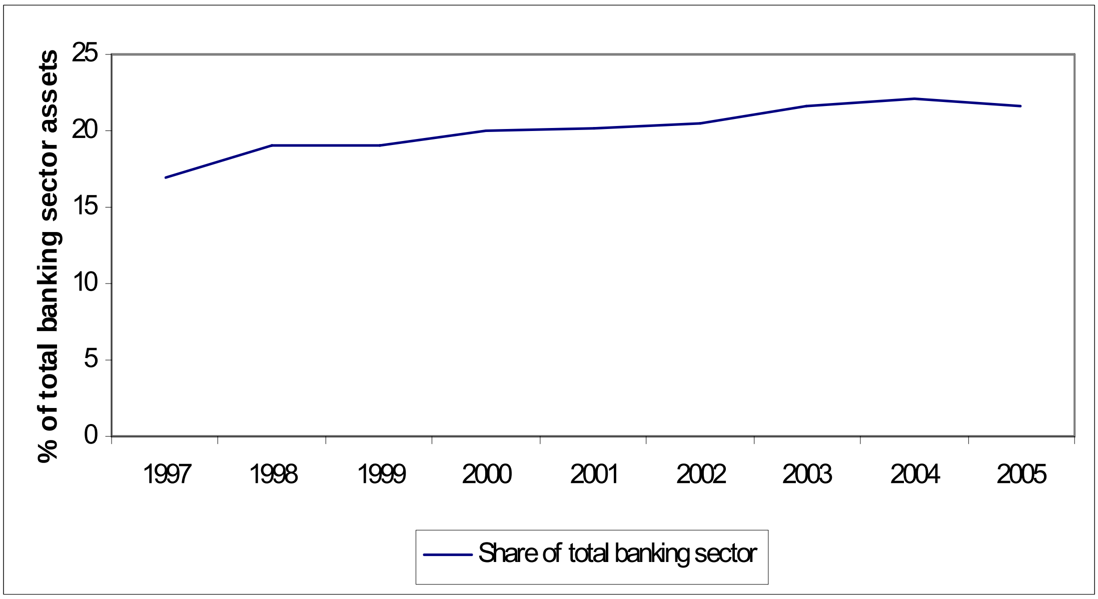


Source: Statistisches Bundesamt

Market shares and concentration

2.8 One factor contributing to the low profitability of German banks may be that their collective market share is small. The five biggest banks in Germany had a 22 per cent market share of total assets in 2005 compared with an average of 42 per cent for the EU15. Nonetheless the market share of the biggest five banks in Germany has increased more rapidly since 1997 (when it was only 17 per cent) than has the EU15 average.

Figure 2.4: C5 ratio, share of the largest 5 credit institutions



Source: ECB

Table 2.2: Herfindahl-Hirschman Index[1]

1997	1998	1999	2000	2001	2002	2003	2004	2005
114	133	140	151	158	163	173	178	174

Source: ECB

2.9 In 2004 there were over 2,000 credit institutions. This gives a ratio of nearly 3 per 100,000 inhabitants while in the EU15 the average was less than 2 per 100,000 inhabitants.

Price and quality competition

2.10 The high number of market participants produces fierce price competition. The consolidation of several online banks (the biggest is DIBA now owned by ING) and their entry into the market has extended the competition for retail customers to rural areas where, until ten years ago banking was dominated by a combination of the Sparkassen and the Volksbanken.

Other factors affecting competition

2.11 The internationalisation and concentration envisaged by the FSAP is constrained by the institutional arrangements of credit institutions in Germany.

[1] The Herfindahl-Hirschman index is defined in the Main Report.

2.12 The (relatively modest but relevant) increase in concentration that has taken place in recent years has been confined to mergers within, but not between, the three tiers of the banking sector. Between 2002 and 2005 alone the number of independent Sparkassen decreased from 519 to 480, the largest merger being that between the Cologne and Bonn Sparkassen and the Sparkasse Bonn. Mergers between the Landesbanken led to a comparable reduction in the number of publicly owned wholesale banks.

2.13 Similarly, in the cooperative sector the number of Volksbanken decreased from 2,909 in 1992 to 1,489 in 2003 and 1,209 in 2005.

2.14 Private banks in Germany had opportunities denied to the Sparkassen and Volksbanken. They could expand abroad or combine with foreign firms expanding in to the German market. However, since the degree of concentration in the private sector was already much greater than elsewhere, there is little evidence that the existence of these opportunities made any real difference. There were, nonetheless some major changes in the sector with the purchase of the third largest German bank, HVB, by the Italian Bank UniCredito a striking example.

Consumer protection

2.15 The level of consumer protection in Germany is comparable with that elsewhere in the developed financial markets of the EU15. Figures from Eurobarometer put customer satisfaction close to the average for the EU. The index decreased from plus 7 (43 per cent positive to 36 negative) in 1999, to minus seven in 2003 (33 per cent positive to 40 negative).

Trade and international penetration

2.16 The banking market in Germany has become more international. In 1998 banks from other EU countries had 49 branches in Germany, but by 2004 this number had increased to 65 and 35 of the 49 new entrants were from the Eurozone.

2.17 Inter-banking loans and deposits have also become increasingly international. In the Eurozone as a whole the volume of cross-border loans rose from 22 per cent to 28 per cent while cross-border deposits increased from 22 to 27 per cent. In Germany the increase was even more pronounced with loans rising from 13 to 21 per cent and deposits from 13 to 17 per cent.

2.18 Loans to public bodies have been similarly affected in recent years. In 2004 German banks lent 5.7 per cent of their total Eurozone government loans to authorities outside Germany, up from 4.1 per cent in 1999.

2.19 The internationalisation of retail loans has increased much more slowly. In 2004 German banks still only made 2.7 per cent of their loans to private borrowers in other Eurozone countries (1.7 per cent in 1999) and only 6.6 per cent to companies in other Eurozone countries (3.6 per cent in 1999).

2.20 German banks have increased their purchases of shares and bonds in other Eurozone countries. While in 1999 only 43 per cent of purchased Eurozone bonds originated outside Germany, by 2004 this had increased to 48 per cent.

Table 2.3: Non-German banks in operation

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Branches of CI's from EU area	46	53	57	62	57	62	64	62	69
Subsidiaries of CI's from EU area	31	32	23	22	21	22	20	21	22
Branches of CI's from third countries	31	31	30	28	23	21	20	21	20
Subsidiaries from third countries	45	40	38	34	33	27	25	21	19

Source: ECB

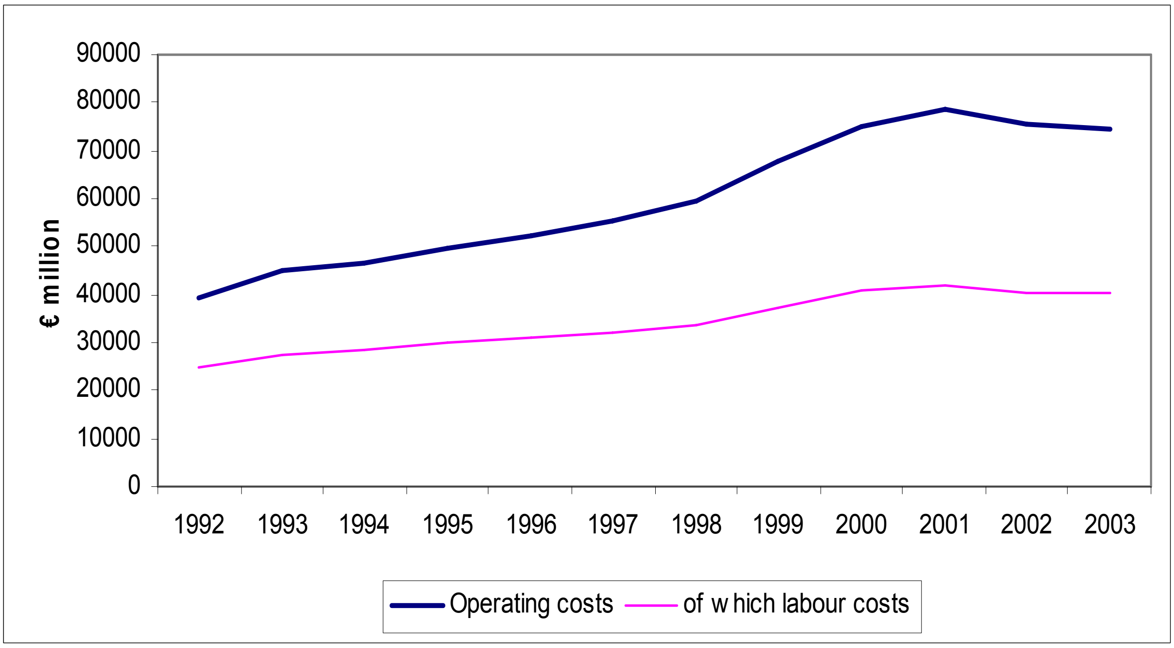
Table 2.4: Mergers and Acquisitions by purchaser

	2000	2001	2002	2003	2004	2005	2006*
Domestic	2	13	10	13	6	9	3
Internal EU	2	3	4	0	1	3	1

*Source: ECB, * first half*

2.21 Overall, as one might have expected, internationalisation in wholesale banking markets has made much greater progress than in retail markets.

Figure 2.5: Operating costs



Source: OECD

Table 2.5: Key performance indicators of the banking sector (%)

Year	Net interest margin[a]	ROA[b]	ROE[c]
1992	2.1	0.6	13.2
1993	2.1	0.6	13.6
1994	2.2	0.5	11.8
1995	2.0	0.6	12.6
1996	1.9	0.5	12.3
1997	1.7	0.5	10.9
1998	1.6	0.7	17.4
1999	1.5	0.4	9.2
2000	1.3	0.3	7.9
2001	1.3	0.2	5.1
2002	1.4	0.1	3.4
2003	1.3	0	-0.1

a: Net interest income to average total assets.

b: Net income before tax to average total assets.

c: Net income before tax to average capital and reserves.

Source: Europe Economics calculation of data from OECD (2005) "Bank profitability"

The Effects of the FSAP and FSWP Legislative Measures on the German Banking Sector

Assessment by category

Competition

2.22 Overall competition was very strong in Germany's banking sector before the FSAP and remains so. Banking sector respondents to the questionnaire felt that increases in competition were confined to the wholesale sector and that most of this increase was due, in large part to the FSAP.

2.23 Given the existing competitive environment of Germany it was always clear that the impact in retail banking would be relatively low. More than two thirds of the banking sector constituted by Sparkassen and Volksbanken is virtually out of the reach of foreign companies and these companies themselves cannot make investments abroad. In the private banking sector foreign entry has increased despite the comparatively low margins and this should eventually further increase competition.

The effect of FSAP on employment

2.24 Given the consolidation that has taken place in recent years, respondents from the banking sector did not expect employment in banking to rise further in the immediate future. The effect of FSAP on employment was regarded as negligible. This again is consistent with their view that most of the effects of the FSAP will be confined to the wholesale sector while the majority of employment is in the retail sector.

2.25 We agree with respondents as regards what has happened so far. However, as explained further below, further ahead our own view is that the FSAP may have sufficiently material effects on the cost of equity to start to enhance the role of equity versus banking finance. A reduced role for banking finance could mean fewer jobs.

2.26 Thus, our conclusion is that the effects of the FSAP on employment so far have been negligible, but in the future will be negative.

Consumer protection

2.27 Respondents from the banking sector considered that consumer protection had improved in recent years and that the FSAP had an important part to play in this. But both consumers and industry thought that further measures are necessary. Our view is that there should be scope for clarification and simplification of the rules, and more information for consumers and effort (on the part of policy-making bodies) to ensure that consumers understand the rules properly.

Cross-border business, takeovers and the development of a regional market

2.28 For the private banking sector cross-border mergers can be an important factor in restoring margins in retail banking. Confined to one third of the market, private banks are deprived of economies of scale. The FSAP could in this respect be very important for the private banks in Germany.

2.29 Our econometric study suggests that the impact of the FSAP on trade in financial services other than insurance and pensions has been to increase imports by 1.2 per cent and exports by 1.4 per cent. Full implementation of the FSAP and FSWP legislative measures is projected to lead to a further 1.1 per cent rise in imports and 2.2 per cent in exports.[2]

Competitiveness

2.30 Given the still low levels of concentration in the industry, some modest increase in banking concentration may enable the private sector to increase its margins and improve its ability to take on foreign competition without giving rise to the inefficiencies associated with a dominant position.

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[2] Note that these effects are additional to any associated with membership of the EU or other global or domestic trends towards openness.

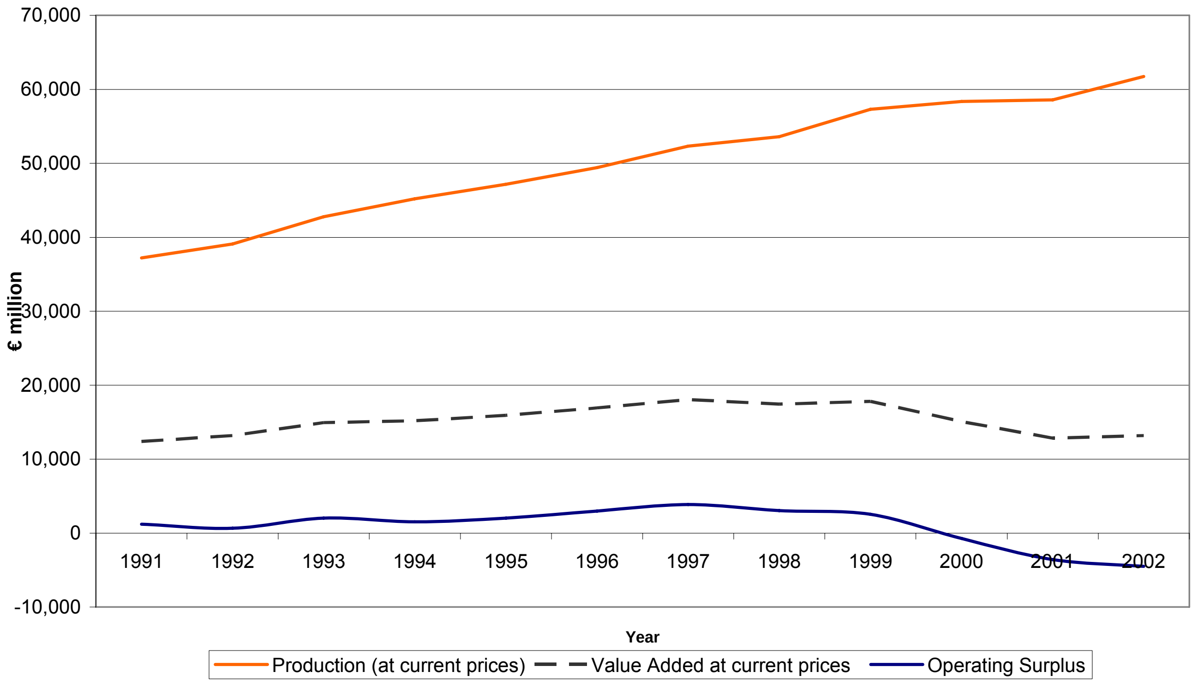
3 THE INSURANCE SECTOR IN GERMANY

The German Insurance Sector

Turnover

3.1 The German insurance industry was hit by the collapse of the dotcom bubble in 2000. Overall revenues continued to rise strongly, but profits were adversely affected — particularly by the revaluation of assets. In 2001 and 2002 profits were negative and have only recently recovered. The insurance sector's resort to out-sourcing was even more extensive that that of the banking sector. Value added sank between 1999 and 2002 while overall revenues grew.

Figure 3.1: Insurance Revenues and Profits



Source: Statistisches Bundesamt

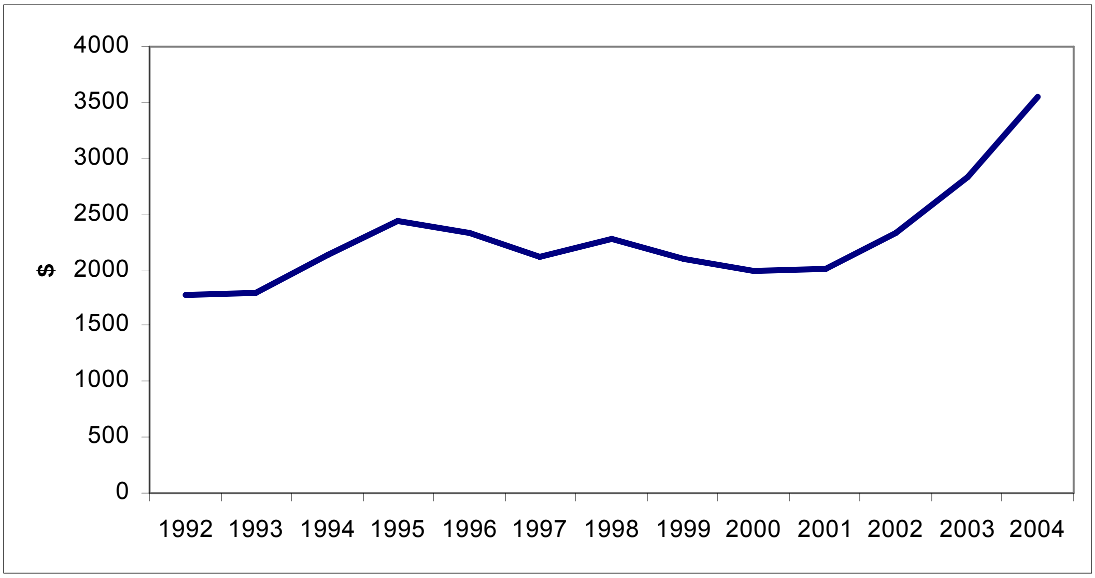
3.2 Since 2001 insurance premiums have continued to increase by three to four per cent per annum.

Table 3.1: Gross premiums in the German insurance business (€m)

	1990	1995	2001	2002	2003	2004
Life insurance	27403	45201	62387	65018	68574	70347
Health Insurance	9546	16408	21718	23082	24741	26400
Damage and Accident insurance	32244	48999	49734	51480	54434	55300
Total	69193	110608	133839	139580	147749	152047

Source: Statistisches Bundesamt

Figure 3.2: Insurance Density (gross direct premiums/population, $ per capita)



Source: OECD

Market shares

3.3 Germany is home of some of the largest insurance companies in the world, including Allianz AG and Munich Re — companies with strong international reputations. But the market for most companies is much more local. If the reinsurance companies are excluded, Allianz is nearly twice as big as its six biggest competitors. The German insurance market is thus very unevenly populated: it consists of one international insurance group, two large international reinsurance companies, three large subsidiaries of international insurance groups and a large number of local players.

Table 3.2: Top Ten insurance companies in Germany (German if not stated)

	Turnover (€ billion)
Allianz	91.7
Münchener Rück	45.7
Allianz Leben	19.1
Ergo	16.6
AMB Generali (Italy)	14.2
Hannover Rück-Gruppe	8.8
AXA (France)	6.7
Wüstenrot & Württembergische	6.1
DBV - Winterthur (Credit Suisse- Switzerland)	4.9
Nürnberger Beteiligungs	3.4

Source: German Industry Insurance Association

3.4 The bear market of the early 2000's accelerated a long standing trend towards greater concentration in the German insurance business. The total number of insurance companies decreased from 725 in 1999 to 670 in 2004.

Table 3.3: Overall number of Insurance companies

	Life Insurance	Pension funds	Health Insurance	Damage and Accident Insurance	Reassurance	Total
1990	122	229	57	346	31	785
1993	131	214	65	354	34	798
1994	130	212	58	282	37	719
1995	132	207	59	281	39	718
1996	135	203	60	280	41	719
1997	131	203	59	281	41	715
1998	132	202	60	275	50	719
1999	138	201	59	280	47	725
2000	134	197	56	271	48	706
2001	133	190	56	265	46	690
2002	132	207	55	261	48	703
2003	119	205	55	251	49	679
2004	119	200	54	247	50	670

Source: Statistisches Bundesamt

3.5 The bear market also changed the investment structure of insurance companies. Bonds and loans have increased at the expense of equities.

Table 3.4: Investment structure of the German insurance structure

	2000	2001	2002	2003	2004
Real Estate	3.0%	2.6%	2.4%	2.2%	2.0%
Shares in associated companies	11.4%	14.2%	17.0%	16.3%	15.0%
Shares	3.8%	3.8%	2.1%	1.8%	1.5%
Investment Funds	22.1%	22.1%	22.1%	21.7%	20.8%
Bonds	16.0%	15.5%	15.4%	16.6%	16.9%
Registered Bonds	25.8%	23.0%	21.5%	20.6%	20.7%
Loans	16.5%	16.8%	17.2%	18.3%	21.0%
Others	1.4%	2.0%	2.3%	2.5%	2.1%

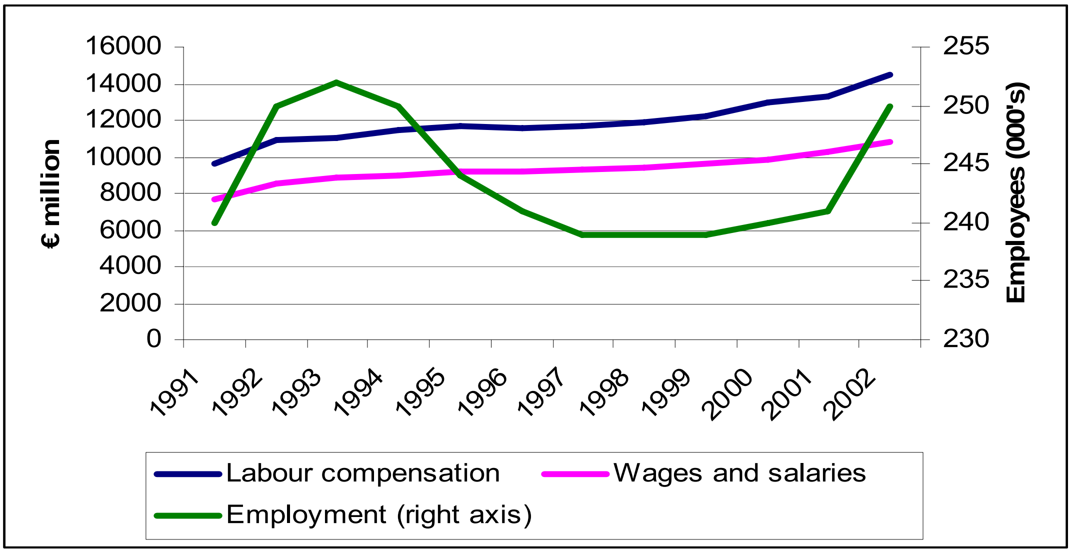
Source: Statistisches Bundesamt

Employment

3.6 The number of employees in the insurance business rose sharply in the years after the German reunification as a result of the increase in insurance employment in east Germany, but fell slightly thereafter in the second half of the 1990s before stabilising in the first years of the new century.

3.7 Wages and labour compensation increased in the decade from 1991 to 2002 especially in the first half of the 1990s, and again this was partly due to the adjustment of east German wages to west German levels.

Figure 3.3: Labour compensation, wages and number of employees

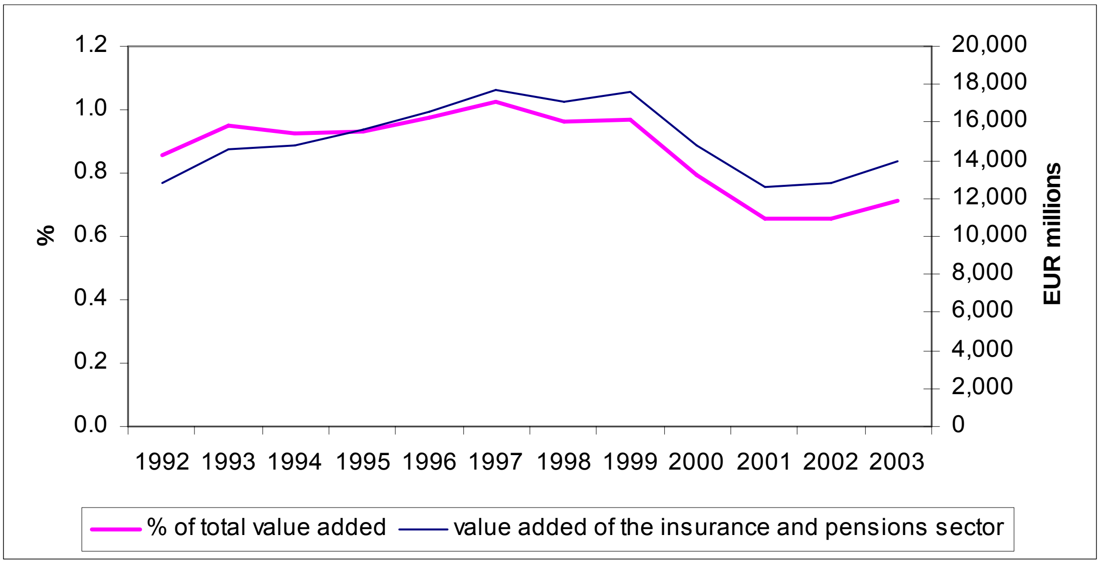


Source: Statistisches Bundesamt

3.8 Other statistics illustrate that the number of employees has decreased since 2002, employment in 2003 fell to 248,000 from 253,000 in 2002. But overall employment in the sector has not greatly changed since the initial increase in employment after German reunification.

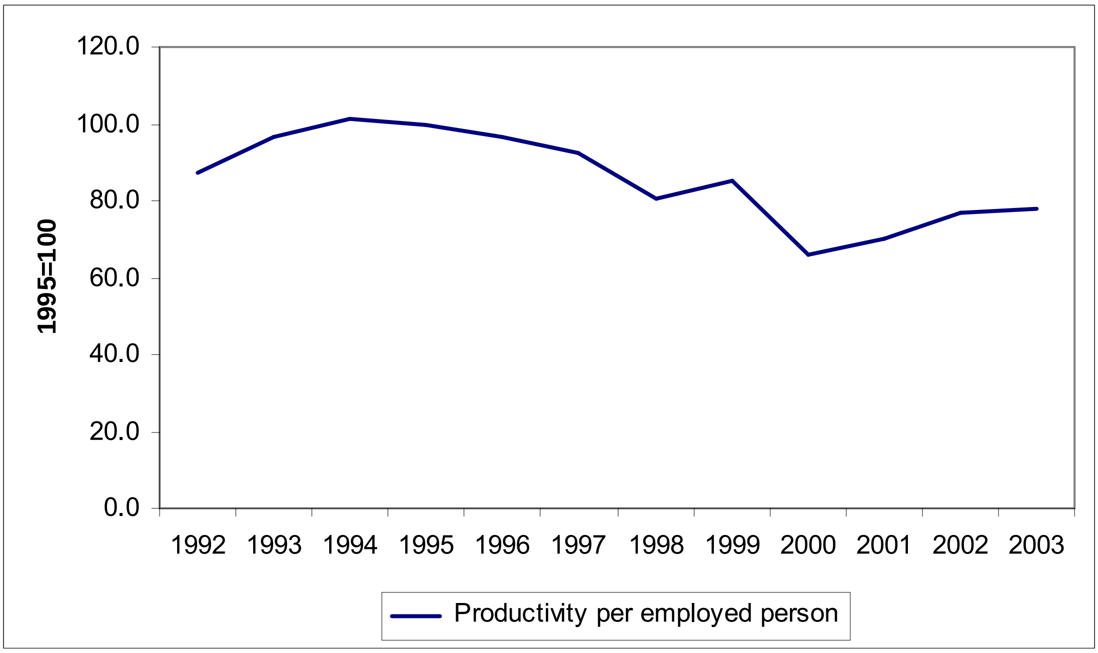
3.9 Although the decline in profitability brought about by falls in the stock market was more significant for the insurance business than for banking, employment was not so affected in insurance. This is partly to be explained by the fact that about half of those working in the insurance business are self-employed representatives who do not appear on the payroll.

Figure 3.4: Value added in insurance



Source: University of Groninge

Figure 3.5: Productivity per employed person (1995=100)

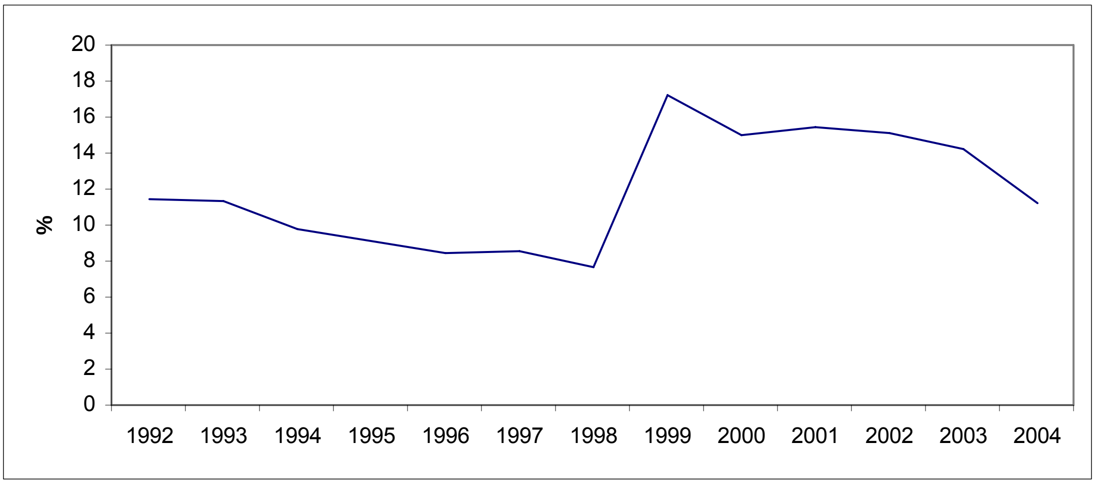


Source: University of Groningen

International entry

3.10 German insurance companies have not increased their business in other EU countries in recent years: in 1999 their foreign premiums were to €1.55 billion, but in 2003 they had fallen to €1.22 billion. Neither has foreign entry significantly increased. In 2000 six international companies were operating in Germany; and this remained unchanged in 2004.

Figure 3.6: Market share of branches/agencies of foreign undertakings as a % of total domestic business



Source: OECD

The Effects of the FSAP and FSWP Legislative Measures on the German Insurance Sector

3.11 In Germany, the most important impact of the FSAP has been on the insurance market and that is likely to continue. In the future the Solvency II Directive may be of particular importance.

Assessment of impact by category

Market entry, cross-border business, and competition

3.12 As the German insurance market still offers a considerable opportunity for foreign entry, it is likely that larger insurance companies from abroad will try to enter the German market, possibly by buying small German insurers.

3.13 However, as we have seen, it appears that the degree of international involvement in the German insurance industry has not increased in the period of the FSAP.

3.14 Concentration in German insurance is relatively high, and without the FSAP enhancing international involvement in the market, it seems unlikely materially to increase competition.

Employment

3.15 In the insurance sector the respondents to our survey believed that the FSAP has had no effect on employment so far but that further implementation will bring about an increase.

Product variety, e-commerce, and prices

3.16 As in other Member States, prices of insurance products appear to have risen over the period of the FSAP. However, this development does not appear to be a *result* of the FSAP.

3.17 Developments in product quality and variety are unclear.

Consumer protection

3.18 Some respondents thought that consumer protection had increased in recent years and would increase further. The Consumer Association, on the other hand, did not believe that there had been any improvement.

3.19 Both sides thought that the number of consumer complaints had increased but that this was not due to the FSAP.

3.20 The respondents also differed as to whether customers' understanding of insurance products has increased.

4 GERMAN SECURITIES MARKETS

4.1 The main German Stock Exchange, the Deutsche Börse in Frankfurt, has been involved in several negotiations about the possibility of international mergers. Negotiations with the LSE in London failed twice and the chairman had to resign in response to pressure from shareholders. Deutsche Börse tried to buy Euronext but at the time of writing appears less likely to be successful than the New York Stock Exchange.

4.2 The Deutsche Börse AG is one of the biggest stock exchange companies. Even though London, New York and Tokyo are bigger in terms of shares traded on the stock exchange, the Deutsche Börse AG has a high market capitalisation by European standards for the sector. Deutsche Börse AG is especially strong in exchange related IT technology. Trading on the Frankfurt Stock Exchange is nearly entirely electronic. Only 3 per cent of the trades on the Frankfurt Stock exchange are still done on the floor, the rest is done electronically using XETRA.

4.3 Nearly 98 per cent of all stock-exchange trading in Germany is carried out in Frankfurt and by XETRA. The other seven regional stock-exchanges concentrate on niche sectors.

4.4 The securities markets have become more international in the last 15 years. The share of foreign securities in portfolios, especially in those of mutual funds, has nearly doubled.

Table 4.1: International composition of domestic individuals securities portfolio

	Direct Investments		Domestic Mutual Funds		Total	
	Domestic issued securities	Foreign issued securities	Domestic issued securities	Foreign issued securities	Domestic issued securities	Foreign issued securities
1987	81%	19%	61%	39%	79%	21%
2002	81%	19%	34%	66%	63%	37%

4.5 Over half of the nearly 300 active traders on the XETRA stock exchange are foreign companies and 25 foreign companies take part in floor trading.

Impacts of the FSAP and FSWP Legislative Measures on the German Securities Markets

4.6 Securities markets were regulated by the Länder until 1995 when the "Bundesaufsichtsamt für den Wertpapierhandel" was set up and the regulation of securities markets was transferred to the federal level although the Länder authorities retained some responsibilities. The Bundesaufsichtsamt was absorbed by the BAFIN in 2002.

4.7 Statutory regulators are more important than in the United States, and self-regulatory bodies are hardly of any importance in Germany.[3]

4.8 The German financial services industry has two connected characteristics: the level of banking is high (perhaps higher than ideal) and the use of equity is, by international standards, underdeveloped.

4.9 The savings instruments favoured by the German population are fixed interest bonds and, in parallel, industry has been financed by banks rather than by the issue of equities. The

3 See, for example, http://www.bundesbank.de/download/volkswirtschaft/mba/2006/200601mba_en_securities.pdf, p40.

Mittelstand (i.e. the German SMEs), have traditionally been financed out of profits and by loans and its ownership is typically private (often family-based). Equities do not play as important a role as in the US or UK financial markets. Extensive changes in this area might require alterations in values and cultural attitudes that go beyond regulating activities within the existing legislative and institutional arrangements.

4.10 The FSAP might have been expected to facilitate some improvements in the efficiency and competitiveness of the German financial markets but the important constraints on development in the balance between banking and equity are not simply regulatory issues.

4.11 It is, however, plausible that looking further ahead, the FSAP could start to have a very significant impact. Our analysis exhibited in the Main Report suggests that there is scope for increased competition, particularly greater competition between exchanges and more extended use of systematic internalising (creating chains of substitution between exchanges) that may be facilitated by MiFID. There appears to be the possibility that this will lead to bidding down equity spreads and other transactions costs, causing a fall in the cost of equity capital of some 20-45 basis points (0.2 to 0.45 per cent). It is conceivable that a fall on this scale could lead to some re-assessment of equity as a source of business finance, and promote more of an equity culture.

Employment

4.12 Effects on employment in securities appear to have been limited, so far, and largely invisible beneath major cyclical movements associated with the boom-and-bust market of the late 1990's and early 2000's. However, looking further ahead, an enhanced role for equity capital could potentially mean a considerable expansion in volumes in the sector (to some extent at the expense of banking finance, as set out above).

4.13 Furthermore, given that systematic internalising is already, to some extent, practiced in Germany, the opportunity MiFID offers for an enhanced role of systematic internalising could give German securities firms the opportunity to capture securities business from other Member States (exploiting the lead it has in this activity).

4.14 For both of these reasons (the enhanced domestic role of equity and the opportunity to capture systematic internalising business) we expect that the future impact of the FSAP and FSWP on employment in Germany will be positive.

Growth

4.15 Furthermore, greater opportunities for German entrepreneurs and small businesses to source international equity capital may have important effects. Our model of the impact on economic growth, exhibited in the Main Report, suggests that this effect could raise the sustainable annual GDP growth rate of Germany by 0.1 per cent.

Cross-border business, takeovers and the development of a regional market

4.16 Our econometric study suggests that the impact of the FSAP on trade in financial services other than insurance and pensions has been to increase imports by 1.2 per cent and exports by 1.4 per cent. Full implementation of the FSAP and FSWP legislative measures is projected to lead to a further 1.1 per cent rise in imports and 2.2 per cent in exports.[4]

4 Note that these effects are additional to any associated with membership of the EU or other global or domestic trends towards openness.

5 FINANCIAL CONGLOMERATES

Financial Conglomerates in Germany

5.1 The goal of conglomerates is to provide a one-stop finance agency to the customer and to use market power to gain better refinancing conditions on the market.

Table 5.1: Financial conglomerates headquartered in Germany

Name	Countries in which they operate	Characterization
Allianz	Germany, Austria, Belgium, Cyprus, Greece, Ireland, Netherlands, Spain, Switzerland, UK, Czech Republic, Hungary, Poland, Romania, Slovakia, Estonia, France, Italy, Latvia, Lithuania, Luxembourg, Portugal, Sweden	Insurance group doing asset management and banking
DEBEKA Group	Germany	DNA
DZ Bank Gruppe	Germany, Ireland, Luxembourg, Spain, Poland, Switzerland, UK	Investment Banking
Inter Group	Germany	DNA
Münchener Rück (Munich Re)	France, Germany, Greece, Italy, Poland, Spain, UK, Switzerland	Reinsurance
Wüstenrot und Württembergische	Germany	Banking and Insurance

Source: EU Mixed Technical Group on the Supervision of Financial Conglomerates, Europe Economics. Note: DNA = Data Not Available

Table 5.2: Other Financial Conglomerates operating in Germany

Name	Head office base	Characterization of Conglomerate	Characterization of Subsidiary
Barclays	UK	Banking	Banking
BNP Paribas	France	Equal focus on retail, corporate and investment banking, asset management	Securities and Investment Banking
Danske Bank	Denmark	Insurance, mortgage finance, asset management, brokerage, real estate and leasing services - mostly banking	Banking
Fortis	Belgium	Banking and Insurance: Contribution to net Profit: Retail Banking 23%, Merchant Banking 27%, Commercial/Private Banking 13%, Insurance Belgium and Netherlands 28%, International Insurance 6%	Banking
Grupo Santander	Spain	Insurance, Banking, Asset Management	Banking
ING	Netherlands	Banking, insurance and asset management	Banking
Mediolanum	Italy	Pensions, investments, loans, banking, insurance	Investment Banking
Nordea	Sweden	Banking, Asset Management, Insurance. Contribution to net profit: Retail Banking 66%, corporate and institutional banking 25%, asset management 5%, life insurance 3%	Investment and Corporate Banking
Old Mutual	UK	Asset management, Life assurance, Banking, Offshore trust and company services	Banking
Prudential	UK	personal banking insurance, pensions and retail investments, to institutional fund management and property investments	Investment banking
RBS	UK	Banking firm doing insurance	Banking
San Paolo-IMI	Italy	Retail and Commercial banking group doing insurance	Banking
SEB	Sweden	Banking firm doing insurance and asset management	Banking
Societe General	France	Corporate and investment bank	Investment and commercial banking with asset management
Standard Life	UK	Banking firm doing investments and pensions	Investment Banking
Svenska	Sweden	Insurance, banking and asset management	DNA

Source: EU Mixed Technical Group on the Supervision of Financial Conglomerates, Europe Economics. Note: DNA = Data Not Available

5.2 It can be seen in the table above that most foreign conglomerates operating in Germany are banking-based, but that insurance and investment banking are more significant components among those conglomerates headquartered in Germany.

5.3 Historically many banks in Germany have had an insurance subsidiary but not many insurance companies had banking subsidiaries. Moreover, because the cross-selling of insurance products by banks is an easy and attractive development, many of the Sparkassen and Volksbanken were universal banks and had their own insurance companies.

5.4 The acquisition of the Dresdener Bank by Allianz AG has produced a powerful new conglomerate but the introduction of a more favourable tax treatment of the sale of assets in 2000 has led some banks to dispose of their insurance activities. Some Sparkassen and Volksbanken have established collaboration with insurance companies forming new financial conglomerates.

5.5 On the other hand, there is a view that collaboration across sectors may fall as the Internet and the development of the Single Market provide opportunities for exploiting economies of scale in other ways.

5.6 According to the Bundesbank there are eight financial conglomerates that have a 43 per cent share of the market for gross premia in the life insurance, damage / accident insurance, reinsurance and health insurance business. On the other hand these eight groups have only a 12 per cent market share of deposits in the banking sector - if foreign conglomerates active in Germany are included the respective market shares rise to 52 per cent for insurance and 15.5 per cent for banking.

5.7 This does not mean that it is usual for a large insurance company to own a bank, despite the case of Allianz and the Dresdener Bank. Insurance business is much more concentrated than the banking market. The five largest insurance companies have a market share of 74 per cent of their market, compared with only 22 per cent for the five largest banks in Germany.

Impact of the FSAP and FSWP Legislative Measures on the German Financial Conglomerates Sector

Assessment by category

5.8 The establishment of a common approach to conglomerates by all of the authorities of the Member States will produce a more equitable competitive environment but the precise effects remains unclear. The German authorities have not formally stated the approach that they intend to adopt and have, so far, confined themselves to monitoring the situation.

5.9 The co-operative and publicly owned sectors of the banking market with their universal banking traditions have, by their association with insurance businesses, created more financial conglomeration. However, these are small and, because of changes in their tax treatment the trend is for a reduction in size among conglomerates in the private sector.

5.10 Since German conglomerates combine elements of banks, insurance companies and securities firms, our assessment will be based on the assessments for all other themes.

Openness to foreign firms

5.11 Our assessments for other sectors have suggested that the effects of the FSAP on openness were positive for banking, limited for insurance, and perhaps positive in the future for securities. As German conglomerates incorporate all three of these other elements, we conclude that the influence of the FSAP is likely to be slightly positive.

Competition

5.12 Among the other sectors, only in securities was the effect of the FSAP assessed as being significantly positive, and then only in the future. For financial conglomerates we would see the overall impact as limited.

Consumer protection

5.13 The effects of the FSAP on consumer protection in the banking sector was assessed as positive, but limited in insurance or securities. For conglomerates we conclude that the overall impact is likely to be limited.

Employment

5.14 Earlier sections assessed that the main change in employment was likely to be some transfer in the future from banking to securities. Since conglomerates incorporate elements of both, we assess the net effect as negligible.

Competitiveness

5.15 For banking we have assessed the competitiveness impact as positive, whilst for insurance negligible and for securities limited in the short-term. Conglomerates may perhaps be better placed, than smaller firms, to take advantage of the multi-jurisdictional regulatory efficiencies and other opportunities the FSAP and FSWP legislative measures have brought and will bring. Our overall assessment is that the impact is likely to be positive.

6 CONCLUSIONS

Assessment

	Impact of FSAP on…				
	Openness to foreign firms	**Competition**	**Consumer Protection**	**Competitiveness**	**Employment**
Banking	Positive	Slightly positive	Positive	Positive	Negligible so far, negative in the future
Insurance	Limited	Negligible	Limited	Negligible	Negligible so far (perhaps positive in the future)
Securities	Probably positive in the future	Limited in the short term; Probably significantly positive in the future	Limited	Limited in the short-term; Potentially significantly positive in the future	Limited so far, positive in the future
Financial Conglomerates	Slightly positive	Limited	Limited	Positive	Negligible

GREECE

1 INTRODUCTORY OVERVIEW

Financial Services Sector in Greece

1.1 The Greek financial sector controls assets which are equivalent to 170 per cent of the annual GDP. One characteristic of the Greek financial sector is the very significant role of banking although in relative terms this has declined in recent years, due to an increase in the significance of capital and money markets. Indeed, there has been a significant increase in the number of:

(a) listed companies in the Athens Stock Exchange;

(b) mutual funds;

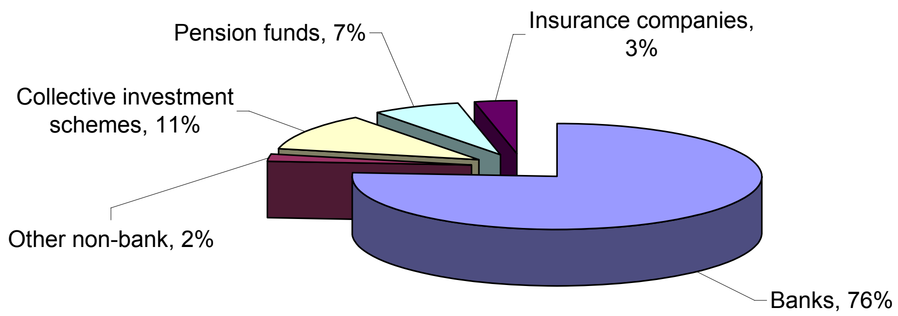
(c) brokerage firms;

(d) investment firms; and

(e) leasing companies.

1.2 However, the weight of banking remains high. This is verified by the IMF data, which show that the major contributor to the financial sector's total assets is banking, with a share of 76 per cent in 2004. The relative size of each sub-sector of the financial sector is shown in Figure 1.1.

Figure 1.1: Greek Financial Sector



Source: IMF

1.3 Until the early 1980's the Greek financial sector used to be regulated by a system of credit rules and characterised by institutional specialisation. The banking system was an instrument of fiscal policy, both in terms of monetary policy and of financing public spending and investment.

1.4 As a result of the liberalization of the financial market in the early 1980's, a cap on the financing of the government by the central bank emerged. The role of the central bank in conducting monetary policy was enhanced.

1.5 Further deregulation took place during the early 1990's, along with the implementation of EU Directives and the modernisation of the capital market:

(a) in 1990, the "parallel market" emerged allowing smaller firms to be listed;

(b) in 1991, the Central Securities Depository Company was established and the role of the Capital Market Committee was enhanced; and

(c) in 1992, the Athens Stock Exchange upgraded its technological operations.

1.6 Due to the expansion of the stock exchange, firms have developed alternative ways to finance their activities, other than bank credit.

Financial Services Regulation in Greece

Division of Responsibility

1.7 Responsibility for financial regulation and supervision of the banking, securities and insurance markets in Greece is spread across the following authorities:

(a) **Ministry of National Economy:** responsible for banking and securities market legislation and related national and international co-operation.

(b) **Capital Market Commission:** responsible for promoting the establishment of sound conditions for the operation of the capital market in order to enhance public confidence both in the quality of supervision and market behaviour. The Commission sets the general terms and conditions governing the organization and operation of the capital market and issues instructions on compliance procedures.

(c) **Ministry of Development (so far):** responsible for the supervision of the insurance market until the Commission for the Supervision of Private Insurance becomes fully operational.

(d) **Commission for the Supervision of Private Insurance (Newly formed):** will take on the responsibility for the supervision of insurance companies; and

(e) **Bank of Greece:** the supervisory authority of the banking sector responsible within the European System of Central Banks for monetary policy and its execution.

Key features of banking regulation

1.8 The Bank of Greece is the main supervisor of banking in Greece.

1.9 The statutory objectives of the Bank of Greece include the stability and efficiency of the banking sector, while securing the transparency of the procedures and transactions taking place within the sector.

1.10 The supervisory function of the Bank of Greece also covers the investment services by banks which are licensed to conduct traditional banking business and securities activities.

Key features of insurance regulation

1.11 The operations of insurance companies are primarily supervised by the General Commerce Secretariat of the Ministry of Development. However, once the newly formed supervisory agency — the Commission for the Supervision of Private Insurance — is fully operational it will take on the responsibilities of supervising the insurance market. The Commission for the Supervision of Private Insurance will report to the Ministry of National Economy rather than the Ministry of Development. The task of the new supervisory agency will be to supervise insurance companies and insurance intermediaries.

Key features of securities regulation

1.12 The securities market is supervised by the Hellenic Capital Market Commission, which is responsible for the regulation of mutual funds, investment firms, the Athens Stock Exchange and securities clearing and settlement systems. A gap in the Commission's regulatory role concerns credit institutions offering investment services, as these are supervised by the Bank of Greece.

Key features of financial conglomerates regulation

1.13 Financial conglomerates fall, by definition, under the auspices of various supervisors.

1.14 The Greek regulatory system divides the financial sector into three distinct sub-sectors: banking, insurance and securities. In regulatory terms, this implies that financial institutions are regulated on the basis of their core activities. Basing regulation on this distinction rather than on functions performed within the financial sector can result in institutions competing in the same market being supervised by different authorities.

1.15 At present, banks offering investment services are regulated by the Bank of Greece, while investment intermediaries are generally regulated by the Hellenic Capital Market Commission.

Views about the implementation

1.16 Although, there have been some criticisms regarding FSAP measures, by and large, the implementation process of the FSAP in Greece appears to have been relatively smooth.

1.17 Key issues identified by stakeholders include:

(a) Tight deadlines for implementation. The time pressure in conjunction with the large volume of measures has at times worked to the detriment of quality.

(b) Some FSAP measures were regarded as not being in compliance with declared aims.

(c) There is a view that, at times, so many measures have been being implemented at once that simply keeping up with the changes imposes a significant burden.

The Impact of the FSAP on the Regulatory Environment

1.18 Prior to the FSAP the Greek regulatory framework was largely rule-based, though there may have been some scope for discretion in certain areas. Whatever scope there was for regulatory discretion may have been reduced in certain areas.

1.19 Respondents to our survey view the level of implementation of the FSAP and the level of regulation in Greece as broadly equivalent to other Member States.

1.20 The FSAP appears to have increased the interaction through regulator-industry relationships and the level of involvement with financial EU authorities in other Member States.

2 BANKING

Headline Overview

Factors specific to Greece

2.1 In the 1990's the process of deregulation of the financial system was carried out at an accelerating pace, along with the implementation of EC Council Directives. There are a number of factors specific to the Greek banking sector which must be considered. These include:

(a) **Re-orientation of the banking sector.** Following the general trend in the Greek economy, the banking sector is being transformed from inward to outward looking, and in particular strengthening its presence in the region of South-East Europe.

(b) **Diminishing government involvement.** It is still the case that there are state-owned banks, while the state has minority holdings in some others. However, there is a trend towards limiting the state's involvement through privatization.

(c) **Low penetration of technology and advanced services (on-line banking, e-money etc).** e-banking has not yet developed in Greece. The low internet penetration rate may be an explanation.

Features of the industry

Number of players

2.2 At the end of 2004, the International Monetary Fund (IMF) reported that there were a total of 60 deposit taking institutions in Greece.[1] Out of the total figure, 10 per cent were state owned banks. The following table details the number of deposit taking institutions, identified by type of ownership, for the years 1998, 2000, 2002 and 2004.

Table 2.1: Number of Deposit-taking institutions in Greece, 1998-2004

	1998	2000	2002	2004
Deposit taking institutions	60	57	62	62
Private	50	48	53	56
Domestic	27	26	32	33
Foreign	23	22	21	23
State-owned	10	9	9	6

Source: IMF

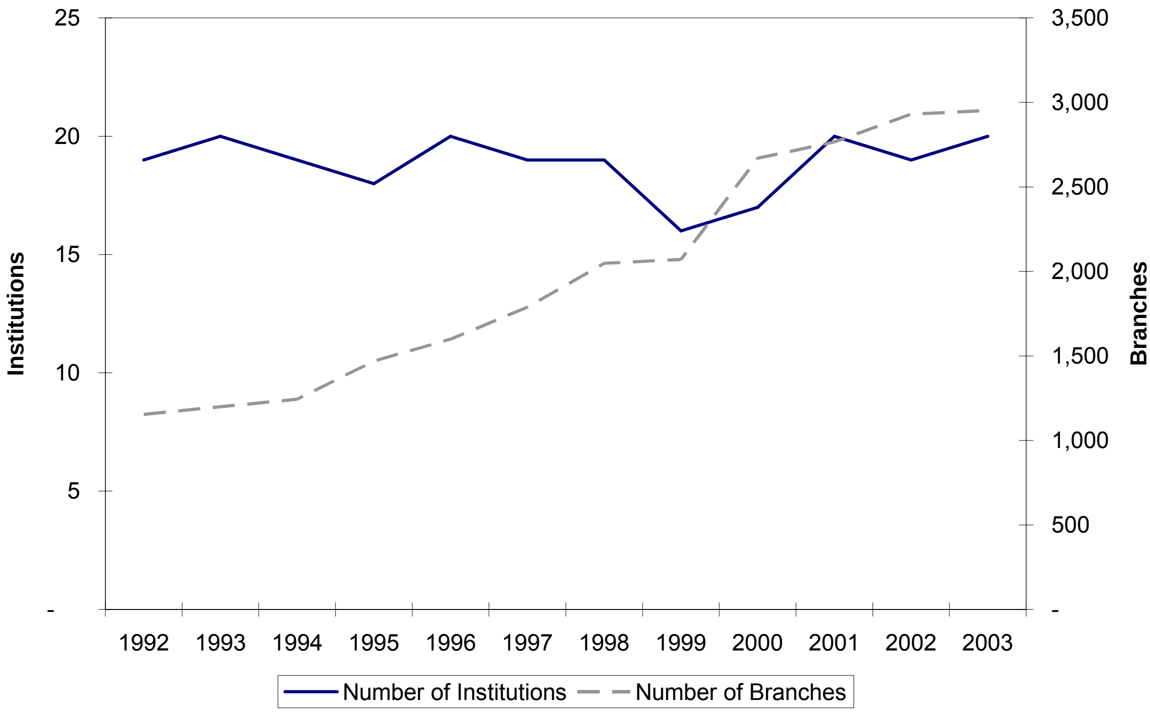
2.3 As it can be seen from the table above, the overall number of players in the market has not dramatically varied over the seven years. However, a message indicated by the numbers is that the state's involvement in the market declines over time as privatization efforts regarding the state-owned banks intensify. The government also has plans to privatise the Postal Savings Banks which has 4.6 per cent of the market.

[1] IMF (January 2006), "Greece: Financial System Stability Assessment" – IMF Country Report No. 06/6.

2.4 Also, even though the number of foreign banks has remained relatively stable over the 1998-2004 period, the foreign banks have a relatively limited presence. The IMF report indicates that foreign banks account for 8 per cent of the market. Entering a new market requires that in the case of a foreign bank it develops its network and becomes a brand name in the new market. Therefore, it may be most likely that foreign banks will attempt to enter the Greek market through strategic alliances with Greek banks or by acquiring a bank with a well developed network. One example of this is the recent privatization of Emporiki Bank (not captured by the data above), which took place in 2006 and gave control of the bank to a foreign institution. In 2003 Emporiki Bank accounted for 10 percent of the market.[2] According to survey respondents, the trend of foreign banks taking over domestic banks should not be attributed to the FSAP measures as, in their view, it reflects the increasing attractiveness of the banking sector in Greece -- in terms of development of the banking business and the expansion to the Balkans and the south eastern European countries.

2.5 Figure 2.1 sets out trends in the number of commercial banks and branches since 1992.

Figure 2.1: Commercial Banks in Greece, 1989-2003



Source: OECD

2.6 As can be seen, the number of institutions fell during the late 1990's, but has risen since the early 2000's.

2 Economic Bulletin (Number 24, January 2005), Bank of Greece

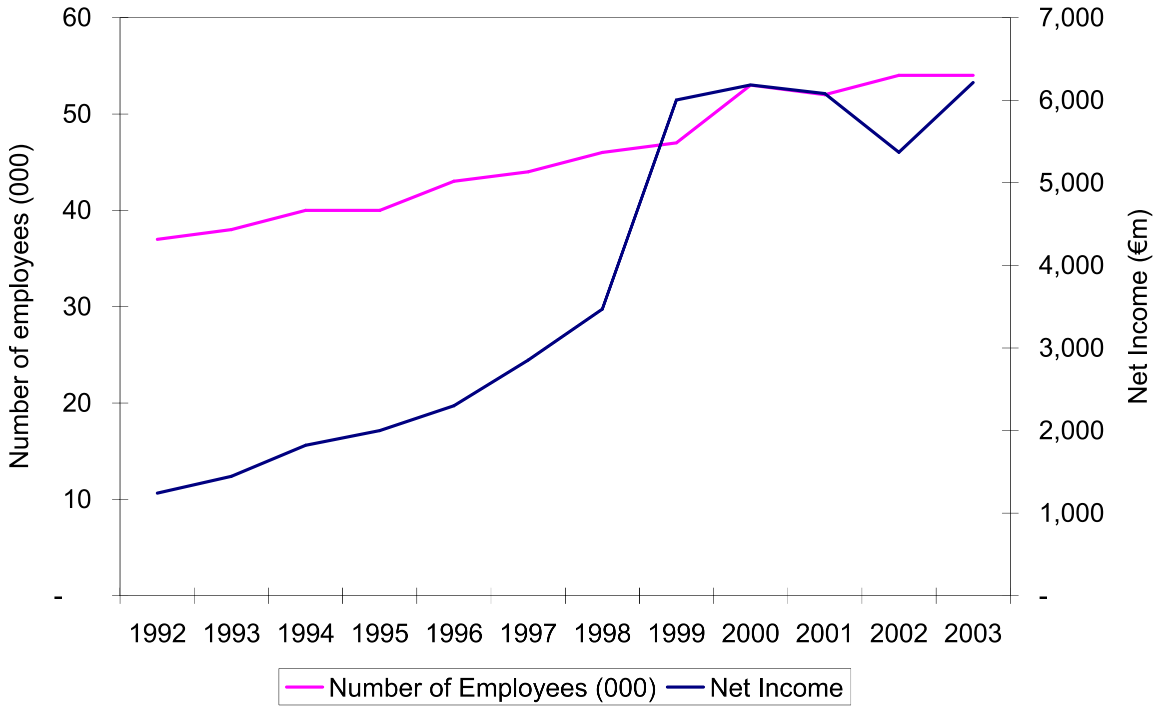
2.7 Due to Greece's participation in the EU, the state was obliged, by European Currency Union (ECU) rules, to liberalize the market. In an increasingly liberalized market, a significant outcome was the mergers and acquisitions throughout 1994 to 2002. This is consistent with the reduction in the number of banks reported in the figure above for 1993–1999. In 2000, while the mergers and acquisitions were still happening, an offsetting force to the reduction of the number of banks was observed as many new banks entered the market. Liberalization is thought to facilitate entry of potentially more efficient firms which in turn induces existing firms to form cost-reducing mergers.

2.8 The number of commercial bank branches increased by 177 per cent from 1,065 in 1989 to 2,953 in 2003. However by 2001, the number of customers per branch was still higher than the EU average — 3,158 people per branch in 2001 compared with 1,852 in the EU[3].

Turnover, employment and profitability

2.9 Figure 2.2 illustrates income and employment in Greek banks.

Figure 2.2: Income and employment in Greek Commercial banks, 1989-2003



Source: OECD

2.10 As illustrated in Figure 2.2, employment in banking has increased in Greece over the past 10 years. It is difficult to predict how the number of jobs will move in the future. On the one hand the anticipated development of e-commerce along with cost cutting will put a downward pressure on employee numbers, while, on the other hand, the opening of new markets will require more employees. Real wages and salaries have tended to at least stay the same, if not increased somewhat in recent years.

2.11 According to OECD data, the sector had a net income of €6.2 billion in 2003, up from €5.37 billion in 2002. With the exception of the two year period between 2000 and 2002

[3] S. Papadopoulos (16 December 2003), "Adjustment of the Greek Banking System in the new European Economic Environment", Bank of Greece.

the net income of the Greek banking sector has been continuously increasing since1992. Following the liberalization of the Greek financial market banks put more emphasis on servicing the private sector, in which the demand for mortgages and loans exceeded the pre-liberalization supply due to regulatory limitations. The returns of such a focus were higher than would have been derived from state securities.

2.12 Using measures such as the rate of return on total assets and the return on equity, Heather Gibson reports that the profitability of Greek banks has been quite erratic throughout the 1989-2003 period[4]. However, one can see an overall downward trend. Gibson relates the huge increase in the 1998-2000 profits — the increase is also evident from the net income rise shown in Figure 2.2 — to the stock market boom, and the subsequent fall to a return to normal profit levels.

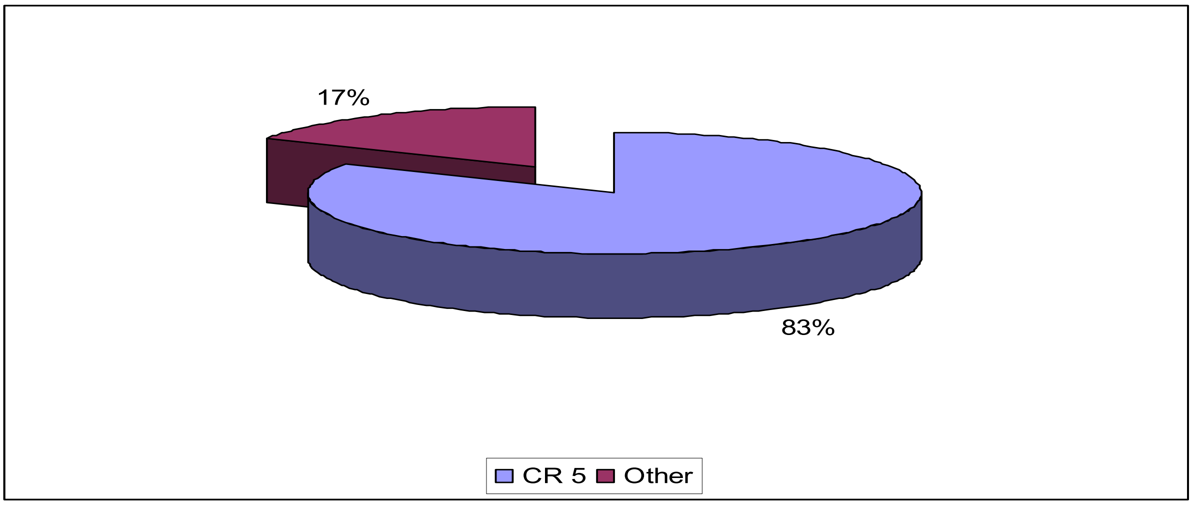
2.13 In 2004 the banks in Greece achieved a net interest income equivalent to 2.7 per total assets, i.e. much higher than any other country in the EU — EU average was 1.3 per cent in the euro area in 2003. This suggests that the "intermediation spreads" (the difference between the buying and selling prices of financial intermediaries) are still high in Greece.

Market shares and concentration

2.14 The combined market share of the five largest bank groups (National Bank of Greece, Alpha Bank, Eurobank, the Agricultural Bank of Greece and Emporiki Bank) was approximately 83 per cent in 2003. Out of the five, the biggest is the National Bank of Greece which was state owned in the past and over which the state still retains some influence through minority shareholdings. Alpha Bank and Eurobank are private banks, Emporiki Bank was acquired by Credit Agricole, while the Agricultural Bank of Greece is still state-owned, even though there are privatisation plans.

2.15 Figure 2.3 sets out the market shares of banks in Greece based on total assets, in 2003.

Figure 2.3: Market Share of Banks (based on total assets), 2003



Source: Economic Bulletin (Number 24, January 2005), Bank of Greece.

[4] Economic Bulletin (Number 24, January 2005), Bank of Greece

2.16 Table 2.2 shows the evolution of the Herfindahl-Hirschman index since 1997.

Table 2.2: Herfindahl-Hirschman index

1997	1998	1999	2000	2001	2002	2003	2004	2005
885	1165	986	1122	892	856	783	798	795

Source: European Central Bank

2.17 The concentration ratio falls for most of the period due to the effects of liberalisation. However, post-1995 the concentration ratio rose due to a period of consolidation taking place in the market. It is evident that of the 25 operating banks in 1993, only 11 remained in 2003, while the rest were acquired by other banks.[5] The Herfindahl index reached its peak in 2000.

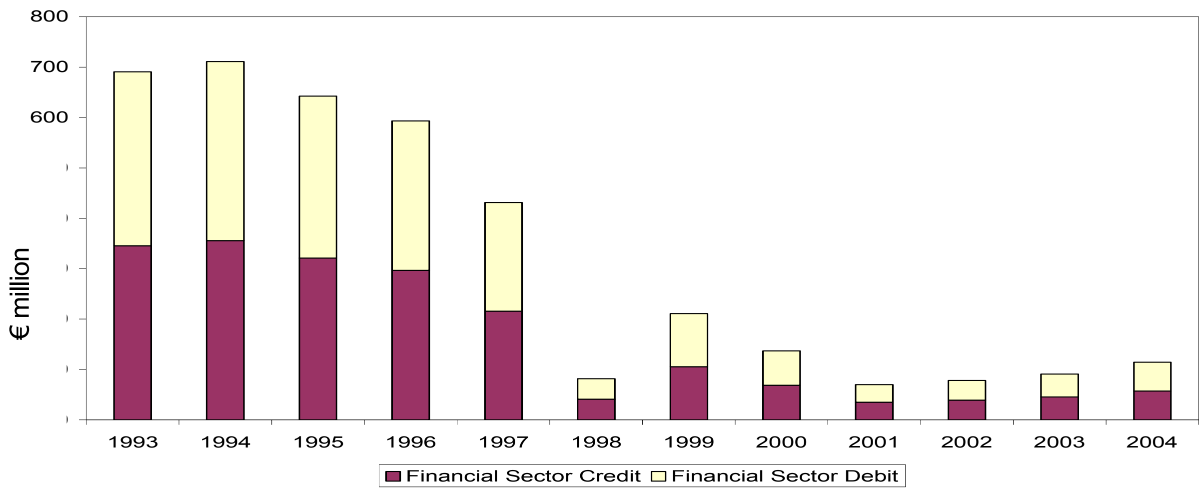
2.18 As a result of new entries to the banking sector, the share of the top two banks was reduced from 54.5 per cent in 1993 to 46.9 per cent in 2003 according to the Economic Bulletin of the Bank of Greece (Number 24, January 2005). At the same time, the share of the next four biggest banks increased from 29.3 percent in 1993 to 44.4 percent in 2003. These banks can compete against one another in a number of banking services.

2.19 Therefore, even though the market remains concentrated by European standards, the liberalisation procedure along with the mergers and acquisitions observed in the banking sector appear to have been beneficial for the competition among the big players in the market.

Trade and international penetration

2.20 Figure 2.4 gives total non-insurance financial services trade for 1993-2004[6]. It appears that Greek trade in non-insurance financial services has significantly dropped since 1997.

Figure 2.4: Greek trade in non-insurance financial services, 1993-2004



Source: Eurostat

2.21 The first foreign bank to set up operations in Greece was American Express, which entered the market in 1921, followed by Citibank in 1964.

5 Source: Economic Bulletin (Number 24, January 2005), Bank of Greece. Notice that the figures on the number of banks reported in the bulletin are not in complete agreement with the OECD data also presented in this Appendix.

6 This is defined as the sum of credits and debits, and covers wider services than just banking.

2.22 Foreign banks, mostly American, started penetrating the Greek banking market in the 1960's in the wake of US multinationals. They focused on a handful of major clients including shipping magnates, bypassing retail banking.

2.23 According to the Hellenic Bank Association, in 2005 there were 20 foreign banks operating in Greece. The largest foreign bank in Greece is Bank of Cyprus, which has its headquarters in Cyprus and is operating in Greece with 110 branches (almost half of all foreign banks' branches and by far the most among non-Greek banks). Citibank and HSBC are the second and third biggest foreign banks in Greece respectively.

2.24 According to the Bank of Greece, with the exception of the major foreign players, an existing perception was that to some extent foreign banks in Greece often tend to focus on financing affiliates of foreign firms, or only large local firms.[7] On the other hand the Bank of Greece is of the view that Greek banks in their effort to expand in Southeast Europe "have entered planning to offer a wide range of services and they see their future closely linked to the evolution of the host economies. They are not entering in order to concentrate in just a few lucrative activities and offer services to other Greek firms."

2.25 The choice of Greek banks to enter these markets could have been affected by one or more of the following reasons:

(a) Expectation of EU accession (especially in the case of Bulgaria and Romania).

(b) Number of Greek companies moving their operations in the neighbouring countries.

(c) Comparative advantage of Greek banks over their international competitors, due to their better understanding of the Balkans region.

Competitiveness

2.26 Our opinion survey found that respondents were of the view that banks are now more efficient than a few years ago and improvements in bank efficiency are expected to further develop in the future.

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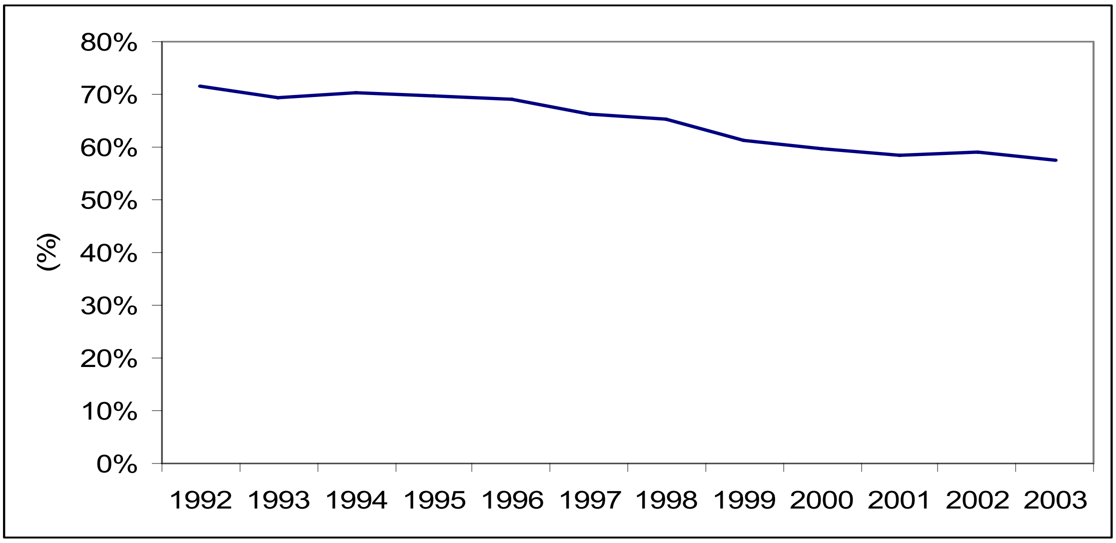
7 Panayotis Thomopoulos — Deputy Governor of the Bank of Greece (4/12/2003), "The Financial Environment in Southeast Europe", Second International Banking Forum for the Southeast European Markets, Economist Conference December 4-5, 2003.

2.27 Operational costs have risen in absolute value — labour costs, though, account for a smaller share of overall operational expenditure in recent years than they did in the past (see the following figure).

Figure 2.5: Labour Cost to Operating Expenses, 1992-2003



Source: OECD, Europe Economics

2.28 The survey also gathered information on the factors that allow Greek banks to face competition from foreign banks. Survey respondents differ in their view as to what are the main factors driving competitiveness of domestic banks against foreign banks, with respondents agreeing only on the importance of the regulatory environment. Other factors identified include: business infrastructure, availability of skilled personnel government responsiveness and access to international markets.

Perceptions of ease of switching, factors affecting competition, and consumer protection

Switching behaviour

2.29 Switching is notoriously difficult to assess, and subjective judgement by those close to the industry is often the main source of information. Our main source of information is our survey. Respondents to that survey took the view that switching has so far increased due to the introduction of new products, increased competition and increased financial literacy of the consumers. Even though switching increased, it is unclear as to what has been the impact of the FSAP on the switching behaviour of bank customers. In the future, switching is expected to increase. However, respondents to our survey are of the view that this would probably have happened irrespective of the FSAP.

Dimensions of price and quality competition

2.30 The survey investigated views of price and quality competition as well as product variety. Market players took the view that prices have declined significantly in the past. The fall in prices though is mostly associated with Greece's accession to the eurozone and the subsequent fall in interest rates. It is difficult to predict future movements, even though a similar pattern in the future is likely to arise. In relation to product variety, it appears that the number of products available on the market has increased over recent years and the trend is expected to continue, with a similar pattern anticipated for e-commerce.

2.31 Part of the product variety could be attributed to the introduction of the FSAP which resulted in the development of new sophisticated banking products. However, a significant increase would have taken place even in the absence of the FSAP.

2.32 It is probably the case that the increase in e-commerce banking products would have taken place irrespective of FSAP because e-commerce in banking was new in Greece.

Other factors affecting competition

2.33 Survey respondents view the intensity of competition as one of the main determinants of whether a particular bank can be dominant in the banking sector. Other factors regarded as important include the threat from potential new entrants and buyer power.

Consumer protection

2.34 A legal text was adopted at the beginning of June 1993. It was an amendment to the Penal Code, making money laundering a criminal offence and amending banking secrecy legislation. It was ratified in mid-July 1993.

2.35 Law 2331/1995 on Prevention and Combating the Legalisation of Income from Criminal Activities was adopted on 24 August 1995. It changes the provisions of the Community Directive and imposes heavy penalties, including the seizure and confiscation of property.

2.36 There has also been a parallel increase in complaints relating to banking products. This is mostly due to the expansion of the retail banking business and the establishment of the Banking and Financial Services Ombudsman.

2.37 Law 2331/1995 determines the framework for addressing Anti-Money Laundering and Combating the Financing of Terrorism issues. However, according to IMF further refinements are needed in order to meet international standards. The Greek authorities are currently amending the Law so as to strengthen the existing preventative measures.[8]

2.38 As of October 2005, the European Commission decided to take Greece to the European Court of Justice for its failure to comply with the Second Money Laundering Directive. In response, the Greek government introduced a new draft law to harmonize the existing anti-money laundering legislation with Directive 2001/97/EC.

2.39 The results of our survey suggest that consumer protection in Greece is widely regarded as having improved over the past five years and respondents envisage it improving further in the future.

The potential future role of technology

2.40 Respondents are of the view that e-commerce in Greece has increased over the last few years.

2.41 However, one must bear in mind the lag between Greece and the more advanced European economies in that respect. Technological advancements in banking which are to be introduced in Greece could allow cost savings and in the context of a competitive market may imply lower prices for the customers.

2.42 Many banks in Greece have an internet site. However, telephone and e-banking are not widely used in Greece. Therefore, there remains scope for development in this area.

2.43 Low internet penetration in the Greek market has affected the degree in which e-banking is used in Greece: e-banking is not widely used, but given the development of the internet it is expected to increase in the future.

2.44 Also, the fact that many banks in Greece do not have an extensive network of branches, as mentioned above, may benefit competition. As e-banking makes having an extensive

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[8] IMF (January 2006), "Greece: Financial System Stability Assessment"– IMF Country Report No. 06/6.

network of branches less significant, banks with smaller networks may benefit in the sense of avoiding costly reductions by closing down branches.

2.45 Law 3148/2003 incorporated the provisions of EU legislation, determining the characteristics of e-money.

Impact of the FSAP and FSWP Legislative Measures on the Greek Banking Sector

Cross-border business, takeovers and the development of a regional market

2.46 Cross-border activities in the banking sector have increased and will continue to do so in the future. The increase has mainly occurred through the use of international branches. So far the FSAP appears to have had a slight impact on the degree of openness of the Greek banking sector to foreign firms, even though prior to the implementation of the FSAP, the Greek market was already opening up to foreign firms. In the future, a greater EU-wide tendency for firms to operate cross-border, driven to an important degree by the harmonising aim and impact of the FSAP, should eventually lead to greater foreign participation in Greece.

2.47 The location of the Greek banks' foreign activity has mainly been in the Balkans and the wider South East European area. It is anticipated that this trend will expand in the future. Northern Africa and the Middle East are also seen as potential areas of interest.

Competition

2.48 The Greek banking sector experienced a period of decreasing concentration, which followed the liberalization of the market in the early 1990's. This downward trend of concentration ratios was reversed during the period of consolidation 1998-2000. However, the effect of this reversion on competition was not necessarily adverse, because, two offsetting factors were favouring competition:

(a) the sector was no longer dominated by a single leader; and

(b) new competitors were entering the market.

2.49 The greater openness of the Greek banking market to foreign banks, combined with the fact that a number of foreign banks have actually set up branches after the implementation of the FSAP, along with many domestic new entrants, suggests that the market has become more contestable in recent years.

2.50 It appears that Greek banks have become more efficient in recent years and consumers are now facing considerably lower prices

2.51 The FSAP measures aimed at facilitating greater foreign entry should result in a higher level of competition, due to more entries into the banking sector as well as more contestability.

2.52 It is interesting to note that respondents to our survey are of the view that the degree of switching behaviour has been largely unaffected by the FSAP, although a possible impact in the future should not be excluded.

2.53 Overall, it appears that the FSAP has had a slightly positive impact on the level of competition in the Greek banking sector.[9]

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9 It should be noted that pan-EU technological trends, such as growth in e-commerce, might not be completely independent of the FSAP (or other parts of the Single Market programmes). This is an issue considered in more detail in the Main Report.

Competitiveness

2.54 Greek banks are operating in an increasingly competitive environment where new domestic banks enter the market and foreign banks acquire previously state-owned ones. The environment has become more competitive partly as a result of the adoption of the euro (as described in the Main Report) as well as the harmonization of the prudential framework with EU directives. Both of these factors have increased financing alternatives for borrowers.

Table 2.3: Key performance indicators of the banking sector (%)

Year	Net interest margin[a]	ROA[b]	ROE[c]
1992	1.6%	1.2%	23.1%
1993	1.6%	1.1%	21.6%
1994	1.4%	1.3%	25.9%
1995	2.1%	1.3%	24.4%
1996	2.0%	0.8%	16.5%
1997	2.3%	1.0%	17.9%
1998	2.4%	1.2%	19.3%
1999	2.7%	3.0%	27.6%
2000	2.7%	1.9%	19.2%
2001	2.7%	1.4%	14.3%
2002	2.4%	0.7%	9.8%
2003	2.7%	0.9%	12.3%

a: Net Interest margin: net interest income/total assets.

b: ROA: income before tax to average total assets.

C: ROE: income before tax to average capital and reserves.

Source: Europe Economics calculation of data from OECD (2005) "Bank Profitability".

2.55 Another factor driving competitiveness is the increasing contestability brought about by the greater openness of the banking sector. In response to increasing contestability, banks have to improve their level of efficiency in order to remain competitive. As a result of increased efficiency, competitiveness intensifies. To the extent that the FSAP has enhanced cross-border activity among the EU Member States, creating opportunities for Member States to penetrate other member state banking markets, we can conclude that the FSAP has had a slightly positive effect on competitiveness in the Greek banking sector.

Employment

2.56 Figure 2.2 illustrates an increase of 46 per cent in employment in the banking sector between 1993 (37,000) and 2003 (54,000). There was an upward trend in employment in the banking sector before the introduction of the FSAP. However, this upward trend was exacerbated in the post 1999 era.

2.57 Overall, the rising level of employment can be partly attributed to: new entrants, the stock market boom (1998-2000) as well as the labour laws and unions which make it difficult for banks to adjust staffing levels downwards.

2.58 From the information above, we are unable to make robust conclusions about the impact of the implementation of the FSAP on the level of employment in the Greek banking sector.

Consumer Protection

2.59 The implementation of the FSAP obliged Greece to speed up the process of introducing stricter laws regarding anti-money laundering and combating the financing of terrorism issues. Therefore, in that respect, the effect of FSAP can be considered positive.

2.60 Furthermore, as a result of increased competition in the Greek banking sector, consumers will be naturally more protected. More competitive firms are bound to offer clients better services or products. As a result, clients will be better protected from abusive practices from companies. Indeed, it is in the companies' best interest not to have abusive practices when faced with competition, if they wish to remain in the market, because disappointed clients will easily change companies that will provide them the same service without having abusive practices.

2.61 Respondents to our survey took the view that the FSAP had a positive effect on consumer protection and that the effects in the future will also be positive. Having said that, they are also of the view that the degree of switching behaviour has been largely unaffected by the FSAP, although a possible impact in the future should not be excluded.

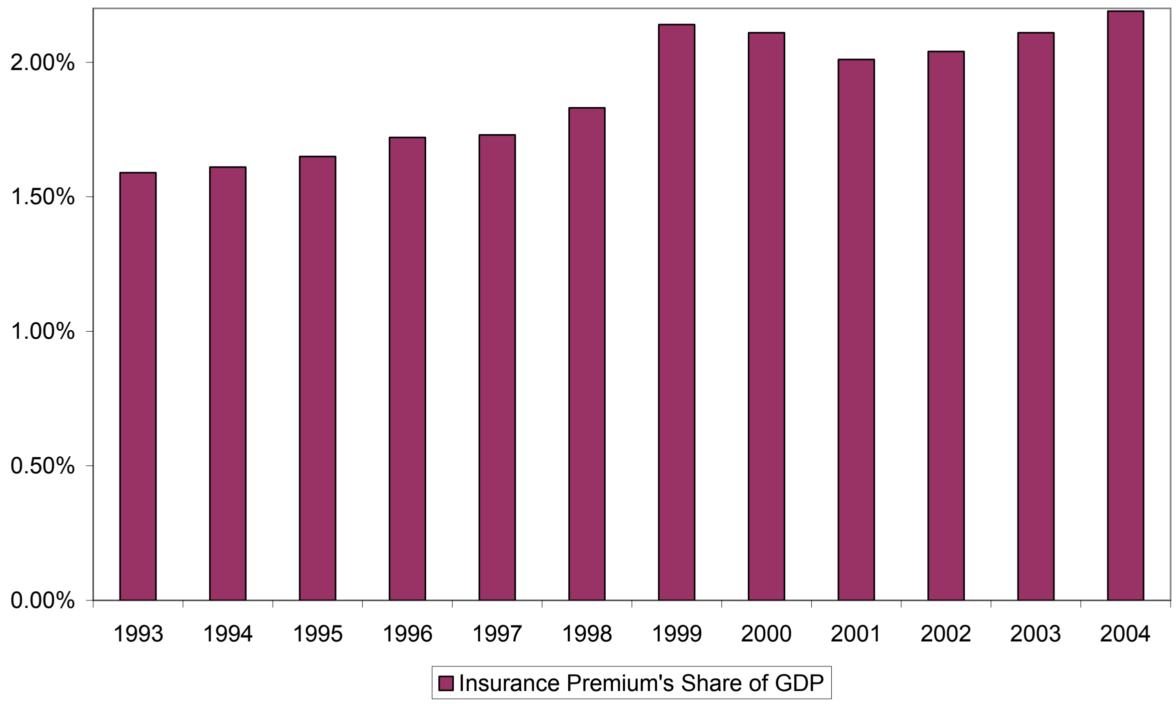
3 INSURANCE

The Greek Insurance Sector

3.1 Despite strong growth in 2003 and 2004, the Greek insurance market remains small. In 2004 the premium income reached €3.6 billion, following a 12 per cent growth rate since 2003. The share of total direct written premium corresponding to life insurance reached 47.7 per cent, while non-life insurance represented a 52.3 per cent share.

3.2 The insurance market's contribution to GDP was equivalent to 2.19 per cent (Figure 3.1). This figure is compared to an EU average of 8.7 per cent in 2002.[10] This suggests that there is considerable scope for development in the Greek Insurance industry.

Figure 3.1: Insurance Premium's share of GDP in Greece, 1993-2004



Source: Association of Insurance Companies Greece

[10] ATE Insurance (www.agroins-capital-market.com/asfalistikos_klados.asp)

3.3 However, even though the insurance market remains small, there has been a significant expansion with gross premiums increasing from under €500 million in 1990 to over €3 billion in 2003 (Table 3.1).

Table 3.1: Gross and Per Capita Premiums in Greece

Year	Gross Premium (€ 000's)	Annual Change (%)	Premium per Capita (€)	Insurance Premium's Share of GDP
1990	477,080	34.9%	46.9	1.2%
1991	615,351	29%	60	1.3%
1992	798,502	29.8%	77.4	1.4%
1993	984,502	23.3%	94.8	1.6%
1994	1,134,017	15.2%	108.8	1.6%
1995	1,300,202	14.7%	124.5	1.6%
1996	1,506,809	15.9%	144	1.7%
1997	1,685,039	11.8%	160.5	1.7%
1998	1,933,503	14.7%	183.9	1.8%
1999	2,408,995	24.6%	228.9	2.1%
2000	2,572,549	6.8%	243.4	2.1%
2001	2,641,954	2.7%	241	2%
2002	2,895,252	9.6%	263.1	2%
2003	3,234, 683	11.7 %	293.9	2.1%

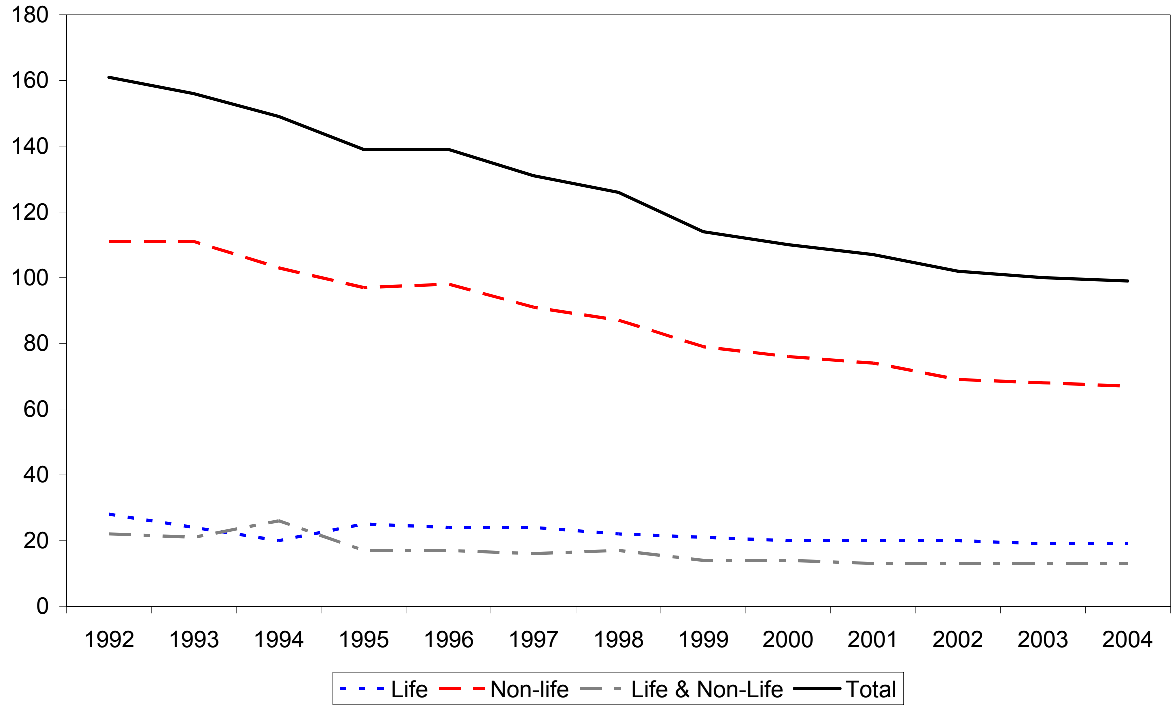
Source: Association of Insurance Companies Greece

3.4 Premium per capita in 2002 in Greece was €263 while Luxembourg had €14,354 and the UK €4,019; Greece had the lowest premium per capita in the EU.

Number of Insurance Companies

3.5 Figure 3.2 gives the number of life and non-life insurance companies in Greece from 1992 to 2004.

Figure 3.2: Number of Insurance Companies in Greece, 1992-2004



Source: Association of Insurance Companies Greece

3.6 Over the last decade, the Greek insurance market has significantly changed. From the 1992 level where 161 companies operated, the market shrank to 99 insurance companies in 2004. Out of the 99 insurance companies, 19 are operating in the life insurance market, 13 are composite and 67 are non-life.

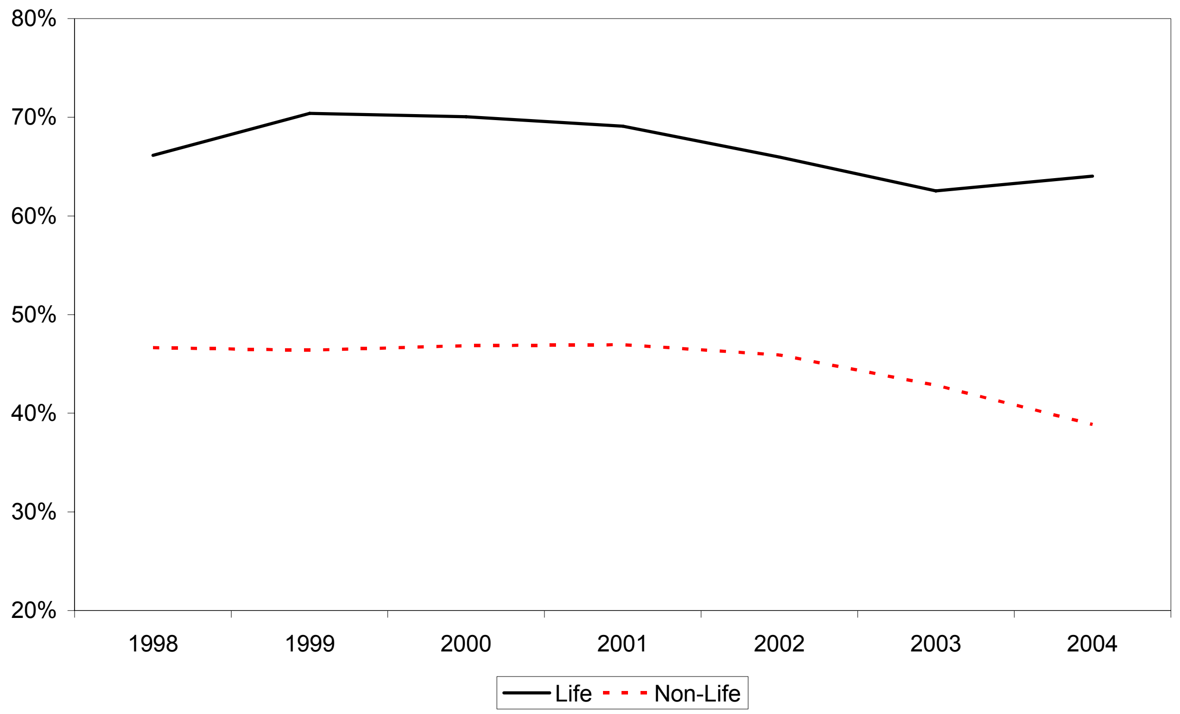
3.7 According to Deloitte, by 2010 the market is expected to be even more reduced, with only 50 companies left operating, as a result of consolidations as well as all the small and undercapitalised companies shutting down. [11]

Market shares

3.8 Figure 3.3 illustrates the concentration ratios of the five largest companies in the life and non-life sectors of the insurance market in Greece for the 1998-2004 period.

[11] http://www.deloitte.com/dtt/section_node/0,1042,sid%253D40267,00.html.

Figure 3.3: Share of the 5 Largest Insurance Companies in Greece, 1998-2004



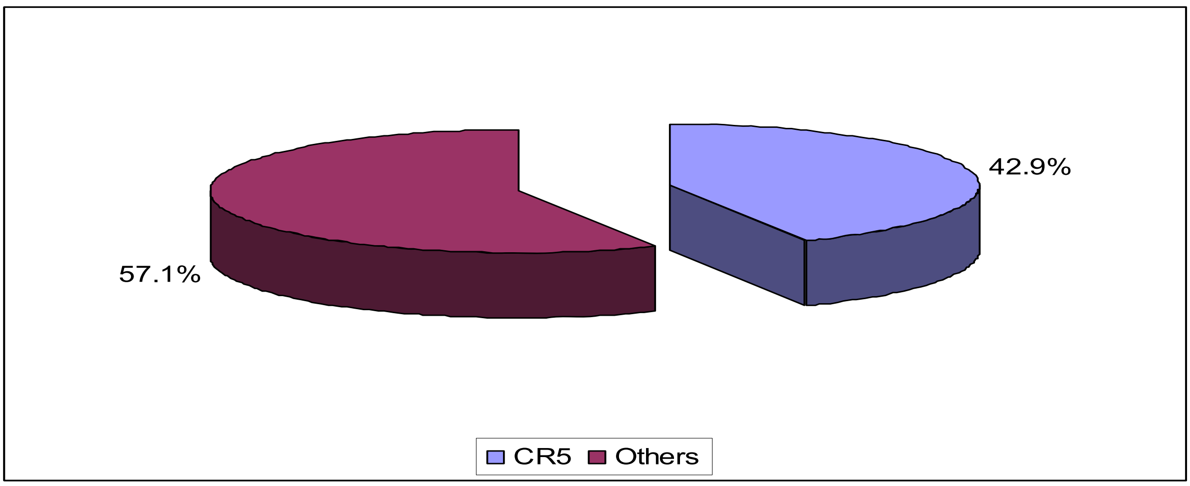
Source: Association of Insurance Companies Greece

3.9 In 2004, the five largest insurance companies in the life insurance market controlled two thirds of the business and the five largest general insurance companies controlled less than 40 percent of the market. Therefore, the life insurance market is significantly more concentrated than the non-life insurance market.

3.10 Most large insurance companies are partly or wholly owned by banks, which makes the insurance system a Bancassurance one.

3.11 Figure 3.4 illustrates the share of major insurance companies in the non-life insurance market.

Figure 3.4: CR5 in the Non-Life Insurance Market, 2003

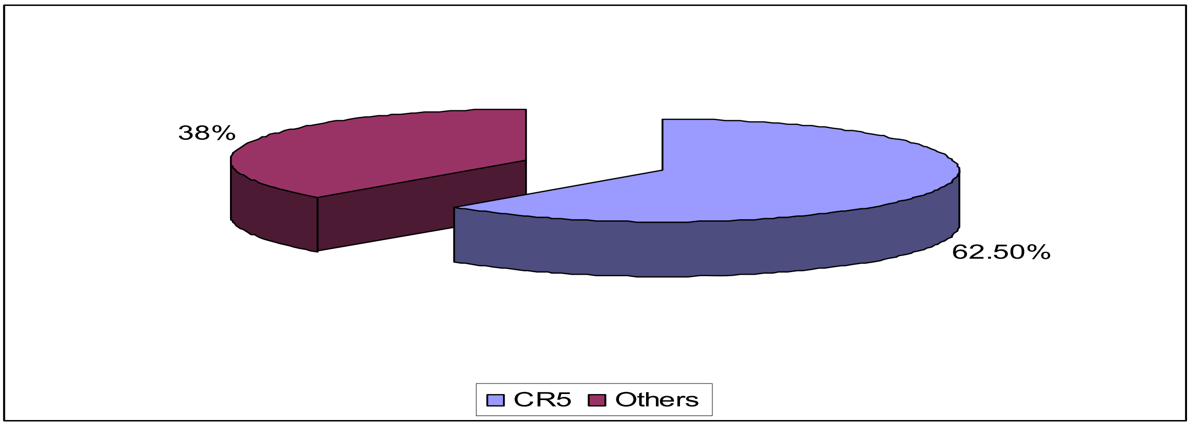


Source: Analysis of data coming from the Association of Insurance Companies Greece. Analysis made by Agrotiki Asfalistiki

3.12 Figure 3.5 illustrates the CR5 for life insurance companies in 2003. key players include Ethniki, Phoenix and Agrotiki Asfalistiki.

3.13 As a total, their concentration ratio accounts for 42.9 per cent of the non-life insurance market shares.

Figure 3.5: CR5 in the Life Insurance Market, 2003



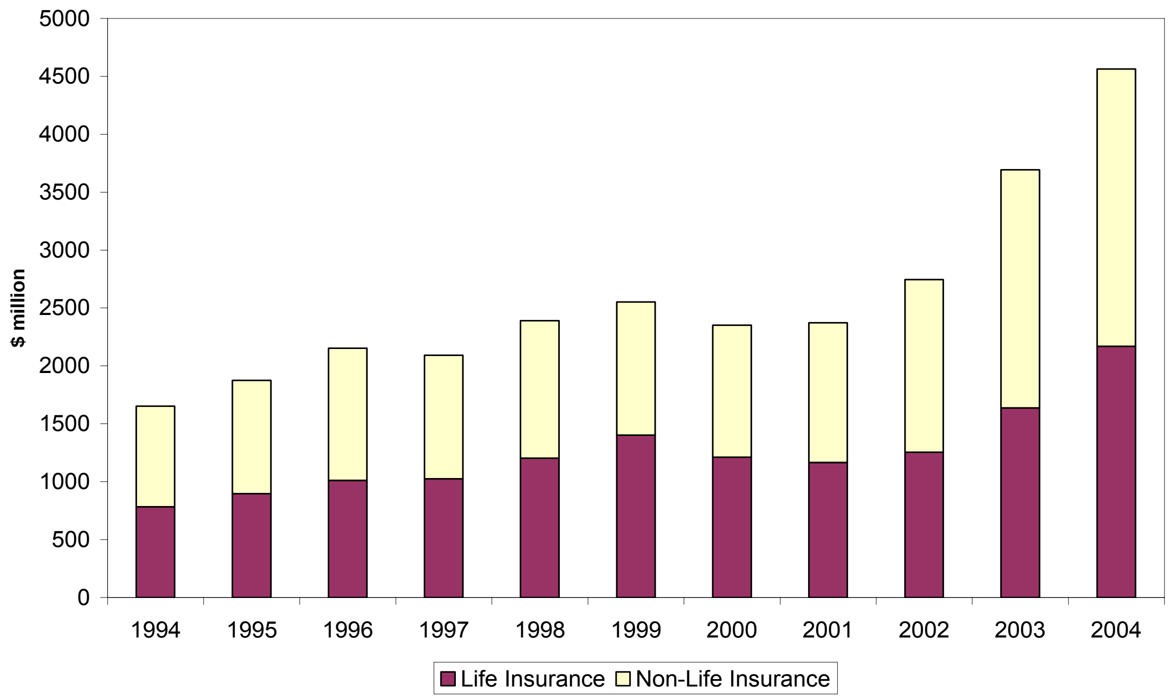
Source: Analysis of data coming from the Association of Insurance Companies Greece. Analysis made by Agrotiki Asfalistiki

3.14 Therefore, despite the number of companies in the market (99 in 2004), premium generation is concentrated in the top five to ten companies.

Turnover

3.15 Figure 3.6 represents the development of life and non-life insurance gross premiums in Greece between 1994 and 2004.

Figure 3.6: Life insurance gross premiums in Greece, 1994-2004



Source: OECD

3.16 Premiums increased during the mid 1990's, stabilised in the late 1990's, and witnessed a major upwards trend in recent years.

3.17 As shown in Table 3.2, the insurance industry's profitability has been poor and volatile.

Table 3.2: Insurance Sector's Profitability

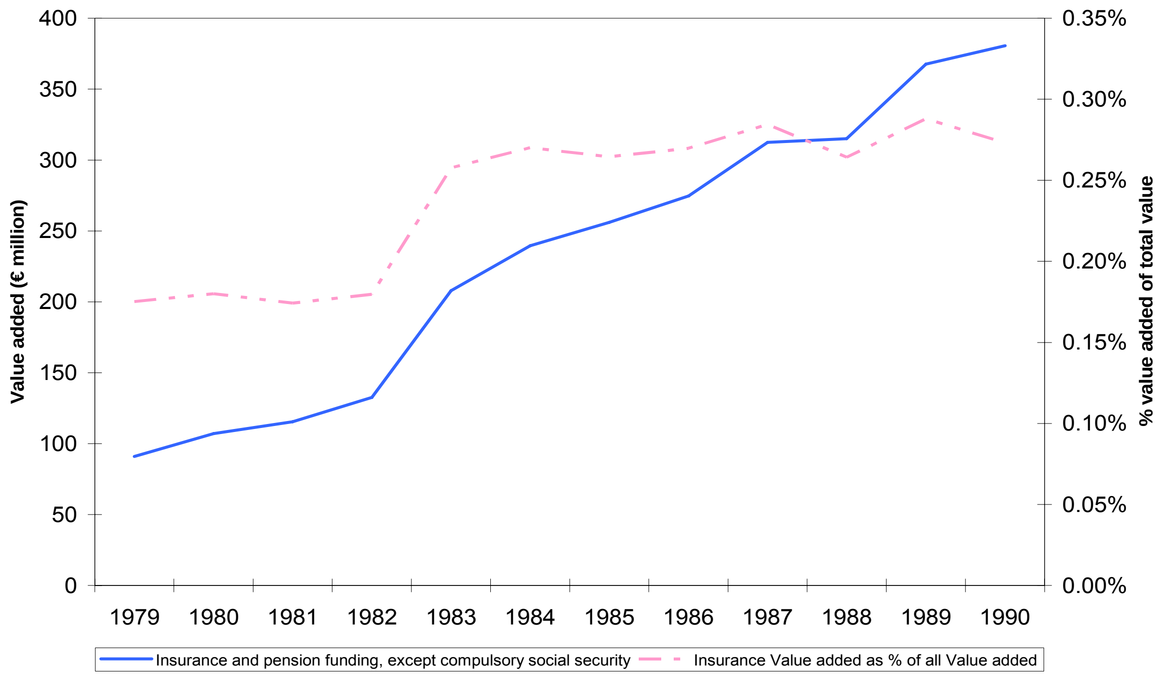
Year	Year's Profit (€ millions)	Growth Rate
1993	26.2	n/a
1994	27.4	4.4%
1995	22.4	-18.2%
1996	24.8	10.5%
1997	35.3	42.6%
1998	64.6	82.7%
1999	347.4	438.2%
2000	167.6	-51.8%
2001	5.7	-96.6%
2002	-202.0	-3637.1%
2003	104.5	-151.7%
2004	-62.9	-160.2%

Source: Association of Insurance Companies Greece.

3.18 According to the IMF assessment report, the underlying reasons for the poor performance are the intense competition and the poor supervision. The report suggests that inadequate supervision and enforcement of regulations has allowed aggressive competitors to under price the market by failing to constitute adequate technical reserves, which has often resulted in failures.

3.19 Figure 3.7 sets out the value added by the Greek Insurance market.

Figure 3.7: Value added of Greek insurance, 1992-2003



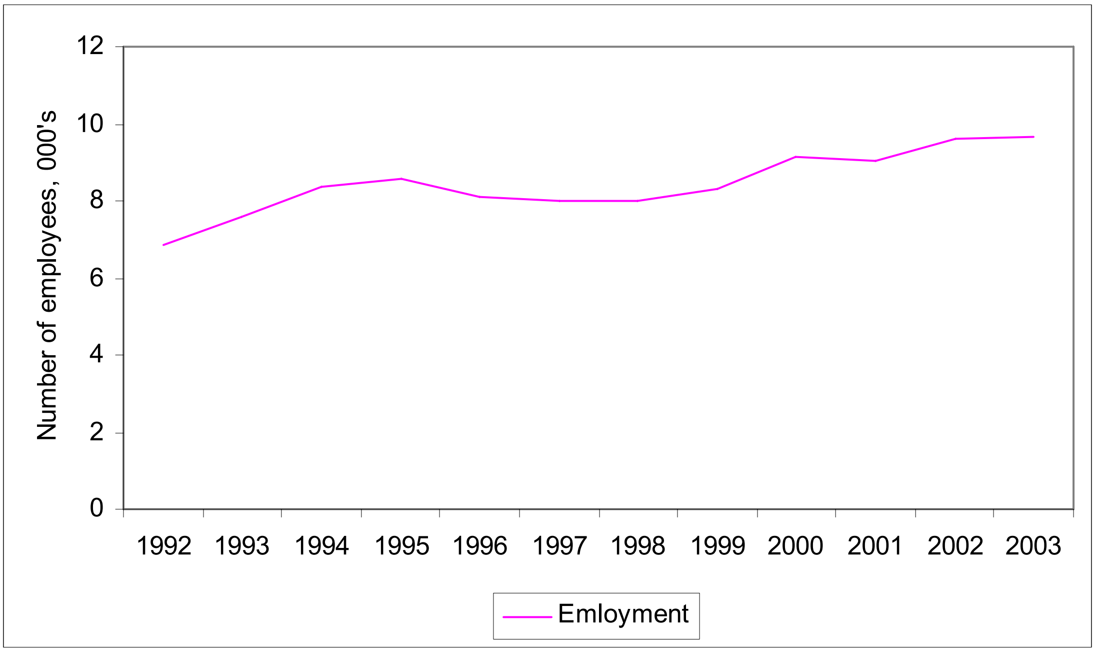
Source: University of Groningen

3.20 The value added has exhibited a constantly increasing trend over the two past decades, and notably since the mid 1990's.

Employment and Efficiency

3.21 Figure 3.8 illustrates an upward trend in employment in insurance going back to 1992.

Figure 3.8: Employment in insurance, 1992-2003



Source: University of Groningen

3.22 According to data presented in the IMF report, one characteristic of the labour force is that it is not well-trained, with premium generation per employee well below the European average (see Table 3.3). However, it is evident that there is a distinct upward trend in recent years, following the implementation of the FSAP.

Table 3.3: Direct Gross Premium per Employee (€millions)

	2000	2001	2002	2003
Greece	0.27	0.28	0.30	0.34
EU15	0.88	1.00	-	-

Source: IMF. EU15 data not available, 2002–3.

International entry

3.23 Around one-third of the companies operating in the market are foreign-owned, and most of the larger domestic firms have foreign connections.

3.24 Table 3.4 shows the split of insurance enterprises according to establishment.

Table 3.4: Greek and Foreign Insurance Companies in Greece, 2001-2004

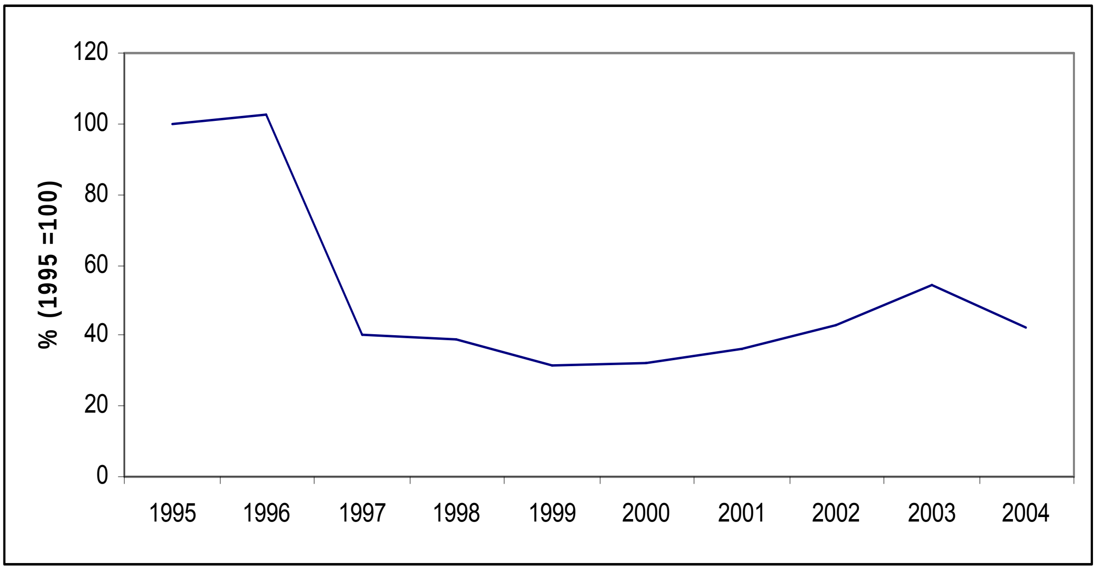
	2001	2002	2003	2004
Greek	73	71	70	70
Foreign	34	31	30	29
Foreign out of Total (%)	32	30	30	29

Source: Association of Insurance Companies Greece

3.25 The penetration of foreign companies into the Greek market appears to be relatively high.

3.26 Foreign life insurance companies account for a market share of less than five per cent of premiums written in 2004 — notice that according to the Ministry of Development foreign companies' share of gross premiums is around nine and eight per cent for 2003 and 2004 respectively.

Figure 3.9: Market share of (branches/agencies of foreign undertakings) in total domestic business (% gross premium basis)



Source: OECD[12]

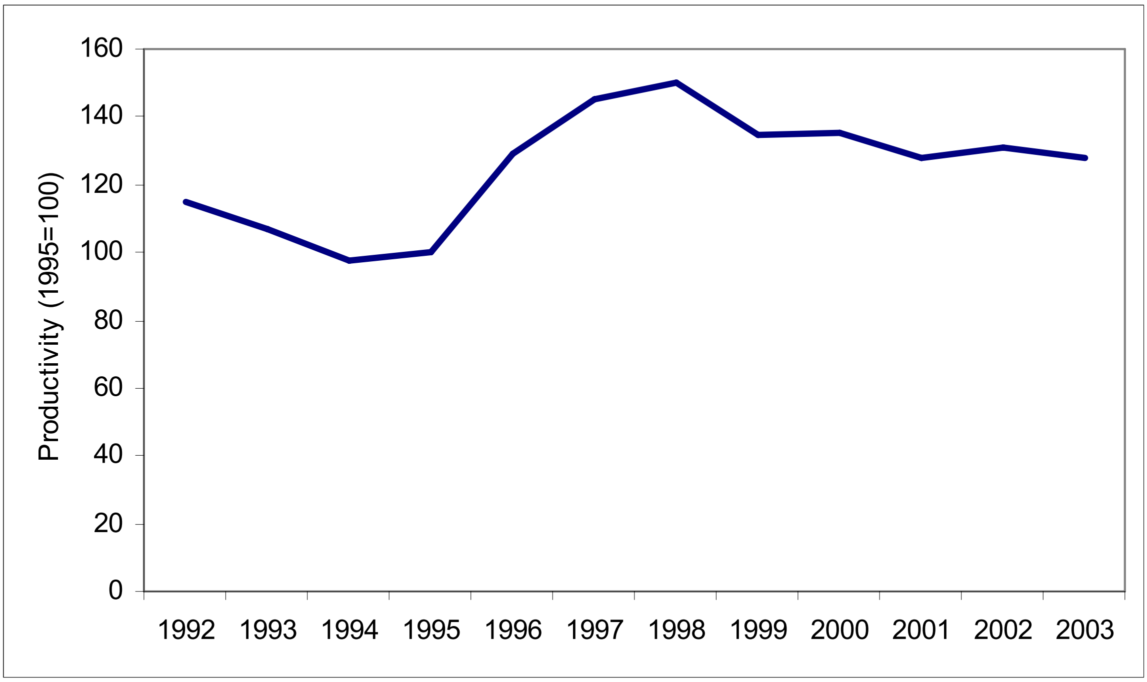
3.27 Since the mid 1990s, there has been downward pressure on the foreign companies' share of premiums, and it is only recently that this was reversed.

[12] The OECD has no observations for foreign penetration on the basis of market share of (foreign controlled undertakings) and (branches/agaencies of foreign undertakings as a % of total domestic business.

Competitiveness

3.28 Figure 3.10 gives labour productivity in insurance and pensions for 1992 to 2003.

Figure 3.10: Labour productivity in the Greek insurance and pensions sector (1995=100), 1992-2003



Source: University of Groningen

3.29 Productivity rose rapidly from the mid 1990's, but then fell during the early 2000's with the bear market.

Impact of the FSAP and FSWP Legislative Measures on the Greek Insurance Sector

Market entry, cross-border business and takeovers

3.30 Prior to the implementation of the FSAP, the share of foreign undertakings in Greek insurance business was low and slowly declining. Since the onset of the FSAP and specifically since 2003 there has been a notable reversion of the trend — even though the level of penetration is still very small. This has been mirrored by the increased share of premiums and not by the number of foreign market participants, which has remained fairly constant over 2001-2004.

3.31 Therefore, from the information above, it is difficult to draw definitive conclusions regarding the impact of the FSAP on the Greek insurance market. However, if the FSAP achieves its aim to harmonise the opean insurance market, it should increase the level of cross-border activity among the EU Member States in the future.

3.32 Interestingly, our survey respondents believe that the impact of the FSAP will be rather limited on the insurance market, especially since some of the directives have only been recently transposed into Greek law, which makes it too early to assess.

Competition

3.33 So far, it is too early to conclusively evaluate the impact of the FSAP on the level of competition in the Greek insurance sector. However, if the FSAP achieves its aim to harmonise the European insurance market, it should increase the level of cross-border activity and therefore increase the level of competition and of contestability in the Greek insurance sector.

Competitiveness

3.34 As can be seen in Figure 3.10, labour productivity rose rapidly in the mid 1990s, but fell after 1999. There is no evidence of increased operational efficiency attributable to the FSAP. However, if the mechanism described above comes into effect, where cross-border activity rises and as a result competition also increased, then there should naturally be an increase in the level of competitiveness as a result of increasing efficiency among the banks that wish to remain in the market. Such results would be partly attributable to the implementation of the FSAP.

Employment

3.35 Despite cyclical variations, the level of employment in the Greek insurance sector has consistently risen since the early 1990's. Therefore, in this case, we may not make a conclusive assessment of the impact of the implementation of the FSAP on the level of employment in the Greek insurance market.

Consumer Protection

3.36 The lack of relevant information concerning consumer protection does not allow us to draw any robust conclusions regarding the impact of the implementation of the FSAP on consumer protection in the Greek insurance sector. However, if further implementation of the FSAP does harmonise the EU insurance market, then it would be logical to believe that consumer protection will rise with more competitive markets and better informed consumers.

4 SECURITIES MARKETS

Greek Securities Markets

4.1 The Athens Exchange (formerly Athens Stock Exchange, ASE) was established in September 1876 as a self-regulated public institution. In 1995, the Stock Exchange was transformed into a Societe Anonyme (SA). In March 2000, Hellenic Exchanges Holding SA (HELEX) was established as the holding company of Athens Exchange SA and listed on ASE's Main Market on 21 August 2000. In 2002, ASE and ADEX (Athens Derivatives Exchange) merged to form ATHEX.[13] The HELEX Group has signed Memorandums of Understanding with a number of Exchanges including Montenegro, New York, Cyprus, FYROM and Belgrade. In 1995, the Thessalonica stock exchange centre (TSEC) was established.

4.2 The ATHEX is a member of the World Federation of Exchanges (WFE), the Federation of European Securities Exchanges (FESE), the European Capital Markets Institute (ECMI), the International Options Markets Association (IOMA) and the European Committee of Options and Futures Exchanges (ECOFEX). The Athens Exchange is under the supervision of the Hellenic Capital Market Commission and the Ministry of National Economy through the governmental supervisor. The Ministry of National Economy delegates the governmental supervisor whose role is to supervise parties' compliance with laws and rules.

4.3 In 2004, the market capitalization of the Athens Exchange represented almost 56 per cent of GDP, slightly below the Eurozone average.

Table 4.1: Size of Capital Markets, % of GDP in 2004

	Greece	Eurozone	EU15
Stock Market Capitalization	55.7	61.5	75.5
Debt Securities	159.1	165.6	157.0
Public	141.7	65.7	59.2
Private	17.4	99.9	97.8

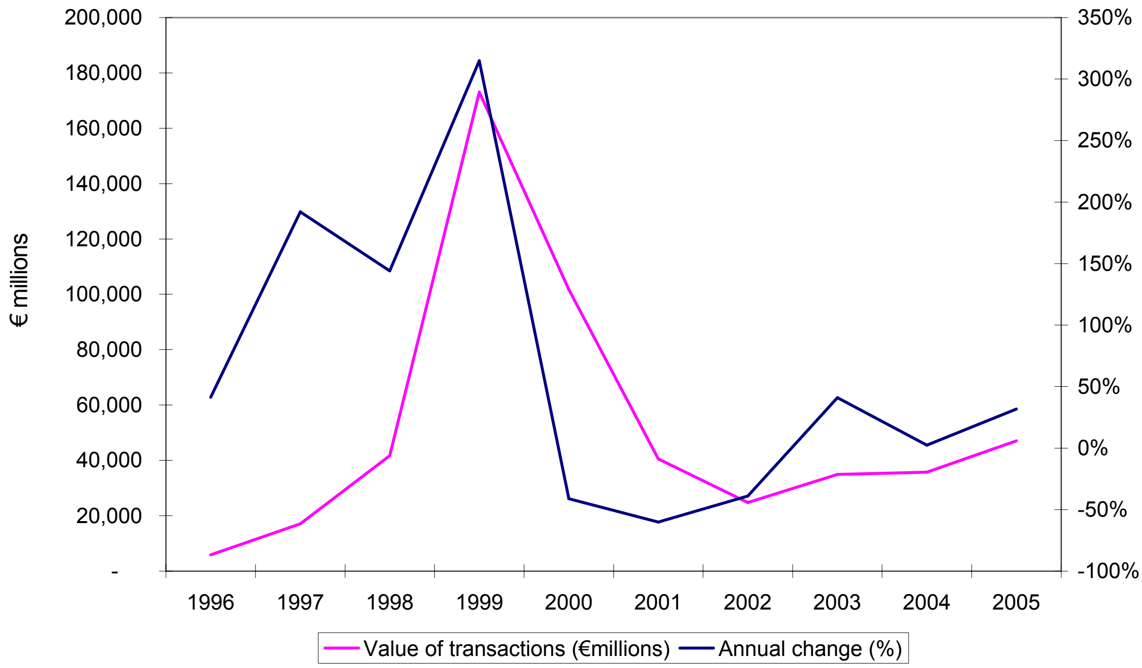
Source: IMF

4.4 However, the turnover ratio[14] (36 in 2004), is well below that in other European exchanges such as London (184), Madrid (123) and Milan (128).

13 In this Appendix ATHEX and ASE are used interchangeably.
14 The turnover ratio is the value of trading shares as a percentage of market capitalization.

4.5 The figure below presents data on the value of transactions in the ATHEX for the period 1996-2005.

Figure 4.1: The Value of Transactions in the Athex, 1996-2005



Source: Hellenic Capital Markets Commission

4.6 Movements have been volatile over the past decade: the stock market experienced a boom in the late 1990's, followed by a sizeable decline in the value of transactions. Over the past few years, the stock market has been recovering from a decline. In 2005, the General Index of the Athens Exchange increased, outperforming both European and American indices.

4.7 At the end of 2006, the Hellenic Capital Market Commission's expectations concerning the course of stock markets in 2007 are positive. The positively increasing trends of the 2003-2005 period are expected to persist, as a result of:

(a) the improvement of the domestic macroeconomic environment;

(b) the buoyant climate in international stock exchanges;

(c) the improvement of corporate profits;

(d) the gradual growth of corporate restructuring; and

(e) the initial public offering activity.

4.8 According to the Hellenic Capital Market Commission, the increased participation of foreign investors in the Greek capital market, as well as the continuous restructuring of stock markets, foreshadow a major alignment of the Greek market to European and International markets.

4.9 The following table presents the number of foreign firms offering investment services in Greece, after accounting for the number of notifications and cancellations for each year, covering the 2000-2005 period.

Table 4.2: Number of Foreign Firms Offering Investment Services in Greece, 2000-2005

	2000	2001	2002	2003	2004	2005
Austria	7	14	19	19	23	28
Belgium	8	10	11	11	12	12
Denmark	5	5	5	5	5	5
France	8	11	14	18	19	22
Germany	1	5	6	7	9	9
Ireland	31	33	35	35	38	38
Italy	3	3	3	4	5	5
Spain	0	1	3	3	4	4
Cyprus	0	0	0	0	1	11
Luxembourg	1	1	1	2	3	3
Malta	0	0	0	0	0	1
Norway	4	6	7	7	7	8
Netherlands	21	22	26	28	31	38
Portugal	0	0	0	0	1	1
Slovenia	0	0	0	0	1	0
Sweden	2	5	6	7	7	7
Finland	0	2	2	4	4	4
Britain	681	789	840	890	940	997
Total	772	907	978	1,040	1,110	1,193
% of Total		17	8	6	7	7

Source: Hellenic Capital Markets Commission

4.10 Between 1995 and 2005, the Hellenic Capital Market Commission had received notifications from 1,193 overseas firms wishing to provide investment services in Greece by means of the "European Passport". These notifications remained active in 836 cases.

4.11 In 5 years, between 2000 and 2005, the number of firms providing investment services in Greece rose by 54 per cent. This represents an increased interest in the Greek market.

Factors Specific to Greek Securities Markets

4.12 Greek markets are relatively reluctant to list their firms, particularly in banking. Indeed, complying with demanding information disclosure (including the likely substantial curbing of tax avoidance opportunities) due to stock market scrutiny and evaluation is not appealing to Greek firms. Many companies avoid using the stock market to finance their expansion and resort to other sources of external financing, the most common source being bank loans.

Impact of the FSAP and FSWP Legislative Measures on the Greek Securities Markets

Cross-border activities

4.13 The increased interest of foreign investors in the Greek securities markets illustrated by the rising number of firms providing investment services in Greece illustrates the increasing openness of the Greek securities market to foreign firms. Our view is that the FSAP may have reinforced the development of the Greek market and may positively influence greater integration of the Greek market to other European markets.

4.14 Our econometric study suggests that the impact of the FSAP on trade (to mid 2006) has been a rise of 2.0 per cent in securities (imports increased by 1.6 per cent and exports by 2.0 per cent). Thus, the FSAP has had a relatively small, but nonetheless, positive effect in increasing the openness of the sector. Full implementation of the FSAP is projected to lead to a further 1.4 per cent rise (imports to rise by 1.2 per cent and exports by 1.5 per cent).[15]

4.15 Interestingly, in the view of the respondents to our survey, an increase of cross-border business is expected over the next years, as a result of further implementation of the FSAP.

Competition

4.16 Further openness of the Greek securities market to foreign firms should naturally enhance the level of competition in the market, due to the increase in the number of competing firms and the threat of contestability. Therefore, since we have established that the FSAP has had a slightly positive impact on the openness of the Greek Securities market to foreign firms, our view is that it has also had a slightly positive impact on competition in that market.

Competitiveness

4.17 An increase in competition should lead to higher competitiveness on the Greek securities market. The same reasoning as above applies in this case. Indeed, since we have established that the FSAP has had a slightly positive impact on competition, we may conclude that it has also had a slightly positive impact on competitiveness in the Greek securities market as a result of increasing efficiency among the participants that wish to remain in the market.

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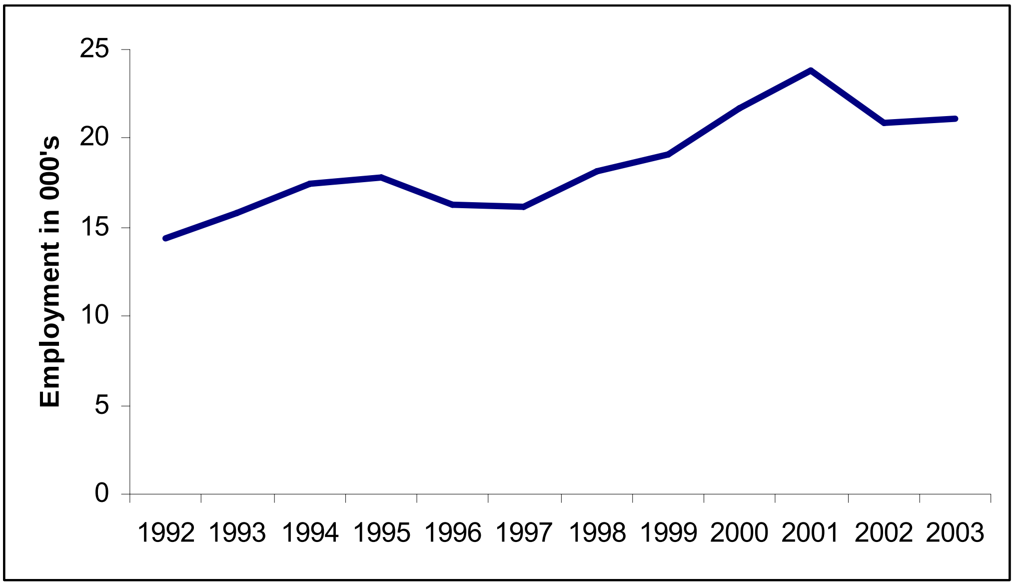
15 Note that these effects are additional to any associated with other implications of membership of the EU or other global or domestic trends towards openness.

Employment

Figure 4.2: Employment in the activities auxiliary to financial intermediation



Source: University of Groningen

4.18 If the aim of the FSAP of de-segmenting the EU market is achieved, and if (as a result) ATHEX expands, then in the short term, the level of employment in the Greek securities market should rise slightly.

4.19 In the long term, the MiFID (with respect to systematic internalising) is likely to create a tendency for securities-related jobs to migrate to London, because of its head-start in such activities. However, the expected general expansion of the European securities markets might also increase the aggregate level of employment in the Greek Securities market.

4.20 Interestingly, according to the results of our survey, the implementation of the FSAP is likely to reduce the increase in the share of trade on the domestic primary exchange.

Consumer Protection

4.21 Consumer protection issues are of relatively limited importance in the Greek securities market. Indeed individuals involved in it are specialised and experienced, and are therefore more aware of their rights and of the way the market works, unlike in other financial sectors. For this reason, the short-term impact of the FSAP on consumer protection in the Greek securities market would be quite limited. However, if the market extends to a more general public, then there could be consumer protection issues, in that a broader range of users would imply more inexperienced users. That said, the MiFID is addressing that long term risk through extensive consumer protection provisions. Therefore, in our view the FSAP has so far had no significant impact on consumer protection in the Greek securities market; but if more inexperienced market users were to use that market, the FSAP might have a positive impact.

5 FINANCIAL CONGLOMERATES

Financial Conglomerates

5.1 The Greek financial market is characterised by close links between the banking and insurance sectors. Increasingly closer links between the banking and insurance sectors are an international phenomenon related to the development and integration of the financial markets (financial diversification and conglomeration). The general aim is to realise economies of scope.

5.2 On 24 April 2006, the Mixed Technical Group on the supervision of financial conglomerates issued a list indicating those groups, with their head office in a Member State of the European Union or of the European Economic Area, that have been identified as financial conglomerates under Article 3 of Directive 2002/87/EC.[16] The list did not include groups with head office in Belgium, Greece, Portugal and Slovenia, as these Member States had not yet completed the process of notification to be considered as conglomerates.

5.3 We could argue that Emporiki, National Bank of Greece and Alpha Bank bancassurance groups are conglomerates, but there are minimum thresholds to be met in accordance with the Financial Conglomerates Directive. In these cases, it is unclear as to whether those thresholds are met or not.

5.4 Therefore, given that conglomerates have not been identified in Greece, it is difficult in the context of this study to make any comments or assessment regarding the impact of the FSAP on financial conglomerates.

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16 Mixed Technical Group (24 April 2006), "Implementation of Directive 2002/87/EC – the Financial Conglomerates Directive, Identification of Financial Conglomerates"

6 CONCLUSION

Assessment

	Impact of FSAP on…				
	Openness to foreign firms	**Competition**	**Consumer Protection**	**Employment**	**Competitiveness**
Banking	Slightly Positive	Slightly positive	Positive	Unclear	Slightly negative in short term, perhaps positive in the long term
Insurance	Unclear. Perhaps positive in the future	Unclear. Perhaps positive in the future	Unclear. Perhaps positive in the future	Unclear	Unclear. Perhaps positive in the future
Securities	Slightly positive	Slightly positive	Limited in short term, perhaps positive in the long term	Perhaps positive in the future	Slightly positive
Financial Conglomerates	-	-	-	-	-

HUNGARY

1 INTRODUCTORY OVERVIEW

Financial Services Regulation in Hungary

Division of Responsibility

1.1 The responsibility for financial regulation and for the supervision of the banking, securities, and the insurance market in Hungary is spread across three main authorities.

(a) **Ministry of Finance (MOF):** Responsibility of the legal framework governing the financial sector resides with the MOF under the oversight of the government.

(b) **National Bank of Hungary:** Its role is largely restricted to monetary aspects, liquidity, and foreign exchange.

(c) **Hungarian Financial Supervisory Authority (HFSA):** Established in 2001 through the merging of three supervisory bodies. It supervises banking, securities, pension finds, and insurance companies. It has no legal remit to issue binding regulations.

Key Features of banking regulation

(a) **Privatization laws (1995**)

(b) **Credit Institutions and Financial Business Act (1996).** Key features include:

- Provisions for the safeguarding of the financial sector.
- Universal banking licenses.
- Harmonization of national with EU standards.

Key Features of Insurance Regulation

(a) **Privatization laws (1995)**

(b) **Insurance Institutions and the Insurance Business Act (2003)**

(c) **Reform of the Hungarian Civil Code (2005).** This affects laws on insurance contracts and compensation.

Key Features of securities regulation

(a) **Offering of Securities, Investment Services and the Securities exchange Act (1996)**

(b) **Foreign Investors Act (1998).** Key aspects include:

- Granting full protection to both businesses and Investments of non-Hungarian resident owners.
- Granting equal treatment of national and non-national investors.

(c) **Elimination of Foreign Exchange Restriction Act (2001).** The Forint was made fully convertible.

Factors Specific to Hungary

1.2 According to the HFSA, Hungary's accession to the EU in April 2004 did not in itself bring about significant changes in the Hungarian financial system.

1.3 This is largely because much of the EU legal harmonization in this sector had by this time already been incorporated into Hungarian national law. Also, by the time of accession many of the domestic institutions had already become deeply embedded within the European environment and majority of banks and insurance companies were already foreign owned.

1.4 The view taken by the HSFA on the impact of accession to Hungary's financial sector is that it has "broadened the potentials of international contacts, offered new synergies, but also created new risks".

1.5 With respect to the level of enforcement of the internal market rules, Hungary is among the better of the new member states in this area. Infringement action is taken by the EC against a member state found not be applying the internal market rules adequately. Only four infringement cases have been brought against Hungary one year after enlargement, whereas Poland, for example, has had 13 cases opened against them.

1.6 The IMF's assessment of Hungary's Anti-Money Laundering regime (AML), in its' 2005 report on the Assessment of Standards and Codes — AML and the Combating of FT [Financial Terrorism], concluded that it has been significantly strengthened. Most important to this has been the revised AML Act in 2003 that was also expanded to cover non-financial and professional services following the second EU Directive on Money Laundering. The IMF found that financial Institutions are well supervised and are well aware of their obligations.

2 BANKING

Headline Overview

Factors specific to Hungary

2.1 As a former command economy, Hungary has been making the transition from a socialist to a market economy. Integral to this has been the gradual replacement of the publicly owned, tightly controlled, closed and inefficient socialist banking sector with a more open, private, and competitive one. Given the dominant role of banks in financial intermediation and in an expanding private sector, the banking sector plays a pivotal role in the whole reform process.

2.2 The Hungarian financial sector went through sweeping reforms during the 1990's, which has led to the emergence of one of the strongest banking sectors in the region. Privatization of the banking system was largely completed during 2003/2004 following the sale of remaining state owned assets.

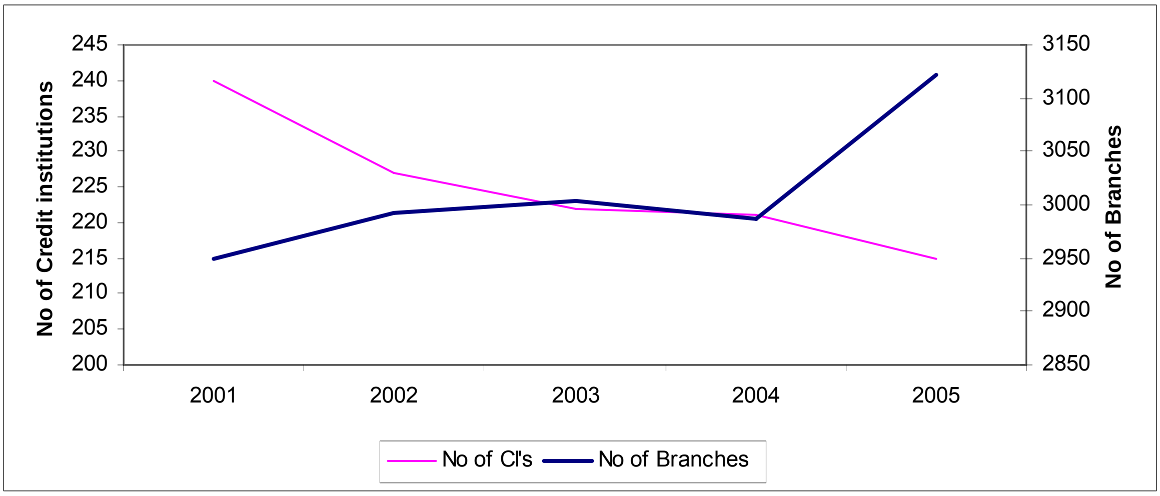
2.3 In 2005, among the New Member States, Hungary had one of the highest level of foreign ownership in its domestic banking system. This has largely been a consequence of having had reduced entry barriers in this sector. The government permitted foreign firms to set up "Greenfield" operations during the privatisation programme that permitted faster and deeper levels of foreign penetration in the Hungarian banking sector than in other countries in the region.

2.4 While the ratio of assets of banks in which foreigners owned as a percentage of total national banking sectors in 1999 were similar for Hungary, Poland, and Czech, in 1994, this ratio was 19.8 percent, 2.2 per cent, and 5. 8 per cent respectively. This indicates that the level of penetration in Hungary was both deeper and faster.

Features of the Industry

Players and employment

Figure 2.1: Number of credit institutions (CI's) and branches 2001-2005.

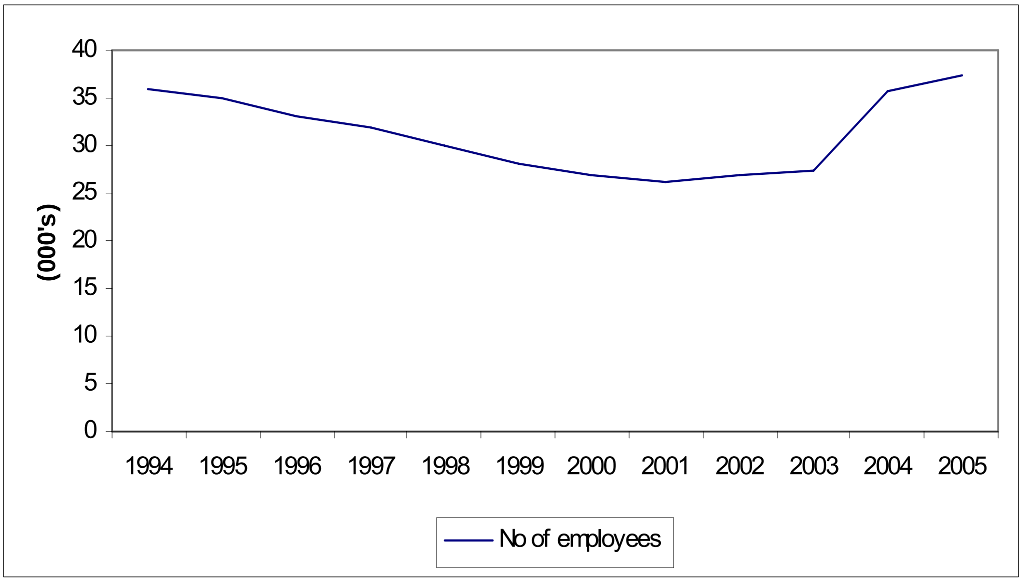


Source: ECB

2.5 Figure 2.1 indicates a sustained increase in the number of branches between 2001 and 2005. Over the same period, however, the number of CI's fell form 230 in 2001 to 215 in 2005. The general decline in the number of CI's may be attributed to the effects of the Hungarian privatization programme in the late 1990's. The restructuring of banks coupled with stricter insolvency laws would have tended to squeeze out inefficient and persistently loss making firms. The reduction is also likely to have been driven by consolidation in the sector.

2.6 The increase in the number of branches however, may have been the result of fiercer competition between the remaining CI's to capture market share. Between 2004 and 2005 the number of people to branches decreased from 47,451 to 46,918. As an indicator of capacity relative to the population this suggests that more investment, driven by market incentives, was made by the banking sector.

Figure 2.2: Employment in the banking sector



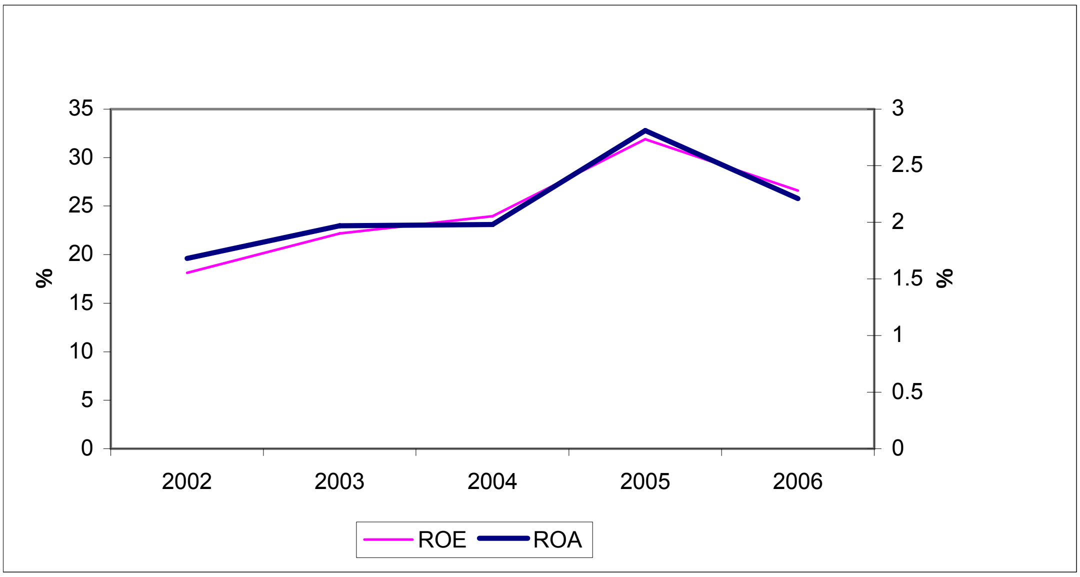
Source: OECD

2.7 While the general trend has been for employment to decline from the mid 1990's, from 2001 it started to rise again and this has coincided with the increase in the number of branch openings and sales points.

Turnover, Profitability, and efficiency

2.8 Figure 2.3 shows the changes in the Return on Assets and Return in Equity of the Hungarian banking sector since 2002. As can be seen, both the ROA and the ROE have increased relatively steadily between 2002 and 2005 followed by a decline from 2005.

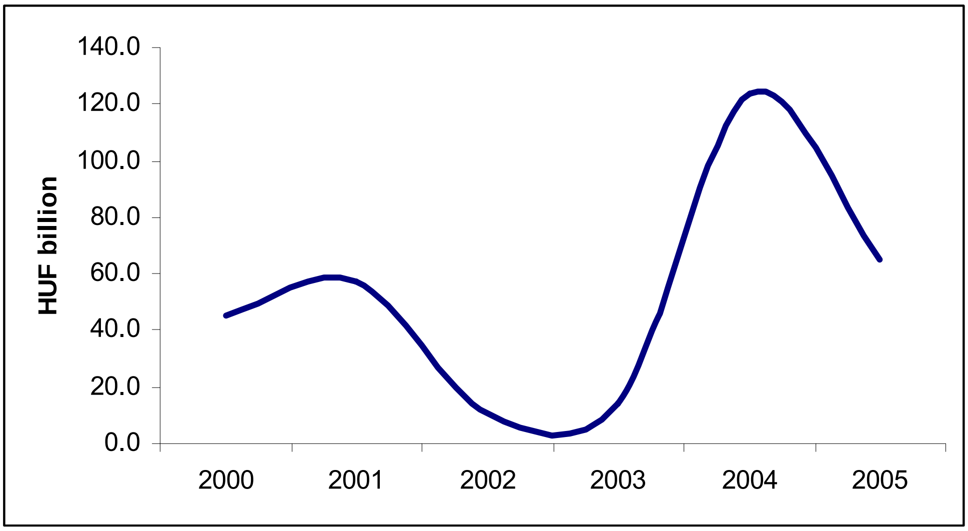
Figure 2.3: Rate of return in assets and equity of Hungarian banks, 2002-2006



Source: HSF

2.9 Firms in this sector appear to have become more efficient in controlling costs to income. The National bank of Hungary Financial Stability Report of 2006 noted that the cost to income percentage of the banking sector fell from approximately 3.75 per cent in 2000 to 2.9 per cent in 2005.

Figure 2.4: Customer deposits in Hungarian commercial banks



Source: Magyar Nemzeti Bank

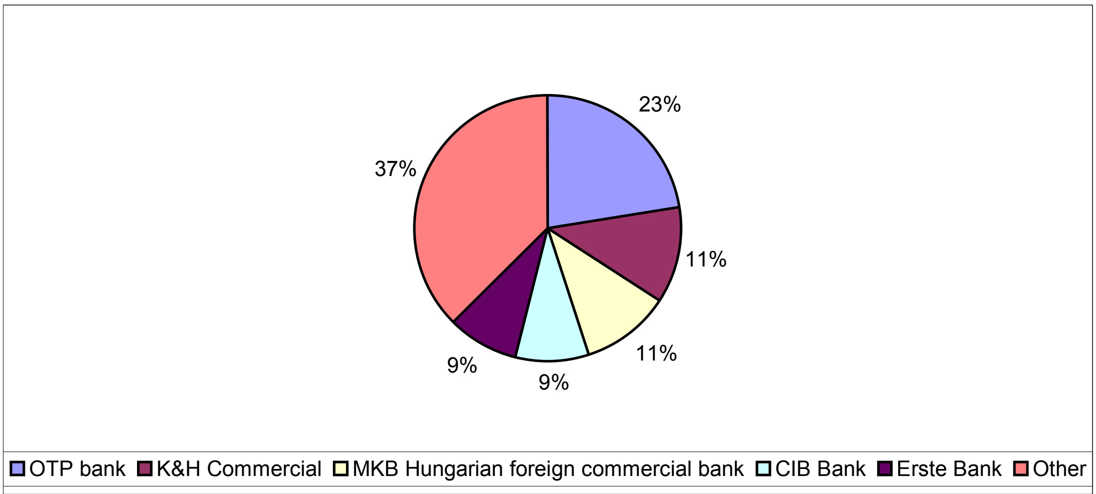
2.10 Figure 2.4 shows an overall increase in the level of customer deposits in Hungarian banks since the 2000. There are a number of factors that may have increased consumer confidence in placing their savings in the Hungarian commercial banking system. The efficiency inducements that would have been created as a result of privatization in the 1990's, as ownership changed from state to profit driven private hands, ranks highly. On average, the net income of commercial banks was greater after privatization than before.

2.11 Improvements in consumer protection and consumer information have also been made. The Deposit Insurance Fund (DIF) has increased its transparency, namely through updates and additions to information on its website (although the effects of this on greater transparency would rely on the level of household internet coverage). Also, the coverage limit of the DIF has increased to 6.5 m, which exceeds the minimum requirement of the EU. These types of moves to increase consumer protection and reduce information asymmetries, would have contributed to increasing customer confidence in placing deposits in the Hungarian banking system.

2.12 In 2004, 27 percent of bank loans were made to households, which were up from 10 per cent in 2000. A large part of this increase occurred since 2002 when more bank lending went to households for mortgage loans following the 2001 Interest Subsidy Programme.

Market share, concentration and competition

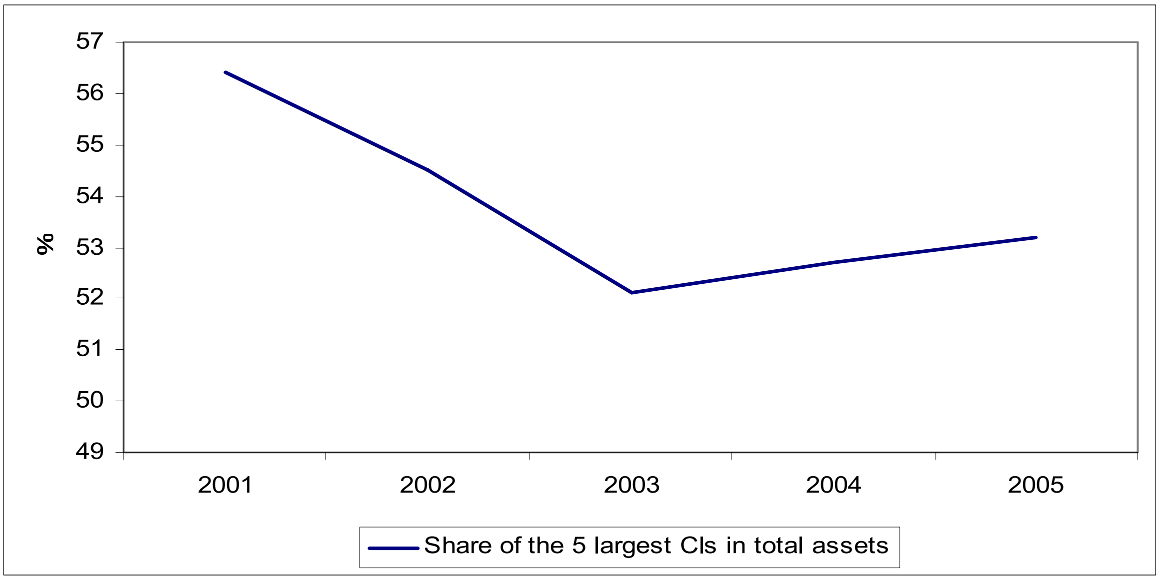
Figure 2.5: Total assets of the top five banks in the Hungarian banking sector 2004



Source: US Department of State

2.13 Figure 2.6 below shows that in 2004, the total share of these five banks accounted for 52.7 per cent of the total national banking sector assets.

Figure 2.6: Share of top five credit institutions in total national banking assets



Source: ECB

2.14 Figure 2.6 illustrates the trends in consolidation that has occurred since 2001. Although it fell from 56.5 per cent in 2001 to 52 per cent in 2003, from 2003 it begun to rise again.

Table 2.1: Herfindahl-Hirschman index[1]

2001	2002	2003	2004	2005
892	856	783	798	795

Source: ECB

Table 2.2: Branches and subsidiaries

	2001	2002	2003	2004	2005
Branches of CI's from EU area	0	0	0	0	3
Subsidiaries of CI's from EU area	25	21	22	20	20
Branches of CI's from third countries	0	0	0	0	0
Subsidiaries from third countries	1	2	3	3	3

Source: ECB

1 The Herfindahl-Hirschman index is defined in the Main Report

Figure 2.7: Number of domestic and cross-border mergers and takeovers, 2001-2006

	2000	2001	2002	2003	2004	2005	2006*
Domestic M&A's	2	3	0	1	2	0	1
Internal EU M&A's	5	1	0	3	0	0	2
Third country M&A's	1	0	0	1	0	0	0

Source: ECB

2.15 Figure 2.7 illustrates both the domestic and international mergers that have taken place between 2001 and the first half of 2006. Mergers and acquisitions are driven by a number of closely linked factors, such as the significant openness of the banking sector and the high share of foreign ownership structure. Another reason accounting for the acceleration of mergers is due to what the HSFA described as the 'over banked' nature of the Hungarian banking sector

2.16 Recent mergers in the Hungarian banking sector include:

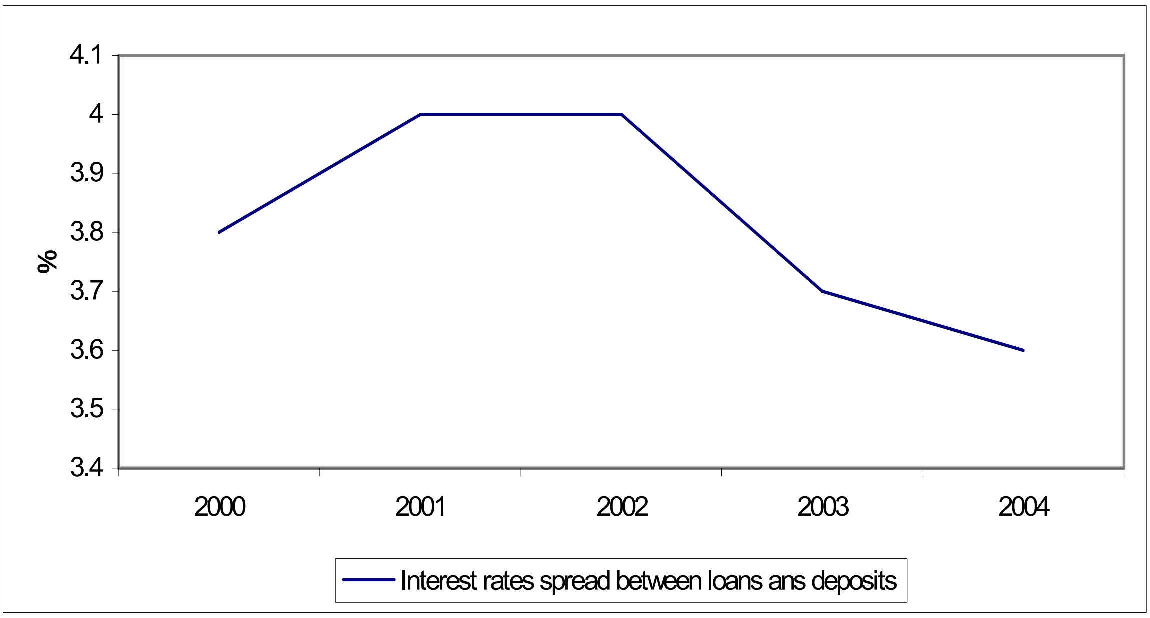
(a) **2003** Erste Bank acquired Postabank.

(b) **2002** Merger between ABN Amro (Magyar) Bank.

(c) **2002** Merger between HVB and Bank Austria.

(d) **2001** Merger between K&H Bank and ABN Amro.

Figure 2.8: Interest rate spreads between deposits and loans



Source: IMF

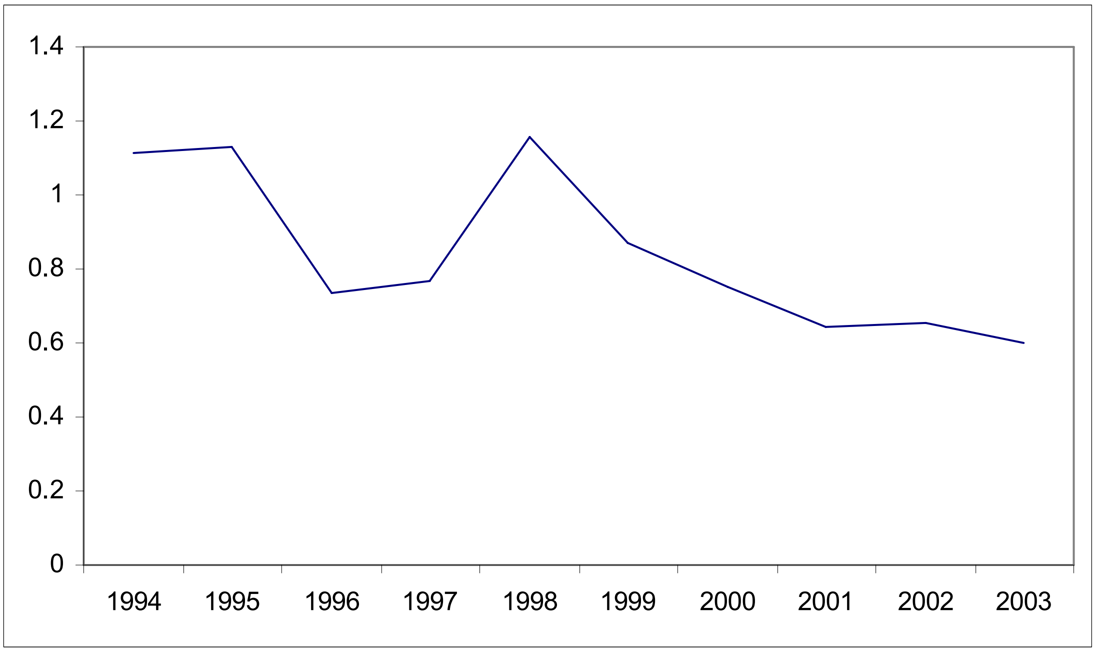
2.17 Figure 2.8 shows a reduction in the average interest rate spread between deposits and loans since 2002.

2.18 The reduction in the interest rate spread as shown in Figure 2.8 indicates there was a squeeze on the profit margins made on loans. This may have been attributed to a general increase in competitive pressures to capture a greater share of borrowers by competing on the basis of price.

Efficiency

2.19 Figure 2.9 illustrates a marked improvement in the cost to income ratio since 1998. As an indicator of efficiency, this suggests that it has been improving. Indeed an important factor of the profitability of the banking sector over the period was both the decline of costs and the serious cost rationalisation in banks. This is largely due to the positive outcome of the privatization and subsequent increase in competition which forced banks to restructure their operations, and to cut their operation costs.

Figure 2.9: Cost-to-income ratio 1994-2003



Source: OECD, Europe Economics. Above figure is expressed as a ratio not a percentage.

Cross-border activity

2.20 The accession of Hungary to the EU in 2004, and the anticipation of it, will have strengthened the incentives for foreigners to set up operations in Hungary to engage in cross-border activities. This is largely through the reduction in both regulatory and technical barriers to cross-border trade that efforts towards creating a single market facilitate. Since 1998, foreign owned subsidiaries have been able to establish subsidiaries in Hungary and purchase more then 10 per cent of shares in domestic firms without having to seek government approval. Firms with offices registered in other EU states simply have to ensure that they have registered with the relevant supervisory body.

2.21 The contribution of this to the change in foreign ownership of national banking assets has been marked. In 1994 the share of national banking assets owned by foreigners was 19.6 per cent whereas by 2004 this had increased to 66.2 per cent.

Technology and Innovation

2.22 Hungary is in the process of "catching up" with the rest of the developed world. The HFSA, in 2002, commented that the IT infrastructure customary in more developed countries was approximately five years away. They also predicted that internet penetration is approximately 5-10 year behind most advanced countries.

2.23 The growth in the level of foreign penetration has been and will continue to be pivotal in this sector. Greater levels of competition, capital, key management skills, new practices, new technology and new products will be the main drivers of growth. Evidence of capacity growth, for example, can already been seen with the increase in the number of ATM's. The number of people to ATM's fell from 3401 in 2001 to 3063 in 2004. If this trend continues, one can reasonably expect employment in the sector to level off or even decline as the abundance of ATM's replaces branches or slows the pace of new branch openings. Also, the spread of Internet banking services is likely to compound these effects.

2.24 According to the EIU, competition in this sector, driven by foreign owned banks, has "revolutionized the technical aspects of cash management and electronic banking over the last several years". There has been an increase of 53 per cent, to approximately 604,000 between 2004 and 2005, in the total number of retail customers using electronic banking services.

2.25 The number of corporate Internet banking clients increased by 58 per cent to 96,000 over the same period.

2.26 A new function has been added to VIBER[2], providing monitoring services for participants. According to the HSFA, this new service will provide for the continuous management of their position by allowing prompt intervention in the event of an emergency. This, it is argued, contributes to the reduction in the systems liquidity risks and to the efficient management of banks' financial liquidity position.

2.27 There has also been a significant degree of product innovation in this sector. The HFSA specifically highlights the spread of credit insurance policies and combined deposits. The latter was introduced in 2004 and the HSFA attributes this new product offering (promoted by heavy marketing), in addition to raising the interest rate on deposits, to banks attempting to increase their selections. As theory would imply, greater competitive pressures will tend to increase product diversity and choice.

Impact of the FSAP and FSWP Legislative Measures on the Hungarian Banking Sector

2.28 With regards to credit institutions, overall investigations of the latter by the HSFA noted that significant progress has been made, with regards to organisational and regulatory changes, in preparation for the Basel II Capital Accord. While institutional focus has mainly focused on credit risk, measures to address operational risks have also been put into place.

2.29 Particular attention has been paid to ensuring that regulations pertaining to the prevention of money laundering are complied with. Big banks are both creating or developing further transaction screening systems.

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[2] VIBER. This real time gross settlement system is a new domestic payment system developed and operated by the National Bank of Hungary. It was implemented in September 1999.
http://english.mnb.hu/Resource.aspx?ResourceID=mnbfile&resourcename=viber_en

2.30 The new capital adequacy regulation allows banks to employ their own internal methods of risk assessment in determining the sufficient level of capital requirements.

Cross-border activities

2.31 Given what appears to be an increase in the number of international mergers and acquisitions in the Hungarian banking sector, it would appear that cross-border activity in this sector has increased. We believe that the FSAP, while not entirely responsible for this, has played a positive role in bringing this about.

2.32 As assessed by the Heritage Foundation, the Hungarian banking sector has been relatively open since 1994 and has not significantly changed since. The Hungarian banking sector scored three (five being the least open and 1 being the most open) in 1995, and then scored two from 1996 to the time of writing. However, the potential to engage in cross-border activity did not necessarily lead firms to capitalise on the opportunities to do so. What we may say is that there have been a number of factors, including the FSAP that have lead to a greater level of cross-border activity to take place.

2.33 Integral to making the transition from a command to a market economy are privatisations, the expansion of the private sector, and establishment of property rights, bankruptcy laws, and trade and price liberalization. The FSAP should have served in accelerating this process in the financial sector through helping to establish, faster than might have been otherwise, the foundations of a robust regulatory and institutional structure. This in turn, should have resulted in improving confidence levels in the Hungarian banking system and thus the risks that foreign service providers were willing to take in setting up banking operations in Hungary.

2.34 This will have been compounded by improvements in macroeconomic stability (i.e. through stabilisation policies and falling rates of inflation) creating an environment more favourable to such developments.

2.35 While there are clearly a number of factors, other than the FSAP alone, that have provided the impetus for greater levels of cross-border activities in the Hungarian banking sector, the effects of the FSAP cannot be divorced from these. Therefore, it is reasonable to say that the FSAP has had a slightly positive impact on the level of openness in the Hungarian banking sector.

Competition

2.36 It is our view that the FSAP has had a positive effect on the intensity of competition in the Hungarian banking sector and the intensity of competition in this sector is to some extent epitomised by the increasing abundance of sophisticated banking products and new technology advancements that competition in the sector appears to have been largely based on.

2.37 The relatively high degree of openness of the banking sector, much of which predated the inception of the FSAP suggests that the element of contestability in the sector already existed. Contestable markets are those where firms tend to behave more competitively than they otherwise might in the absence of any threat of potential entry. However, to the extent that threats arising from contestability have strengthened, through increasing the incentives for foreigners to capitalize on the openness of the sector, the FSAP appears to have had a relatively positive effect on the intensity of competition in the Hungarian banking sector.

2.38 However, there are also a number of other factors, described earlier in the report, that have driven competition in this sector, such as:

(a) The restructuring and rationalisation of the banking sector (i.e. the removal of soft-budget constraints, the greater possibilities of bankruptcies facing persistently inefficient firms, the shedding of excess labour, and the entrenchment of profit incentives) following the wave of privatization in the 1990's.

(b) Tax funded subsidized mortgage loans that intensified competitive pressures to capture greater shares in what became a more lucrative form of bank lending.

Consumer protection

2.39 It appears that the FSAP has reduced the asymmetry of information between banks and its consumers thereby increasing the degree of transparency and the level of consumer protection in the sector.

2.40 Due to the detailed guidelines on corporate governance, the principal risk management methods of banks have improved and become more sophisticated. This also serves to improve consumer protection by improving the internal controls and checks of banks.

2.41 Additionally, the HSFA's strategy to improve consumer awareness over rights is also anther means through which consumer protection has tended to improve. Indeed, improving consumer protection regimes, in large part, requires that consumers are as aware as possible both of their rights and the ways that they are able to exercise them.

2.42 Overall, our judgement is that the FSAP can be regarded as having had an indirect as well as direct effect on improving the strength of the consumer protection regime in the Hungarian banking sector.

Competitiveness

2.43 Given the relatively positive impacts we believe the FSAP to have had on increasing in the level of competition in the sector, we are of the view that the FSAP has therefore has a relatively positive effect on the overall competitiveness of the sector. However, in the long run the net effects of the FSAP are unclear.

2.44 Fiercer competition should increase the overall efficiency of operations in the Hungarian banking sector. Prices naturally become more competitive. Higher levels of competition will also increase the rate of technological advance and product innovation — for example, Schumpeter's 'creative destruction'[3] in the market.

2.45 There are however, a number of other factors, as described earlier that have driven competition in this sector and thus the degree of competitiveness.

2.46 Improvements in the efficiency of the banking sector appear to have coincided with the inception of the FSAP despite the fact that the compliance costs associated with greater regulation stemming from the FSAP, in the short run at least, are likely to have increased.

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[3] The expression 'creative destruction' was brought to economic discourse by Schumpeter's book 'Capitalism, Socialism, and Democracy'. The term denotes the process of 'industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one'.

2.47 While the FSAP appears to have had a positive impact on consumer protection, there may be potential adverse effects of this on the degree of competitiveness. The increase in the regulatory burden facing firms operating in the sector may both increase compliance costs and to some extent raise entry barriers in this sector in the future. Thus, the long-term effects of the FSAP on competitiveness are so far unclear.

Employment

2.48 More merger and acquisition activity, that we believe will be partly driven by the FSAP, might be expected to reduce the level of employment in the sector. At the same time however, the increases in the rate of new products entering the market and the expansion into new markets, again partly facilitated by the effects of the FSAP, can be expected to increase the level of employment in this sector.

2.49 Thus, we believe that the overall effect of the FSAP on employment is as yet unclear.

2.50 It is interesting to note that respondents to our survey believe that employment in the sector in the future is expected to generate many new jobs due to innovative new products and that this will be partly assisted by the FSAP in opening up new markets.

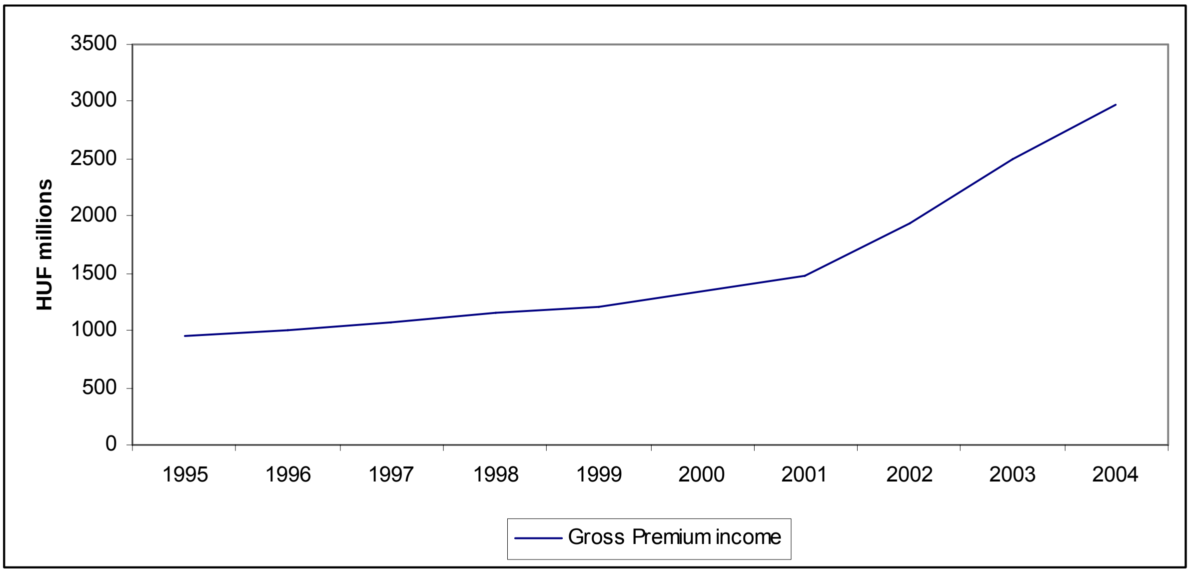
3 INSURANCE

Features of the Industry

Income, Employment, and Productivity

3.1 The Association of Hungarian Insurance Companies reported that the profits of this sector in 2005 were 14.6 per greater than in 2004.

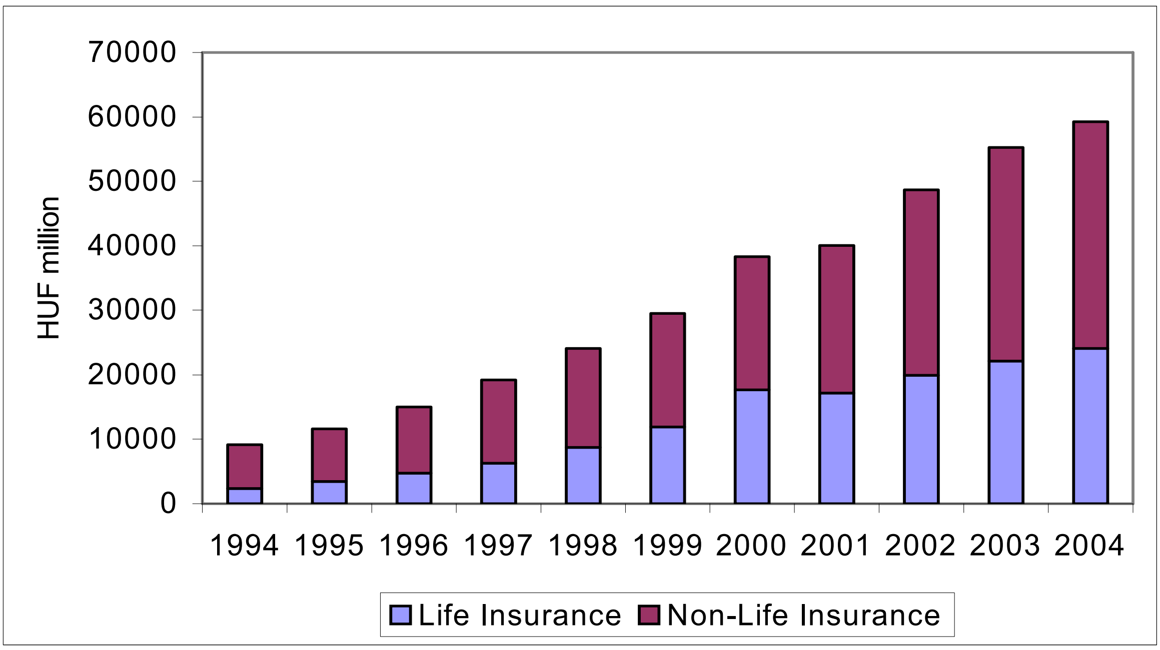
Figure 3.1: Gross premium income of the Insurance sector



Source: Assoociation of Hungarian Insurers

3.2 As Figure 3.1 shows, there has been a marked growth in gross premium income over the reported period. From 2001 part of this increase would have been attributed to the increases in the number of mortgage bank loans taken out and the accompanying insurance policies purchased, following the 2001 interest subsidy scheme for mortgage loans.

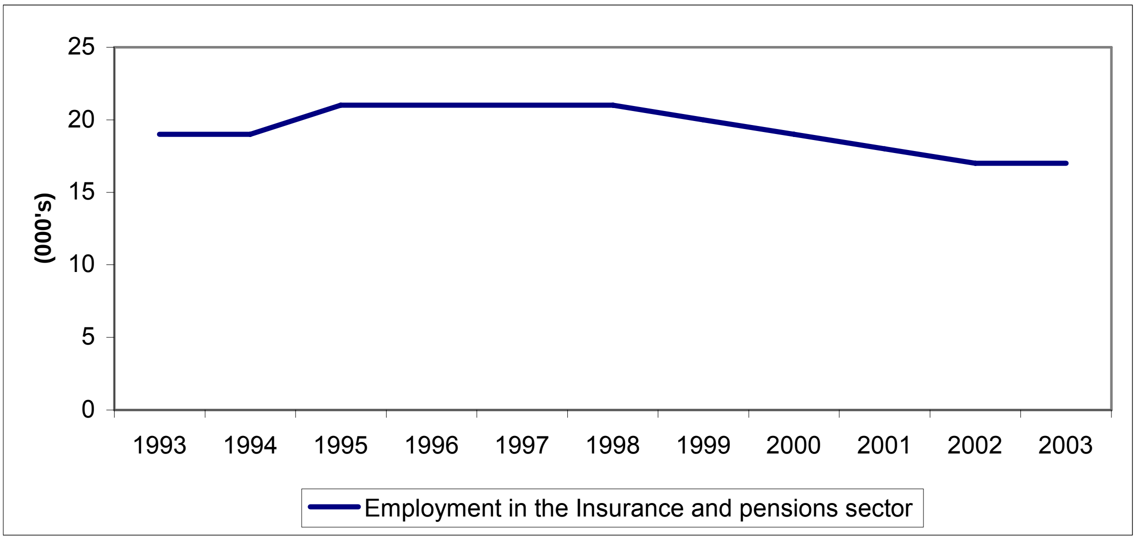
Figure 3.2: Life and Non-Life Insurance premium income



Source: Association of Hungarian Insurers

3.3 Figure 3.2 illustrates a relatively greater increase in non-life over life insurance premiums over the reported period.

Figure 3.3: Employment in the Insurance and Pensions sector



Source: University of Groningen

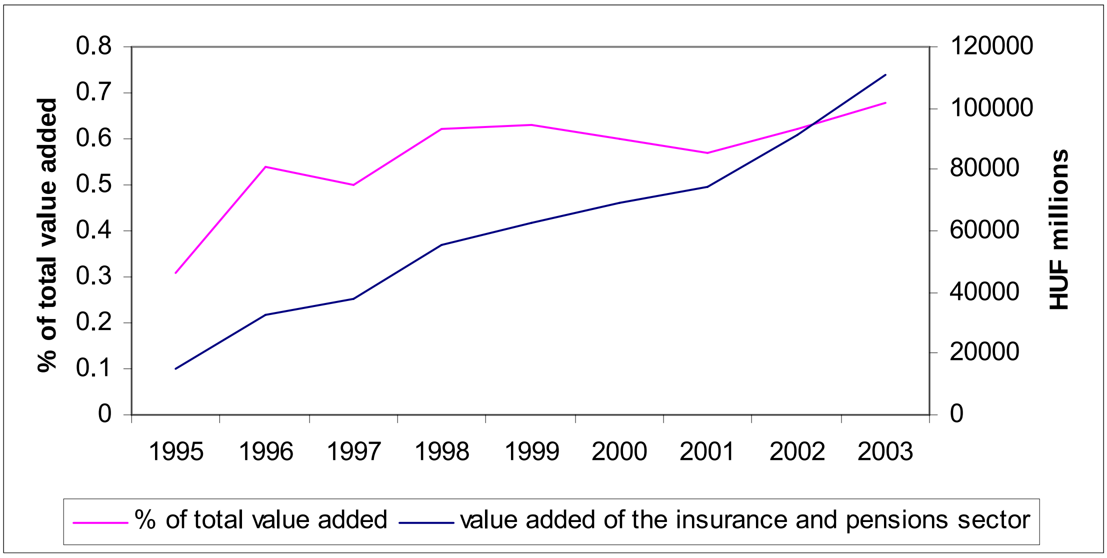
3.4 Figure 3.3 shows a relatively steady level of employment in the Insurance and Pensions sector.

Competitiveness and Productivity

Figure 3.4: Labour hours (per annum) and Labour productivity (1995 = 100) in the Insurance and Pensions Sector

Source: Groningen Growth and Development Centre

Figure 3.5: Value added of the Insurance and Pensions sector

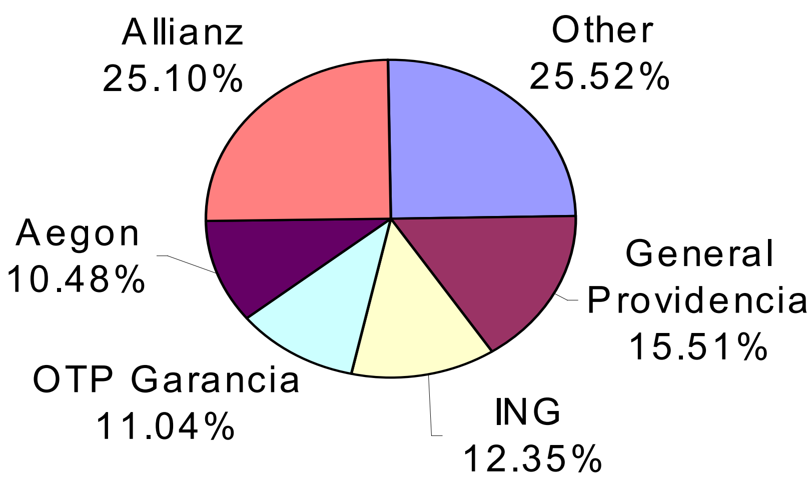


Source: Groningen Growth and Development Centre

3.5 As can be seen from Figure 3.5, the value added of the insurance and pensions sector as a share of total value added in the economy saw a sustained increase over the period. This indicates a growth in the importance of this sector in the Hungarian economy.

Market share and Competition

Figure 3.6: Market share of commercial Insurance companies in 2005



Source: Association of Hungarian Insurers

3.6 There are a number of factors to suggest that market concentration has fallen and competition increased due to Hungary's accession to the EU in 2004. For example, the aggregate market share of the top five insurance companies in 2005, as shown in Figure 3.6, was 74.5 per cent, down from 78 per cent in 2003.

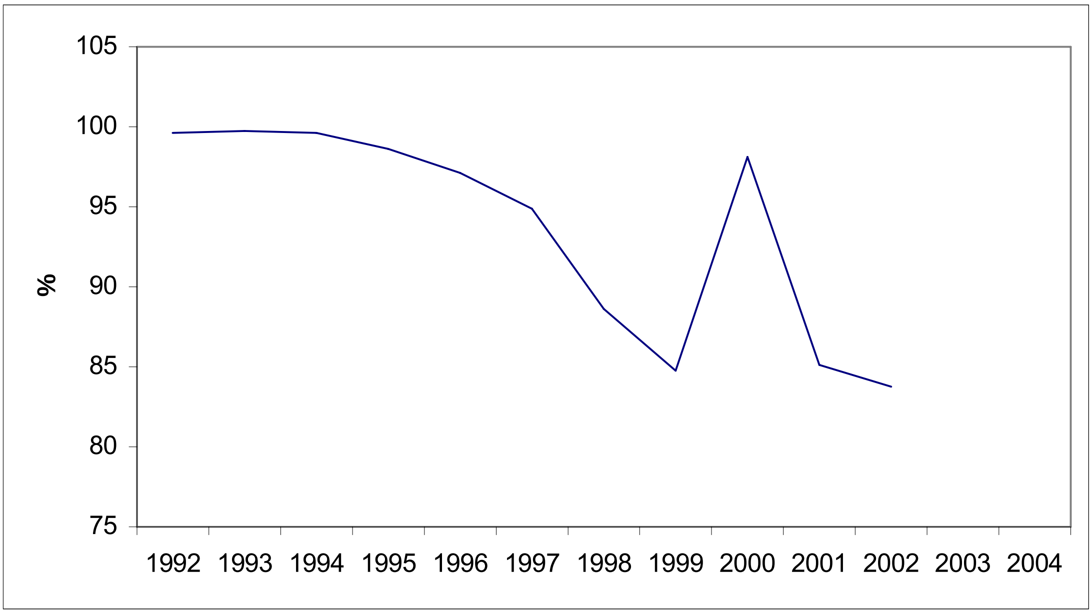
3.7 Accession has also reduced entry barriers in this sector by reducing the technical and regulatory barriers to engaging in cross-border activities. Following Hungary's accession to the EU in 2004, over 200 insurance companies in member states informed the HFSA of their intension to undertake insurance activities in Hungary providing cross-border services.

3.8 According to the Hungarian Association of Insurance Companies, the insurance market has already begun to feel the presence of branch offices and insurance companies providing cross-border activities.

3.9 Entry barriers in this sector have also been reduced by the change in state legislature in 1996 that permitted banks to apply for "universal licenses" to offer services in this sector in addition to banking services.

Foreign Penetration

Figure 3.7: Market share of branches/agencies of foreign undertakings as a % of total domestic business



Source: OECD[4]

The Impact of the FSAP and FSWP Legislative Measures on the Hungarian Insurance Sector

Cross-border activities

3.10 The FSAP appears to have had a limited impact on the level of cross-border activity in the Hungarian insurance sector. As highlighted by Figure 3.7, the level of foreign penetration in the Hungarian insurance sector, to a large extent, predated the FSAP. However, it would appear that EU accession in 2004 has played a vital role in prompting over 200 insurance companies to express their intention to engage in cross-border services, and thus mitigating what appears to have been a decline in the level of foreign penetration since the mid 1990's.

[4] The OECD has no observations for 2003–2004

3.11 However, while EU accession is likely to have played the larger role so far, given the difficulties at this stage in disentangling the effects of the EU accession and the impacts of the FSAP one should not rule out the possibility of the FSAP having contributed in creating an environment more attractive for foreign operators to offer cross-border services. Namely, through the reduction of the technical and regulatory barriers to cross-border activities.

Competition

3.12 Given our above assessment we do not believe the FSAP to have had more than a slight impact on the intensity of competition in this sector.

3.13 As described in the banking sector, the greater the openness of a sector, the more contestable the market should be and thus the ferocity of competition should be greater than would be the case if contestability was not a characteristic of the market.

3.14 Thus, while the insurance market has become more open and therefore contestable, this is likely, in large part, to have been the case independently of the FSAP.

Consumer protection

3.15 We are of the view that the FSAP is likely to have had a relatively positive improvement in the degree of consumer protection. The FSAP should have strengthened the comprehensiveness of the consumer protection by virtue of transposing the directives into national law but it should also increased the robustness and credibility of the regulatory and institutional framework underpinning the insurance sector.

3.16 The LX Law of 2003 that was effective upon EU accession requires insurers to almost triple their mandatory capital reserves from HUF 500 million to HUF 1.5 billion, is a direct example of measure implemented to increase client protection.

3.17 Interestingly, respondents to our survey believed that the level of transparency in the sector has improved, thereby reducing the degree of information asymmetry between firms and consumers. Coupled with stricter corporate governance rules, the FSAP can be seen as having played a pivotal role in protecting consumers of insurance products more.

Competitiveness

3.18 Given the above assessments, the FSAP appears, thus far at least, to have had no appreciable impact on the degree of competitiveness of the Hungarian insurance sector.

3.19 Furthermore, given the compliance costs stemming from having to both adapt and comply with the transposed FSAP directives, the FSAP may prove to have a negative impact on the insurance sector as the burdens for firms from having to comply with greater regulation may serve in raising entry barriers in the sector and thereby mitigating the strength of contestability.

Employment

3.20 The level of employment in the insurance sector appears to have remained relatively constant between 1993 and 2003 despite the productivity of employees having risen dramatically since 1994.

3.21 It may be interesting to note that the respondents of our survey do not believe that the level of employment in the future is likely to grow above the current level and that this is independent of the FSAP.

4 SECURITIES

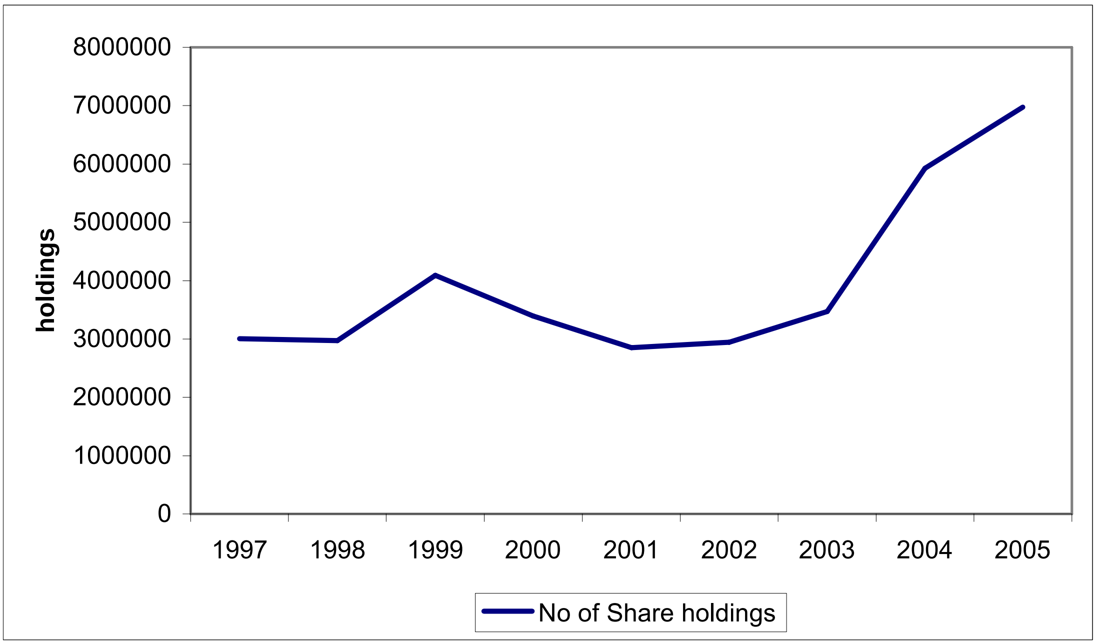
Features of the Industry

4.1 The BSE opened in 1990 and in 2004 was among the new member states to become a full member of the Federation of European Securities Exchanges.

4.2 In the same year, the BSE was acquired by a group of Austrian institutional investors led by the Vienna Stock Exchange.

4.3 In 2005, the BSE had 46 companies with listed shares and its total market capitalization was HUF 16.42 billion.

Figure 4.1: Share holdings quoted on the BSE 1997-2005

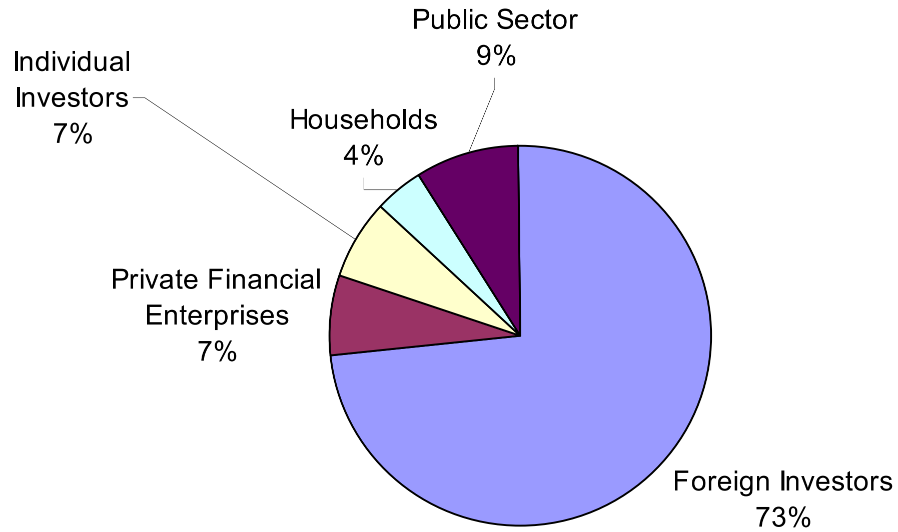


Source: National Bank of Hungary.

4.4 As can been seen from Figure 4.1, there has been a surge in the number of holdings of shares quoted on the BSE. The BSE stock market capitalization in 2004 was 26 per cent of GDP and was up from 18 per cent in 2002. Over this period there has also been an increase in the diversity of products available. For example, mortgage bonds were introduced and derivative trading, particularly in futures, has expanded.

4.5 Figures from the National Bank of Hungary show that as of June 2006, four large company stocks (OTP, MOL, Magyr, Telecom, and Richter) accounted for 83.9 per cent of total shares outstanding (measured in terms of market capitalization of shares on the BSE).

Figure 4.2: Share Ownership Structure of the BSE 2003



Source: National Bank of Hungary

4.6 Figure 4.2 shows the foreign-dominated ownership of the BSE.

4.7 Hungary's accession to the EU in 2004 required further alignment with EU standards, eliminating discrimination between national and non-national investors. Accompanied by stronger investor protection and stronger corporate governance, primarily through amendments made to the Capital Markets Act, this has served in removing disparities in investment barriers and has raised Hungary's investment climate profile.

4.8 Hungary has also expanded the number range of tax holidays and incentives available for foreign investors through the Smart Hungary scheme, originally approved in 2002 and modified in 2004.

4.9 In the light of the steady rising international interest rate level and the increasing uncertainty among investors with respect to emerging countries, the HFSA predicts in its 2005 Annual Report that the market risks associated with securities portfolios are likely to increase.

4.10 Given the ownership structure of the BSE, the sensitivity of foreign investors to exchange rate risks, as well as the global and regional investment climate, makes this sector vulnerable to swings in both sentiment and economic fundamentals beyond the scope of national borders

The FSAP and the Hungarian Securities Sector

4.11 The Capital Markets Act came into force in 2002 and replaced the 1996 Securities Act. This has further aligned Hungarian legislation with the relevant EU Financial Directives on Investment Services, namely on investment services, public offerings and trading services, investment funds, investor protection, and supervising of financial services.

4.12 Amendments to the Capital Markets Act were made in 2005 with the intention of strengthening investor protection, encourage new listings on the BSE, and further harmonizing Hungarian legislation with EU law.

Impact of the FSAP and FSWP Legislative Measures on the Hungarian Securities Sector

Openness

4.13 It would appear that the FSAP thus far has had a slightly positive impact on the degree of openness of the Hungarian securities market. This is mainly due to accession and a number of Government initiatives having had the more significant impact on opening this sector up to foreign investors.

4.14 The transposition of the FSAP directives into national law, have served in removing the technical and regulatory barriers in the way of foreign investors participating in this sector.

4.15 However, the liberalization of Hungary's capital market, mainly through the elimination of foreign exchange controls in 2001 and the granting of equal treatment of both national and non-national investors were, in large part, prerequisites of accession.

4.16 When capital markets are liberalized, capital will tend to flow from capital abundant countries to those with a smaller capital stock where the marginal returns are greater. This would explain the growth in foreign capital inflows into Hungary's security market and thus the foreign dominated ownership structure of the BSE as illustrated in Figure 4.2. Foreign ownership has been growing from 73 per cent in 2003, to 74.4 per cent in 2004, up to 77 per cent in 2005.

4.17 Greater participation in the Hungarian stock markets seems likely to continue. This seems especially so given moves to further improve the attractiveness of Hungary's investment climate. For example, as of January 2006, withholding taxes on dividends paid to foreign companies, including those registered in non- EU member states, were fully abolished. This will tend to raise the marginal returns to investments.

Consumer protection

4.18 Consumer protection issues are likely to more pertinent in new member states such as Hungary, as opposed to old member states. Their relative stage in financial market development means that the comprehensiveness of the consumer protection regime may be relatively wanting.

4.19 It would appear that the FSAP has contributed positively to strengthening the level of consumer protection in the Hungarian securities market.

4.20 Strengthening regulations on corporate governance and reporting requirements of listed companies serves to mitigate the principal-agent affect and to reduce information asymmetries in the market. This should act as a boost to investor confidence in investing in these companies. The wider economic benefit of this is to improve the share of both national and non-national savings that is channelled into the economy's most productive and efficient productivities, thereby improving the prospects for long-term economic growth.

4.21 Furthermore, amendments to the Capital Markets Act that were made in 2005 with the intention of strengthening investor protection have tended to encourage new listings on the BSE, and further harmonize Hungarian legislation with EU law.

Competitiveness

4.22 Overall it would appear that the effect of the FSAP on the securities market is unclear.

4.23 As the FSAP has served in regulating as opposed to deregulating the Hungarian securities market (as has been the case in a number of the older member states) the FSAP may have served in removing what was previously a source of competitive advantage of the Hungarian securities market and thus negatively impact the competitiveness of the sector. The compliance costs associated with increased regulation may serve in making the securities listing a more expense way for firms to raise capital thereby reducing the attractiveness of listing.

4.24 Coupled with this, the increased compliance costs in the level of consumer protection may also serve in reducing the competitiveness of this sector. Indeed, too much consumer protection may deter investors with a relatively larger appetite for risk from purchasing holdings that are listed.

4.25 On the other hand, there are also factors to suggest the FSAP has had the opposite effect. The Companies Act, amended in 2004 to reflect the FSAP directives, incorporates the primary legislation on corporate governance. This is being further amended to strengthen the rules for large companies whilst reducing the number of formalities for small companies to lessen the burden of compliance costs. This serves in making the cost of public listing easier for small firms, thereby reducing the cost of capital and widening the availability of capital sources. This may improve incentives to list on the Hungarian securities market and thus serve to improve competitiveness.

Employment

4.26 So far, it is difficult to make definitive conclusions about the impact of the FSAP on employment in the Hungarian securities sector. However, a possible outcome could be the following: in the medium term, a portion of securities jobs are likely to migrate to London (and perhaps also Luxembourg) as systematic internalisers take advantage of the opportunities MiFID brings and as London (in particular) takes advantage of its lead in systematic internalising. However, the FSAP is also expected to encourage sufficient growth in total volumes that the migration of a portion of jobs to London will not offset the wider gains — i.e. securities jobs will increase in the future, even though the effect up to now will have been limited.

5 FINANCIAL CONGLOMERATES

5.1 Financial conglomerates come under the supervision of the HFSA.

Table 5.1: Financial conglomerates with Head Office in Hungary

Name	Characterization
OTP	Banking, insurance

Table 5.2: Financial conglomerates operating in Hungary

Name	Head office base	Characterization of Conglomerate	Characterization of Subsidiary
Allianz	Germany	Insurance group doing asset management and banking	Banking with some insurance
BNP Paribas	France	Equal focus on retail, corporate and investment banking, asset management	Banking with some insurance
Grupo Santander	Spain	Insurance, Banking, Asset Management	Banking
Gruppo Banca Intesa	Italy	Banking	Banking
Provident Financial	UK	Lending company whose speciality is home credit	Banking - home credit
San Paolo-IMI	Italy	Retail and Commercial banking group doing insurance	Banking

Source: Mixed technical group, Europe Economics

Impact of the FSAP and FSWP Legislative Measures on the Hungarian Financial Conglomerates

5.2 As we can see in Tables 5.1 and 5.2, conglomerates operating in Hungary tend mainly to engage in banking activities. Thus, the conclusions for financial conglomerates in Hungary are those that held for the banking sector.

Openness

5.3 We have seen that the form of entry by banks into Hungarian has been affected, and that openness in the insurance sector has probably increased. In addition, the FSAP measures for regulation of Financial Conglomerates should create a more standardized regulatory environment, reducing costs of compliance for large firms operating across multiple jurisdictions.

5.4 Further, we should, in general, expect a programme such as the FSAP to be of greater short-term benefit to existing larger players than smaller players, since larger players will more obviously gain from a standardized cross-border environment.

5.5 Thus our assessment is that the FSAP will encourage greater openness.

Competition

5.6 We have seen that competition is expected to be relatively enhanced in the banking sector and this can be expected to apply for financial conglomerates also.

Consumer protection

5.7 Effects on the degree of consumer protection in the banking sector are expected to be positive.

Employment

5.8 We assess the effects on employment in the banking sector as unclear and thus expect the same to apply for financial conglomerates.

Competitiveness

5.9 As competitive pressures stemming from abroad and domestically are expected to be increased by the FSAP, we would expect this to lead to greater competitiveness of Hungarian conglomerates.

6 CONCLUSIONS

Assessment

	Impact of FSAP on…				
	Openness to foreign firms	**Competition**	**Consumer Protection**	**Competitiveness**	**Employment**
Banking	Positive	Positive	Positive	Positive, unclear in future	Unclear
Insurance	Limited	Limited	Positive	Limited	
Securities	Slightly positive	Positive	Positive	Unclear	Limited. Perhaps positive in the future
Financial Conglomerates	Positive	Positive	Positive	Slightly positive	Unclear

IRELAND

1 INTRODUCTORY OVERVIEW

Financial Services Regulation in Ireland

Division of responsibility

1.1 The Central Bank of Ireland was re-named the Central Bank and Financial Services Authority of Ireland (CBFSAI) on 1 May 2003. This body carries out all the activities formerly carried out by the Central Bank of Ireland, and additional regulatory and consumer protection functions for the financial services sector. The CBFSAI has two component entities:

(a) **The Central Bank**, which has responsibility for monetary policy functions, financial stability, economic analysis, currency and payment systems, investment of foreign and domestic assets and the provision of central services; and

(b) **The Irish Financial Services Regulatory Authority (Financial Regulator)**, which is an autonomous entity within the CBFSAI and has responsibility for financial sector regulation and consumer protection.

1.2 The Financial Regulator is responsible for the regulation of all financial services firms in Ireland and has clearly defined regulatory responsibilities that cover all Irish financial institutions.

Key features of financial regulation

1.3 The main legislation is (the first three apply across each of the three areas):

(a) The Central Bank and Financial Services Authority of Ireland Act, 2003.

(b) The Central Bank and Financial Services Authority of Ireland Act, 2004.

(c) Central Bank Act 1998.

(d) Insurance Act, 2000.

(e) Pensions (Amendment) Act, 2002.

(f) Investment Intermediaries Act, 1995.

(g) Stock Exchange Act, 1995.

The Implementation Process and General Effects of FSAP in Ireland

1.4 Although there have been some criticisms of and resistance to FSAP measures, by and large the implementation process of the FSAP in Ireland appears to have been smooth with few difficulties.

1.5 Key issues identified include:

(a) uncertainty about which Member States will implement Common Reporting requirements of Basel II; and

(b) fear that inconsistent adherence to transposition timelines across some Member States may create an uneven playing field.

Consequences of the FSAP for the Regulatory Environment

1.6 Prior to the FSAP the Irish regulatory framework was principle, as opposed to risk-based. It has been argued that the FSAP has reversed this principle-based approach and increased the amount of basic regulation.

1.7 The scale of change in domestic regulation is regarded as significant for a subset of directives. For instance MiFID and the Transparency directives introduce significant new reporting requirements.

1.8 The level of FSAP implementation and level of regulation in Ireland seems broadly equivalent with that in other Member States.

1.9 The FSAP seems not to have been regarded as increasing the interaction of regulator-industry relationships and the level of involvement with other financial EU authorities.

Specific Factors to Ireland

1.10 Ireland is a member of the single currency and was one of the initial 11 countries forming the EMU on 1 January 1999.

1.11 Over the last 15 years Ireland has been successful in attracting international financial services companies. These have been attracted to Ireland for several reasons, including an attractive fiscal and regulatory environment; the availability of a highly skilled and educated workforce; a favourable relative cost structure; a robust telecoms infrastructure; political stability; and by effective marketing.

1.12 In total there are approximately 450 international institutions directly operating from Ireland, including over 50 per cent of the top 50 global financial institutions. These institutions provide a wide range of services including banking, asset financing/leasing, corporate treasury management, asset management, securities trading, custody and administration, and international insurance and assurance activities.

1.13 Since around 2000, Ireland's attractiveness as a location for international financial services has undergone major change. The corporate fiscal environment is still very favourable although other jurisdictions have followed Ireland's lead in this respect. The availability of skilled labour is even greater now having been supplemented by returning emigrants, from the US and the UK in particular. However, although Ireland still has cost advantages over many international centres, it is no longer considered to be a low cost location. The cost of skilled labour and property has increased relative to other markets in recent years. Additionally, other countries/regions have improved considerably in terms of marketing the attractiveness of their locations.[1]

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[1] Deloitte report: Study on the Future of the International financial services sector in Ireland, September 2004.

International Financial Services Centre (IFSC) Dublin

1.14 Dublin's IFSC[2], which was set up by the Irish Government with EU approval in 1987, is a location for a range of internationally traded financial services, including banking, asset financing, fund management, corporate treasury management, investment management, custody and administration and specialised insurance operations.

1.15 The IFSC was established under legislation designed to boost activity and employment in the Irish economy. The Finance Act 1987 established a special 10 percent corporation tax rate for certified services companies, except for those operations that set up before July 1998, which continued to avail of the rate until the end of 2005. From the 1st January 2006, Companies in the IFSC in Dublin have paid tax at the normal corporation tax rate of 12.5 per cent, the special IFSC rate ended in accordance with agreements between Ireland and the EU on state aid rules.

1.16 Recent figures showed that the Irish Exchequer collected more than €700m in corporation tax from IFSC companies in 2002. More than 430 international operations are approved to trade in the IFSC, while a further 700 managed entities are approved to carry on business under the IFSC programme. The centre is a host to half of the world's top 50 banks and to half of the top 20 insurance companies.

Comparison with other EU states

1.17 The coordination centres in Belgium, continually effective since 1983, have been another example of a preferential tax regime encouraging developments in the financial sector. The fiscal advantages provided to these coordination centres were focused around:

(a) Corporate Income Tax on Profits.

(b) Withholding taxes.

(c) Share Capital Duty.

(d) Real Estate taxes.

(e) Corporate Income Tax on Ongoing Dividends.

(f) Work permits and Special Income Tax Allowance.

Other factors

1.18 Ireland had a 2.2 per cent share of world services exports in 2004. In comparison, Ireland’s share of the world economy was around 0.32 per cent, underlining the openness of the Irish economy to world trade, particularly in services.

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2 For more information see www.ifsconline.ie.

1.19 Insurance is Ireland's second largest services export category after computer services. Insurance exports now account for 19.4 per cent of services exports up from 12.6 per cent in 1999. Between 1999 and 2004 insurance exports grew by 310 per cent, exports were €2 billion in 1999 and grew to €8.2 billion in 2004.

1.20 Financial services exports grew by 159 per cent between 1999 and 2004.[3] Financial services as a percentage of total services exports stood at 9.6 per cent in 2004, down only marginally from 9.9 per cent in 1999.

1.21 Insurance services imports of €6.3 billion and financial service imports of €2 billion combined comprised 16.1 per cent of Irish services imports in 2004. Insurance imports have risen 164 per cent since 1999. Financial services imports have risen 71 per cent since 1999.

1.22 Exports from the IFSC have been one of the main drivers of Irish services export growth in recent years. Companies based in the IFSC account for the majority of Irish insurance and financial services exports.

1.23 The growth in IFSC exports since 1999 of 234 per cent have outpaced the 167 per cent growth in total Irish Services exports. IFSC exports as a percentage of total services exports have risen from 27.5 per cent in 1999 to 34.5 per cent in 2004, amounting to €14.6 billion.

1.24 IFSC imports have also grown since 1999 but at a slower rate of 156 per cent. In 2004 they stood at 18.1 per cent of total services imports.

1.25 There was a net trade surplus of €4.9 billion in IFSC activities in 2004. It is estimated that 17,600 people were directly employed in IFSC companies in 2004 with many more employed in supporting industries. In 2004 assets administered by IFSC companies amounted to €600 billion and the €663 million collected in tax represented 12.4 per cent of the corporation tax take in Ireland.

[3] Forfas International Trade and Investment Report 2005.

2 BANKING

Headline Overview

Number of players and concentration

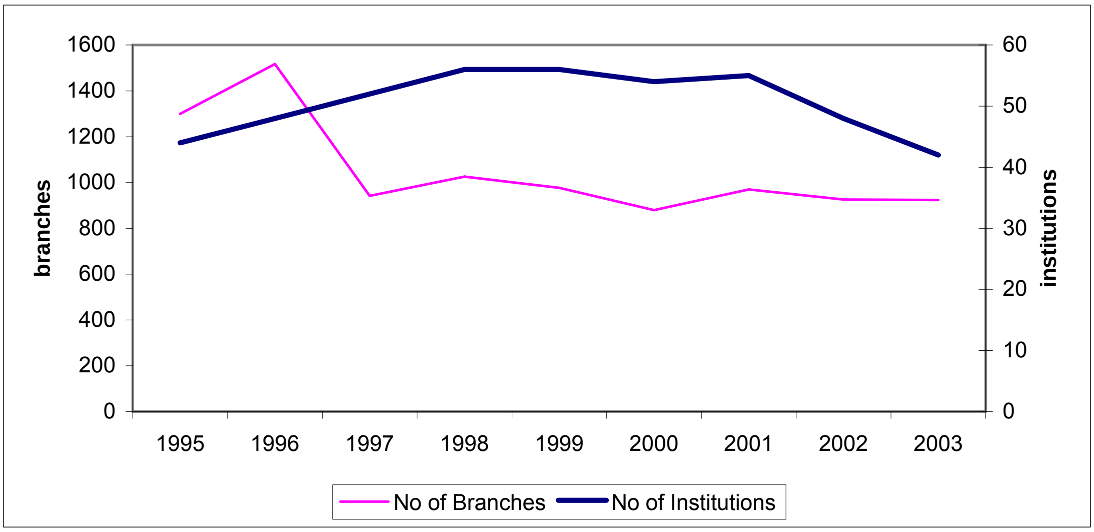
2.1 The IFSRA's Banking Supervision encompasses the authorisation of banks and building societies, their prudential supervision on an ongoing basis and the development of supervisory guidance and requirements for their operation.

2.2 In accordance with EU legislation, EEA credit institutions are entitled to establish in Ireland on a branch basis or to provide services on a cross-border basis (i.e. without having a physical presence in Ireland). "Passporting" of services in this way is subject to a notification procedure through the home country regulator to the Financial Regulator. The home country regulator is largely responsible for the prudential supervision of these institutions.

2.3 More than 60 credit institutions offered banking services in Ireland in 2003, of which 11 had branch networks. However just forty of these are incorporated in Ireland, while the remainder are authorised in another EU Member States and operate in Ireland on a branch basis. There are also over 400 credit unions in Ireland, which are co-operatively owned entities. They report to the Registrar of Friendly Societies.

2.4 Figure 2.1 illustrates the trends in the number of institutions and branches incorporated and operating in Ireland.

Figure 2.1: Banks in Ireland, 1995-2003



Source: OECD

2.5 Commercial banking in Ireland is dominated by two Irish owned, publicly quoted banks, Allied Irish Bank (the biggest bank), and Bank of Ireland who control 70 per cent of the market[4]. Two other banks make up the "Big four", Ulster Bank, a member of the Royal Bank of Scotland Group, and National Irish Bank, a subsidiary of National Australia Bank.

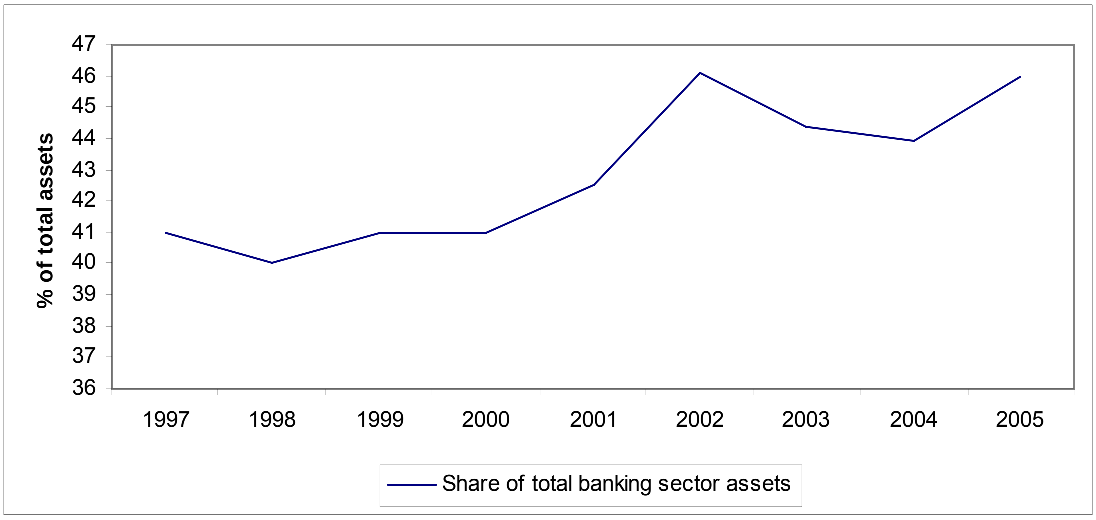
Table 2.1: Personal current account market shares 2003

Bank	Market share range
Allied Irish Banks	35%-50%
Bank of Ireland	30%-40%
National Irish Bank	0%-5%
Permanent TSB	5%-20%
Ulster Bank	5%-10%

Source: Competition Authority Report: Competition in the (non-investment) banking sector in Ireland p9

2.6 Corporate banking services are provided by the non-associated domestic and international banks. These banks include merchant, commercial and industrial banks, offering a range of banking treasury and international trade services, primarily to corporate customers. Ireland has attracted a large number of foreign banks in recent years due to the strength of the Irish economy and a favourable tax regime.

Figure 2.2: Share of the 5 largest Irish credit institutions in total assets (%)



Source: ECB

[4] 2006 Index of Economic Freedom – Ireland report.

Table 2.2: Herfindahl- Hirschman Index[5]

1997	1998	1999	2000	2001	2002	2003	2004	2005
500	473	480	486	512	553	562	556	600

Source: ECB

2.7 Figure 2.2 shows that the aggregate level of concentration in the Irish market peaked in 2002 and declined afterwards. However as Table 2.1 proves there are segments of the market that are more highly concentrated.

2.8 The H-H index in Table 2.2, suggests that the increase in the aggregate concentration level has been accompanied by a decrease in the intensity in competition in the sector.

Table 2.3: Foreign Credit Institutions in Ireland

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Branches of CI's from EU area	18	21	26	28	32	31	31	31	31
Subsidiaries of CI's from EU area	21	24	24	24	25	25	20	21	22
Branches of CI's from third countries	0	0	0	0	1	1	1	1	1
Subsidiaries from third countries	7	7	7	8	11	12	11	11	10

Source: ECB

Table 2.4: Mergers and Acquisitions

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Number of domestic M&A's	0	0	0	0	0	0	1	0	1
Number of EU M&A's	0	0	1	0	1	1	0	0	0
Number of third country M&A's	1	0	2	0	0	0	0	0	0

Source: ECB

2.9 The number of foreign credit institutions has increased over the period.

2.10 Credit institutions provided some €82.2 billion outstanding in mortgage finance by June 2005, according to the Central Bank of Ireland — enabling Ireland to have one of the highest owner-occupier levels in the EU. They also supply funding for businesses, small and large, to set up and grow, providing jobs and opportunities across the economy. There was some €74.1 billion in lending outstanding to business by June 2005.[6]

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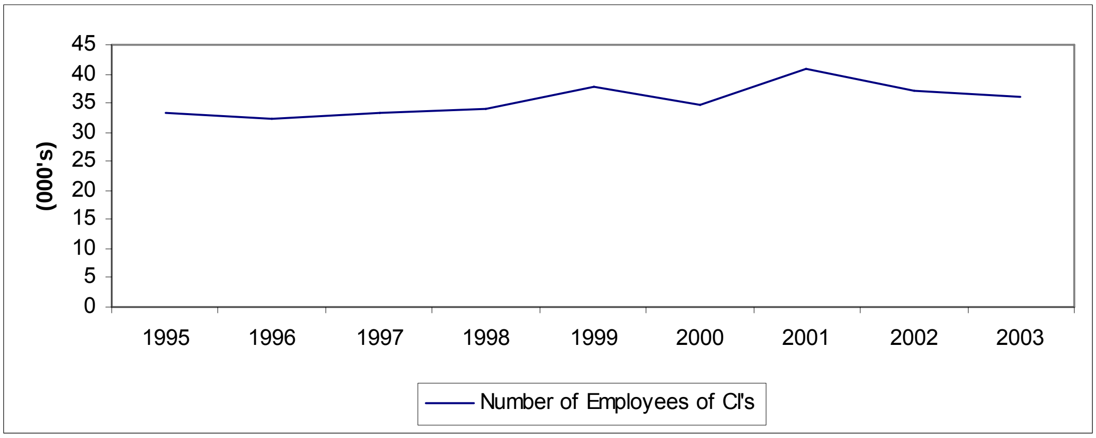
5 The Herfindahl-Hirschman index is defined in the Main Report.
6 IBF website.

Turnover, employment and profitability

2.11 Figure 2.3 illustrates employment in Irish banks.

2.12 Employment followed a relatively level trend from the mid-1990s to 2001 when it increased only to fall again after 2001. In the last two years of data available employment fell by more than 10 per cent. Income has been increasing constantly however, since 1995 and remained fairly stable in 2003.

Figure 2.3: Employment in Irish banks, 1995-2003 (000's)



Source: OECD

Trade and international penetration

2.13 Figure 2.4 gives total non-insurance financial services trade for 1999-2004.[7] It confirms that the Irish banking sector's openness and international penetration has continued to increase over the last few years.

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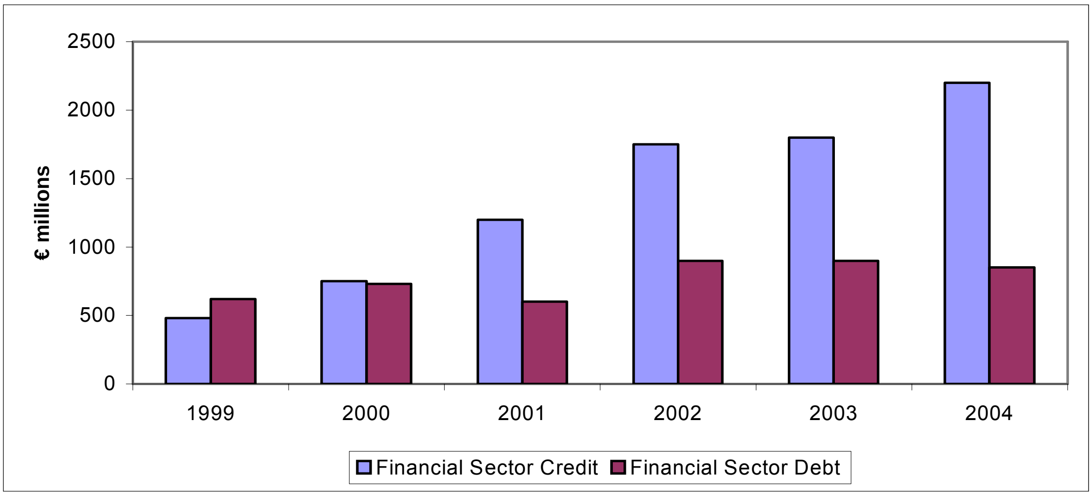
7 This is defined as the sum of credits and debits, and covers wider services than just banking.

Figure 2.4: Irish trade in non-insurance financial services, 1999-2004



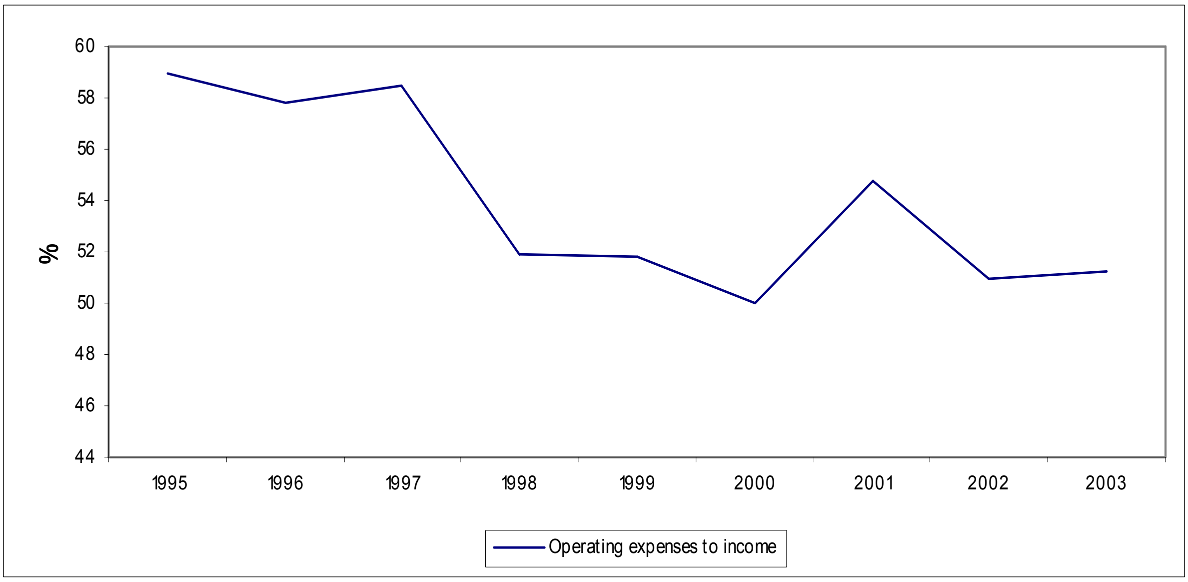
Source: Eurostat

Competitiveness

2.14 Figure 2.5 gives the cost to income ratio of Irish banks.

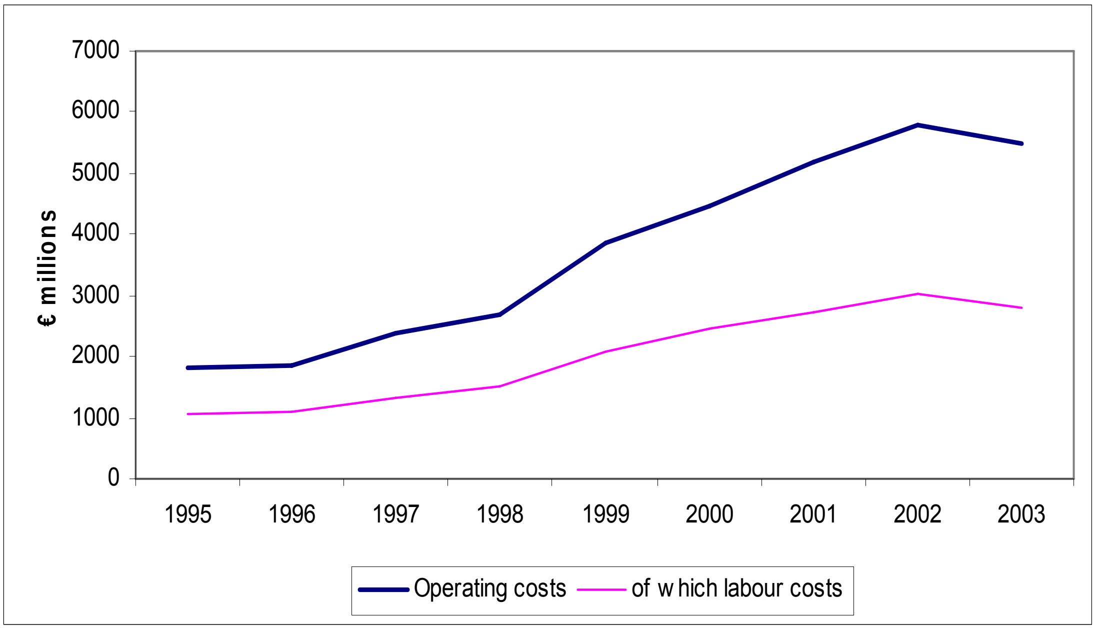
2.15 It appears that banks are now more efficient than a few years ago. Cost income ratios of Irish banks compare well with European peers and therefore Irish banks are well placed to face international competition.

Figure 2.5: Operating expenses to income, 1995-2003 (as %)



Source: OECD, Europe Economics

Figure 2.6: Operating costs and labour costs



Source: OECD

Table 2.5: Key performance indicators of the banking sector (%)

Year	Net interest margin[a]	ROA[b]	ROE[c]
1995	3.0	1.5	20.2
1996	2.5	1.5	20.1
1997	2.2	1.3	19
1998	1.9	1.4	21.6
1999	1.8	1.4	18.1
2000	1.6	1.2	17.9
2001	1.5	0.9	12.3
2002	1.4	1	15.6
2003	1.1	0.8	15.2

a: Net interest margin — net interest income to average total assets.
b: ROA — net income before tax to average total assets.
c: ROE — net income before tax to average capital and reserves.
Source: Europe Economics calculation of data from OECD (2005) "Bank profitability"

Ease of switching, factors affecting competition and consumer protection

2.16 The 2006 Heritage Foundation/Wall Street Journal Index of Economic Freedom report[8] describes Ireland's banking and financial system as "advanced and competitive". The report states that in 2004, total assets of licensed credit institutions represented over 400 per cent of GDP — the second largest ratio in the EU after Luxembourg.

2.17 However, although the Irish bank sector may overall be competitive, there appear to be problems in specific areas. The Competition Authority published a report[9] in 2005 that identified anti-competitive problems in the three sectors examined – personal current accounts, lending to small business, and the role of the payments clearing system. These problems typically included: the fact that customers with personal current accounts are effectively locked into their existing services because it is so difficult to change banks, resulting in banks not competing for existing account holders but fighting aggressively for those opening new accounts; that banks were not passing on interest rate decreases to small and medium enterprises (SME's) lending customers, a problem costing small businesses an estimated 85 million euro a year; and the structure of the payment clearing system inhibiting new banks offering services in Ireland.

2.18 The Competition Commission made 25 recommendations intended to make the banking industry more competitive. The recommendations were addressed to the government, the Financial Regulator, the clearing companies, and the banks and included:

(a) Personal current accounts**:** improve the switching code for personal current accounts; develop a transferable direct debit; end double taxation of plastic cards; provide personal current account interest rate information; promote personal current account interest rate awareness.

(b) Loans to small businesses: implement an effective switching code for small businesses; make it easy to compare current accounts.

(c) Payments clearing system: create a single Board of Directors for the Payments System; expand membership of the IPSO; analyse new technology for clearing electronic copies of cheques; investigate the establishment of an automated clearing-house.

(d) Payments clearing system: create a single Board of Directors for the Payments System; expand membership of the IPSO; analyse new technology for clearing electronic copies of cheques; investigate the establishment of an automated clearing house.

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8 Website: http://www.heritage.org/research/features/index/country.cfm?id=Ireland

9 Competition in the (non-investment) banking sector in Ireland, published 22 September 2005.

2.19 In the Irish Bankers Federation's "Response to the Post-FSAP Expert Group on Banking – Final Report", the IBF gave the following examples, in the Irish context, of barriers which can lead to the fragmentation of the Single Market in retail financial services:

(a) The regulation of bank charges under Section 149 of the Consumer Credit Act, 1995. This is a price control in respect of bank charges and is unique, the IBF believes, within the European Union. It is a serious disincentive to innovation and impacts on consumer choice and competition.

(b) The imposition of government taxes such as stamp duties on payment cards are an example of fiscal measures which reduce competition and therefore integration of the financial services markets and could constitute barriers to entry to new providers.

(c) The E-Commerce Act, 2000 specifically excludes consumer credit contracts from its protection. This is contrary to the concept of, and militates against, the provision of on-line banking services and reduces the attractiveness of this market in Ireland.

2.20 Respondents to our survey believe that the measures recommended by the competition authority have had a positive effect on switching behaviour. They also point out that increased consumer protection is in place in Ireland.

Impact of the FSAP and FSWP Legislative Measures on the Irish Banking Sector

Assessment by category

Cross-border business, takeovers and the development of a regional market

2.21 As a Member State of the EU, Ireland has had a tradition of taking advantage of the opportunities created by the Single Market.

2.22 Cross-border activities in the Irish banking sector have increased and will probably continue on this trend. This can be mainly attributed to the presence of the IFSC in Dublin which allowed a number of foreign banks to set up branches and offer services to the Irish market.

2.23 Since the FSAP tends to encourage greater cross-border activity across the EU, our view is that it has also had a slightly positive effect on the level of openness of the Irish banking sector to foreign firms.

2.24 In the future, further implementation of the FSAP should lead to a greater EU-wide tendency for firms to engage in cross-border operations which should eventually lead to greater foreign participation in Ireland.

2.25 Our econometric study suggests that the impact of the FSAP on trade has been a of rise of 1.4 per cent in imports of financial services other than insurance and pensions, and a rise of 1.7 per cent in exports. Full implementation of the FSAP is projected to lead to a further 0.9 per cent rise in imports and 1.9 per cent in exports.[10]

Competition

2.26 Since 1998, the Herfindahl-Hirschman Index has remained low. In general, the Irish banking market is not very concentrated. Furthermore, in recent years, there have been no major developments in mergers and acquisitions.

2.27 Although the FSAP has had a slightly positive impact on the degree of openness of the Irish banking sector, the fact that the market was already open prior to the FSAP implies that the level of competition was already relatively high, in the form of active competition or contestability. Therefore, so far, the impact of the FSAP on the level of competition in the Irish banking sector has been limited.

2.28 Figure 2.2 and Table 2.2 suggest that Ireland's banking sector is not highly concentrated on the whole. However, there are segments of the market that exhibit a high degree of concentration. For instance, two Irish owned banks control over 70 per cent of the personal current account market (see Table 2.1). This may indicate a lack of competition in the market. A lack of significant new entry means that competition is dependent on rivalry among incumbents. Therefore the ability of customers to switch current accounts is very important. If current account holders are locked in, it inhibits rivalry between existing current account providers, makes it difficult for a new provider to attract customers and, through their gateway role, dampens competition in other banking products.

2.29 A recent Competition Authority report[11] identified anti-competitive problems in the three sectors examined: personal current accounts; lending to small business; and the role of payments clearing. The report stated that personal current account holders find it difficult to change banks and are effectively locked into their existing service. They state that this is largely due to structural arrangements within the banking sector, the behaviour of the banks themselves, and unintended consequences of government regulation.

2.30 Since the Competition Authority commenced its study into this sector, a number of changes have occurred in the personal current account market. These have the potential to increase competition. In December 2004 Danske Bank announced the purchase of National Irish Bank; in January 2005 the IBF launched a PCA switching code; in March 2005 the ESB the state-owned electricity company agreed to sell its network of 54 branches to Bank of Scotland (Ireland).

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[10] Note that these effects are additional to any associated with membership of the EU or other global or domestic trends towards openness.

[11] Competition in the (non-investment) banking sector in Ireland, published 22 September 2005.

Employment

2.31 Figure 2.3 illustrates that since the commencement of the FSAP the number of jobs in the banking sector followed a mildly upward trend. Since the figure suggests that the trend was already in place prior to the FSAP, we have no reason to believe that the FSAP has had a significant impact on the level of employment in the Irish banking sector.

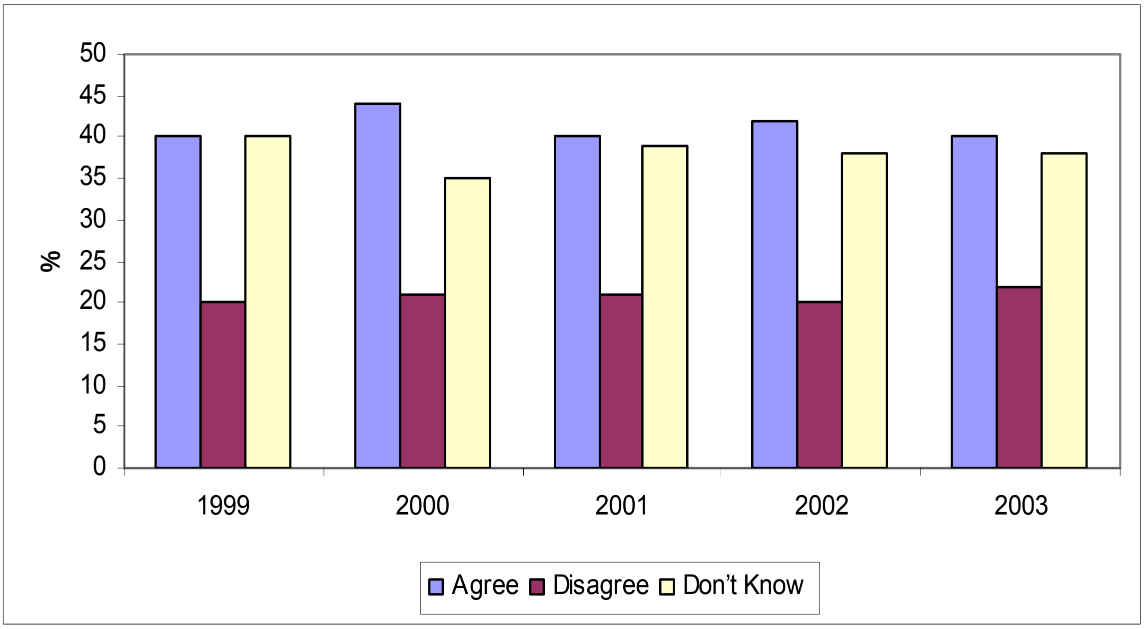
2.32 However it may be argued that the FSAP contributed to an acceleration of the trend by allowing more entries in the market as well as contributing to the introduction of innovative products.

Consumer protection

2.33 Figure 2.7 illustrates that the share of consumers who feel adequately protected in the financial market has remained considerably stable since 1999 (around 40 per cent), with a slight tendency to increase. On the other hand the share of people that disagree with the statement seems to have declined slightly. After a big drop in 2000 it has increased by approximately 35 per cent. This is five percentage points lower than in 1999.

2.34 From the figure below, there is no reason to believe that the FSAP has had a significant impact on consumer protection in the Irish banking sector.

Figure 2.7: Percentage on survey respondents that are in agreement and disagreement with the statement "Consumer rights are adequately protected in relation to financial services"



Source: Eurobarometer

Competitiveness

2.35 As illustrated in Figure 2.5, since the implementation of the FSAP the operating expenses to income ratio of Irish banks has followed a slightly decreasing trend. The 1998 to 2003 time period is characterised by three different steps.

2.36 From 1998 to 2000 the ratio declined slightly from nearly 52 to 50 per cent following a trend that dated back to 1994. In 2001, the ratio peaked at 56 per cent, probably driven by the bear market and then went back to the 1999 level in 2003.

2.37 Our view is that the level of competitiveness has risen as a result of the FSAP. Indeed, the decrease in the operating expenses to income ratio between 1997 and 1998 is far more significant than in the previous year. It appears that in 1997, Irish banks had already starting getting prepared for the FSAP. This made them more competitive.

2.38 Furthermore, further implementation of the FSAP should lead to: an increase in openness of the Irish banking market to foreign firms, as well as an increase in openness of other Member States' banking markets to Irish entry. In the future, this should raise the level of competitiveness in the Irish banking sector.

3 INSURANCE

The Irish Insurance Sector

Non-life

3.1 The Financial Services Regulator only regulates non-life companies that have their headquarters in Ireland: it currently supervises 90 undertakings in the non-life section. Companies that are doing business in Ireland, on a freedom-of-service basis, are supervised by their home-country regulator.

3.2 There are 20 branches of undertakings with their Head Office outside Ireland. Approximately four hundred companies have notified the Financial Services Regulator of their intention to write business into the Irish market on a freedom-of-services basis. This figure grows on a weekly basis.

Life

3.3 The Financial Services Regulator only regulates Life companies that have their headquarters in Ireland and currently supervises forty-nine undertakings. There are also 14 Branches of undertakings with their Head Office outside Ireland.

Reinsurance

Reinsurance companies are not at present subject to a formal solvency supervision regime. However, the Financial Services Regulator has the power to order a reinsurance company to cease writing business if it is not satisfied with the manner in which it conducts business. A formal reinsurance regulatory regime will be introduced in the near future and will be informed by current deliberations at European and international level.[12]

3.4 As of 31 December 2004 there were 175 Irish Authorised undertakings. This was comprised of 51 Life and 124 Non-Life companies, all located in Ireland. In addition there were 40 branches of undertakings with their Head Offices located in other Member States of the European Economic Area (EEA) comprised of 11 Life and 29 Non-Life companies and 2 branches (1 Life and 1 Non-Life) of undertakings with their Head Offices located outside the EEA.[13]

3.5 In addition, 606 companies, predominately located in EEA Member States, had authority to write business on a Freedom of Service basis. This figure is comprised of 116 Life undertakings and 490 Non-Life undertakings.

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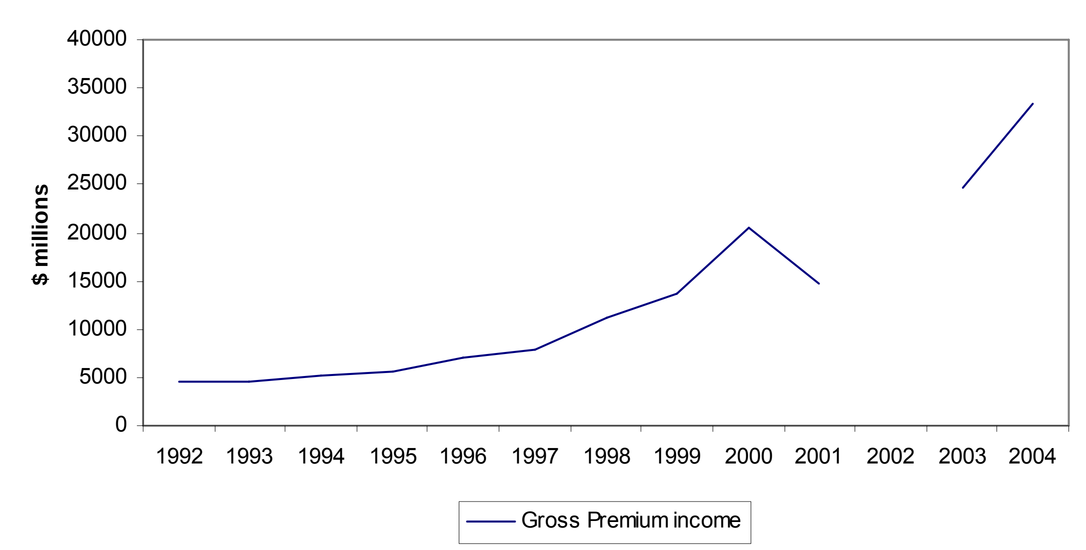
[12] IFSRA website.
[13] Financial Regulator's Insurance Statistical Review.

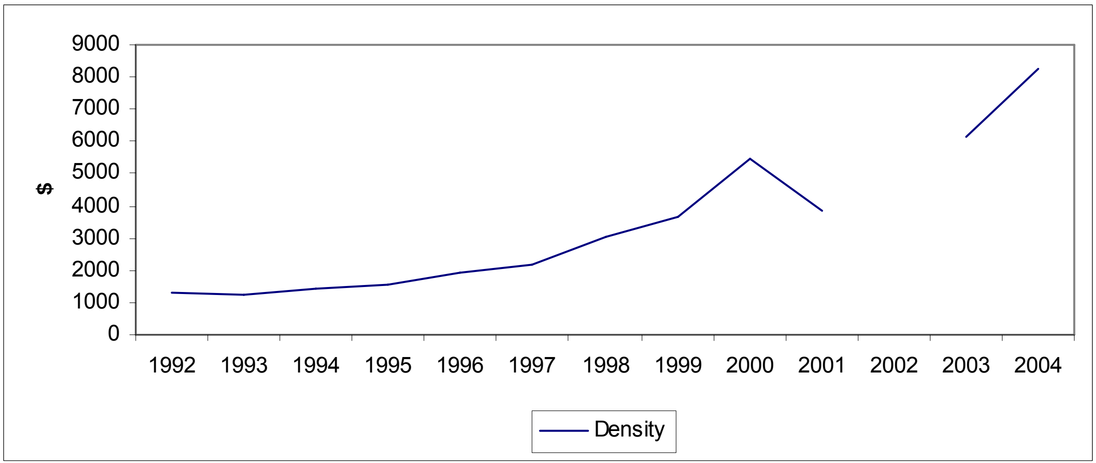
Turnover

Figure 3.1: Gross premium income in Ireland, 1992-2004



Source: OECD. 2002 data absent from series.

Figure 3.2: Insurance Density (gross direct premiums/population, $ per capita)



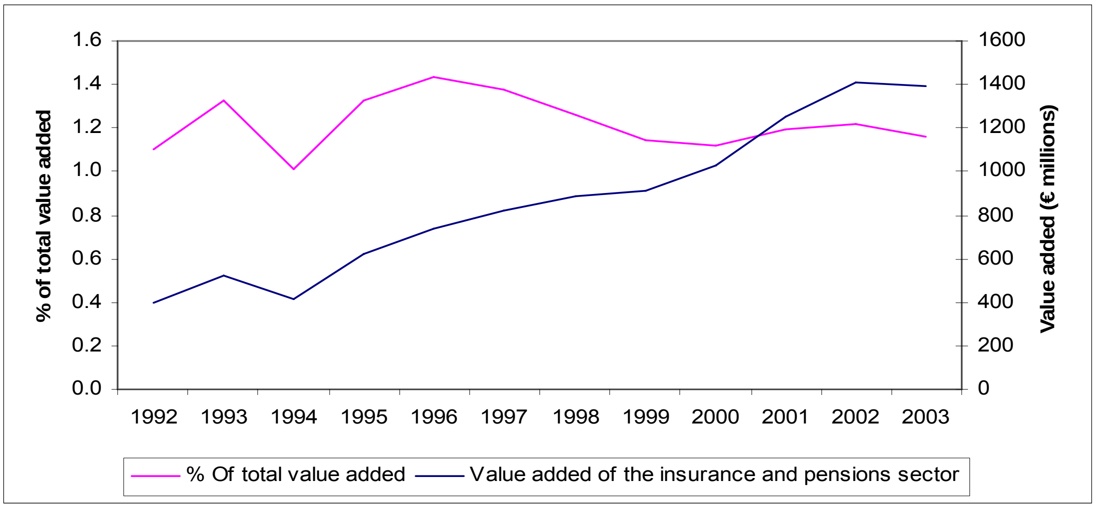
Source: OECD. 2002 data absent from series.

3.6 It can be seen that premiums written increased by more than 300 per cent from the inception of the FSAP to 2004.

3.7 Figure 3.3 illustrates the value added for the insurance and pensions sector. The increase in premiums written may be explained by the overall upward trend that the Irish economy experienced in recent years.

3.8 In 2003, the sector contributed 50 per cent more to the total of value added in the economy than it did at the beginning of the 1990s.

Figure 3.3: Value added of Irish insurance



Source: University of Groningen

Market shares

3.9 In 2003, there were over 600 insurers authorised to write liability and motor business premiums in Ireland but not all of them are active in the market. Table 3.1 shows the market shares in 2001-2003.[14]

3.10 The table shows that the ten largest companies control 95 per cent of the market. It can also be seen that the share of the 5 largest companies remained constant at around 65 per cent. However, the composition of the five biggest players has considerably changed.

[14] This information was taken from Competition Issues in the Non-life Insurance Market volume II. Paper E Analysis of the 2003 statutory returns in the Irish market and related matters – non life market.E2 –E4.

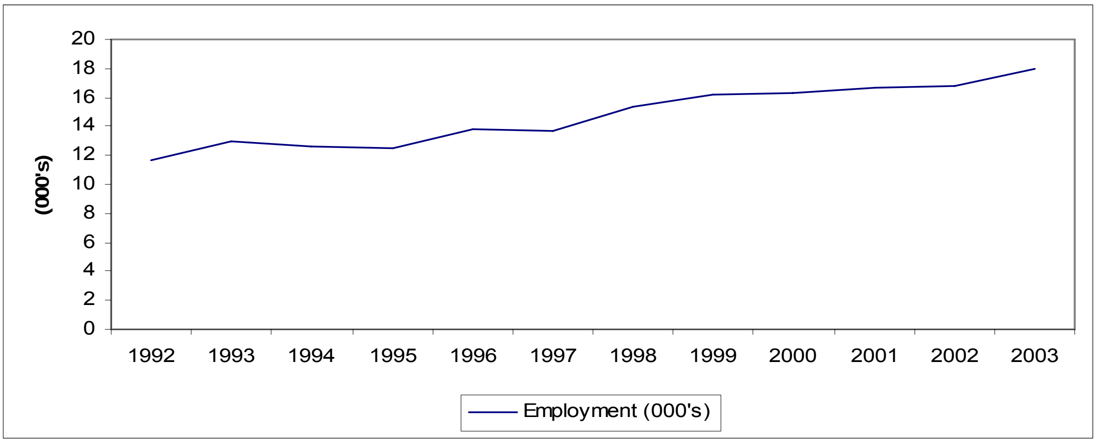
Table 3.1: Irish Insurer Market Share in 2001 – 2003

Net EPI Liability	**2003**		**2002**		**2001**	
	Rank	**% IND.**	**Rank**	**% IND.**	**Rank**	**% IND.**
Hibernian General	1	19.4	1	20.3	1	19.5
Quinn Direct	2	12.3	8	6.2	10	1.9
Allianz Corp	3	12.2	2	14.5	2	13.9
I.P.B.	4	10.9	3	9.6	4	10.1
FBD	5	9.6	5	9.1	6	8.4
Eagle Star Ireland	6	7.8	4	9.1	7	7.6
Royal Sun Alliance	7	7.4	6	8.7	5	9.2
Allianz Ireland	8	6.1	9	6.0	8	6.3
St. Paul	9	5.3	7	6.7	3	13.3
A.I.G.	10	5.1	10	4.9	9	4.9
Totals		**96.2**		**95.2**		**95.1**

Employment

3.11 Figure 3.4 illustrates an upward trend in employment in insurance going back to before the FSAP. However, employment growth does appear to have accelerated after the onset of the FSAP, and this may reflect greater export activities, taking advantage of a generally more receptive international marketplace (such increased receptiveness not being unrelated to the FSAP).

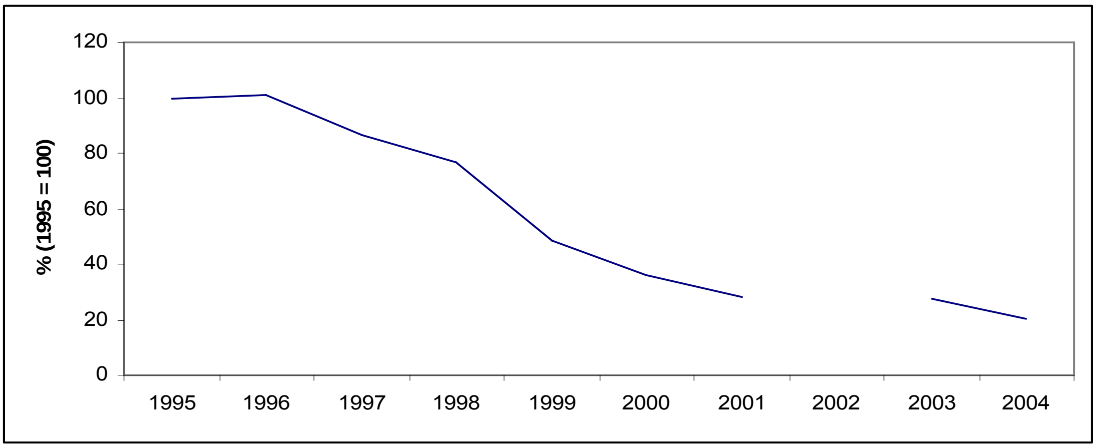
Figure 3.4: Employment in insurance, 1992-2003



Source: University of Groningen

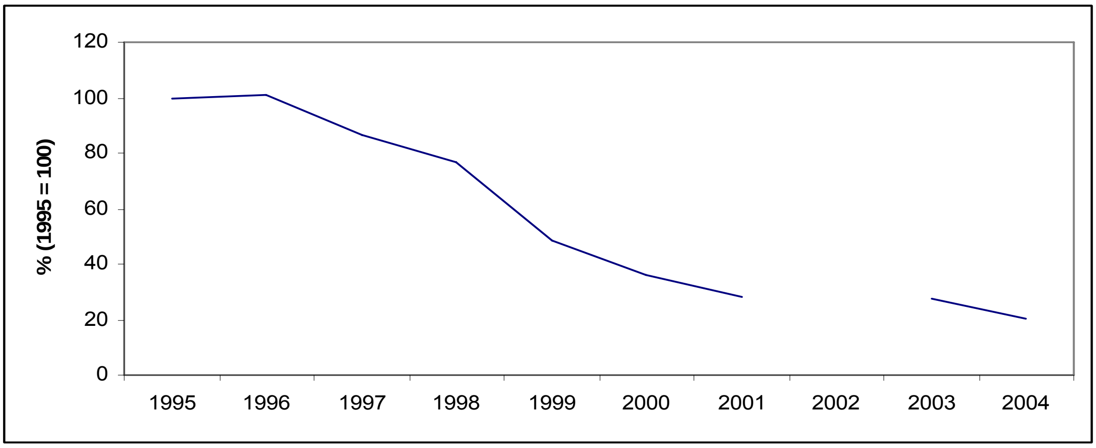
International entry and penetration

3.12 Growth in the Irish insurance sector has taken place through the increase of local suppliers, as illustrated above. The share of the market accounted for by foreign undertakings, fell from more than 25 per cent at the beginning of the 1990s to less than 5 per cent in 2004.



illustrates this trend.

Figure 3.5: Market share of (branches/agencies of foreign undertakings) in total domestic business (% gross premium basis)[15]



Source: OECD[16]

3.13 Insurance is Ireland's second largest services export category after computer services. Insurance exports now account for 19.4 per cent of services exports up from 12.6 per cent in 1999. Between 1999 and 2004 insurance exports grew by 310 per cent, exports were €2 billion in 1999 and grew to €8.2 billion in 2004. Financial services exports grew by 159 per cent from 1999 to 2004.

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[15] The OECD does not have observations for 2002.

[16] The OECD has no observations for foreign penetration on the basis of market share of (foreign controlled undertakings) and branches/agencies of foreign undertakings as a % of total domestic business.

3.14 Insurance services imports of €6.3 billion and financial service imports of €2 billion combined comprised 16.1 per cent of Irish services imports in 2004. Insurance imports have risen 164 per cent since 1999. Financial services imports have risen 71 per cent since 1999.

Competition

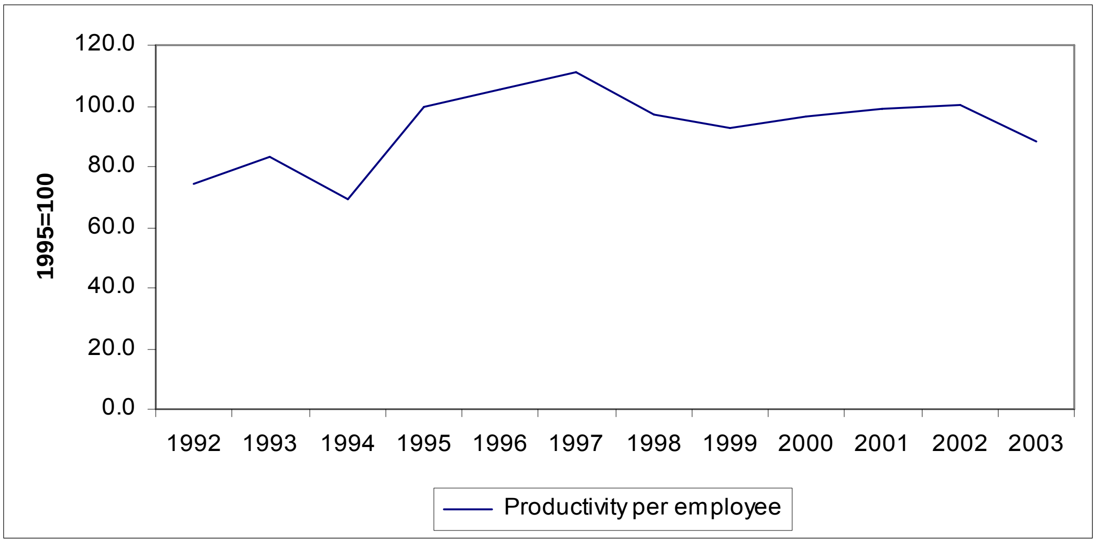
3.15 The Competition Authority carried out an analysis of competition in the non-life insurance sector in Ireland focussing on motor insurance, employer's liability insurance and public liability insurance.

3.16 The report stated that market concentration is high in some motor insurance markets such as drivers aged 17 to 20 on a full license where the leading four firms account for 90 per cent of premiums, and overall is moderately concentrated. In 2003 the leading four motor insurers accounted for 70 per cent of all premiums[17].

3.17 Market concentration in liability markets is moderate overall with the leading four firms accounting for up to 60 per cent of premiums, but in some more narrowly defined liability markets it is more concentrated. The Competition Authority made 47 recommendations to industry participants, regulators and the government. The recommendations were designed to increase the level of competition in the non-life insurance sector so that markets worked well for consumers.

Competitiveness

Figure 3.6: Labour productivity per person in Irish insurance and pensions sector



Source: University of Groningen

3.18 Productivity rose rapidly from 1990 to 1997 and then fluctuated around the 1995 value.

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17 Competition Issues in the Non-life Insurance Market, Final report and recommendations March 2005.

Impact of the FSAP and FSWP Legislative Measures on the Irish Insurance Sector

Level of implementation

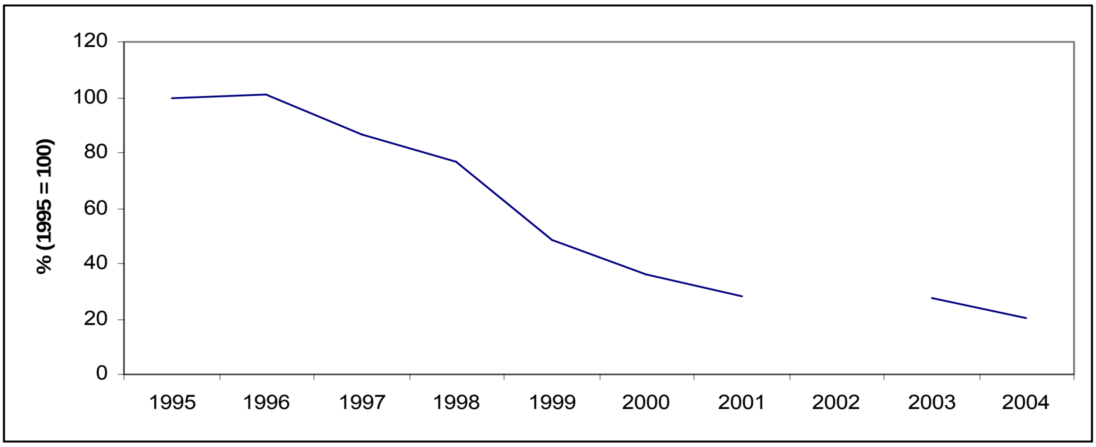
3.19 Ireland is generally on track with the implementation of the FSAP directives into national law and no particularly serious issues have emerged.

3.20 Companies authorised from 20 March 2002 have complied with the Solvency I criteria in the completion of their 2004 financial returns and all insurance companies will be required to comply with Solvency I in respect to their 2006 financial returns.

3.21 The rules on minimum amounts of capital required were strengthened for both Life and Non-Life companies. In addition, for non-life insurance, the number of different minimum guarantee funds was reduced from four to two and the rules were simplified.

Assessment of impact by category

Market entry, cross-border business and takeovers



3.22 shows that the share of foreign branches and agencies in the Irish insurance sector has been declining. There is no reason to believe that the FSAP has had any significant impact on this trend.

Competition

3.23 So far, there is no evidence that would suggest that the FSAP has had any significant impact on the level of competition in the Irish Insurance sector. Further implementation of the FSAP may potentially have a positive effect on competition in the Irish insurance sector by enhancing contestability or reducing concentration.

Competitiveness

3.24 Despite cyclical variations, labour productivity has remained relatively stable throughout the late 1990's, early 2000's. It has been fluctuating around the 1995-1996 value. Again it is very difficult to disentangle FSAP effects from the general trend of the Irish economy and it would be wrong to claim that the FSAP has caused the slowdown in productivity growth. A rise in competition in the future, triggered by further implementation of the FSAP, may also increase the level of competitiveness in the Irish insurance sector.

Trade

3.25 Since 1998, exports in the insurance sector have grown rapidly. From 1999 to 2004 Ireland's insurance exports as a percentage of its services exports rose by 6.8 per cent, suggesting that other factors rather than labour productivity influenced competitiveness of the Irish insurance sector.

3.26 The growth in insurance exports has far outstripped that of financial services exports in general between 1999 and 2004.

Consumer protection

3.27 We do not have data specific to the insurance sector and therefore we need to rely on the financial sector data presented. These show that the share of consumers that feel adequately protected in the financial market has remained considerably stable since 1999 (around 40 per cent), with a slight tendency to increase. On the other hand the share of people that disagree with the statement seems to have declined slightly. After a big drop in 2000 it has increased to around 35 per cent, five points lower than in 1999.

3.28 It would be useful to have data before the commencement of the FSAP to make a proper comparison but it can be argued that the effect of the FSAP on consumer protection has been limited.

Employment

3.29 The level of employment in the Irish insurance sector has been growing since the early 1990's. It is our view that the FSAP has had a limited impact on the level of employment in the Irish insurance sector. Indeed, Ireland has experienced a very significant general economic boom since 1996, which is not attributable to the implementation of the FSAP.

4 SECURITIES

4.1 The Irish Stock Exchange has two markets: the official equity index known as the Irish Stock Exchange Equity Index (ISEQ), and the recently launched Irish Enterprise Exchange (IEX), which has replaced the Developing Companies Market and Exploration Companies Market. The IEX is available to small or mid-sized Irish companies who are able to obtain a dual listing both on the IEX and on London's alternative Investment Market (AIM). The rules for listing on the IEX are much less arduous than those for listing on the ISEQ. The Exchange is regulated by the Financial Regulator.

4.2 Currently over 1450 securities are listed on the Irish Stock Exchange with the most significant volumes of trading in the equities and Government bond markets. There are currently over 4,200 investment funds and sub-funds listed on the ISE. The Irish Corporate Bond market is very small with very few bonds in issue.

Foreign investment

4.3 Non-residents may freely invest in all Irish domestic securities and there are no specific industry sector limitations except for the case of Ryanair.

4.4 Brian Healy, Director of Trading and Regulation of the ISE was quoted in the Exchange News dated 24 October 2005: "…trading in Irish equities on the ISE has been strong with values traded showing growth of 50 per cent over 2004 bringing year to date equity trading to more than €80 billion…"

4.5 The following table shows the value of Irish equities issued from 1999 to 2003.

Table 4.1: Value of Irish Equities Issued 1999–2003 (€ 000's)

Value of securities issued	**1999**	**2000**	**2001**	**2002**	**2003**
Irish Stock Exchange	154,694	218,675	209,876	189,358	188,244
CBISSO	23,628	21,784	-	-	-
NTMA settlement system	275	114	794	397	195

Source: Irish Stock Exchange

4.6 The cross-border securities clearing and settlement transactions within Europe, especially equities transactions, are still much higher and riskier than if cleared and settled domestically. The fragmented structure of local securities depositories is hindering the integration of financial markets in Europe, because investors are not accustomed to enjoying opportunities cross-border.[18] A smoothly functioning integrated infrastructure for clearing and settlement will allow the investors higher risk-adjusted returns on savings and better position to diversify portfolios, as well as higher liquidity and competition in the capital markets. Corporations would also be favoured with better access to financing capital, and competition would force financial intermediaries to offer a wider range of financial products at lower prices.

Dematerialisation of securities

4.7 An extensive consultation carried out by the Irish Stock Exchange in late 2004, with domestic and foreign participants in the Irish market, established that dematerialisation should be pursued as a matter or priority for the Irish equity market.

4.8 Currently, the majority of Irish equities are in dematerialised form settled through CREST, held at Registrar level. All Irish Government Bonds are held in dematerialised form, held and settled in Euroclear. [19]

Impact of the FSAP and FSWP Legislative Measures on Irish Securities Markets

Cross-border activities

4.9 The Irish securities market must have scope for liquidity gains through further implementation of the MiFID. Indeed, such an implementation should create gains for Ireland as a listing venue as a result of a reduction in costs.

4.10 Furthermore, it is to be considered that the Irish securities market might integrate into a significant stock exchange in the future, as a result of further implementation of the FSAP. Because of an established trend of trading with the UK, the Irish securities market could integrate the London Stock Exchange. However, another option could be to integrate Euronext or Easdaq because of Ireland’s historical tendency and aspiration to integrate with the core traditional EU Member States.

Competition

4.11 The possible developments mentioned above should enhance competition in the Irish securities market. Therefore, further implementation of the FSAP should have a positive impact on competition in the Irish securities market.

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[18] Cross-border securities, Clearing and Settlement Infrastructure in the European Union as a Prerequisite to Financial Markets Integration: Challenges and Perspectives Cynthia Hirata de Carvalho, HWWA Discussion Paper 2004.

[19] Bank of Ireland Securities Services Market Profile 2006.

Competitiveness

4.12 Since the Irish securities market is relatively small, if it was to integrate with a large liquidity pool, then costs should be reduced, which in turn should make Dublin a more attractive listing venue. Such a result would be partly due to further implementation of the FSAP.

Employment

4.13 So far, the FSAP has had a limited effect on employment in the Irish securities market. However, in the longer term, as a result of higher cross-border activity, enhanced competition as well as competitiveness in the Irish securities market, employment in the Irish securities market is expected to grow. Therefore, although in the short term the FSAP has had no significant impact on employment in the Irish securities market, in the longer term, it should have a positive impact.

4.14 Furthermore, although in the medium term a portion of securities jobs are likely to migrate to London as systematic internalisers take advantage of the opportunities MiFID brings and as London takes advantage of its lead in systematic internalising, the FSAP is expected to encourage sufficient growth in total volumes that the migration of a portion of jobs in London will be offset by wider gains — i.e. Securities jobs will increase in the future, even though the effect up to now will have been limited.

Consumer protection

4.15 Consumer protection issues are of relatively limited importance in the securities market. For this reason, the short-term impact of the FSAP on the Irish securities market would be limited. However, if the market extends to a more general public, then there could be consumer protection issues, in that a broader range of users would imply more inexperienced users. That said, the MiFID is addressing the long term risk through extensive consumer protection provisions. Therefore, in our view the FSAP has so far had no significant impact on consumer protection in the Irish securities market; but if more inexperienced market users were to use that market, the FSAP might have a positive impact.

5 FINANCIAL CONGLOMERATES

Table 5.1: Financial conglomerates with head of group in Ireland

Name	Countries in which they operate	Characterization
Bank of Ireland	UK, Ireland	Banking
Irish Life and Permanent	UK, Ireland	Insurance with some Banking

Source: EU Mixed Technical Group on the Supervision of Financial Conglomerates, Europe Economics

Table 5.2: Other financial conglomerates operating in Ireland

Name	Head office base	Characterization of Conglomerate	Characterization of Subsidiary
Allianz	Germany	Insurance group doing asset management and banking	Insurance with some banking
BNP Paribas	France	equal focus on retail, corporate and investment banking, asset management	Banking with Securities
Danske Bank	Denmark	Insurance, mortgage finance, asset management, brokerage, real estate and leasing services - mostly banking	Banking
DZ Bank Gruppe	Germany	Investment Banking	Investment Banking
Eureko	Netherlands	Insurance group doing asset management and banking	Insurance with some banking
Fortis	Belgium	Banking and Insurance: Contribution to net Profit: Retail Banking 23%, Merchant Banking 27%, Commercial/Private Banking 13%, Insurance Belgium and Netherlands 28%, International Insurance 6%	Banking
Gruppo Banca Intesa	Italy	Banking	Banking
HBOS	UK	Banking firm doing insurance, brokerage and asset management	Banking
Mediolanum	Italy	Pensions, investments, loans, banking, insurance	Investment Banking
Old Mutual	UK	Asset management, Life assurance, Banking, Offshore trust and company services	
Prudential	UK	Personal banking insurance, pensions and retail investments, to institutional fund management and property investments	Insurance with some banking
San Paolo-IMI	Italy	Retail and Commercial banking group doing insurance	Banking
Societe General	France	Corporate and investment bank	Corporate Banking
Standard Life	UK	Banking firm doing investments and pensions	Investment Banking

Source: EU Mixed Technical Group on the Supervision of Financial Conglomerates, Europe Economics

Impact of the FSAP and FSWP Legislative Measures on Financial Conglomerates

Openness to foreign firms

5.1 Our assessments for other sectors have suggested that the effects of the FSAP on openness were slightly positive for banking, limited for insurance, and maybe positive in the future for securities. As Irish conglomerates mainly incorporate banking activity, we conclude that the influence of the FSAP is likely to be positive.

Competition

5.2 Among the other sectors, only in securities and insurance was the effect of the FSAP assessed as being slightly positive, and then only in the future. For financial conglomerates we would see the overall impact as limited and maybe positive in the future.

Consumer protection

5.3 The effects of the FSAP on consumer protection in the banking and insurance sector was assessed as limited, and maybe positive in the future in the securities. For conglomerates we conclude that the overall impact is likely to be limited.

Employment

5.4 Earlier sections assessed that the main change in employment was limited in the banking and insurance sector and perhaps positive in the future in the securities. Since conglomerates mainly incorporate elements of banking and insurance, we assess the net effect as limited.

Competitiveness

5.5 For banking and securities we have assessed the competitiveness impact as positive, whilst for insurance limited. Conglomerates may perhaps be better placed, than smaller firms, to take advantage of the multi-jurisdictional regulatory efficiencies and other opportunities the FSAP and FSWP legislative measures have brought and will bring. Our overall assessment is that the impact is likely to be slightly positive.

6 CONCLUSIONS

Assessment

	Impact of FSAP on…				
	Openness to foreign firms	**Competition**	**Consumer Protection**	**Competitive-ness**	**Employment**
Banking	Slightly positive	Limited	Limited	Positive	Limited
Insurance	Limited	Perhaps positive in the future	Limited	Limited	Limited
Securities	Perhaps positive in the future	Perhaps slightly positive in the future	Perhaps slightly positive in the future	Perhaps slightly positive in the future	Limited so far. Perhaps positive in the future
Financial Conglomerates	Positive	Limited. Maybe positive in the future	Limited	Slightly Positive	Limited

ITALY

1 INTRODUCTION

Financial Services Regulation in Italy

1.1 Tables 1.1 to 1.3 set out the primary and secondary Italian financial services legislation.

Table 1.1: Italian main financial legislation

Legislation	Description
1993 Banking Law	In the area of banking supervision, broad objectives are defined in the 1993 Banking Law (BL) as the sound and prudent management of supervised institutions, as well as the overall stability, efficiency and competitiveness of the financial system. The institutional framework and the relationship between financial agencies are defined in the 1998 Consolidated Law. The BL has established a structured and comprehensive public information system for the timely dissemination of data and information on policy developments and regulatory changes. Internal governance arrangements, the publication of audited financial statements and statutory provisions governing conflicts of interest and staff conduct provide assurances of integrity.
Legislative Decree 310/2004	*The reform of company law*. It introduced several measures to coordinate the reform of company law with the Consolidated Law on Banking, completing the coordination work initiated earlier in the year with Legislative Decree 37/2004.
Legislative Decree 197/2004 transposed Directive 2001/24/EC	*Incorporation into Italian law of the directive on the reorganization and winding-up of credit institutions*. The new rules are designed to ensure the uniform and universal application in the Community of the regulations relating to reorganization and winding-up with specific exceptions (these include, for example, employment contracts, rights in property and financial instruments, and innovation and netting agreements).
Legislative Decree 170/2004 transposing Directive 2002/47/EC	*Incorporation of the directive on financial collateral arrangements into Italian law*. This directive introduced provisions governing financial collateral arrangements supplementing the Civil Code's general provisions regarding guarantees. The new legislation establishes simplified rules for the conclusion of such arrangements and mechanisms that ensure the certainty and rapidity of their enforcement.
Legislative Decree 38/2005 - some of the options left open by Regulation (EC) 1606/2002,	*Application of IAS/IFRS to the accounts of banks and companies in the financial sector*. This requires listed companies to prepare their consolidated accounts as of the financial year starting on or after 1 January 2005 in accordance with the International Accounting Standards/International Financial Reporting Standards (IAS/IFRS) adopted within the European Union.
Law 62/2005 transposing the Directive 2003/6/EC and the related implementing directives issued by the Commission	*Incorporation of the market abuse directives into Italian law*. This introduces rules aimed at countering behaviour likely to distort the proper functioning of the financial markets. The rules, included in a new title of the Consolidated Law on Finance, provide for two types of administrative and criminal offences; insider trading and market manipulation.

Source: Annual Report (2005) Bank of Italy

Table 1.2: Italian secondary legislation

	Description
Decree 5 August 2004	*Company organization and corporate governance.* This measure lays down the general criteria with which banks must comply in defining their corporate governance systems, with especial reference to the importance of these systems for sound and prudent management and competitiveness
March 2005	*Transposition of the Revised International Capital Framework.* In March 2005 the Bank of Italy notified the banking system of the start of work on the transposition of the revised capital framework drawn up by the Basel Committee and the subject of proposals for EU directives.
	Cassa Depositi e Prestiti. Cassa Depositi e Prestiti S.p.A. defines the criteria determining the organizational and accounting division between the "separate section", which is responsible for financing central government and local authorities from funds raised by Poste Italiane S.p.A. and guaranteed by the State, and the remaining intermediation business.
Ministerial Decree 150/2004	*Regulation of banking foundations*. New regulations for banking foundations.
July 2004	*Minimum duration of certificates of deposit*; concerning the duration of bank CDs and savings certificates (between 1 month and 5 years).
July 2004	*Business continuity in the event of a disaster*. Regulations relating to the preservation of business activity in the event of a disaster
November 2004	*New EU member states*. Regulations were issued concerning the prudential treatment of exposures to residents of the ten countries that had most recently joined the European Union
June 2004	*Securities and financial intermediaries*. Alignment with the reform of company law.
April 2005	*Asset management companies and investment funds*. Revision of the whole body of regulations issued by the Bank of Italy governing collectively managed assets which also completed the transposition of the UCITS Directives (2001/107/EC and 2001/108/EC).
June 2004	*Financial intermediaries*. Guidelines concerning the ways in which financial intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking are to account in their financial statements and supervisory reports for the securitization of credits and securities held for third parties. The measure also specifies the related prudential rules.

Source: Annual Report (2005) Bank of Italy

Table 1.3: Recent reform

Legge 28 dicembre 2005, n. 262 (artt. 19-22)
Italian Law 262 of December 28 2005 has updates the legislation for protecting savings and regulating financial markets. It amends Legislative Decree 58 of February 24 1998 (the Financial Act). The changes have been made in two main areas. First, Law 262 widens the powers of internal control bodies of listed companies. The board of auditors, the supervisory board and the management control committee can now direct requests for information on the results of company transactions or on specific transactions directly to the management and control bodies of the relevant subsidiaries of the company. Each member of the board of auditors, of the supervisory board and of the management control committee has the right to convene meetings of certain company bodies (with the exception of the shareholders meeting, which must be convened by at least two members) and to be assisted by company employees in the performance of their functions. The powers of the board of regular auditors of joint stock companies have also been strengthened. They now may approve the bringing of actions against the directors of a company. Second, Law 262 has introduced new rules for the regulation of financial markets and for the issue of financial products by banks. Before Law 262 was enacted, the provisions of article 94 *et seq.* of the Financial Act related to the regulation of public offerings did not apply to financial products issued by banks. This exemption has been repealed and, consequently, a bank that intends to make a public offering has to give prior notice to Consob before preparing the relevant prospectus. Further, the new article 100-bis of the Financial Act introduced by Law 262 provides that, in the case of public offerings and subsequent circulation of financial products in Italy, financial intermediaries who transfer them are responsible to non-professional investors for the solvency of the issuer for one year from the date of the issue. Liability may only be avoided if the financial intermediary delivers an information memorandum containing the information that Consob requires to be provided to non-professional investors.

Factors Specific to Italy

1.2 There are a number of general features peculiar to the Italian financial service industry that might be of non-trivial importance when conducting an evaluation of the FSAP. These include:

(a) **The size of the economy**. Small and medium size firms make up the bulk of the Italian private sector, and traditionally rely upon self-financing. The Italian corporate sector is characterised by a large number of small firms, often family-controlled, and a small number of very large firms, also often family-controlled even when publicly quoted.

(b) **The economic gap between the North and the South.** In Southern Italy the quality of regional banking services and its effect on economic growth have become a political issue. *Per capita* GDP in the South is 30 per cent lower than the national average. The gap narrowed substantially in the post-war period but has remained more or less stable for the last 20 years. For a long time the risk of bank lending, as measured by the incidence of losses, has been much higher in the South than in the North**.** This was a consequence not only of the greater fragility of firms but also of lower lending standards.

(c) **Public provision of benefits.** As in other Mediterranean countries, the Italian welfare system is characterized by a high degree of fragmentation with benefit systems that differ according to the various sectors of the population The welfare system is also characterized by a dualism between “strong” and “weak” beneficiaries, particularly with respect to social security; a traditional reliance on cash subsidies (money transfers rather than direct social services); the relatively recent creation of the national health services (based on the principle of universal protection); and the central role of the family in compensating for deficiencies of public provision of welfare. In the Mediterranean model the family is expected to play a very large part in providing financial support and care for disadvantaged family members. Publicly provided services are inefficient, and poor in quality and delivery. Because of the importance of cash benefits in the Italian welfare system, pensions constitute, by comparison with the rest of the EC, a large proportion of total welfare expenditure. An attempt to reduce publicly provided pensions has been strongly opposed by the Union Organisations and by large sectors of the population. It is now the subject of bitter political debate.

(d) **National protectionism.** Despite EU membership and the consequent acceptance of Treaty obligations, Italy has sometimes pursued a national protectionist policy in regard to bank ownership which appears inconsistent with Treaty obligations. Strong representations from the European Commission for example in relation to bids this year by BBVA, a Spanish bank, for Italy's BNL, even though it did not win it, and another by ABN Amro of the Netherlands for Banca Antonveneta, who did win it, may have altered this policy.

(e) **Financial scandals.** A recent series of bond defaults, including Cirio, Parmalat and corporate scandals such as the Banca Popolare Italiana, which implicated the Governor of the Bank of Italy, highlights the need for improvement in the system of corporate governance and oversight provided by the market.

Conclusion

1.3 The effects the FSAP in Italy, which are significant, are only part of the changes brought about by the development of an internal market in financial services. This development is part of the general process of procedural and technological modernisation that, independent of the FSAP, is driving the integration of national financial markets.

1.4 If it is accepted that it is useful to think of market development as following a progressive pattern — from national to regional and then to European and global markets — then Italy should perhaps be placed at an early stage in this process. Italy has yet to complete the first stage of this evolution and the more extensive integration of its economy will only come when national markets are more firmly established. Policies of protectionism should be understood (even if not condoned) as arising from a concern to complete this transition.

1.5 Given this early stage of financial development and the persistent problems in the clarity and effectiveness of legal process and the evident shortcomings of corporate governance there must be a strong presumption that the full and effective implementation of the measures envisaged in the FSAP would confer very considerable economic benefits to Italy.

2 BANKING

The Italian Banking Sector[1]

2.1 It can be argued that the rate of change in Italian banking and financial markets over the last decade has been much higher than in other Member States. There were a number of important reforms in the late 1980s and early 1990s. Some of these amounted to fundamental changes in the regulatory regime.

2.2 The banking sector is the core source of funding for the domestic economy. After an initial burst of mergers and consolidation banking is still relatively fragmented and consolidating at a slower pace. Banks control some insurance companies and asset management companies. The latter are the second most important class of financial institutions.

Ownership

2.3 Following the 1993 Banking Law the banking system was very rapidly transferred to private ownership. The share of total assets attributable to banks controlled by public entities or non profit foundations (Fondazioni), which may have been as high as 70 per cent before privatisation, had fallen to 25 per cent by 2002 and to 10 per cent in 2006.

2.4 The 1993 Banking Law allowed financial intermediaries to constitute themselves as universal banks or to specialise in any way that they chose. Universal banks are common in Italy. They combine retail and wholesale banking, short, medium and long-term credit, Fund Management, investment banking, leasing and insurance.

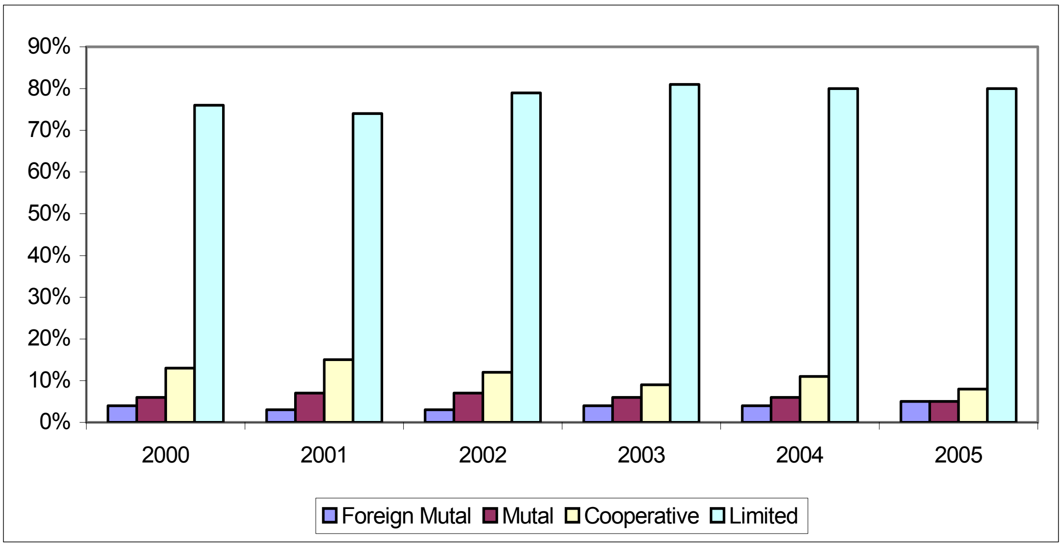
2.5 Italian banks can be grouped into four categories - limited companies, cooperatives, mutuals and foreign bank branches.

2.6 At the end of 2004 the Italian financial system consisted of 778 banks and 653 investment firms, asset management companies and other financial companies. The financial system also includes the *Cassa Depositi e Prestiti*, which Law 326/2003 transformed into a limited company. This is government-owned, does not take retail deposits but can issue bonds on behalf of the Italian post office.[2]

2.7 Figure 2.1 below shows that limited companies in the Italian banking sector now have 80 per cent of banking assets. Foreign companies still only have a small share of assets at around 5 per cent.

[1] See IMF Country report - March 2006 No. 06/112.
[2] See Bank of Italy Annual Report 2005.

Figure 2.1: Italian Banking System Structure (in terms of total banking assets)



Source: Source: Bank of Italy

2.8 Table 2.1 below shows that although the number of mutual banks is quite large, they account only for a small percentage (5.2%) of the market in terms of total banking assets,

Table 2.1: Italian Banking System Structure by type

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Limited*	222	237	239	240	252	253	244	242	245
Cooperative	78	60	49	44	44	40	38	37	36
Mutual	583	563	531	499	474	461	445	439	440
Foreign	55	59	57	58	60	60	61	60	60
Total	**935**	**921**	**876**	**841**	**830**	**814**	**788**	**778**	**781**

**Including limited banks accepting and non- accepting medium and long terms funds.*

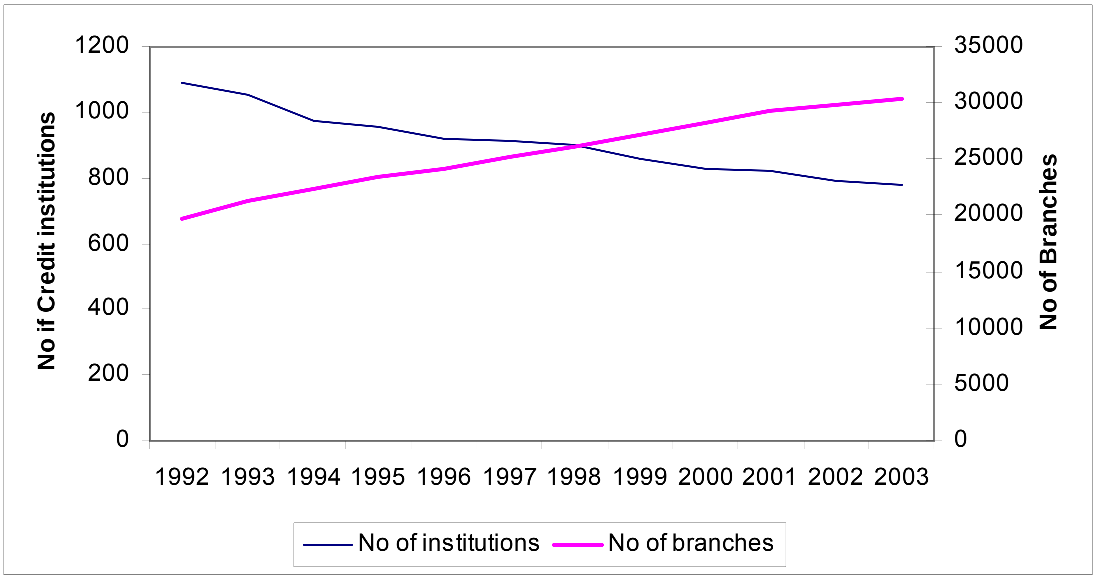
Source: Bank of Italy

Table 2.2: Non-Italian Banks

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Branches of CIs from EU area	18	21	26	28	32	31	31	31	31
Subsidiaries of CIs from EU area	4	5	6	7	7	7	7	6	10
Branches of CIs from third countries	19	18	18	16	13	13	13	10	10
Subsidiaries from third countries	3	3	3	2	2	2	2	3	3

Source: ECB 2005

Figure 2.2: Number of Credit Institutions and Branches



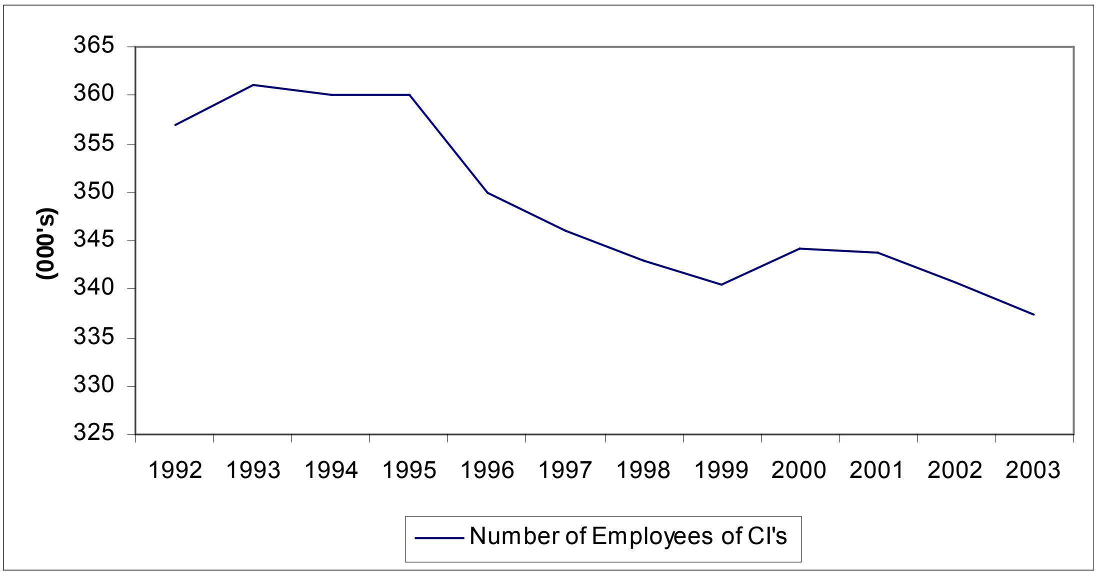
Source: OECD

2.9 The activity of the Italian banking sector is not very diverse. In 2000 there were four balance sheet components that were relatively underdeveloped for Italian banks compared with banks in the other euro area countries: *inter-bank activities, securities portfolio, loans to households and foreign assets*. The foreign assets to total assets ratio was 4.3 per cent, almost seven percentage points lower than the euro-area average.

Turnover, employment and profitability

2.10 Figure 2.3 illustrates employment in Italian banks.

Figure 2.3: Employment in Italian banks, 1992-2003 (000's)



Source: OECD

2.11 Employment in banking sharply increased at the end of the eighties and then declined from the mid nineties. Income increased from the first years of the 1980s and then fell in line with the decline in the number of employees. However from 1997 to 2000 profits rose sharply. This increase immediately followed the initial implementation of the FSAP and a few years after the beginning of privatisation.

2.12 This improvement in profitability can be attributed in part to privatisation which provided incentives to increase cost-efficiency, in part to the wave of mergers and acquisitions that provided opportunities for the exploitation of economies of scale and in part by the FSAP which gave added impetus to the process begun with the 1993 Banking Law, providing additional incentives and a more competitive framework for the newly privatised undertakings.

Mergers and acquisitions

2.13 Between 1990 and 2000 the Italian banking system experienced one of the fastest processes of consolidation in continental Europe. Since 1990, there have been 566 mergers and acquisitions involving banks accounting for almost 50 per cent of total assets. This activity has been fairly constant, apart for the very intense period between 1998 and 2000. Between 1993 and 2002 the number of banks declined by about one quarter, from 1,100 to more than 800, notwithstanding the entry in the market of more than 200 new intermediaries.

2.14 Mergers and acquisitions from 1995-2004 are shown in Table 2.3 below.

Table 2.3: Mergers and acquisitions

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**Total**
No of Banks	970	937	935	921	876	841	830	814	788	778	
of which mutual banks	619	591	583	563	531	499	474	461	445	439	
Mergers											
No of Transactions	47	37	24	28	36	34	31	18	20	10	**285**
of which mutual banks	28	25	12	19	23	23	21	16	14	7	**188**
*Assets**	1.57	0.47	0.8	2.65	0.39	1.51	0.08	0.06	0.2	0.04	**7.77**
of which mutual banks	0.1	0.05	0.05	0.09	0.06	0.09	0.06	0.05	0.05	0.02	**0.62**
Acquisition of majority control											
No of transactions	19	19	18	23	28	24	9	12	7	7	**166**
*Assets**	4.5	1.08	3.42	11.0	14.3	4.86	1.55	5.06	1.47	0.35	**47.6**

**Note: as a percentage of total system assets, Source: Bank of Italy*

Table 2.4: Mergers and acquisitions by purchaser

	2000	2001	2002	2003	2004	2005	2006*
Domestic	38	15	32	32	22	34	7
Internal EU	3	4	7	9	8	6	4

**First half, Source: ECB*

2.15 The result of this intense period of consolidation has been:

(a) A significant reduction in the *number of banks* operating in Italy. In one decade this reduction was more then 20 per cent (from 1000 to 800). However, this also reflects a change in the composition of the banks — the number of banks under the form of S.p.A. (i.e. Joint Stock Company) has increased, while popular and cooperatives banks (i.e. mutual) have decreased significantly. This is due to the changes in the legal framework brought about by privatisation and which involved changes in the legal definition of some institutions.

(b) At the same time the *number of branches* increased by 35 per cent during the period 1993-2002.

(c) The *market share* of the five largest groups increased from 34 to 54 per cent, a level comparable with the figures for France but higher than those for Germany.

(d) Although the branch networks of groups have increased in size, the number of groups has decreased. From 1994 to 2002 the number of banks operating as members of a group has almost doubled. See Table 2.5.

Table 2.5: Banks and groups (December 2002)

	No of groups	No of banks	% of Banks belonging to a group
1994	94	151	15
2002	78	231	28

Source: Cattolica di Milano - Centre of Economic Studies

Table 2.6: Top 5 Italian banks: assets, capital profits and market value,

Rank	Bank	Assets (€ bn)	Tier 1 capital (€ bn)	Pre-tax profit (€ bn)	Market value (€ bn)
1	**UniCredit**	787.0	28.8	4.1	61.1
2	**Banca Intesa**	273.5	15.1	4.2	31.1
3	**San Paolo IMI**	263.3	10.9	3.0	21.4
4	**Banca Monte dei paschi di Siena**	153.7	6.0	1.1	10.8
5	**Capitalia Gruppo Bancario**	134.1	5.6	1.5	15.9

Source: OECD

Market shares and concentration

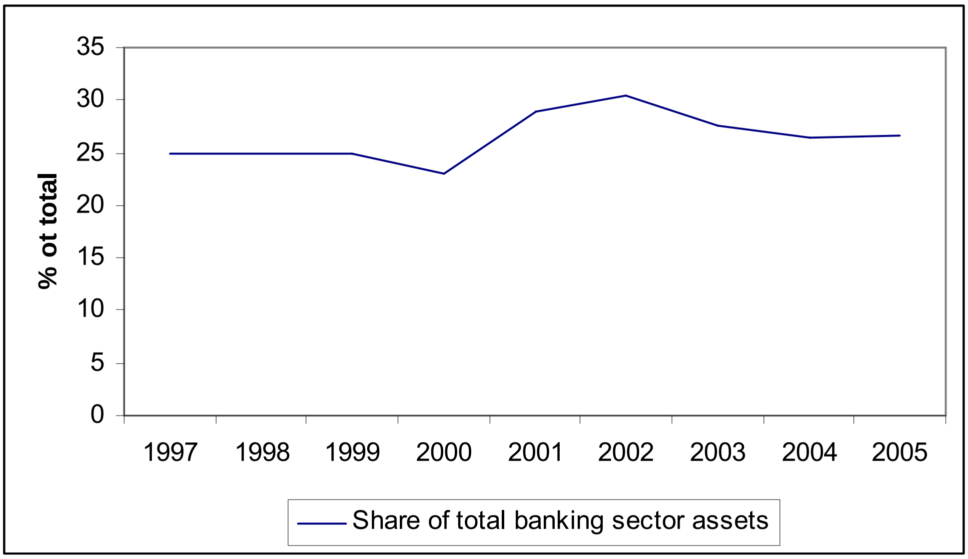
2.16 Figure 2.4 shows the evolution of the CR5 concentration index in the Italian banking sector since 1997. It emerges that the sector is not highly concentrated given that the largest five single institutions (as opposed to groups) represent now slightly more than 25 per cent of the market.

Table 2.7: Herfindahl-Hirschman Index[3]

1997	1998	1999	2000	2001	2002	2003	2004	2005
201	210	220	190	260	270	240	230	230

Source: ECB

Figure 2.4: CR5 Concentration in the Italian banking sector 1997-2005



Source: OECD, Europe Economics

2.17 This data needs to be interpreted with caution as in Italy banks are often part of a group. If the share of the largest groups rather than single banks is taken into account then the five biggest players have more than 50 per cent of the market, which is more comparable to other EU Member States.

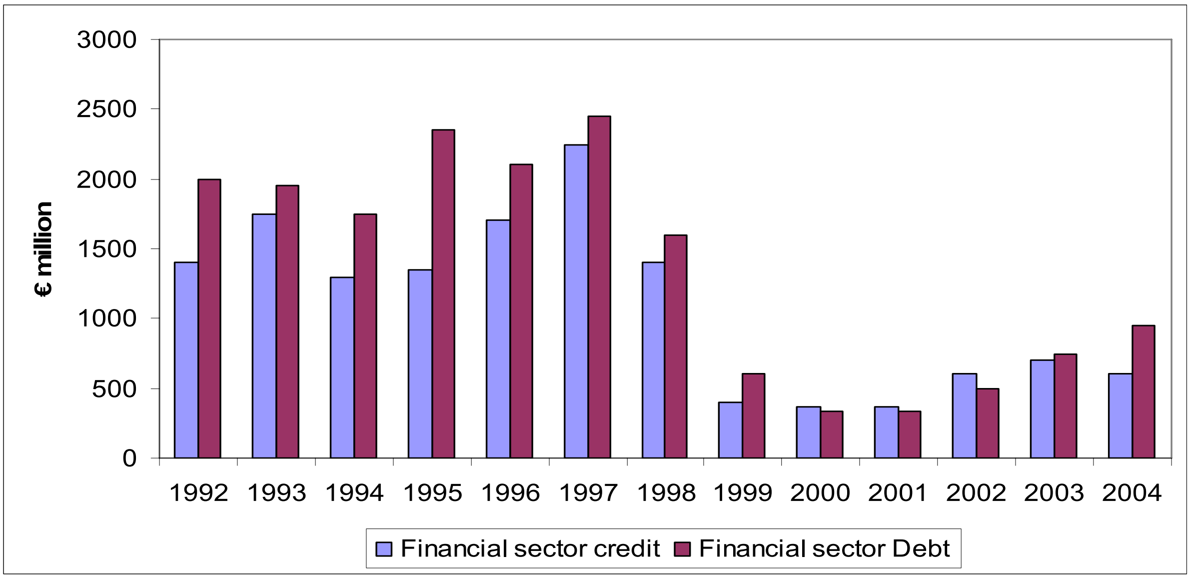
Trade and international penetration

2.18 The Italian banking sector has traditionally been closed to foreign competition and penetration. For example, the ex-governor of the Bank of Italy was viewed as against foreign ownership of Italian banks. This is, of course, inconsistent with the Community *acquis* and there has recently been heavy pressure from the European Commission for Italy to change its approach. In early 2006 the governor was forced to resign. He was accused of illegally preventing foreign banks from buying majority shares in Italian banks and of favouring the bids of Italian groups over those of foreign groups.

[3] The Herfindahl Index is defined in the Main Report.

2.19 Figure 2.5 gives total non-insurance financial services trade for 1993-2004.[4] Based on the data available, it appears that trade was very volatile, peaking in 1997 and then falling back. Trade in 2004 was some one third that in 1997, but more than one and a half times that of 1999.

Figure 2.5: Italian Trade in non-insurance financial services, 1992-2004

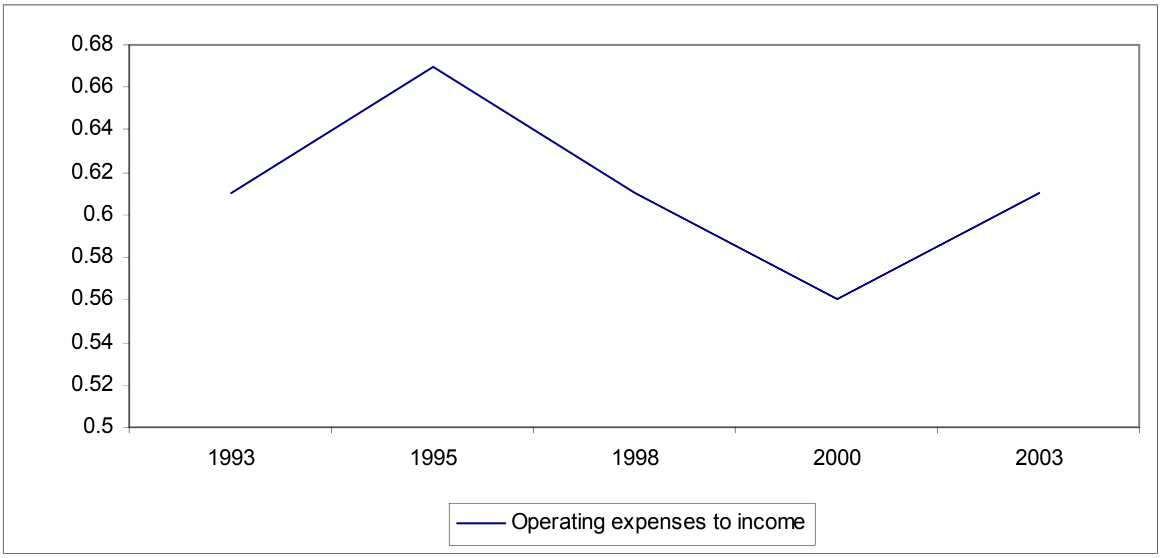


Source: Eurostat

Competitiveness

2.20 Figure 2.6 gives the cost to income ratio of Italian banks.

Figure 2.6: Cost to income ratio of Italian Banks



Source: OECD, Europe Economics. Note: above figure represents ratio not %.

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[4] This is defined as the sum of credits and debits, and covers wider services than just banking. Figures correspond to € millions.

2.21 The ratio remained fairly stable until the publication of the FSAP but fell sharply from 1997 to 2000. Over the last few years however it climbed back to its 1998 level.

2.22 The rapid increase in income in 1997 can be seen by looking at the return on equity data. The other measures of profitability are much less affected.

Factors specific to Italy

2.23 There are some specific factors that must be considered:

(a) **The prevalence of Universal banking** which allows for substantial economies of scope but also leads to vertical integration and to conflicts of interest.

(b) **The impact of privatisation** in determining the changes to banking law and structure.

(c) **Regional banks with an increasing number of branches.** Banks have a strong local presence (and sometimes regional overlapping) which often make cuts very difficult to achieve.

(d) **The importance of non-profit foundations (the Fondazioni[5])** among the largest shareholders in the largest Italian banks, a factor which is sometimes alleged to represent one of the greatest obstacles to consolidation. As non-profit entities, these foundations are not exposed to the pressure of market forces so that they may be a brake on improvements in productivity and allocative efficiency. On the other hand, it is sometimes argued that that they provide stability to the banks, allowing them to focus on long run projects, which might not happen if they were subject to take-over threats. Furthermore, by being linked to the regional economy where firms operate, they are important to ensure that SMEs receive the credit they need (because of lower asymmetries of information).

(e) **Cross shareholdings.** The ownership structure of Italy's major banking groups appears to be inefficient and confused with companies sharing control of each other. For instance Mediobanca has a stake in companies, principally Generali, the large Italian insurer, and is itself owned by other groups such as Capitalia and Unicredit.

Impact of the FSAP and FSWP Legislative Measures on the Italian Banking Sector

The effect of the FSAP on employment and wages

2.24 It is difficult to establish whether any particular change in the banking system has been the result of the implementation of FSAP regulations or whether it has been, more generally, the consequence of privatisation and globalisation policies. However it is reasonable to suppose that the process of modernisation of the Italian banking sector is likely to have been stimulated in part by Community action.

[5] Foundations are self-governed non-profit entities, entrusted with capital the proceeds of which can be used to fund projects of their own choice, within a range of public-interest activities, such as research, hospitals, public works, etc, stated in the law. They are required to relinquish control of the banks by 2006 and have been diversifying their investments. With a total net worth of about € 35 billion they are potentially a very significant institutional investor. For the sake of comparison, the total capitalization of non-bank companies quoted on the exchange is about 450 billion. And assuming an average yield of 5 per cent on their investments, they would have a spending capacity of nearly 2 billion, or about one tenth of the government deficit.

2.25 The number of employees in the banking sector declined from 1997 onwards. However the reduction in the number of employees has not been as dramatic as in other European countries. The reduction was about 10 per cent, while in Finland, for example, it was more than 30 per cent. This may have been due to persistent rigidities in employment law.

2.26 It can be argued that the wave of mergers and acquisitions constituted a market response, quite independent of political considerations, to the inadequacy of Italian banks within the European and international arena. The intensive re-organisation plans and earlier retirement strategies improved the operating efficiency of the banking system and reduced overstaffing. The total number of employees fell by 20,000 from 1995 to 2000.

2.27 However, it might also be argued that the consolidation of the Italian banking system was a response to the opportunity provided by FSAP regulations and that the mergers and acquisitions would not have been so easily achieved without Community facilitation. It is not unreasonable to conclude that the FSAP has been an important factor in reducing banking employment.

The effect of FSAP on consumer protection

2.28 According to the annual report of the Bank of Italy there were 72,230 complaints about the improper use of payment cards in 2004, an increase of 28.7 per cent over the previous year.

2.29 The Eurobarometer survey results for the 1999-2003 period show that Italy has been consistently (with Greece) one of the countries where consumers, on average, did not feel that they were adequately protected when using financial services. However, while in most Member States the number of people who felt adequately protected has tended to decline, in Italy there was a very small increase, suggesting that, at best, the FSAP might have had a small, slightly positive effect on consumer protection.

The effects of FSAP on competition

2.30 This section examines the effect of the FSAP on the supply side of the industry. We have seen previously that there has been a significant wave of mergers and acquisitions in the sector, so reducing the number of players, but that the number of branches has increased, so increasing local competition. In December 2004 there were about 31,000 branches in Italy, over 7,500 more than 1994. This is equivalent to some 5 branches per 10,000 inhabitants, which is in line with figures for the main euro-area countries. It is hard to see this as anything other than the general effect of wider globalisation and modernisation processes as well as of the application of the FSAP and the development of the internal market. In this respect, legislative and regulatory changes and new forms of supervision introduced during the nineties were decisive in lowering barriers, reducing market segmentation and integrating the Italian financial system into Europe.

2.31 This suggests that the FSAP has helped to improve the competitive framework of the Italian banking sector.

Switching costs

2.32 Authorities in Italy are still concerned that prices for basic banking systems are too high and hamper competition and contestability of the market. An investigation into this is being conducted by the Italian Competition Commission (AGCM). There are, nonetheless, signs of the possibility of a significant improvement

2.33 In Italy the average annual cost for banking services is one of the highest in Europe. There are also significant costs for customers in switching from one bank to another and these apparently inhibit competition and any consequent reduction in prices.

Table 2.8: Average cost for banking services

	2004	**2005**
Average cost for banking services (€)	247	252

Source: Adiconsum

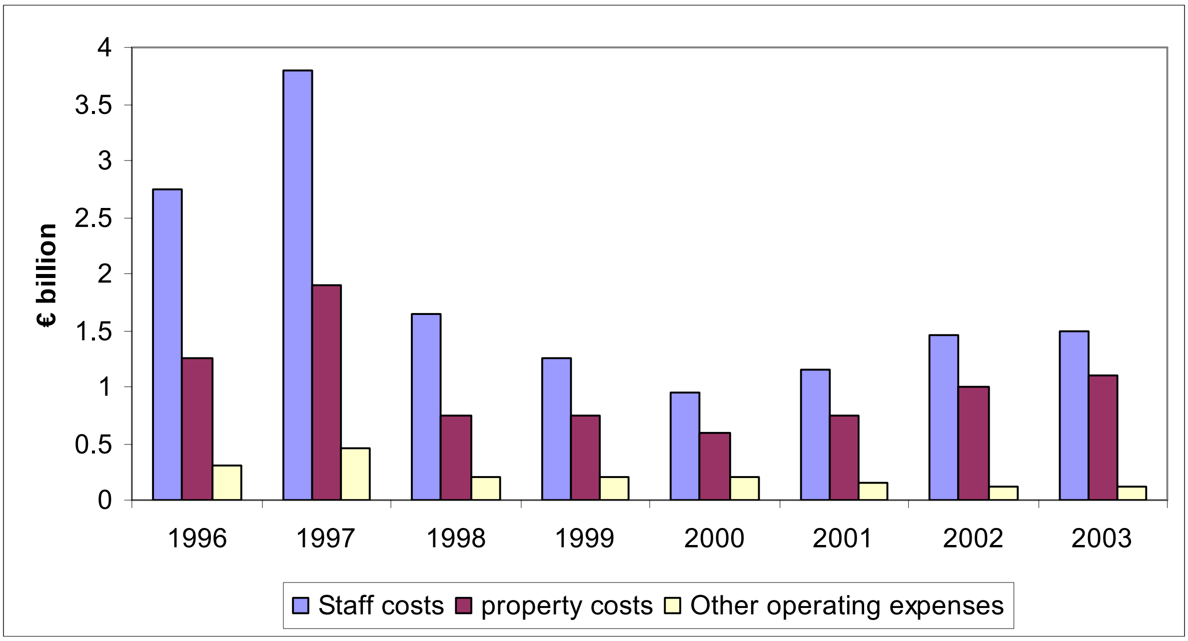
In addition to the financial cost of moving an account the importance of relationships in the financial system means that there are private costs in changing banks. Banks compete more on quality and ranges of products than on prices.

2.34 The recent Law 248/2006 has introduced some important modifications to the Banking Law (Law 385/1993): in particular, Law 248/2006 has established that customers have the right to close a current account without expenses or penalties. This reform may reduce switching costs and help foster competition within the Italian banking sector.

The effect of FSAP on market functioning and innovation

2.35 Figure 2.7 below shows that since 1997 the main cost categories steadily declined until 2001 but have slightly increased since this date.

Figure 2.7: Main cost categories

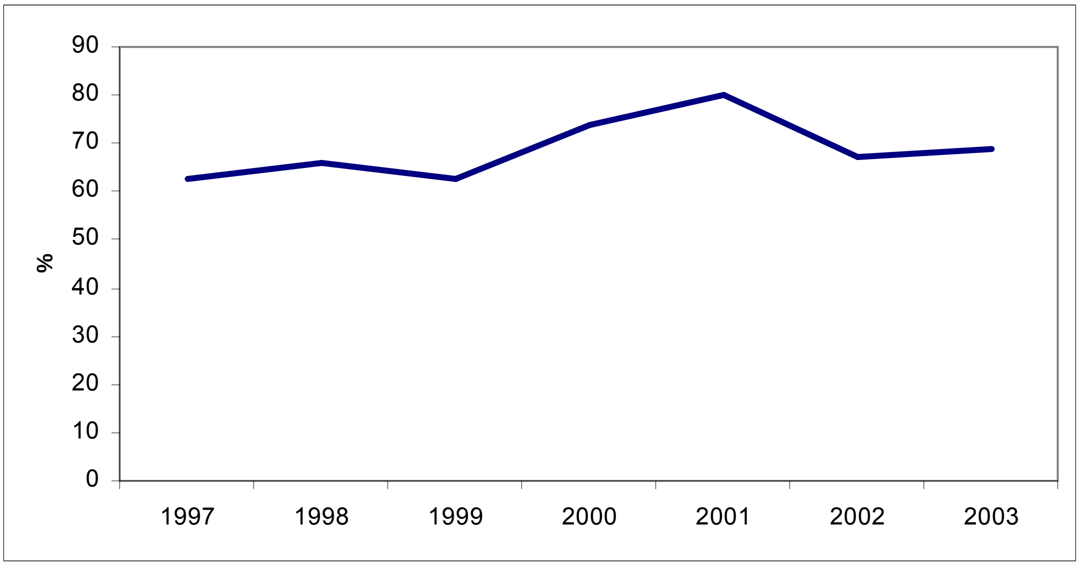


Source: OECD

2.36 We can also note that the relative importance of staff costs sharply declined: for instance, in 1997 staff costs were about twice as large as property costs, while in 2003 they were just about 50 per cent larger: this can be attributable both to the fall in employment and, perhaps, to a fall in the cost of labour.

2.37 Figure 2.8 below shows efficiency scores from data envelope analysis (DEA) — a mathematical technique commonly employed to measure the efficiency of firms and sectors — over the period 1997-2003. The figure shows a clear upward trend with a peak in 2001.

Figure 2.8: DEA efficiency scores (%)



Source: Berger and Humphrey, 2005.

2.38 Internet payments have increased in proportion to total payments in recent years, mainly because of on-line use of such traditional instruments as cards and credit transfers. On-line transactions using credit cards, the most commonly used instrument, accounted for 8.8 per cent of the total, an increase of 1.5 percentage points. Credit transfers ordered on-line rose by 8 million to over 23 million (5.7 per cent of all credit transfers). However, take up has been slow and in innovative sectors the incidence of on-line payments by means of pre-paid bank instruments and e-money decreased from 2.3 per cent in 2003 to 1.5 per cent in 2004. [6]

2.39 Table 2.9 below shows Italian charges for domestic transfers. These continue to present a disincentive for switching.

Table 2.9: Italian charges for domestic transfers

	Via Internet	Via bank	Via Tel.	Standing Payment Order	At branch with Current account	At branch for cash
Average	0.9	1.33	1.4	1.85	3.34	5.03
Max charge	4	3.6	5	5	5	10.33

Source: ABI

[6] Source: Bank of Italy annual reports.

2.40 Furthermore, while the rollout of new technologies would imply a move towards more cost-efficient delivery channels than the traditional bank branch, the success of various forms of remote banking has been rather mixed. Moreover, an intensified focus on the retail banking market has transformed branch networks into important sales outlets for a growing variety of financial services.

The effect of FSAP on competitiveness

2.41 Table 2.10 shows that the profitability of the sector (return on equity) increased up to 2001 and declined after this date.

Table 2.10: performance indicators of the banking sector (%)

Year	Net interest margin[a]	ROA[b]	ROE[c]
1992	3.3	0.7	9.8
1993	3.0	0.9	12.0
1994	2.7	0.3	4.3
1995	2.9	0.4	5.9
1996	2.8	0.6	8.0
1997	2.4	0.4	5.5
1998	2.3	0.9	13.2
1999	2.3	1.0	13.9
2000	2.4	1.3	17.6
2001	2.6	1.0	14.0
2002	2.4	0.8	10.9
2003	2.2	0.7	10.0

a: Net interest margin — net interest income to average total assets.

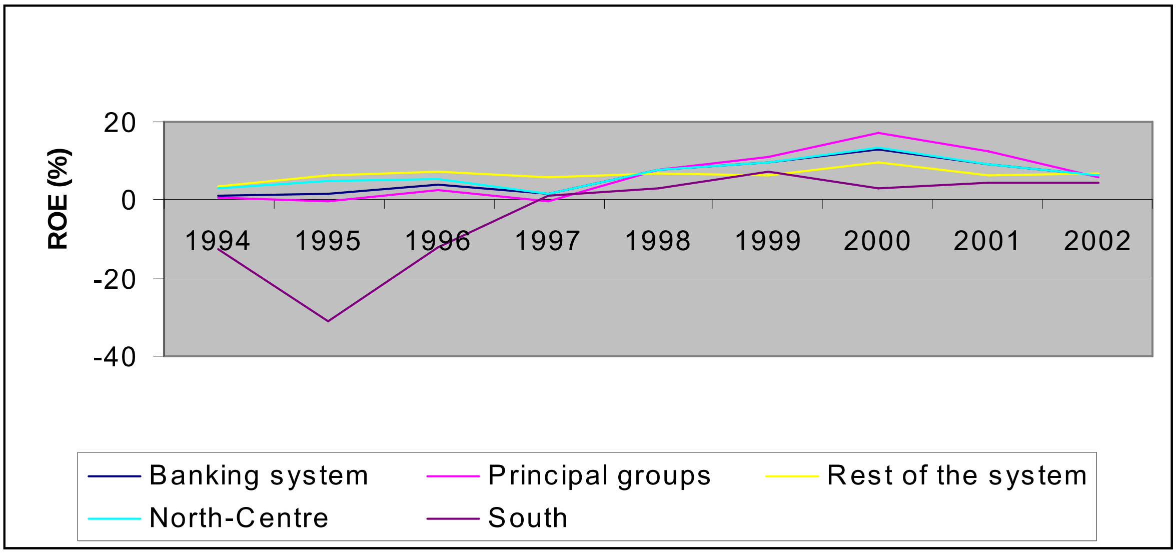
b: ROA — net income before tax to average total assets.

c: ROE — net income before tax to average capital and reserves.

Source: Europe Economics calculation of data from OECD (2005) "Bank profitability"

2.42 Figure 2.9 illustrates the general pattern amongst market segments apart from those in the South of Italy, where profitability continued to rise after mid 2000, albeit at a low level.

Figure 2.9: Return on Equity 1994-2002



Source: Bank of Italy

2.43 These data, coupled with the significant reductions in costs (at least until 2001) would seem to suggest that FSAP had a positive impact on competitiveness.

Effects of FSAP on cross-border trade

2.44 Our econometric study suggests that the impact of the FSAP on trade has been a rise of 1.1 per cent in imports of financial services other than insurance and pensions, and a rise of 1.4 per cent in exports. Full implementation of the FSAP and FSWP legislative measures is projected to lead to a further 1.1 per cent rise in imports and 2.3 per cent in exports.[7]

The effect of FSAP on banking sector trade

2.45 From Table 2.11 below we can see that whilst Italy has become more 'open' relative to other EU Member States, this has not been reflected in higher penetration (by non Italian companies) or greater relative internationalisation of the sector. This may well reflect the protectionist policies pursued by the Italian administration at a time when other EU Member States, partly as a consequence of the FSAP, are opening their markets.

2.46 However, the very recent evolution of the ABN-Amro and BBVA's cases might suggest that, finally, the FSAP measures might be displaying a positive effect in opening the market to foreign firms.

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7 Note that these effects are additional to any associated with membership of the EU or other global or domestic trends towards openness.

Table 2.11: Level of internationalization of Italy compared with EU countries

	2001	2002	2003
Openness	51	48	52
Penetration	38	36	29
Internationalization	89	84	81

Source: BCE

2.47 However, at the same time Italian banks have established presence in New Member States and Candidate countries as shown in Table 2.12 below:

Table 2.12: Presence of foreign banks in selected Eastern European countries

	New EU Members							EU Candidates	
	Czech Republic	**Hungary**	**Poland**	**Slovenia**	**Slovak Republic**	**Romania**	**Bulgaria**	**Croatia**	**Turkey**
Number of banks, Of which	35	36	60	22	21	33	34	41	50
Foreign controlled, of which	23	27	45	5	17	23	23	11	12
Italian controlled	1	2	1	1	2	2	1	8	1
Total Assets (€ billions)	79.5	54.4	105.4	21.6	23.8	15.0	6.3	27.5	136
Share held by foreign controlled banks	86.1	74.4	55.1	12.7	73.1	53.6	52	43.4	2.8
Share held by Italian controlled banks	1.9	8.9	12.7	6.0	23.2	1.4	23	47.6	5.2

Source: ECB, National Central Banks and Supervision Authorities

Conclusions

2.48 In this section we have seen that the Italian banking sector has undergone some of the changes which are to be expected from the FSAP process. For example, there has been a significant wave of mergers and acquisitions and before 2001 at least there was a trend for greater efficiency in the sector.

2.49 However, we can also see that national protectionist policies and the remaining lack of financial development in Italy have constrained the potential benefits of greater integration. The banking sector remains disproportionately populated by small banks offering relationship based services for their customers.

2.50 Despite apparent compliance with the Community framework, the legal framework in practice is still less well established than in some other EU Member States and corporate governance remains sub optimal. More purely cultural practices may impair uptake of financial services products such as mortgages and inhibit the development of new financial services products.

2.51 In this respect it is clear that the most important impacts of the FSAP process remain to be felt in the Italian banking sector.

3 INSURANCE

Headline Overview

3.1 The Italian insurance market is the sixth largest in the world.

3.2 Life insurance accounts for about 65 percent of the premiums, compared to the EU average of 70 percent. The total assets of the insurance companies amount to 34.6 percent of GDP in 2004 (27.3 percent life and 7.3 percent non-life).

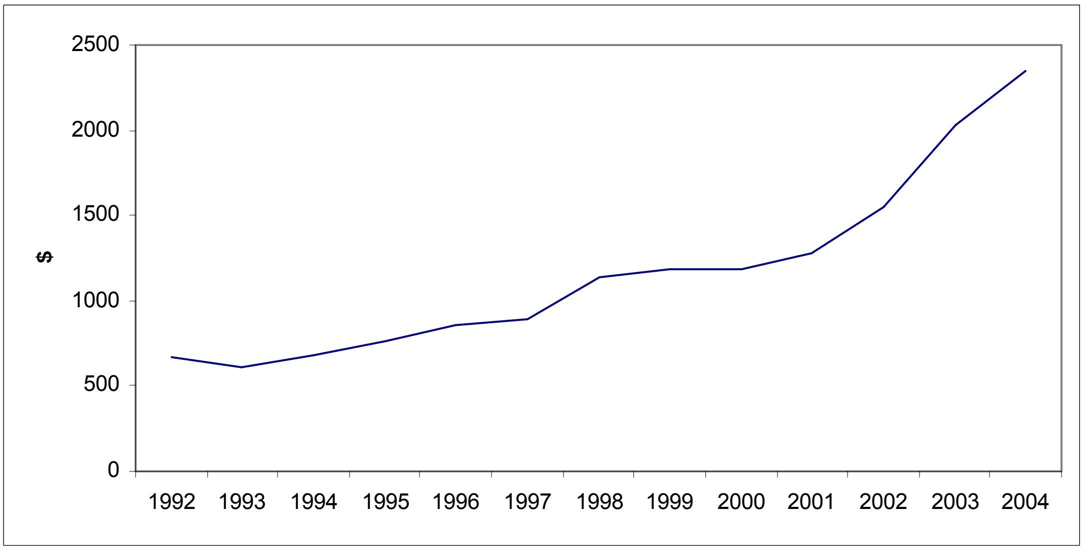
3.3 Market penetration is low, with gross domestic premium income accounting for 7.6 per cent of GDP in 2004, compared to the EU average of close to 9 percent.

Table 3.1: Insurance Density - Italy

Year	Premiums per capita in $	Premiums as percentage of GDP
2000	1084.3	5.80
2001	1186.4	6.27
2002	1435.1	6.97
2003	1913.1	7.45
2004	2217.9	7.60

Source: Swiss Re

Figure 3.1: Premiums per capita ($ per capita)



Source: OECD

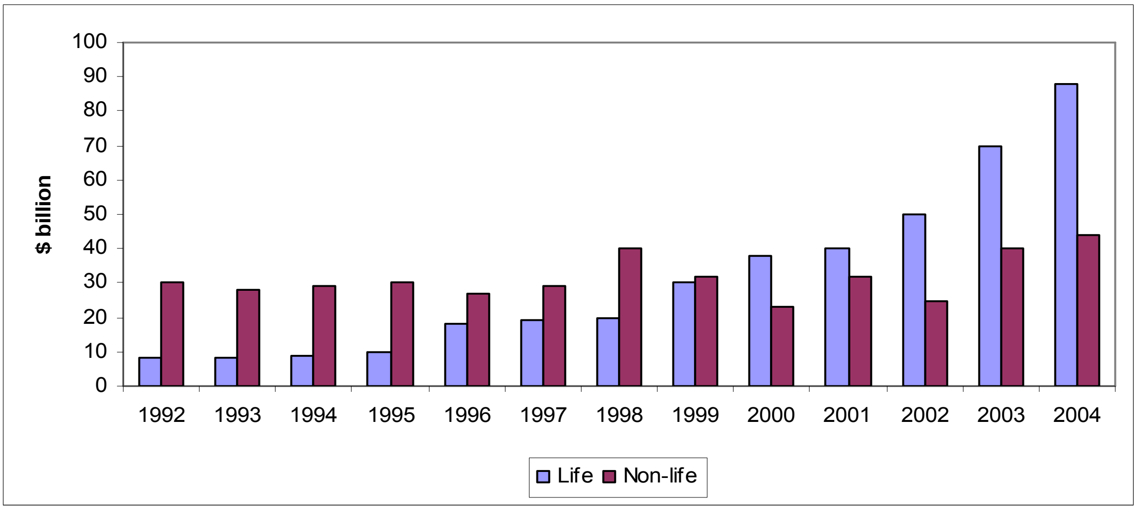
3.4 Banks and post offices are the predominant life insurance distribution channel, accounting for 59 percent of sales in 2004. The agency distribution channel also remains important, accounting for about 30 percent of life insurance sales and 88 percent of non-life insurance sales in 2004. Financial advisers account for most of the remaining life insurance sales, with brokers handling the balance of the non-life sales, focusing on the medium to large commercial risks.

3.5 Life insurance products are predominantly savings-oriented, and include traditional and unit-linked policies. The products sometimes incorporate guaranteed rates of return, but the exposure of insurers to the risks of such guarantees does not appear excessive. In terms of asset mix, the insurance sector invests 12 percent of its assets in equities, 30 percent in unit trusts, 57 percent in fixed-income products, and 1 percent in real estate.

Growth in the market

3.6 Figure 3.2 gives the development of life and non-life insurance gross premiums in Italy from 1983 to 2004. From this we can see overall a steady and accelerating rate of growth in gross premiums.

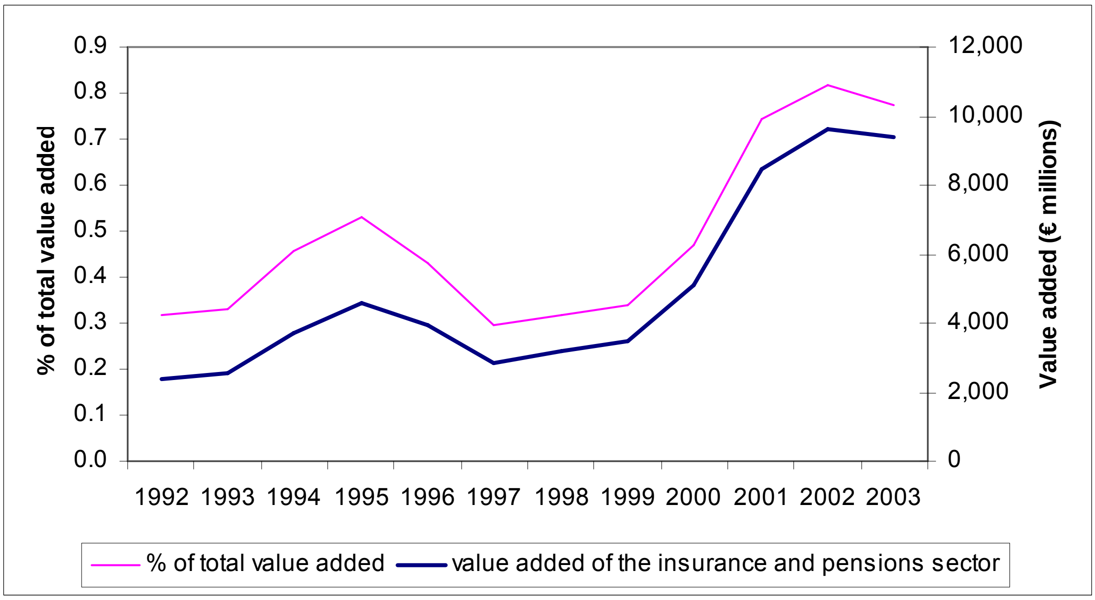
Figure 3.2: Insurance gross premiums in Italy 1992– 2004



Source: OECD

3.7 It can also be seen that the growth in life premiums has been consistent over this period. These have experienced strong growth after a fall in premiums in the early 1990s. Growth in non-life premiums has been much less consistent over the same period.

Figure 3.3: Value added of Italian insurance



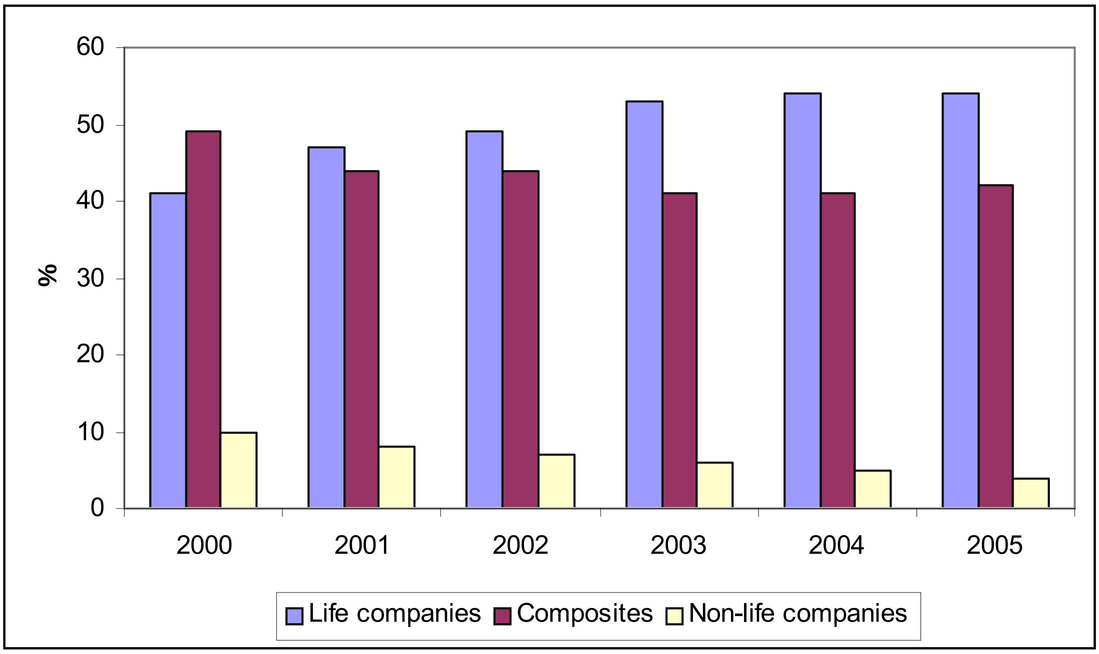
Source: University of Groningen

3.8 The above figure sets out value added. As can be seen, value added was growing slowly up to the end of the 1990s accelerated sharply afterwards up to 2001 but subsequently declined.

Structure of the market

3.9 The Italian market is currently dominated by a relatively small number of large insurance groups. The groups include *Generali*, *Fondiaria-SAI*, *Unipol* and *RAS*, each of which serves the Italian life and non-life sectors via nationwide agency networks. We can see from Figure 3.4 that life companies have gradually been increasing their share of total assets.

Figure 3.4: Insurance corporations in terms of assets (by % share of total)



Source: ANIA

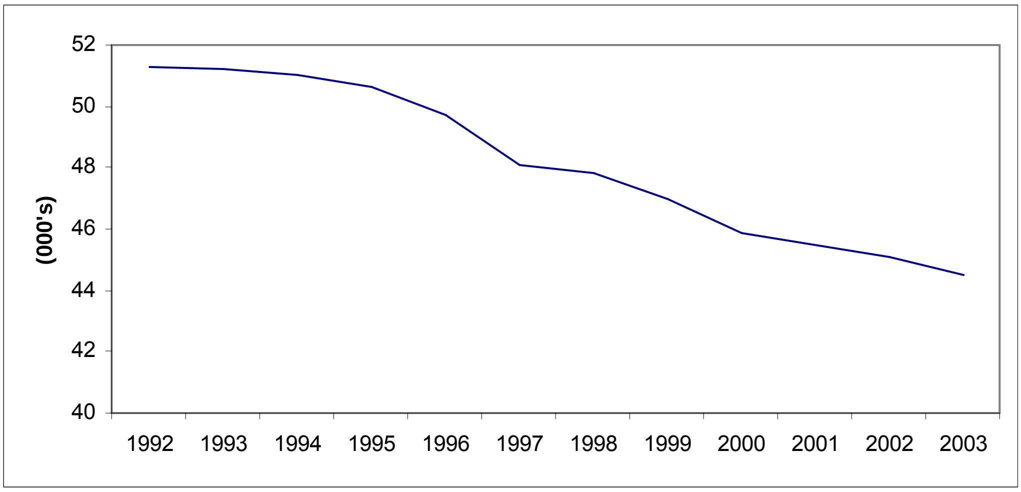
Mergers and acquisitions

3.10 As for the banking sector, the insurance market has experienced a wave of consolidation over the period considered thanks to privatization and the drive by companies to achieve economies of scale.

Employment

3.11 Employment in the insurance sector peaked in 1993 at just over 50,000 workers and had declined by over 5000 workers by 2003. This is shown in Figure 3.5 below.

Figure 3.5: Employment in the insurance sector (000's)

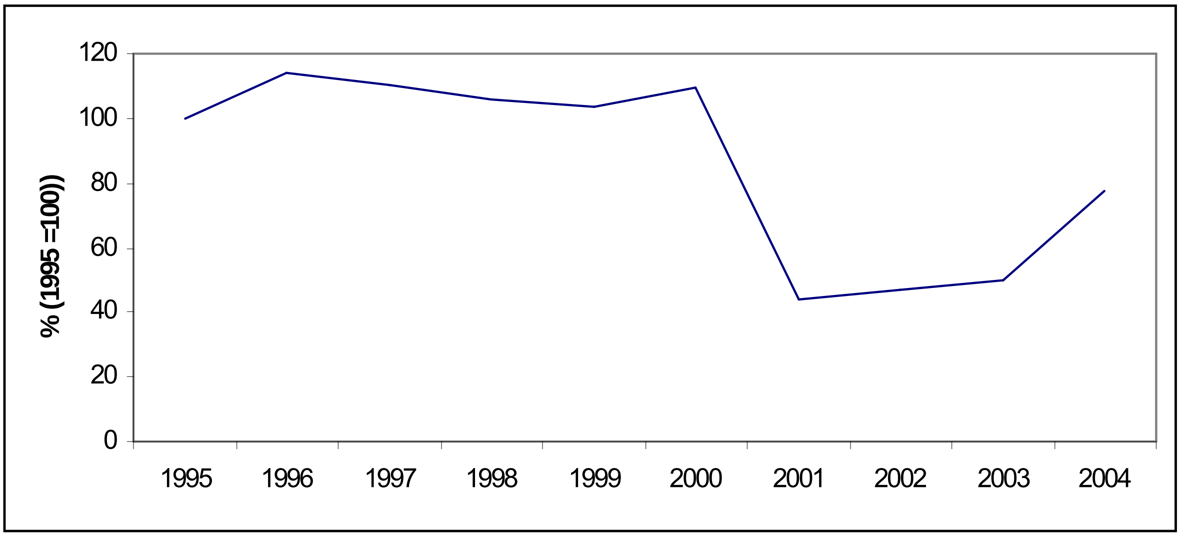


Source: University of Groningen

International Entry

3.12 Figure 3.6 shows the gross premiums of 'foreign undertakings' in Italy. The degree of foreign penetration fell somewhat from 2000 but has been on the increase again from 2001.

Figure 3.6: Gross premiums of branches/agencies of foreign undertakings as % of total domestic business



Source: OECD[8]

[8] The OECD has no observations for foreign penetration on the basis of market share of (foreign controlled undertakings) and (branches/agencies of foreign undertakings as a % of total domestic business.

3.13 Foreign life insurance companies account for a consistent part of the market of premiums written. The trend is upwards but not at the same pace as in other EU countries. However, given the high starting level, this is not surprising.

Competitiveness

3.14 Figure 3.7 gives data on labour productivity (measured as value added over total employment) in insurance and pensions from 1992 to 2003.

Figure 3.7: Labour productivity per worker in the insurance and pension sector (1995=100)

Source: University of Groningen

3.15 We can see from this figure that although there has been considerable volatility in labour productivity there has also bee a clear upward trend over this period (driven by the increase in value added and the fall in employment).

Competition issues

3.16 The recent Law 248/2006 has introduced some provisions aimed at increasing the degree of competition in one particular segment of the insurance sector, car insurance. In particular, Law 248/2006 has established that insurance companies and their agents are forbidden to enter into selective distribution agreements in relation to compulsory car insurance: in other words, agents may sell to motorists compulsory insurance policies of different insurance companies. Furthermore, any agreement aimed at imposing the minimum retail price on the agent or the maximum discount on compulsory car insurance instruments to consumers have been made illegal by Law 248/2006, article 8.

Factors Specific to Italian Insurance Market

3.17 There are some specific factors that must be considered:

(a) **Disproportional structure of the welfare system** that limits the distribution of market coverage as regards Healthcare. The demand for private health insurance is very limited (only 1% of the total healthcare expenditure). However, change in the structure of Italian households has modified this demand (between 1991 and 2002 it increased from 0.9 million to 1.6 million) especially in Central and Northern Italy.

(b) A number of **segments are underdeveloped**: environmental liability; health (given the presence of national health system 30% are paid for privately); long term care and others.

(c) **Insurance fraud is widely believed to be a widespread phenomenon** in Italy, especially in the South. Although we emphasize that it was not within the scope of this study to consider whether this perception is true, its impact on market confidence is potentially relevant.

(d) **Banking and insurance activities are merging.** Bancassurances has become more pre-eminent only in the past decade. Joint ventures between banks and insurers have been successful especially in life insurance.

Impact of the FSAP and FSWP Legislative Measures on the Italian Insurance Sector

Level of implementation

3.18 The results of the survey suggest that FSAP measures in the insurance sector have been mostly implemented in Italy. Market participants have generally adapted to the new provisions.

3.19 The Italian regime was essentially in line with international principles and rules even before the FSAP. However, as a result of the FSAP significant improvements have been registered in the areas covered by the relevant measures. Moreover the Italian Insurance Supervision Authority (ISVAP) has issued guidelines in the areas of corporate governance, internal control and risk management and reinsurance.

3.20 Italian insurers are also starting to prepare for Solvency II although the detailed provisions are not yet known.

3.21 All in all, it is reasonable to conclude that the impact of the FSAP on the Italian insurance sector has been significant.

Assessment by category

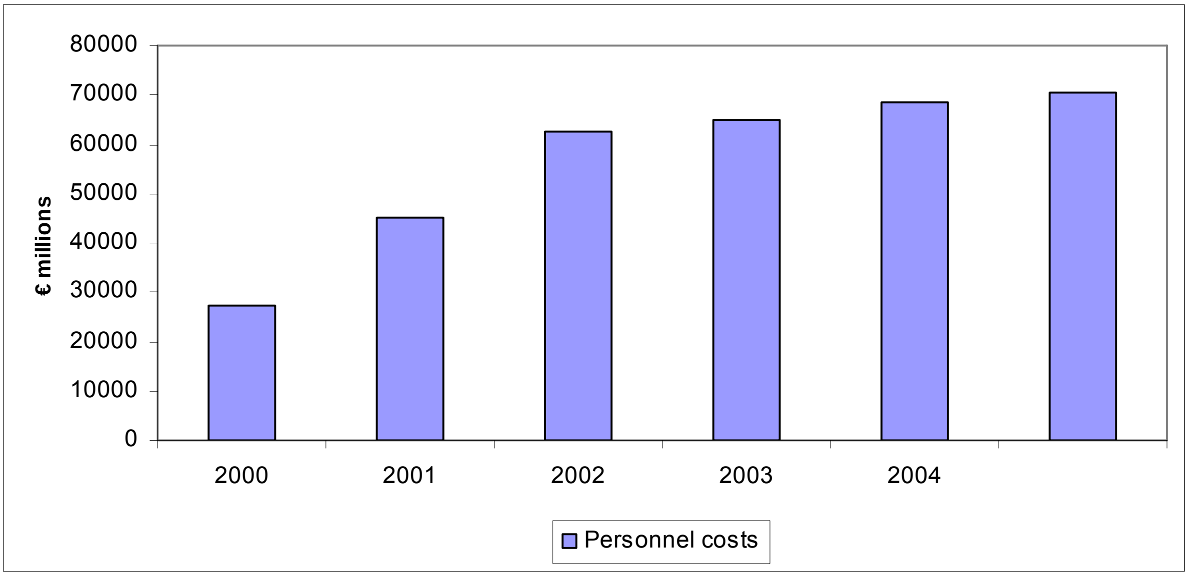
The effects of the FSAP on employment and wages

3.22 Figure 3.5 in the previous paragraphs showed that employment in the insurance sector has declined since the late 1990s. Stakeholders who participated in the survey do not attribute any effect to the FSAP: other factors have had a prevalent effect.

3.23 Therefore, even if the data did show a reduction in employment following the implementation of the FSAP, stakeholders do not attribute an important role to the FSAP in determining the employment dynamics of the sector. It seems difficult to conclude that the FSAP had any impact at all on employment in this sector, although if there was one, that was probably negative.

3.24 Labour productivity has increased since the introduction of the FSAP. However we can see from Figure 3.8 below that in practice the level of personnel costs for Italian insurance companies has risen in recent years. Whether the increase is attributable to the FSAP is difficult to say. Survey respondents believe that the impact has been negligible.

Figure 3.8: Personnel costs



Source: ANIA trends

Effects of the FSAP on Market entry, competition, cross-border business and takeovers

3.25 Although the long Italian participation in the European market (and consequent absorption of pre-FSAP insurance-related directives) may already have created scope for greater foreign entry, it seems plausible that an EU-wide greater tendency to engage in cross-border business, not unrelated to the FSAP, may have been a factor. This result is confirmed by the stakeholders who participated in the survey.

3.26 The expectation expressed in our survey is that the rise in foreign business will continue into the future. Stakeholders tended to believe that the FSAP may have had a small positive effect.

3.27 The increase in mergers is also attributed by stakeholders to the FSAP.

3.28 The data as well as stakeholders' views seem to indicate that FSAP has had a positive impact on the openness of the market to foreign firms which, in turn can be expected to be the cause of a higher degree of competition in the sector.

The effects of FSAP on competitiveness

3.29 In practice it is difficult to disentangle FSAP effects from the consolidation process in the Italian financial sector or from the financial markets boom-and-bust of the late 1990s and early 2000s.

3.30 Stakeholders do not have a common view on the past and future development of insurer efficiency but it is likely that the consolidation process will lead to improvements in this sector in Italy.

3.31 It is likely that the FSAP had a small but positive effect by contributing to speed up the process.

3.32 Respondents to our survey did not perceive any increased vulnerability of Italian firms to foreign takeovers. Nonetheless the availability of skilled personnel, access to international markets, the tax system, and the level of operational costs will be important factor in determining success in dealing with international competition.

3.33 However, the FSAP has helped Italian insurance companies by reducing their regulatory burden and it is likely that in the long run Italy will benefit from the access to the wider international market facilitated by the FSAP.

Effect of the FSAP on product variety, e-commerce, and prices

3.34 Stakeholders believe that the variety of relevant products available on the insurance markets in Italy has increased in recent years but they do not have a common view on what will happen in the future. Whilst it is believed that the FSAP has played a primary role in the determination of the past trends no further effects of the FSAP are predicted here.

3.35 A similar pattern emerges with regards to e-commerce of insurance products: this trade has increased and this is regarded as having been stimulated by the FSAP but no further effects of the FSAP are predicted.

3.36 The enhanced competition should in principle lead to a decrease of prices.

3.37 However, according to stakeholders due to particular situations in motor third party liability, which predate the FSAP, prices increased in this sector. The antitrust authority intervened in 2003 to ensure that a cartel was not formed.

3.38 Overall, it seems that insurance companies are improving their efficiency, reducing their operational costs and improving the productivity of their labour, but there is concern that they are not passing the improvements to consumers.

The effect of FSAP on consumer protection

3.39 In recent years the Italian regulator has turned its attention to encouraging policies of greater disclosure and information among consumers, especially with regard to the management of disputes and the setting up of a complaints register within undertakings. ISVAP, the regulator of private insurance companies, took decisive action to enhance transparency in the insurance sector to the benefit of users.

3.40 In October 2004 ISVAP obliged insurance companies to publish on their websites information relating to policy conditions, the information note, the current price of fund units (unit-linked policies) and of assets (index-linked policies) as well as the territorial structure and location of the distribution network with agents' names.

3.41 In the first nine months of application of such provisions undertakings received about 50,000 complaints which, in nearly half of the cases, have been satisfactorily resolved.

3.42 Survey participants provided additional information on the effects: the degree of understanding of insurance products increased slightly and is predicted to increase more thanks to the FSAP.

3.43 Stakeholders do not have a common view on the pattern followed by complaints and on the effects of the FSAP on this issue. Finally, switching became easier in recent years and is predicted to become even easier but there are no effects attributed to the FSAP.

3.44 Overall the impact of FSAP on consumer protection appears to have been positive.

Conclusions

3.45 More than six years after the transposition into Italian law of the EC Directives aiming at the liberalization of the insurance industry, progress made in introducing competition has been fairly modest, especially for the motor vehicle segment of the market. Gains generally expected from the process of liberalization, notably improved service quality and a lowering of tariffs, have not yet materialized.

3.46 However, in other respects the FSAP has had positive effects; in, for example, establishing increased regulatory and legal certainty and in reducing the burden of earlier regulation.

4 SECURITIES

The Italian Securities Market

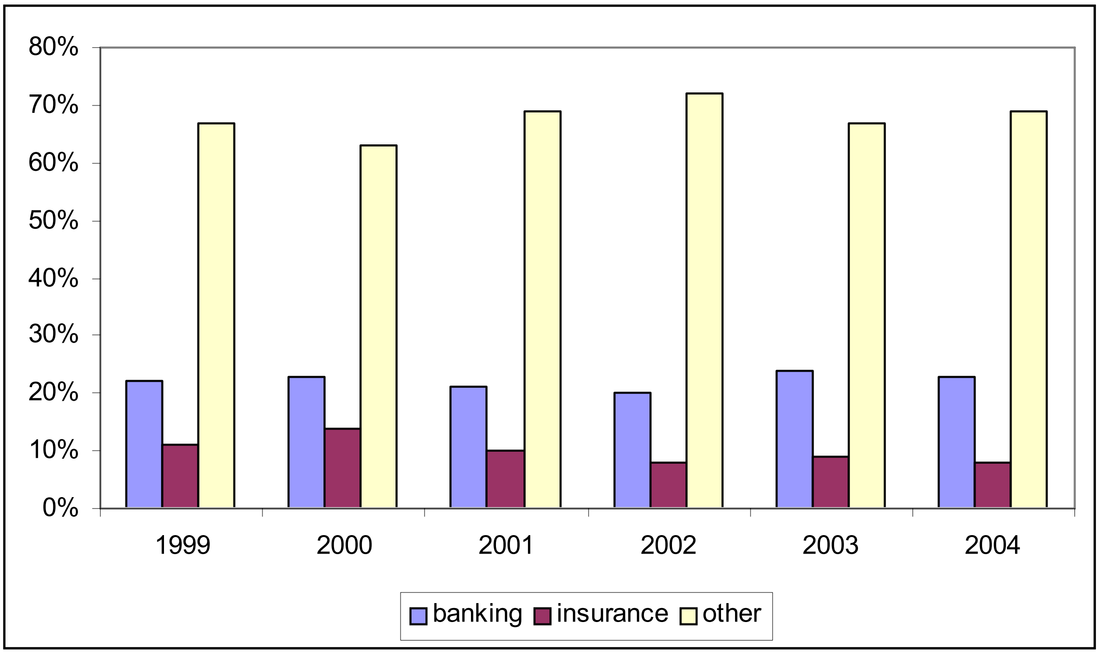
Headline overview

4.1 Ownership of all the markets for the trading of corporate and government securities was privatized between 1996 and 1999, after nearly half a century during which the markets were set up, managed and supervised within the framework of public law.

4.2 The Italian Stock Exchange, *Borsa Italiana*, is the joint-stock company responsible for organizing and managing the Italian Stock Exchange, and was created in 1997 after the privatization of the stock exchange and has been operational since January 1998.

4.3 Figure 4.1 below gives a breakdown by sector of the shares traded on the Italian Stock Exchange.

Figure 4.1: Sectoral shares of equities traded on the Italian Stock Exchange



Source: Bank of Italy

4.4 *Borsa Italiana* is responsible for:

(a) defining and organizing the operation of the markets;

(b) defining the requirements and procedures for issuing companies and brokers to be admitted to the markets;

(c) overseeing and managing the market; and

(d) managing the central computer system.

4.5 *Borsa Italiana* also carries out other organizational, commercial and promotional activities aimed at developing value-added services for the financial community. The primary objective of the Italian bourse is to ensure the development of the equity, bond and derivative markets, maximizing their liquidity, transparency and competitiveness while at the same time seeking to achieve high levels of efficiency and profitability.

4.6 *Borsa Italiana* manages the regulated markets, which include the equities market, fixed income markets, and derivatives markets. All markets, regulated by the Bank of Italy, have a disaster recovery plan, which is tested annually.

4.7 Stock exchange activity is regulated by Italian law and monitored by the *Commissione Nazionale per le Società e la Borsa* (CONSOB), which is similar to the Securities Exchange Commission in the United States. CONSOB regulates the admission of corporate debt issues to the official listed markets.

4.8 The major owners of the stock exchange include banks and credit institutions (80 percent), listed companies (seven percent) and brokerage houses (six percent). Instruments traded on the Italian Market include equities, government bonds, corporate bonds and Euro bonds.

4.9 There are two Guarantee Funds in the Italian market: the Settlement Guarantee Fund and the Trading Guarantee Fund. Foreign investors are able to access either fund, if they are direct participants in the market.

4.10 The Italian Stock Exchange manages 3 regulated equity markets (MTA, Mercato Expandi and MTAX which replaced the segment previously known as Nuovo Mercato), one market for funds (MTF), a derivative market (IDEM), a securitized derivatives market (SeDex) and two fixed income markets (MOT for government securities and corporate bonds and EUROMOT, for Eurobonds and Asset Backed securities).

4.11 MTS manages the government bonds wholesale market (MTS) and a multi-dealer to client internet-based government bond wholesale market (Bondivision).

4.12 The first European electronic market for government bonds, founded in 1988 and privatized in 1997, was the MTS *S.p.A.* (MTS) The Bank of Italy and the *Borsa* CONSOBs regulate the MTS. MTS provides wholesale electronic markets for Italian government bonds, asset-backed securities and quasigovernment bonds (all major Euro denominated EIB issues and eurobonds issued by the Republic of Italy).

4.13 TLX manages the TLX market where corporate bonds, Italian and EU government bonds and funds and equity linked securities are traded. Both the central depository (Monte Titoli) and the clearing house (Cassa di Compesazione e Garanzia SpA) are mostly owned by the Italian Stock Exchange.

4.14 Domestic, EU and non EU investment firms and banks can be admitted directly to trading in the markets operated by Borsa Italiana on their own or on their customers' account, provided that they are authorised intermediaries as required by the Consolidated Law on Finance.

4.15 'Locals', foreign intermediaries dealing only for their own account and 'Agenti di cambio', Italian intermediaries dealing only for customers' account, can also apply for membership. Non Italian resident Institutions may access the market directly or through an Italian based branch.

4.16 All participants have to fulfil organisational and technical requirements and demonstrate their ability to settle and clear their contracts, directly or through a settlement/clearing agent. All requirements apply both for the initial admission to trading of intermediaries and for their continued eligibility. Applicants may decide to apply for all the markets operated by Borsa Italiana at the same time, submitting one single application, or to apply separately for each single market.

4.17 In order to satisfy the organisational and professional requirements required for admission to trading on the markets, intermediaries must comply with the provisions set up in the "Criteria for admission of intermediaries to the markets", approved by Borsa Italiana's Board of Directors.

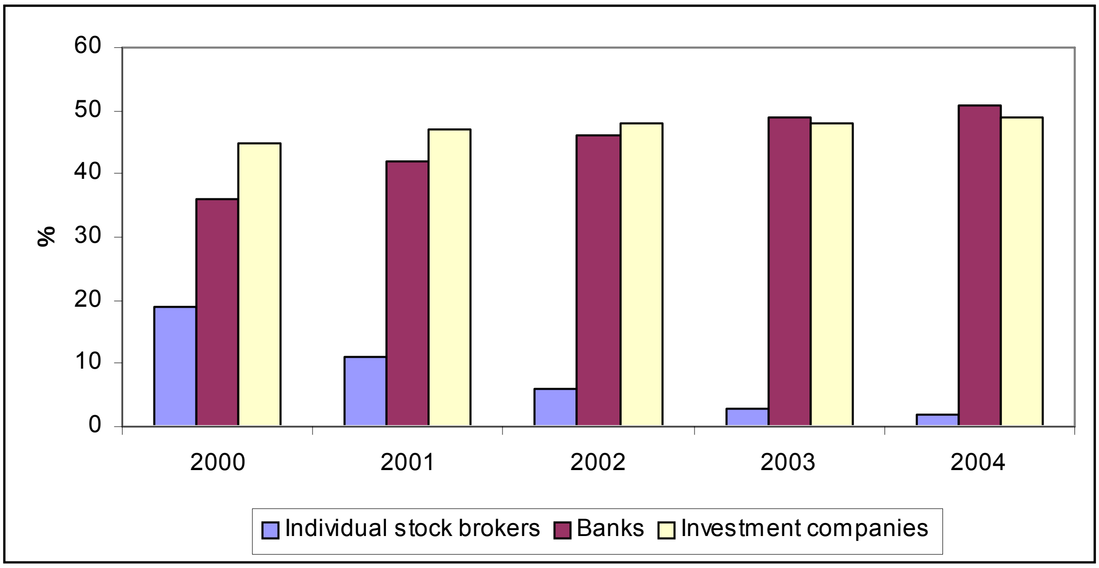
Table 4.1: Breakdown of the number of authorized intermediaries

	2000		**2001**		**2002**		**2003**		**2004**	
	No	**%**	**No**	**%**	**No**	**%**	**No**	**%**	**No**	**%**
Individual stock brokers	27	17.8	18	11.5	9	6.4	5	3.9	4	3.1
Banks	57	37.5	70	44.6	70	46.8	65	50.8	66	51.6
of which foreign international clients	7	4.6	12	7.6	12	9.9	17	13.3	17	13.3
Investment companies	67	44.1	67	42.7	67	45.4	57	44.5	56	43.8
of which foreign international clients	8	5.3	9	5.7	9	9.9	17	13.3	21	16.4
Locals	1	0.7	2	1.3	2	1.4	1	0.8	2	1.6
of which foreign international clients	1	0.7	2	1.3	2	1.4	1	0.8	2	1.6
Total	**152**		**157**		**148**		**128**		**128**	
Total Foreign	**16**	10.6	**23**	14.6	**23**	21.2	**35**	27.4	**40**	31.3

Source: Borsa d'Italia

4.18 Table 4.2 shows the breakdown of intermediaries by type. From this it is clear that banks are the most represented category. The number of investment firms has dropped, while that of local firms has increased.

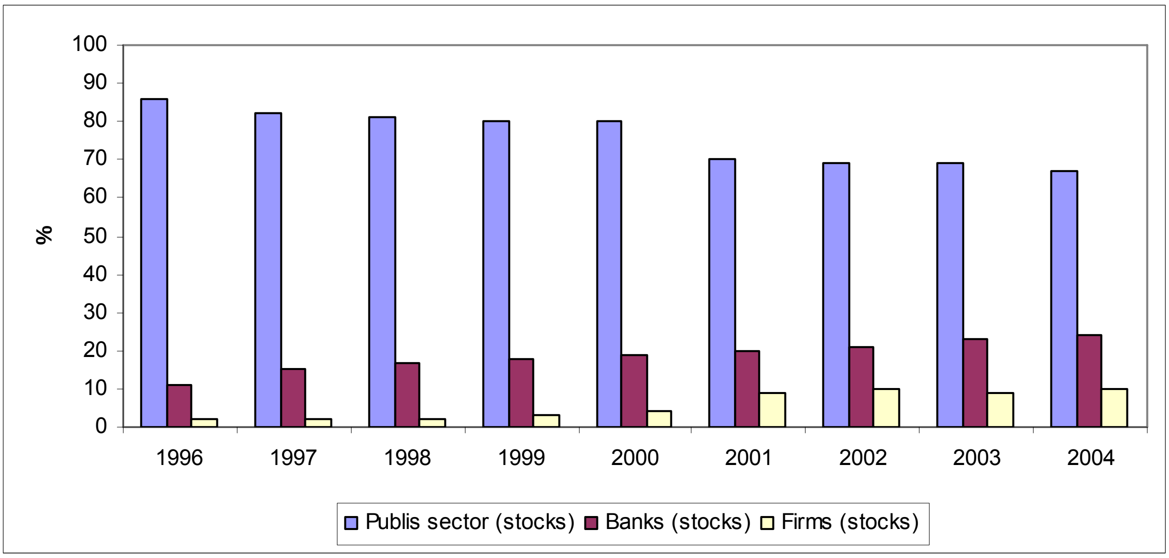
Figure 4.2: Breakdown of Intermediaries by type: 2001-2004



Source: Bank of Italy

4.19 Italy's securitization market has grown rapidly. By 2004 bank loan securitization amounted to € 24 billion related to the NPL. It appears that since 2002 securitization transactions increasingly reflect funding purposes, as well as balance sheet and risk management objectives, suggesting that the market has further matured.

Figure 4.3: Percentage composition trends of bonds and public sector securities

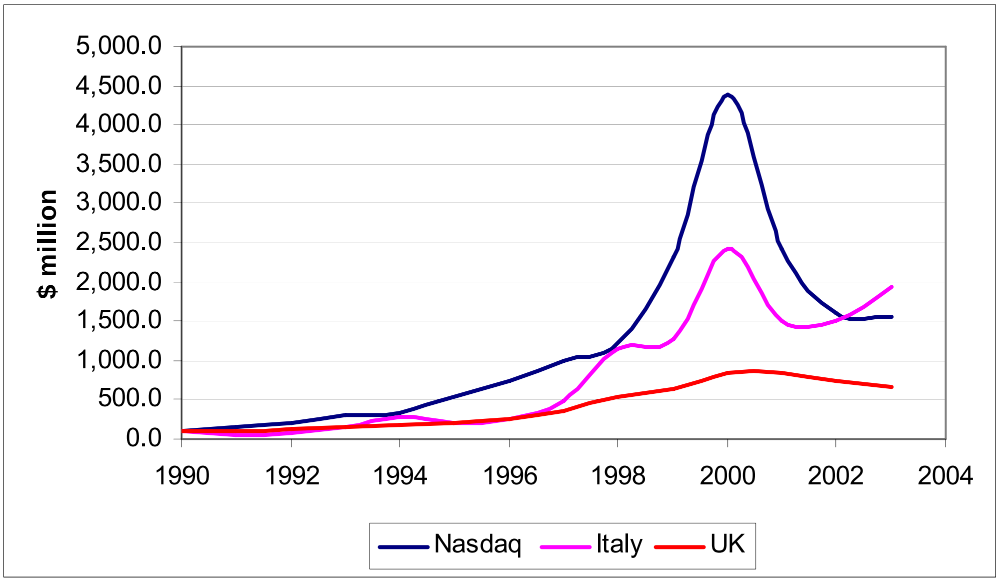


Source: Bank of Italy

4.20 The limited development of equity markets reflects the lack of an "equity culture" in Italy, the small number of big private corporations as well as the marginal importance of certain institutional investor's classes such as pension funds.

4.21 In contrast, the Italian government bond market is the largest and the most liquid in Europe, and has been the driving force of international capital market integration with its MTS platform.

Figure 4.4: Total value of share trading, Nasdaq, Italy and UK



Source: World Federation of Exchanges

4.22 Figure 4.3 shows that while up to 1997 the Italian stock exchange followed a pattern which was very similar to the one of LSE it became more closely related to the US market thereafter. This is a sign of the Italian stock market's increased international connections in recent years.

4.23 The number of listed firms is shown in Table 4.3 below. From 1996 to 2006 they increased from 248 to 286.

Table 4.2: Main indicators of Italian Stock exchange

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Listed firms	248	239	243	270	297	294	295	279	278	282	286
Capitalization (€ millions)	202	315	485	727	818	592	458	487	581	77	677
Capitalization (% GDP)	20.6	30.7	45.0	65.6	70.2	48.6	36.3	37.5	43.1	49.1	47.3
Average Turnover (€ millions)	322	697	1680	1998	3422	2611	2515	2695	2851	3730	4340

Source: Borsa Italiana 2006

Factors Specific to Italy

4.24 There are some specific factors that must be considered:

(a) **The Bourse is dominated by former-state owned entities.** Some of the listed companies are still under public control.

(b) **Reluctance of Italian firms to go to public**. Pagano et al. (1998) analyzes the reasons behind the reluctance of Italian firms to go public. Company size is a very significant determinant of listing, suggesting that the fixed costs of listing may be an important explanatory factor to the decision to going public. Such costs are likely to be important if calculations extend beyond the out-of-pocket expenses incurred in obtaining and maintaining the listing, to the broader implications of complying with the much more comprehensive information disclosure (which can inhibit the ability to avoid tax) resulting from stock market scrutiny and appraisal. Many young start-up companies do not use the stock market to finance their expansion, resorting to other sources of external finance, typically bank loans, which might be reckoned as more efficient if the costs of transparency were to be included.

(c) **Corporate governance improvement.** A recent study by the IMF indicates that Italian corporate governance incorporates a high degree of investor protection, in some areas even more stringent then international practice, but the realisation of these benefits is frustrated by a failure to enforce the regulations.

Impact of the FSAP and FSWP Legislative Measures on the Italian Securities Sector

4.25 The table below maps the relevant FSAP measures onto Italian securities markets and identifies which areas each measure could have a potential effect on.

Table 4.3: Mapping FSAP onto securities markets

FSAP Measure	Detail	When confirmed transposition in Italy	Issues for securities markets
Directive on the taking up, pursuit and prudential supervision of the business of electronic money institutions Directive 2000/46/EC	To create a legal framework for the free movement across the EU of electronic commerce, including financial services.	2004	Trade, market functioning, innovation
Directive on the supplementary supervision of credit institutions, insurance undertaking and investment firms in a financial conglomerate Directive 2002/87/EC	Determines how the lead supervisor of a financial conglomerate should be decided and ensures that gaps in supervisory arrangements are filled.	2005	Consumer protection, competition, competitiveness
Directive supplementing the Statute for a European Company with regard to the involvement of employees Directive 2001/86/EC	Governs the involvement of employees in the affairs of European PLCs.	2005	Jobs
Directive on Take Over Bids Directive 2004/25/EC	To have a minimum framework for the national approval of takeovers.		Trade, competition
Directive amending the insurance directives and the ISD to permit information exchange with third countries Directive 2000/64/EC	Harmonises requirements for the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public on a regulated market within EU.	Law missing	Market functioning, trade, competitiveness
Two directives on UCITS Directive 2001/107/EC Directive 2001/108/EC	Amends previous Directives on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment schemes in transferable securities (UCITS).	2003	Consumer protection, trade
Directive on insider dealing and market manipulation (market abuse) Directive 2003/6/EC	Harmonises rules on the prevention rules on the prevention of insider dealing and market manipulation in both regulated and unregulated markets.	2005	Consumer protection
Directive on prospectuses Directive 2003/71/EC	Designed to provide a "single passport" for issuers of equity and debt securities so that, once an issue of securities meets prospectus requirements in one country, the securities can be sold across the EU.	No notification	Trade
Directive on Markets in Financial Instruments Directive 2004/39/EC.	Extends the coverage of the existing ISD scheme and introduces more extensive requirements on firms on items such as the conduct of business and internal organisation.	Deadline 2007	Trade, competitiveness

Table 4.4: Main securities regulatory legislation

The 1998 Consolidated Law of Financial Intermediation (Consolidated Law) sets out the institutional framework for the regulation and supervision of the Italian securities market. Under this Law, Consob *has responsibility for market efficiency and transparency, proper conduct of business by intermediaries and investor's protection*, while *BI* is responsible for *prudential supervision and financial stability of intermediaries*. It also has direct responsibility for the supervision of wholesale markets in government securities, although Consob is responsible for the regulation and supervision of market abuse in that market.
The main provisions governing Consob are set out in Law 216/1974 as amended in the Consolidated Law. BI's organization and competences are comprised in different legal sources: its bylaws ratified by Royal Decree 1067/1936 as amended, the Consolidated Law on Banking (Legislative Decree 385/1993 Consolidated Law on Banking) and the Consolidated Law.
The Consolidated Law was recently amended by Law No. 62/2005, which implemented the Market Abuse Directive. While most of the changes needed to transpose European Directives into the Italian legal framework have already been introduced, some are still needed to harmonize it with the Prospectus Directive.

Assessment

The effect of FSAP on the regulatory framework

4.26 The FSAP has had a significant positive impact on the Italian securities sector. Italy was one of the Member States which had a "concentration rule", now eliminated by the MiFID. The main purpose of a concentration rule was that, by pooling liquidity, it aided price formation and discovery, thereby providing a mechanism for promoting best execution. Nonetheless, the MiFID introduced further explicit best execution provisions, detailed rules for pre- and post-trade transparency, and rules governing execution of transactions. The MiFID built on the concentration rule by fostering cross-border competition and competition between trading systems.

The effect of FSAP on cross-border trade

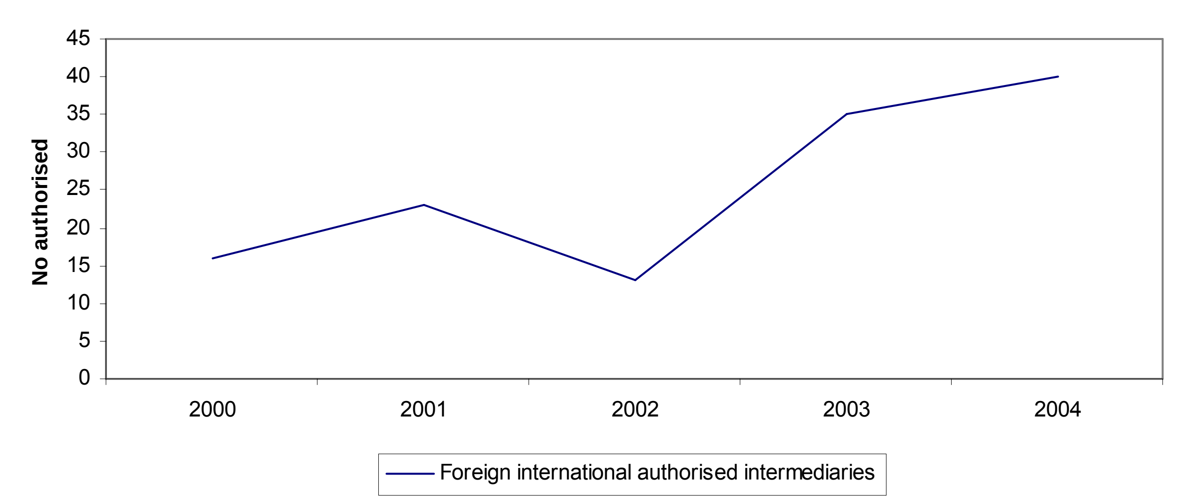
4.27 A key aim of the MiFID is the expansion of cross-border activities to create a well-functioning single European market for securities.

4.28 Since the second half of the 1990s foreign participation in the Italian stock market, though limited, has been increasing. In 2000 it reached 9.9 per cent (against 4.3 per cent in 1998). Market liquidity has moved into line with that of other major European stock exchanges.

4.29 The number of foreign players has also risen. This is shown in Figure 4.5 below and Table 4.5 overleaf. It is likely that this development has been encouraged by the FSAP.

4.30 All in all, FSAP seems to have exerted a significantly positive effect on the market openness to foreign firms.

Figure 4.5: The number of foreign intermediaries in the Italian stock market 2000-2004



Source:

Table 4.5: Composition of the assets of individual and collective asset management products by type of product* 1996-2004

	Italian Funds	Foreign Funds**	Oher foreign collective investment undertakings	Individually managed portfolios***	Total
1996	42.7	2.9	--	54.4	100
1997	52.6	3.5	--	43.9	100
1998	63.9	3.9	--	32.2	100
1999	65.1	8.5	--	26.4	100
2000	59.6	12.4	3.6	24.4	100
2001	54	13.7	3.7	28.6	100
2002	50.6	13.3	3.4	32.7	100
2003	50.2	15.2	4.1	30.5	100
2004****	49	16.1	3.7	31.2	100

Sources: Assogestioni and Bank of Italy. * Rounding may cause discrepancies in the last figure. ** Funds controlled by Italian groups, *** Net of investments in mutual funds, **** Refers to June 2004

The effects of FSAP on competition, market functioning and innovation

4.31 This section examines the effect of the FSAP on the supply side of the industry.

4.32 Italian share prices moved in different directions depending on the market considered. In line with international trends, the historical Mib index for the Stock Exchange (MTA) rose by about 18 per cent (15 per cent in 2003), while the index of the Nuovo Mercato fell by about 18 per cent, after breaking the downward trend under way since 2000 and rising by about 27 per cent in 2003.

4.33 The Bank of Italy has conducted a study which estimated all the costs necessary to enter to the market and found that they are relatively high. This, together with the tendency of firms to stay unlisted, suggests that the barriers to entry remain prohibitive for the majority of the firms notwithstanding the numerous regulations introduced by FSAP intended to eliminate them.

4.34 In November 2005, Borsa Italiana entered into a 49:51 joint venture with Euronext to obtain a major stake in MTS, the leading electronic market for European wholesale fixed income securities, perhaps indicating a greater tendency to reach out internationally.

4.35 Thus, so far the impact of the FSAP appears to have been relatively limited. However, looking ahead, implementation of the MiFID and the consequent abolition of the concentration rule and hence greater scope for increased competition, particularly greater competition between exchanges and more extended use of systematic internalising (creating chains of substitution between exchanges), that may be facilitated by MiFID. Our models, exhibited in the Main Report, suggest there is the possibility of this bidding down equity spreads and other transactions costs, causing a fall in the cost of equity capital in Italy of some 60-80 basis points (0.6 to 0.8 per cent) — a considerable reduction.

The effects of FSAP on competitiveness and employment

4.36 The increase in international competition brought about by the FSAP and the abolition of the concentration rule, must be expected, over the long run, to increase the competitiveness of the sector.

4.37 So far, it is difficult to make definitive conclusions about the impact of the FSAP on employment in the Italian securities sector. However, a possible outcome could be the following: in the medium term, a portion of securities jobs are likely to migrate to London (and perhaps also Luxembourg) as systematic internalisers take advantage of the opportunities MiFID brings and as London (in particular) takes advantage of its lead in systematic internalising. However, on the other hand, MiFID is likely to encourage more of a culture of equity so that the total volume of equity jobs related to Italy will be greater and even though some of those jobs will in the future be located in London, it may yet be that the number of jobs located in Italy will increase.

Conclusions

4.38 There has been increased European and international participation in the Italian stock market, partly due to the FSAP process and partly as a result of the broader development of the internal market. Whatever the effect of the FSAP in accelerating the process it is hard to suppose that the Italian market could have remained in isolation indefinitely.

4.39 However, barriers to listing remain and this may be a significant barrier to growth for small firms. This may reflect continuing regulatory and legal uncertainties and the difficulties of product innovation.

4.40 The remaining reliance of small firms on relationship-based banking for finance may limit financial development in Italy with consequent effects on wider economic growth.

4.41 In this respect it can be argued that the FSAP process has not yet provided the critical breakthrough in moving Italy towards a financial system typical of the more developed Member States.

5 FINANCIAL CONGLOMERATES

5.1 The Italian financial market has been historically characterised by a relatively large number of conglomerates and by close links between the banking and insurance sectors. Increasingly closer links between the banking and insurance sectors are an international phenomenon and related to the development and integration of the financial markets (financial diversification and conglomeration). The general aim is to realise economies of scope.

Table 5.1 : Conglomerates based in Italy

Financial Conglomerate	Base country	Co-ordinator	Relevant Competent Authorities (where different from the coordinator)
Gruppo Banca Intesa	Italy	Bank of Italy	HFSA (Hungary) ISVAP (Italy)
Gruppo CARIGE	Italy	Bank of Italy	ISVAP (Italy)
Holmo	Italy	ISVAP (Italy)	Bank of Italy
Mediolanum	Italy	Bank of Italy and ISVAP (Italy)	Bank of Italy and ISVAP (Italy)
Monte dei Paschi di Siena	Italy	Bank of Italy	ISVAP (Italy)
San Paolo – IMI	Italy	Bank of Italy	ISVAP (Italy)
UniCredito	Italy	Bank of Italy	ISVAP (Italy)
Delta Lloyd	Netherlands	DNB (NL)	BaFin (Germany) FSA (UK)

Table 5.2: Main financial conglomerates operating in Italy

Name	Head office base	Countries in which they operate	Characterization of Conglomerate	Characterization of Subsidiary
Allianz	Germany	Germany, Austria, Belgium, Cyprus, Greece, Ireland, Netherlands, Spain, Switzerland, UK, Czech Republic, Hungary, Poland, Romania, Slovakia, Estonia, France, Italy, Latvia, Lithuania, Luxembourg, Portugal, Sweden	Insurance group doing asset management and banking	Insurance
BANCO Bilbao Vizcaya Argentaria	Spain	Spain, Portugal, Belgium, France, UK, Germany, Italy, Switzerland	Finance and Insurance	DNA
Barclays	UK	France, Spain, Portugal, Italy, Germany, the Netherlands, Switzerland, Austria, Belgium and Luxembourg	Banking	Banking
BNP Paribas	France	Austria, Belgium, Czech Republic, Cyprus, France,. Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Norway, Poland Portugal, Slovakia, Spain, UK,	equal focus on retail, corporate and investment banking, asset management	Banking
Fortis	Belgium	Belgium, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Poland, Spain, Switzerland, Turkey, UK, Portugal, Denmark, Austria	Banking and Insurance: Contribution to net Profit: Retail Banking 23%, Merchant Banking 27%, Commercial/Private Banking 13%, Insurance Belgium and Netherlands 28%, International Insurance 6%	Banking
Grupo Santander	Spain	Spain, Portugal, Belgium, France, UK, Germany, Italy, Switzerland, Poland, Netherlands, Czech Republic, Hungary, Luxembourg	Insurance, Banking, Asset Management	Banking
ING	Netherlands	Netherlands, Belgium, France, Spain, Greece, Germany, Austria, Italy, UK, Poland, Luxembourg, Romania	Banking, insurance and asset management	Banking
Munich Re	Germany	France, Germany, Greece, Italy, Poland, Spain, UK, Switzerland	Reinsurance	Reinsurance
Old Mutual	UK	Austria, Cyprus, Denmark, Finland, France, Germany, Ireland, Italy, Poland, Portugal, Spain, Sweden, UK	Asset management, Life assurance, Banking, Offshore trust and company services	
RBS	UK	UK, France, Italy, Germany, Austria, Greece, Spain, Portugal,	Banking firm doing insurance	Corporate and Investment Banking
Societe General	France	Austria, Belgium, France, Germany, Ireland, Italy, Norway, Portugal, Poland, Portugal, Spain, Sweden, UK, Switzerland	corporate and investment bank	Investment banking for Corporate clients

Source: EU Mixed Technical Group on the Supervision of Financial Conglomerates, Europe Economics. DNA = data not available.

Impact of the FSAP and FSWP Legislative Measures on the Italian Financial Conglomerates Sector

5.2 As we can see in Tables 5.1 and 5.2, although some conglomerates operating in Italy do engage in insurance activities, the most important conglomerate activity is banking. Thus, the conclusions for financial conglomerates in Italy are close to those for banking.

Assessment by category

Openness

5.3 We have seen that the form of entry by banks into Italy has been affected, and that openness in the insurance sector has probably increased. In addition, the FSAP measures for regulation of Financial Conglomerates should create a more standardized regulatory environment, reducing costs of compliance for large firms operating across multiple jurisdictions.

5.4 Further, we should, in general, expect a programme such as the FSAP to be of greater short-term benefit to existing larger players than smaller players, since larger players will more obviously gain from a standardized cross-border environment.

5.5 Thus our assessment is that the FSAP will encourage greater openness.

Competition

5.6 We have seen that competition is expected to be slightly enhanced in both banking and insurance, and this can be expected to apply for financial conglomerates, also.

Consumer protection

5.7 Effects on consumer protection in both banking and insurance are expected to be positive, although more so in banking. Overall consumer protection should be increased.

Employment

5.8 We assess the effects on employment in both banking and insurance sectors as slightly negative. Furthermore, our view is that the FSAP may be a factor in conglomerates in Italy losing market share to more specialised players (particularly in the insurance sector).

5.9 The view of respondents to our survey was that the FSAP will contribute to a growth in the number of jobs in financial conglomerates. However, our own view is that, over time, the effect of the FSAP is likely to be somewhat negative.

Competitiveness

5.10 As pressures of competition from abroad and domestically are expected to be increased by the FSAP, we would expect this to lead to greater competitiveness of Italian conglomerates.

Conclusions

5.11 The effects of the FSAP on Financial Conglomerates have been captured by our previous analysis of effects in banking, insurance and securities.

5.12 Our survey of stakeholders shows that there are positive perceived effects of the FSAP on the formation of new conglomerates. However, there are no perceived incremental effects (either positive or negative) of the FSAP on the number of jobs, wages, and operational costs of financial conglomerates in Italy. It should, however, be noted that we were unable to identify any independent assessment of these stakeholders' claims.

6 CONCLUSIONS

6.1 Italy is of particular interest for the study of the impact of Community policy in this area by virtue of its peculiarity as a mature economy with economic institutions that have typically been regarded as relatively poorly developed.

6.2 The reasons for this institutional deficit are often alleged to have arisen from a number of basic factors:

(a) the large disparities between the various regions of Italy both economically and in terms of their political cultures and especially between north and south. Political, social and economic integration has been the fundamental problem of the Italian state since its foundation;

(b) an economy which owes its dynamism to the generation of high added value from entrepreneurship as opposed to the exploitation of economies of scale in investment;

(c) the historic weaknesses of Italian public institutions and especially the legal system in terms of its complexity, slowness, costs and uncertainty of outcome;

(d) consequent endemic corruption affecting large areas of public life - albeit with some notable exceptions;

(e) a history of economic organisation typified by the "para-statal", producer-driven organisations established by Mussolini and which survived his fall, where the distinction between political and market considerations were obscure;

(f) the importance of the family in a society where public institutions were regarded as weak (or sometimes even regarded as positively untrustworthy); and

(g) a consequent preference for family-based business models — and such models tend to reduce accountability (e.g. versus companies with external shareholders or significant bank loans) — together with an associated preference for funding through retained profits and bank loans and a reluctance to seek (or perhaps difficulty in obtaining) public equity participation.

6.3 Although many, if not all, of these factors have been losing their force with the passage of time they are all still the main determinants of the barriers to Italian political and economic development and they remain considerable. As academic studies have shown, the kind of relationship banking still prevalent in industry inhibits product innovation, small firm formation and growth. Similarly, the poor quality of corporate governance deters investment. The legal system provides inadequate protection for commercial interests and so increases risk.

6.4 Clearly, Italy is potentially one of the most important beneficiaries of the EC reforms aimed at establishing efficient national and international markets. But the strength of cultural resistance to change is very considerable and the impact of the FSAP has been limited.

6.5 So it is that while FSAP and FSWP legislative measures has led to regulatory reform in consumer protection and corporate governance, there has been regulatory progress in the insurance industry and some marginal improvements in the securities industry, the effects of the FSAP and FSWP legislative measures in terms of greater trade and improved financial development remain elusive or less than had been hoped. In banking efficiency has improved, pay has increased and there has been very considerable consolidation among Italian-owned enterprises.

6.6 At the same time efficiency gains in banks do not seem yet to be well-established, banking concentration remains low in spite of mergers, banking ownership remains problematic in terms of its market-orientation, and foreign investment in the banking system has been frustrated by Italian political attitudes. At least early during the period of the FSAP, a general and underlying brake on change may have been constituted by Italian employment legislation, and although the past ten years have seen very considerable reforms in Italian labour law that may well have removed this brake, it is still early to tell definitely whether this is so.

6.7 It is, perhaps, important not to expect too much too quickly. The barriers to economic development in Italy have been entrenched for over a hundred years and it is unlikely that they will be resolved very rapidly. It is also important to remember that the Italian economy's performance in terms of its growth since, for example, its accession to the Treaty of Rome, has been very impressive and indeed, over this period has been superior, for example, to that of the United Kingdom. The Italian ability to change in the longer term should not be underestimated.

6.8 Nonetheless, in institutional terms, Italy has much to do in order to satisfy the requirements of European best practice. Expectations of progress should be comparable to those attached to the efforts of the newest Community members. Italy has still to establish its national markets; it cannot fully integrate itself with the international markets until it can satisfy the institutional pre-conditions required for effective collaboration across national frontiers.

6.9 Perhaps the most important factor in this process of institutional modernisation and market integration is political. The application of the FSAP and FSWP legislative measures requires very different behaviour and assumptions from those that still prevail in Italy. These improvements, if they are to be achieved in any reasonable time frame, require a political commitment to make changes that are effectively discontinuous — what is required, as in the newer Member States, is revolution rather than evolution.

6.10 Such a commitment is, of course, implied by subscription to the Treaty of Rome, but the evidence is that Italy's compliance with EC regulation is much less than perfect and has been so for a long time. This has no doubt created an expectation, internationally as well as nationally, that the chances of fundamental change in Italy are small. If so these expectations may well further discourage foreign participation.

6.11 However, if greater financial development *can* be achieved, the potential rewards are significant. Our models (exhibited in the Main Report) of the scope for enhanced financial development in Italy, suggest that full and vigorous integration into a Single European financial market could raise the Italian GDP growth rate by 0.1 per cent.

Assessment

	Impact of FSAP on…				
	Openness to foreign firms	**Competition**	**Consumer Protection**	**Competitiveness**	**Employment**
Banking	Positive	Positive	Perhaps positive?	Positive	Somewhat negative
Insurance	Positive	Positive	Positive	Positive	Perhaps negative
Securities	Significantly positive	Limited so far; potentially significantly positive in the future	Negligible	Negligible so far; potentially significantly positive in the future	Perhaps positive in the future
Financial Conglomerates	Negligible	Positive	Negligible	Positive	Perhaps positive

LATVIA

1 INTRODUCTORY OVERVIEW

Financial Services Regulation in Latvia

Division of responsibility

1.1 Responsibility for financial regulation and supervision of the banking, securities and insurance markets in Latvia is spread across the following authorities.

(a) **The Financial and Capital Market Commission:** unified regulator of banks, insurance companies and insurance brokerage companies, participants of financial instruments market, as well as private pension funds; and

(b) **The Bank of Latvia:** the central bank of the Republic of Latvia, the principal objective of which is to regulate currency in circulation by implementing monetary policy to maintain price stability in Latvia.

Key features of banking regulation

1.2 The main overseers of banking in Latvia are the Financial and Capital Market Commission and the Bank of Latvia.

1.3 The main legislation affecting the Latvian banking system includes:

(a) Law on Credit Institutions (1995). This law is the centre piece of the regulation of banking activities in Latvia;

(b) Law of Guarantee of Deposits of Natural Persons (1998). It provides a further plank of banking regulation in addition to the Law on Credit Institutions (1995);

(c) Law on the Bank of Latvia (1992). It sets out the objectives and statutory responsibilities of the Bank of Latvia; and

(d) Financial and Capital Market Commission Act (2001). It establishes the role and responsibilities of the Financial and Capital Market Commission;

Key features of insurance regulation

1.4 The operations of insurance companies are overseen primarily by the Financial and Capital Market Commission. The main legislation affecting the Latvian insurance system includes:

(a) The Law on Insurance Contract (1998), which applies to insurance against losses (material values of interest), and insurance and personal insurance (life, health, physical condition, personal civil liability);

(b) Law on Insurance Companies (1998), which regulates the activities of insurance companies; and

(c) Financial and Capital Market Commission (2001) Act.

Key features of securities regulation

1.5 The Riga Stock Exchange is part of the Nordic marketplace (also including Stockholm, Tallinn, Helsinki, Vilnius and Copenhagen) owned by OMX.

1.6 The main regulations affecting the Latvian securities market include:

(a) Securities Law (1995), which aims at regulating the order of public release, registration and circulation of securities, activities and liability of securities market participants. It also aimed at protecting the interests of investors by securing publicity, equal access to the securities market and equal access to information on public release, registration and circulation of securities.

(b) Financial and Capital Market Commission (2001) Act.

Key features of financial conglomerates regulation

1.7 Financial conglomerates fall, by definition, under the auspices of various supervisors. However, as the Financial and Capital Market Commission in Latvia has such wide ranging responsibilities it has regulatory responsibility for all aspects of conglomerate activity in Latvia. However, the conglomerates operating in Latvia are based in Finland, Germany and Sweden and in these cases the final supervision responsibility falls on the home country regulators. Further, in all cases it is only a small proportionate of the activities of these conglomerates that occurs in Latvia.

The Implementation Process and General Effects of the FSAP in Latvia

1.8 Respondents to our survey thought that in the absence of the FSAP the regulatory system in Latvia would be characterised as rule based with some discretion. A rule based regulatory system is one characterised by direct rules which set out the conditions and limits of business activity. Under this system, "fine tuning" is required to keep abreast of market developments. However, the scope for discretion that respondents to our survey saw as contained in the Latvian regulatory system likely to be in place without the FSAP, may well have enabled such "fine tuning" to occur. Respondents to our survey were of the view that the FSAP has not reduced the scope for regulatory discretion in financial services in Latvia, so it seems "fine tuning" is just as likely to occur now in Latvia as it ever was.

1.9 All respondents to our survey were of the strong opinion that the burdens of the FSAP fell disproportionately on smaller entities. This is likely to be a cause of much concern in Latvia as all sectors of financial activity in the country are characterised by having a relatively large number of small players involved. In the view of respondents to our survey the problems involved with a disproportionate FSAP burden falling on smaller entities were further compounded by having an unreasonably short time frame for the introduction of the FSAP measures.

1.10 Legislation relating to the FSAP only started to take effect in Latvia in 2004 and some of such legislation only started to take effect as late as July this year. Therefore, much of this legislation has had little time to bed in and its full effects are unlikely to have fed through yet.

1.11 Respondents to our survey were of the view that market expectations did not adjust to the FSAP prior to its implementation, but did so after its implementation in response to the FSAP.

2 BANKING

Some background information

2.1 We have identified the following features regarding the Latvian banking sector:

(a) The Bank of Latvia has observed that "as one of the key monetary policy instruments, interest rates have lost their effectiveness in cases requiring adjustment of macroeconomic trends, as more than half of loans to residents have been granted in euro".[1] Such widespread usage of euros in Latvia underlines the integration of the Latvian economy with the eurozone and, as the Bank of Latvia notes, has implications for macroeconomic management.

(b) The lats was successfully re-pegged to the euro in January 2005. In May 2005 Latvia joined ERM II, unilaterally preserving the fluctuation band of the lats exchange rate established several years ago. Latvia aims to join the eurozone in 2010. Latvia comfortably meets most of the Maastricht criteria for eurozone membership, satisfying the exchange rate, interest rate and two fiscal criteria. Given that Latvia only fails to meet the inflation criterion, its economy can be said to be closely aligned with the eurozone.

(c) According to the European Central Bank and the European Commission, Latvia does not satisfy the inflation criterion for eurozone membership, which specifies that annual inflation cannot exceed the average of "the three best performing EU Member States in terms of price stability" by more than 1.5 percentage points in the year prior to the examination. This is a consequence of previous Latvian policy preference to favour control of exchange rates to control of inflation. Having opted for stable exchange rates, Latvia has seen inflation rise.

(d) Latvia's population declined by 12 per cent between 1991 and 2002 when it stood at 2.35 million. Its population density of 36.3 people per square kilometre is below western European averages. It is, therefore, a small country with a declining, sparsely distributed population. Such a small economy is necessarily greatly impacted by external factors.

(e) In spite of the fact that since gaining independence in 1991, the defining feature of Latvian politics has been the political instability generated by a proportional representation system populated by a plethora of political parties, Latvian economic policy over the same period has been characterised by its consistency, most particularly in terms of its central objectives, namely to secure membership of the EU and now the eurozone. As Aivaras Abromavicius, a fund manager at East Capital, a Stockholm based firm, observes "despite all the political turbulence in the (Baltic) region, policy has been consistent. They will do whatever it takes to control inflation".[2]

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1 The Bank of Latvia, Annual Report 2005.
2 The Financial Times, 26 August 2005.

Headline Overview

2.2 Latvia's move towards independence from the Soviet Union began in 1990 and, unlike in Estonia for example, this move was not marked by the swift creation of a two-tier banking system. Instead, 45 branches of the former Soviet banks were combined and placed under the control of the Bank of Latvia before being privatized over the next three years. This contributed towards a rapid expansion in the number of private banks, similar to that seen in Estonia around the same time, with 61 private banks operating in Latvia in 1993.

2.3 Riga quickly became an offshore financial centre servicing Russian flight capital. However, lack of experience, insider lending and lax supervision resulted in the banking crisis in 1994-95. All three Baltic countries went through a similar crisis in their formative years of establishing banking systems post-independence. Fifteen banks went out of business in Latvia in 1995, including Banka Baltija, which accounted for about one-third of total deposits that year.

2.4 As in Estonia for example, few restrictions were placed on foreign ownership of banks and, in many ways, such ownership was actively sought, while following the banking crisis of 1994-95 the Bank of Latvia sought to tighten banking supervision and institute international standards of auditing for all banks so as to move the country in line with international standards. The combination of best practice imported from abroad by foreign owners of banks and the efforts of the Bank of Latvia improved banking standards and regulation, restoring market confidence, as shown by the rapid growth in deposits over 1997.

2.5 These improvements did not, however, insulate the Latvian banking sector from the Russian crisis of 1998. This crisis contributed to the ongoing consolidation of the sector as bankruptcies, mergers and acquisitions have seen the number of players in the market progressively decrease over the past fifteen years.

2.6 As well as encouraging the ongoing process of concentration the Russian crisis also precipitated a reorientation of Latvian banking, towards the EU and away from the CIS market. This was the next stage in Latvia's evolution from a financial centre servicing Russian flight capital to one integrated into EU financial markets, particularly, as throughout the Baltics, the Nordic markets. As a consequence, banks based in other EU countries have increasingly been a feature of Latvian banking. The increased competition that their presence has brought has lead to increased specialisation of some banks in particular market segments. In particular, in recent years more specialist providers have increasingly sought to make capital available to SMEs.

2.7 The 25 commercial banks operating in Latvia are the dominant feature of Latvian finance as a whole. Latvia is similar to its Baltic neighbours in that its financial sector is relatively small and bank dominated but Latvia has a higher number of commercial banks — 25 compared with 11 in Estonia and 9 in Lithuania.

Number and ownership of players

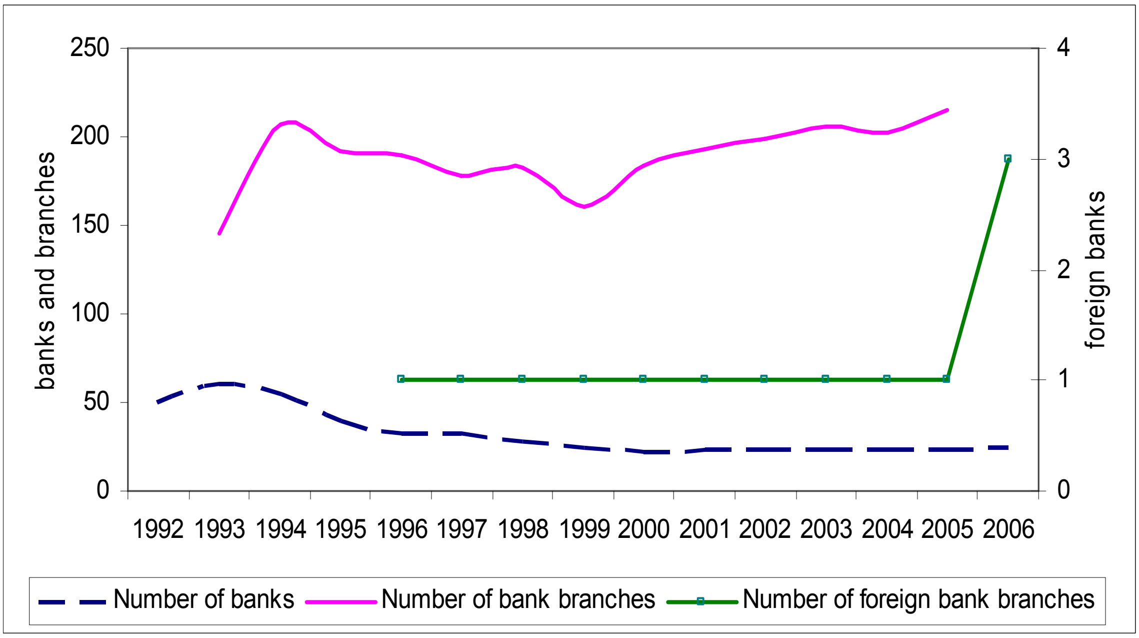
2.8 Figure 2.1 illustrates the increasing level of concentration that is characteristic of the Latvian banking system for most of the post-Soviet period. This process of concentration was encouraged by the crises of 1994-95 and 1998 and continued unchecked until very recently.

2.9 2006 saw the number of banks in Latvia increase from 23 to 25. Market entrants may have been encouraged by opportunities afforded by EU membership or the FSAP but this increase would seem to suggest that the process of concentration in Latvian banking has drawn to something of a close.

2.10 Since the crises of 1998 the number of branches has increased. This would suggest increased activity levels within the context of a market, while not as concentrated as those in Latvia's Baltic neighbours and less so than in previous years, is still reasonably concentrated.

2.11 2006 has also seen the number of foreign bank branches in Latvia jump from one to three, a trend possibly connected with the FSAP.

Figure 2.1: Banks in Latvia

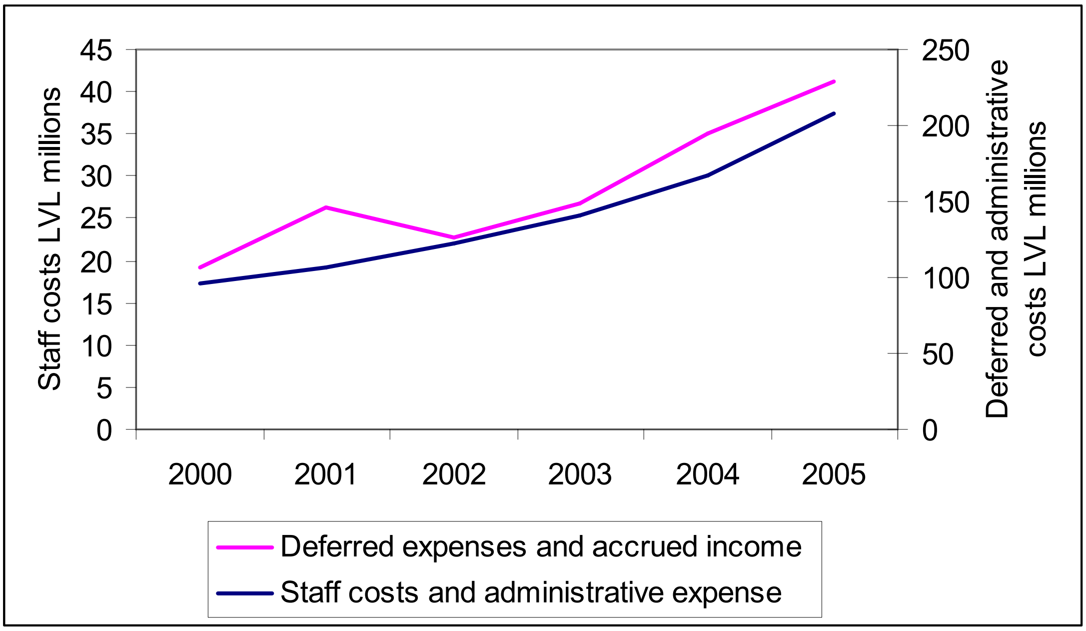


Source: Association of Latvian Commercial Banks. Note: data relating to 1992-1995 absent from foreign bank branches series. Data relating to 1992 and 2006 absent from bank branches series.

Turnover, employment and profitability

2.12 Figure 2.2 shows that expenditure on salaries by Latvian banks has increased rapidly in recent years while the income of banks has not increased as rapidly. Salaries are, therefore, taking up a higher proportion of turnover.

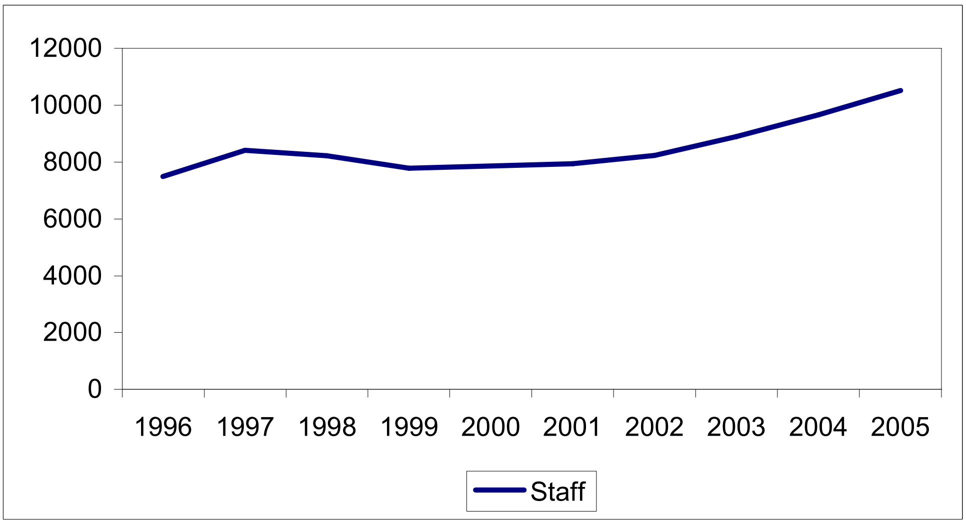
Figure 2.2: Income and Salaries of Banks in Latvia, 2000-2005



Source: Association of Latvian Commercial Banks

2.13 Total expenditure on salaries has steeply risen but the individual salaries of all employees in the Latvian banking sector cannot have risen as sharply, as Figure 2.3 illustrates. It appears that the number of staff employed in the sector has increased considerably in recent years. Therefore, the total expenditure on salaries is being divided amongst an increased number of employees.

Figure 2.3: Employment in Latvian Banks, 1996-2005



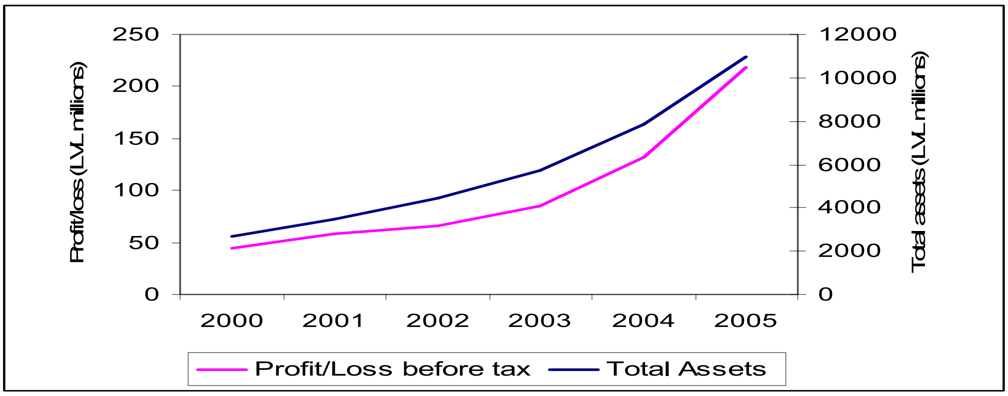
Source: Association of Latvian Commercial Banks

2.14 The years following the crisis of 1998 saw cut backs in employment by Latvian banks but employment figures have grown strongly since the turn of the millennium. This is a trend which has gathered pace in recent years, suggesting it has been encouraged by the FSAP. Or, at least, the FSAP has not had a seriously negative effect on this upward trend.

2.15 Income may have grown less strongly, as Figure 2.2 illustrates, but assets and profit/loss in Latvian banking have both grown very strongly in recent years.

2.16 The Bank of Latvia also commented positively upon the effect of EU membership upon the financial sector and this membership can certainly be seen to have contributed towards the positive outlook seen in the banking sector currently.

Figure 2.4: Assets and Profit/Loss of Latvian Banks, 2000-2005



Source: Association of Latvian Commercial Banks

Market Shares and concentration

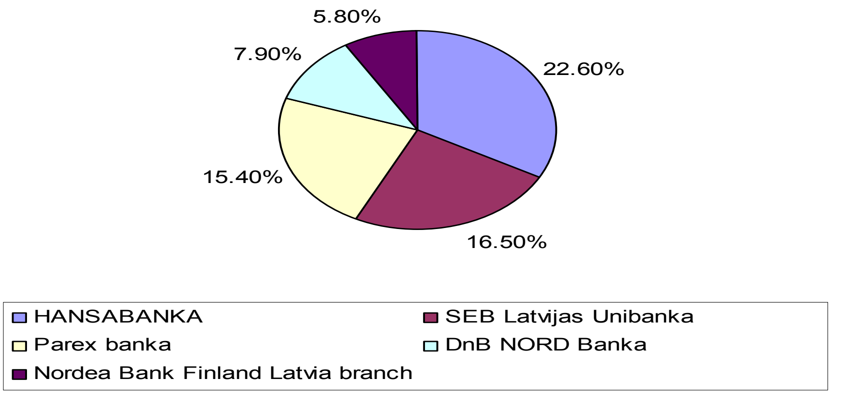
2.17 The market may be thought of as being split between large, medium and small players.

2.18 The three largest players in the market are Hansabanka (22.6 per cent), SEB Latvijas Unibanka (16.5 per cent) and Parex Banka (15.4 per cent).

2.19 There are five medium sized players in the Latvian banking market which hold market shares of between 4.3 per cent and 7.9 per cent, collectively accounting for 28.5 per cent of the market.

2.20 There are also sixteen small players in the Latvian banking market that have market shares ranging between 2.5 per cent of the market and hardly any of it at all. Collectively these banks account for 17.1 per cent of the market.

Figure 2.5: Market Share of Banks in Latvia

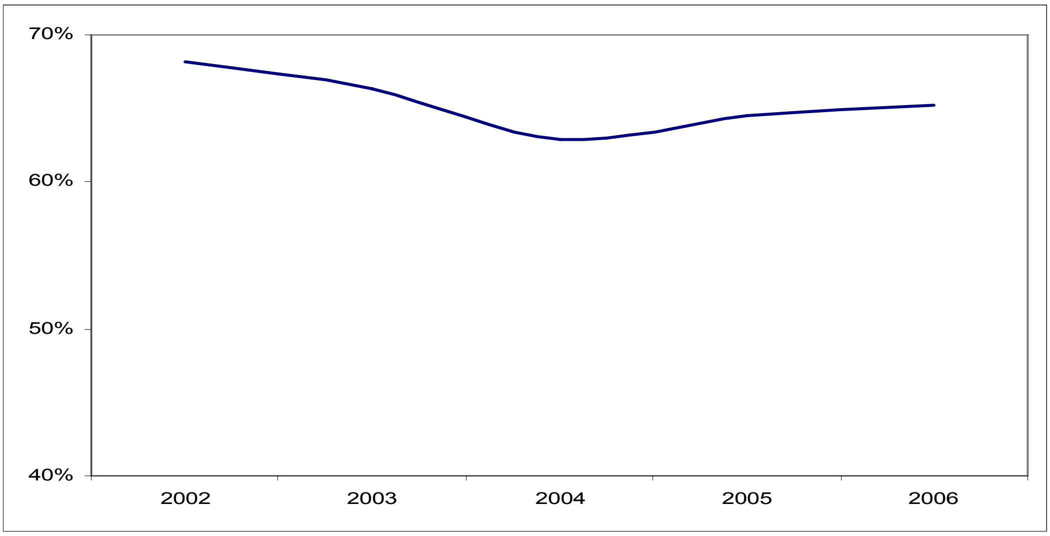


Source: Association of Latvian Commercial Banks

2.21 As Figure 2.5 illustrates 54.5 per cent of the market is accounted for by large players, while medium and small sized players account for 28.5 per cent and 17.1 per cent of the market, respectively. Therefore, the market is characterised by a relatively high number of players (as has been noted, 25 banks compares with 11 in Estonia and 9 in Lithuania) and the market features players of a wide range of sizes. Nonetheless, the large players exercise considerable market influence, having a combined market share of over 50 per cent, and are, therefore, quite dominant.

2.22 Indeed, as Figure 2.6 illustrates, concentration ratio of 5 has remained consistently high in recent years. The Concentration ratio of the largest credit institutions, represents the percentage market share the largest credit institutions hold in the banking sector. There was some evidence this ratio was falling in the years leading up to Latvia becoming an EU Member State but since that time this concentration ratio has risen again. Therefore, EU membership has coincided with a time when the market dominance of the largest players has increased and EU membership may have contributed towards this trend.

Figure 2.6: Market Share of 5 largest Banks in Latvia



Source: Association of Latvian Commercial Banks

2.23 The Herfindahl index is a measure of the size of firms in relationship to the industry and an indicator of competition among them. Decreases in the index generally indicate a loss of pricing power and an increase in competition. In broad terms an index below 1,000 indicates an un-concentrated industry, between 1,000 and 1,800 a medium level of concentration and anything above 1,800 indicates high concentration. Since 2001, the Latvian Herfindahl-Hirschman index appears to have slightly decreased.

Table 2.1: Herfindahl-Hirschman Index[3]

2001	2002	2003	2004	2005
892	856	783	798	795

Source: ECB "EU Banking structures, 2006"

3 The Herfindahl-Hirschman index is defined in the Main Report.

Perceptions of ease of switching, factors affecting competition, and consumer protection

Switching Behaviour

2.24 As has been said, Latvia has a relatively large number of players in the banking market by Baltic standards, suggesting that switching may be more feasible in Latvia than in other Baltic Member States.

2.25 This suspicion may be seen to be borne out by the way the big three players in Latvian banking have competed for market share in recent years. In 2003 Hansabanka were the third largest bank in Latvia with a market share of 15 per cent, slightly less than SEB Latvijas Unibanka, while Parex Banka was the market leader with 20 per cent of the market. By the following year Parex Banka's market share had dropped to 18 per cent and Hansabanka held a clear second place with 16.4 per cent. By 2005 Parex Banka's market share had declined still further to 16.4 per cent and Hansabanka had become market leaders with 18.7 per cent of the market, while the market share of SEB Latvijas Unibanka also continued to grow. The strong rise of Hansabanka and the decline of Parex Banka continued into 2006 with Hansabanka now holding a 22.6 per cent market share and Parex Banka having a 15.4 per cent market share. The rising and falling fortunes of banks in the Latvian banking sector show that it is a fluid and competitive market place.

2.26 The FSAP implementation has, therefore, coincided with a time in which the banks with the largest amounts of foreign capital behind them (Hansabank and SEB Latvijas Unibanka) have strengthened their market positions. It may be that the Swedish banks behind Hansabank and SEB Latvijas Unibanka have brought expertise and capital that have acted to encourage Latvian consumers to switch to their products or made it easier for them to do so.

2.27 There is, however, some evidence of a relative lack of financial literacy in Latvia that would militate against switching. In November and December 2003 Eurobarometer asked a sample of people in each of the New Member States (NMS-10) how difficult or easy they would find eight things to do with banking and insurance. At 30 per cent, Latvia had the second highest number of respondents (after Lithuania) in the NMS-10 unable to even say whether a banking task was difficult or not to complete, which would suggest that, at least, a significant minority of Latvians find some banking tasks very difficult indeed. This context would imply that Latvia has a relatively high number of consumers who do not feel confident enough to switch bank. This conclusion may be supported by the fact that 56 per cent of Latvians told Eurobarometer that they did not expect expert financial advice from financial institutions. A lack of financial literacy may, therefore, be compounded by a lack of financial advice, possibly making Latvians less likely to switch bank.[4]

2.28 Nonetheless, the shifting fortunes of Hansabanka and Parex Banka suggest that at least some Latvians are willing and able to switch banks. It would, of course, be no surprise if ability and willingness to switch bank were not uniformly distributed amongst Latvians. Some may be far more confident and sophisticated consumers than others.

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4 Eurobarometer, Public Opinion in the Candidate Countries, Financial Services and Consumer Protection, May 2004.

The Potential Future Role of Technology

2.29 According to the Association of Latvian Commercial Banks in 1998 the number of transactions made at Point-of-Sale (POS) stood at 3390, the number of Automatic Teller Machines (ATMs) was 238 and the number of payment cards was 207,000. These figures have since jumped staggeringly to 957 and 2,107,000 in 2006 respectively.

2.30 Eurobarometer has, however, evidence that at the time of becoming a Member State Latvians were less likely than anyone else in the NMS-10 bar Poles to use a credit card, were amongst the most likely in the NMS-10 to consider non-cash payment systems difficult to use and were less likely than anyone in the NMS-10 bar the Lithuanians and the Slovakians to make a financial transaction over the telephone. Moreover, only 23 per cent and 18 per cent of Latvians trust telephone and internet banking, respectively.[5]

Trade and international penetration

2.31 The history of the three big players in Latvian banking (Hansabanka, SEB Latvijas Unibanka and Parex Banka) contains revealing insights on Latvian banking, particularly in respect of trade and international penetration.

2.32 What became the Hansabank Group, the parent company of Hansabanka, was initially established by two local entrepreneurs in Tallinn, Estonia, in the early 1990s. The Group now has the largest market share in the three Baltic countries, with one third of this combined market. German-Latvian Bank, like the Hansabank Group, was a product of the flurry of banking activity in the Baltics in the early 1990s. In 1996 the Hansabank Group became one of the great successes of Estonian banking by buying out German-Latvian Bank to expand beyond Estonia's borders. This was one of the first instances of an Estonian bank expanding in this way and so impacting upon the development of banking more widely in the Baltics. By 1998, however, Swedish FöreningSparbanken (Swedbank) obtained over 50 per cent of the Hansabank Group's shares through a share issue. In 2005 Swedbank bought out minority shareholders to gain full ownership of the Hansabank Group. This created a significant Swedish presence in Latvian banking.

2.33 The history of SEB Latvijas Unibanka tells a similar story to that of Hansabanka. SEB Latvijas Unibanka was born in the frenzy of banking activity that the early 1990s witnessed, emerged as a major national player during the period of banking consolidation that went on throughout the 1990s and was eventually bought out by a large, Swedish bank. The website of SEB Latvijas Unibanka notes:

> "The negative influence of the 1998 financial crisis in Russia forced SEB Unibanka to re-evaluate the situation in order to preserve its defined strategic goals — to be the leading bank in Latvia and the Baltic region. To achieve this goal, SEB Unibanka elected to cooperate with the Skandinaviska Enskilda Banken (SEB), whose strategic plans called for major investments in the banks of Latvia and the other Baltic States".[6]

2.34 SEB Latvijas Unibanka is now part of a banking group that services 4 million clients in 20 countries.

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[5] Eurobarometer, Public Opinion in the Candidate Countries, Financial Services and Consumer Protection, May 2004

[6] http://www.seb.lv/en/about/us/history/

2.35 Parex Banka was registered on 14 May 1992 as one of the first commercial banks in Latvia. It was the only Latvian bank to return a profit in 1998, the year of Russian financial crisis, and during that year received a substantial syndicated loan from seven major western banks. In the same year, Parex Banka was formally recognised by German Bundesbank, receiving representative office status in Frankfurt, and further international expansion was achieved in the next year through the acquisition of Baltic Polis, Lithuania, by Parex Insurance Company. This trend of expansion at home and abroad continued over coming years but Parex Banka remains 86 per cent owned by its two founders, Valery Kargin and Viktor Krasovitsky. Parex Banka may have expanded its shareholder base and it now includes funds managed by various international finance houses but its ownership and management remain very much distinct from the other big players in Latvian banking, Hansabanka and SEB Latvijas Unibanka. The Banker[7] reports:

> "Lacking the financial resources of its foreign-backed Baltic rivals, Parex prides itself on its local knowledge and remaining fleet of foot. Parex's vice-president Gene Zolotarev boasts that it is the only bank in the Baltics to have never made a loss, year on year, despite the various crises that have swept the region. 'Foreign competition is a challenge but, year to year, we can stay on top as we are good at anticipating trends. We have no Soviet baggage and never developed any bad habits. On the other hand, the foreign banks are trying to adapt their international products to the local market which doesn't always work,' says Mr Zolotarev".[8]

2.36 Figure 2.7 shows that the proportion of banking assets in Latvia owned by non-Latvian residents has been in decline since the turn of the millennium. If anything, EU membership has coincided with a quickening in the pace of this trend. Very few assets beyond those held by Hansabank Group and SEB Latvijas Unibanka, two of the big players in Latvian banking and both owned by Swedish based financial groups, are owned by non-Latvian residents. However, as we have seen, the period since EU membership has coincided with the market shares of Hansabank Group and SEB Latvijas Unibanka increasing. This suggests that banks with assets held by non-residents may be better placed to take advantage of the market conditions that EU membership has created than those banks with assets held by residents.

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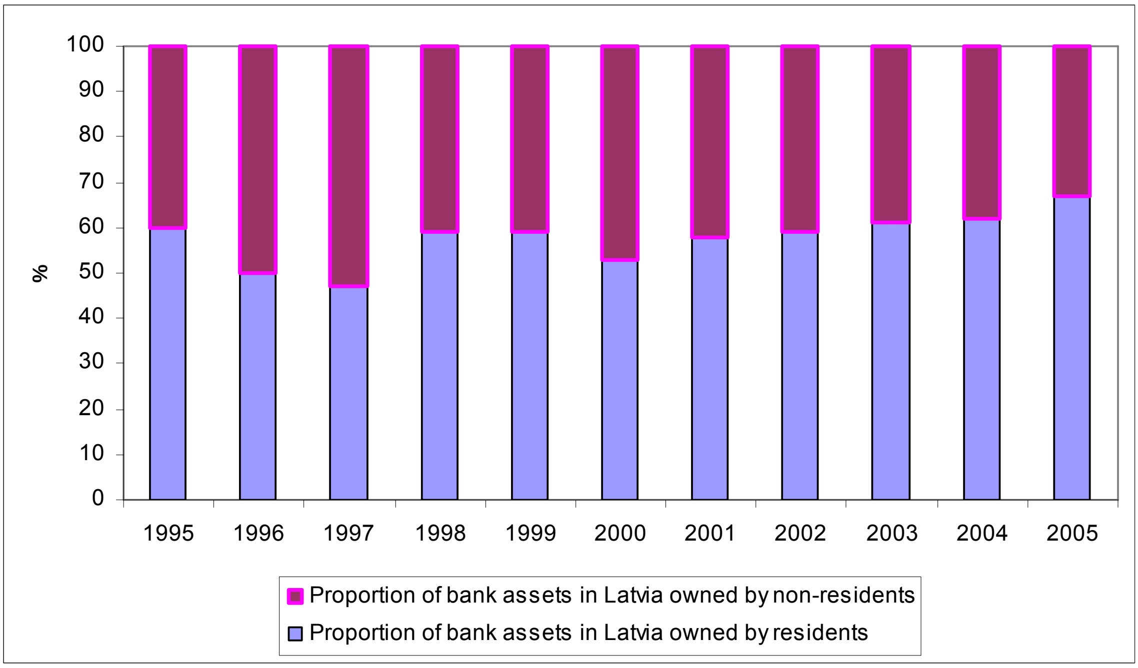
7 The Banker is a financial magazine published by Financial Times Business (FTB) - the publishing wing of the Financial Times.

8 The Banker, 4 July 2005.

Figure 2.7: Ownership of Banks in Latvia



Source: Association of Latvian Commercial Banks

2.37 Table 2.2 below also does not show evidence of the FSAP leading to a significantly increased international presence in Latvia.

Table 2.2: Foreign credit institutions (Non Latvian) in Latvia, 2001-2005

	2001	2002	2003	2004	2005
Branches of credit institutions from EU area	1	1	1	1	1
Subsidiaries of credit institutions from EU area	3	3	3	5	6
Branches of credit institutions from third countries	0	0	0	0	0
Subsidiaries of credit institutions from third countries	3	4	4	3	3

Source: ECB

2.38 However, Table 2.3 does suggest a slightly increased level of mergers and acquisitions within the EU since the FSAP measures were introduced, though, this increase adds to a very low base.

Table 2.3: Mergers and Acquisitions

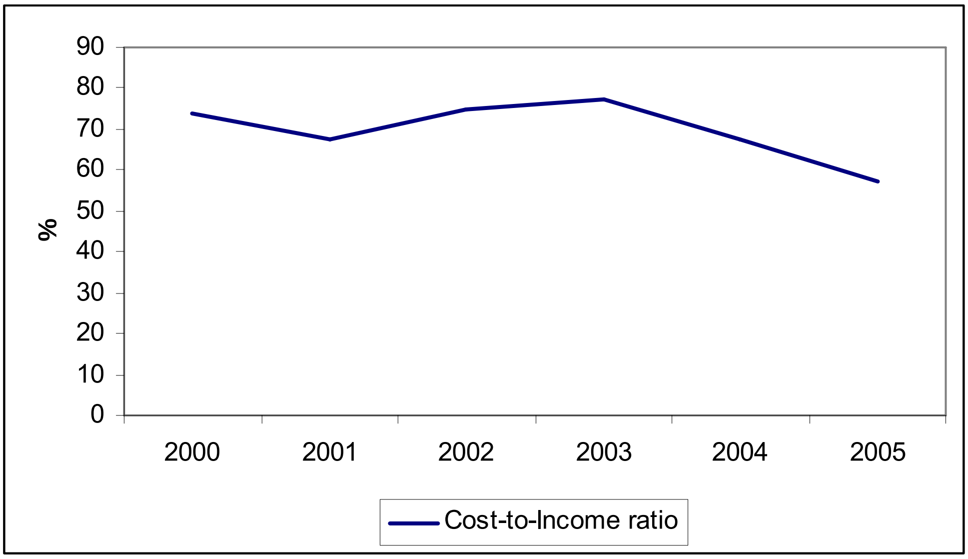
	2000	2001	2002	2003	2004	2005	2006*
Domestic M&A's	0	0	0	0	0	0	0
Internal EU M&A's	1	1	0	0	2	3	0
Third country M&A's	0	0	2	1	0	0	2

*Source: ECB, *half year*

Competitiveness

2.39 Figure 2.8 gives the cost to income ratio for Latvian banks. Despite some cyclical variations, there does not appear to be significant change.

Figure 2.8: Cost to Income, 2000-2005



Source: Association of Latvian Commercial Bank. Note: cost comprise staff and administrative costs and depreciation.

Impact of the FSAP and FSWP Legislative Measures on the Latvian Banking Sector

Cross-border business, takeovers and the development of a regional market

2.40 Figure 2.7 shows that the proportion of banking sector assets owned by non-Latvian residents has been in decline since the introduction of the FSAP measures, while Figure 2.6 shows that concentration ratio 5 have both increased over the same period. The decline in banking sector assets owned by non-Latvians would perversely suggest that the FSAP has acted to slow the full creation of a regional market. However, the direct beneficiaries of the increased level of concentration in Latvian banking are the two largest banks, both backed by international, Swedish banks and both significant players throughout the Baltics. Therefore, the period since the introduction of the FSAP measures has been characterised by an improvement in the position of the banks most deeply integrated and involved with the regional market.

2.41 This would seem to suggest that the regional Baltic and Nordic market will continue to deepen in coming years, while the opening of a branch of a foreign bank in Latvia, as illustrated in Figure 2.1, also suggests a deepening of Latvian integration into international markets. This is also suggested by the fact that respondents to our survey think that it is likely that in coming years Latvian banks will operate in more EU Member States.

Competition

2.42 Two features of the Latvian banking market suggest a strong level of competition. First, the market positions of the big three players have, as we have seen, been subject to some fluctuation in recent years. There seems to be some extent to which the two biggest players in Latvian banking, Hansabank Group and SEB Latvijas Unibanka, compete in the market with the expertise and capital that their Swedish backers give them against the local knowledge of the smaller players. The development of market shares since the introduction of the FSAP measures might suggest that the FSAP has acted to create a market more favourable to banks backed by larger, international players.

2.43 Nonetheless, the number of players in the Latvian banking market is very large by Baltic standards. This is the second market feature that is suggestive of a high degree of competition. There are far more players in Latvian banking than there are in Estonian or Lithuanian banking, yet the number of potential customers in each market are comparable. This inevitably produces more intense competition in Latvia.

2.44 There is a question as to how many of the very small players in Latvia will continue to survive in a market that, partly as a consequence of the FSAP, is ever more integrated into regional, European and global markets.

Competitiveness

2.45 The improved fortunes, as illustrated by the increased concentration ratios seen in Figure 2.6, of the Hansabank Group and SEB Latvijas Unibanka, the banks backed by international, Swedish players, suggests a strengthening of the position in Latvia of those banks most deeply integrated into the regional markets. It is questionable as to what extent the many small players in Latvian banks, who are not so integrated into regional markets, will be able to compete in coming years as the regional market continues to develop. Therefore, the large number of small players in Latvian banking, while being a source of more intense domestic competition and increased customer choice, may be a handicap in terms of Latvian ability to compete in regional and European markets.

Employment

2.46 Figure 2.2 shows a rapid growth in both incomes and salaries, while Figure 2.3 shows that employment in banking has increased since the introduction of the FSAP measures. Respondents to our survey see this as having occurred due to new jobs being created as a consequence of innovative products being developed, partly, as a consequence, in turn, of the new markets that the FSAP helped to open up. This was seen as a trend that was likely to continue in the future.

Consumer protection

2.47 Not all measures and directives of the FSAP were introduced in Latvia until 2005. For example, 2002/65/EC concerning the distance marketing of consumer financial services was only transposed into Latvian legislation on 30 November 2004. Therefore, it is too early to say definitively whether or not the FSAP has added to consumer protection or not.

2.48 Nonetheless, it would seem that the FSAP measures are an improvement on what had gone before in Latvia in respect of consumer protection. However, there was a strong sense amongst respondents to our survey that Latvian financial operators and regulators were conscious of the need to improve consumer protection prior to the relevant FSAP measures being transposed in Latvia.

2.49 When considering consumer protection in Latvia it is worth keeping in mind the low level of financial literacy that the Eurobarometer study citied earlier suggested. With low levels of financial literacy there is always a limit to the extent to which even the best designed regulation or state actions can protect consumers as consumers lack the necessary knowledge, skills and awareness to best protect themselves and they will always be vulnerable to unscrupulous providers of banking products. It is not clear that the FSAP has done anything in Latvia to encourage greater consumer protection by improving financial literacy. If the findings of the Eurobarometer study hold, therefore, this remains a pressing issue for Latvian banking.

Conclusions

2.50 In light of the above, so far it appears difficult to disentangle directly observable impacts of the FSAP on the Latvian banking sector from the broader process associated with the development of the internal market.

2.51 However, in the banking sector increasing salaries and employment can be observed, which suggests a rising demand for financial services and possibly an increasing level of financial development.

2.52 Further, the relative position in Latvia of those banks most integrated into regional markets has strengthened since the introduction of the FSAP, suggesting that the FSAP has encouraged a deepening of regional markets. By setting common rules with other Nordic countries and greater regulatory certainty for potential investors, the FSAP may have encouraged this trend and the establishment and deepening of a pan-Nordic and Baltic market for banking services.

2.53 In this respect Latvia seems an increasingly attractive location for banks seeking foreign expansion, particularly those from Scandinavia, and the competitiveness and profitability of the sector should ensure that this is likely to remain the case. The possibility of squeezing out some of the many small players in Latvian banking may also attract increased foreign capital to Latvian banking in future. This is particularly likely given the extent to which Latvian macroeconomic indicators are increasingly in line with eurozone ones. This will increasingly act to reduce the risk for foreign capital attracted to Latvia.

2.54 The FSAP rules do not appear to be doing anything significant to hinder the long-term competitiveness and profitability of the Latvian banking sector.

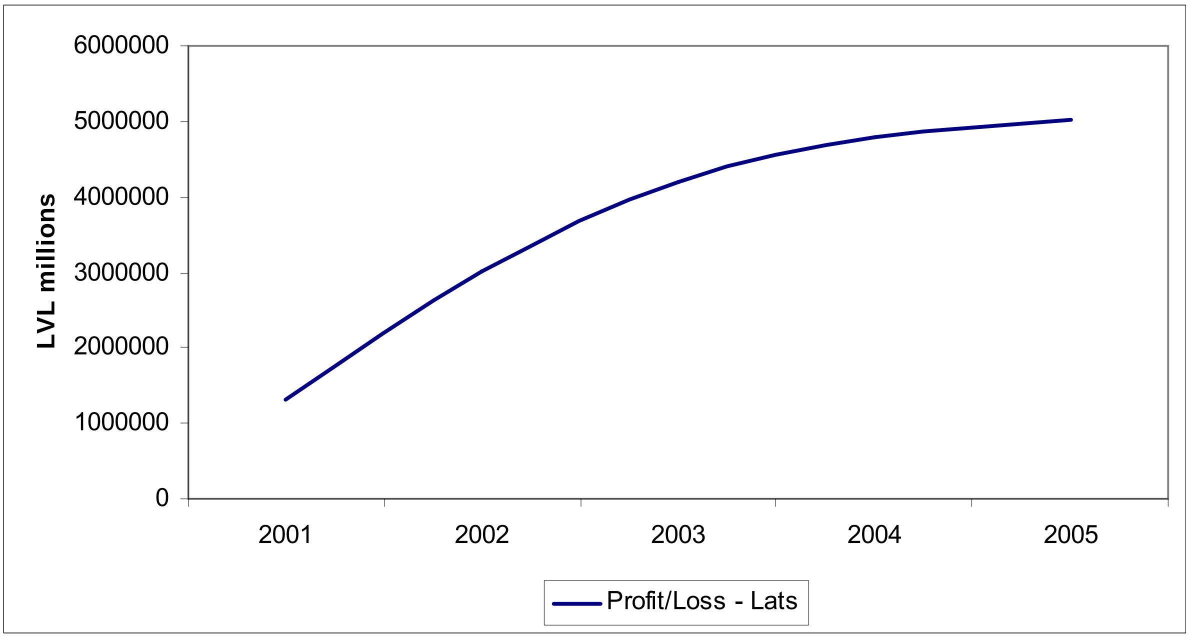
3 INSURANCE

The Latvian Insurance Sector

Profitability

3.1 Figure 3.1 gives an indication of the development and strength of the Latvian insurance sector, with profits steadily increasing in recent years.

Figure 3.1: Profit of Latvian Insurance Companies (LVL millions)

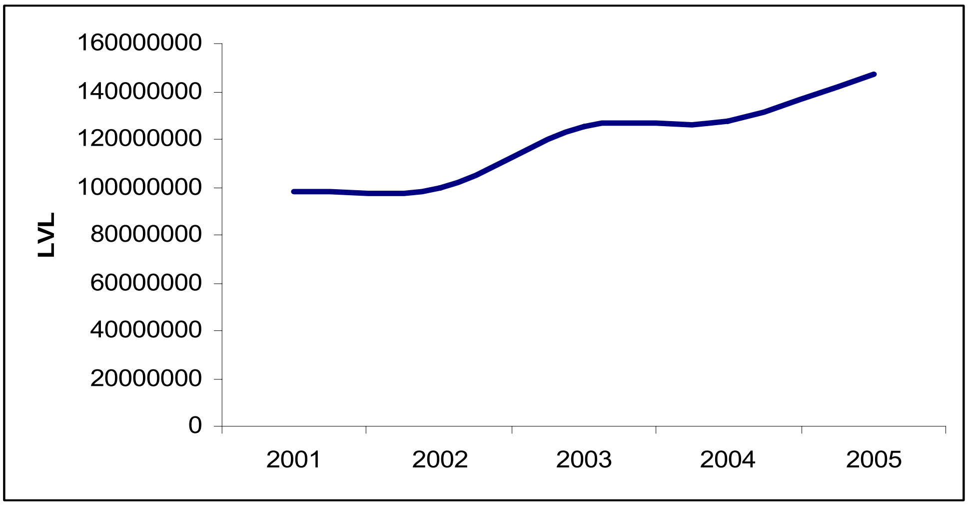


Source: The Financial and Capital Market Commission

Turnover

3.2 Figure 3.2 shows that the growth of the Latvian insurance sector is reflected not only in increased levels of profitability, as Figure 3.1 showed, but also in an increasing level of turnover, as shown by gross premiums written.

Figure 3.2: Gross Premiums Written



Source: The Financial and Capital Market Commission

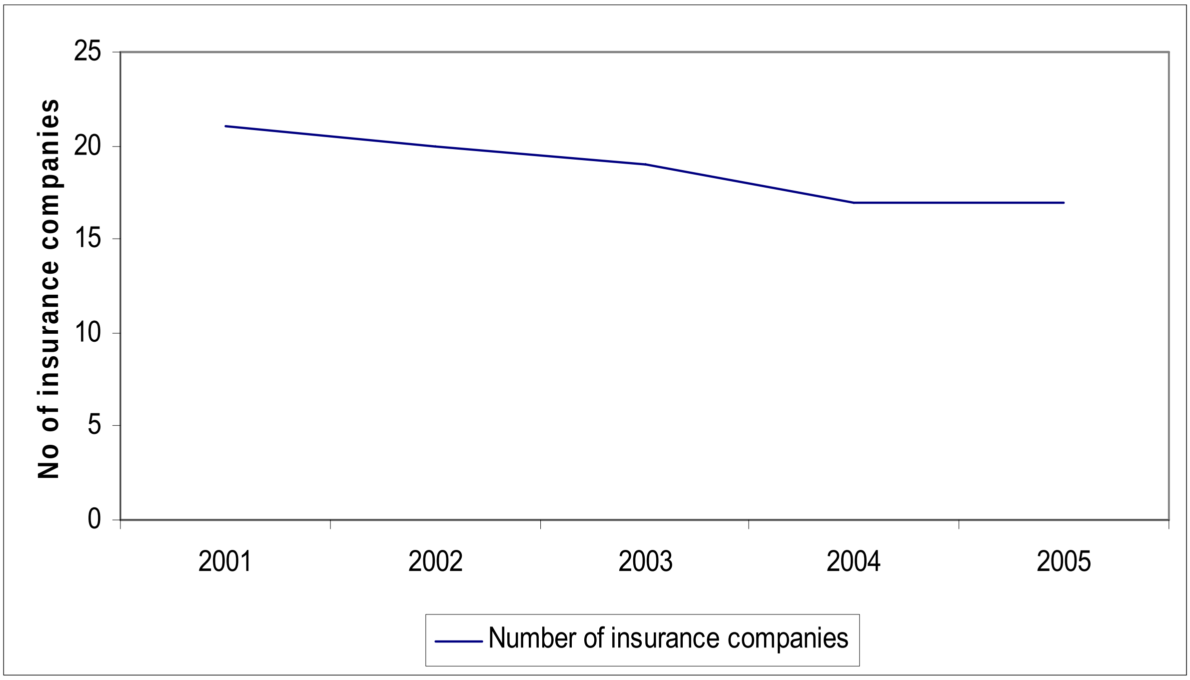
3.3 The Financial and Capital Market Commission reports:

> "In 2005, the insurance market developed rapidly, the volume of gross premiums written in 2005 over the previous year was 19.2%, and the real increase in the volume of gross premiums written in 2005 over the previous year constituted 12.5% (compared to -1.5% in 2004)". [9]

Number of Players

3.4 Turnover and profitability may be increasing but Figure 3.3 shows that this is occurring in the context of a more concentrated market, as recent years have seen the number of players in the market decline.

Figure 3.3: Number of Insurance Companies



Source: The Financial and Capital Market Commission

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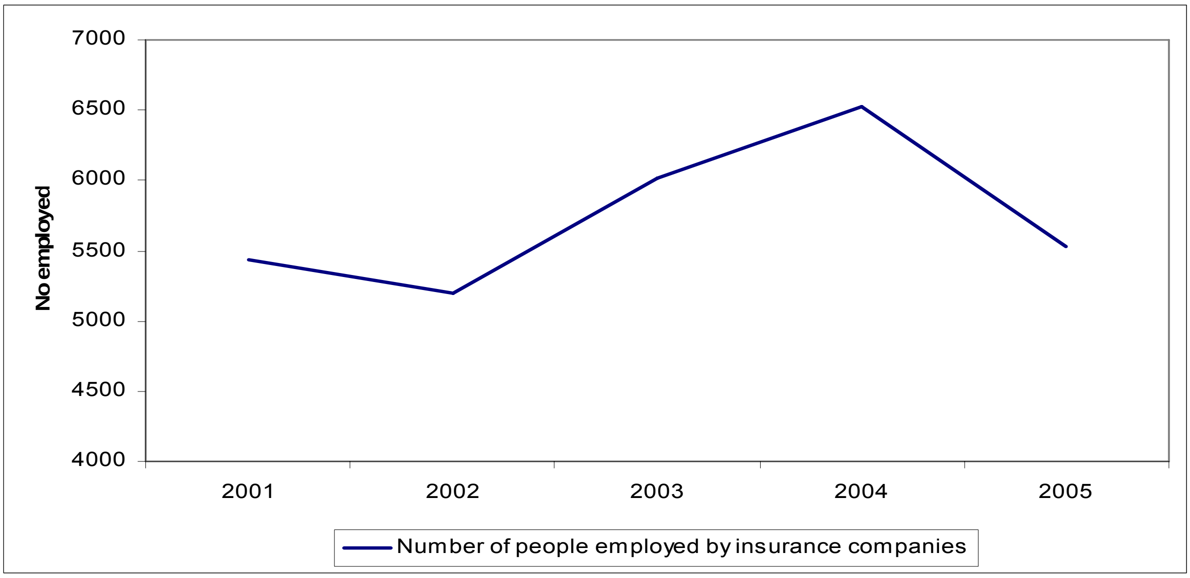
9 The Financial and Capital Market Commission, Latvian Insurance Market in Figures, 2001-2005.

Employment

3.5 In spite of increasing levels of activity, as defined by turnover, which is illustrated in Figure 3.2, recent years have seen fluctuating levels of employment in the Latvian insurance sector. The years since EU membership and the introduction of the FSAP measures have actually coincided with a decline in employment.

Figure 3.4: Number of People Employed by Insurance Companies

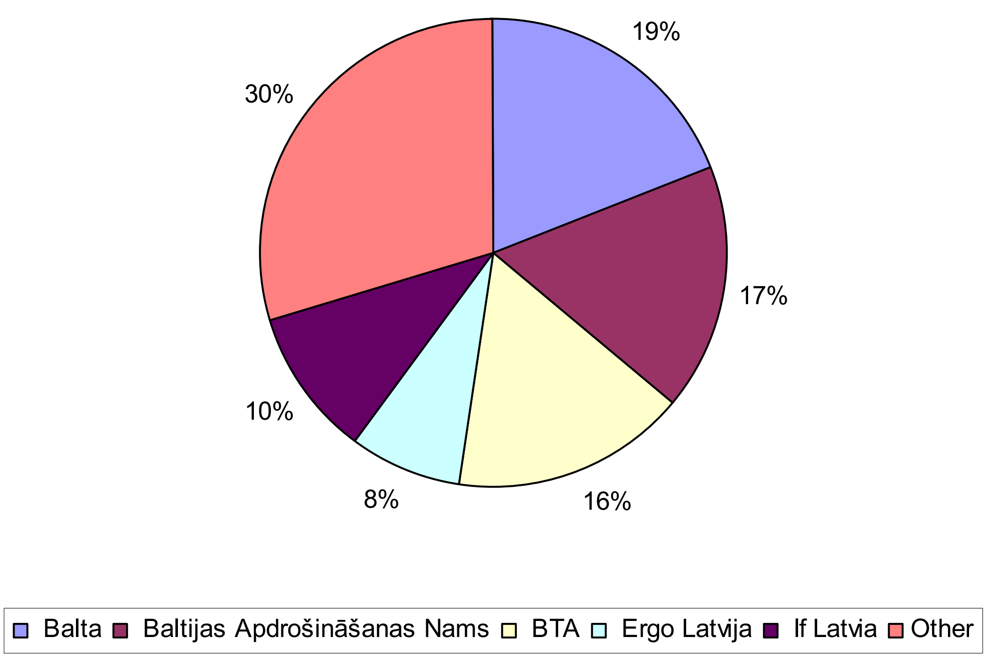


Source: The Financial and Capital Market Commission

Market Share

3.6 Figure 3.5 sets out the market shares of insurance companies in Latvia.

Figure 3.5: Market Share of Insurance Companies in Latvia by Gross Premiums



Source: Latvian Insurers Association

3.7 As in the banking sector, the Latvian insurance sector has more players (19) than this sector of for example the Estonian economy (13). A number of these players are so small, however, that they are not even visible on Figure 3.5. Indeed, 12 Latvian insurance companies have market shares of less than five per cent. The market power of the vast majority of players in the Latvian insurance market is, therefore, very minimal to non-existent.

3.8 The major shareholders in AAS Balta, the market leader, are the Danish insurer Codan (51.9 per cent), the European Bank for Reconstruction and Development (24 per cent) and the Danish investment fund IO Fund (24 per cent). Codan is part of the Royal & Sun Alliance group of companies, the leading UK insurer. ASS Balta observe the following:

> "Balta has become a full-fledged member of the Royal & Sun Alliance global network. This gives a possibility to use up-to-date, world-practice proven solutions, which ensure client servicing in accordance with the highest standards".[10]

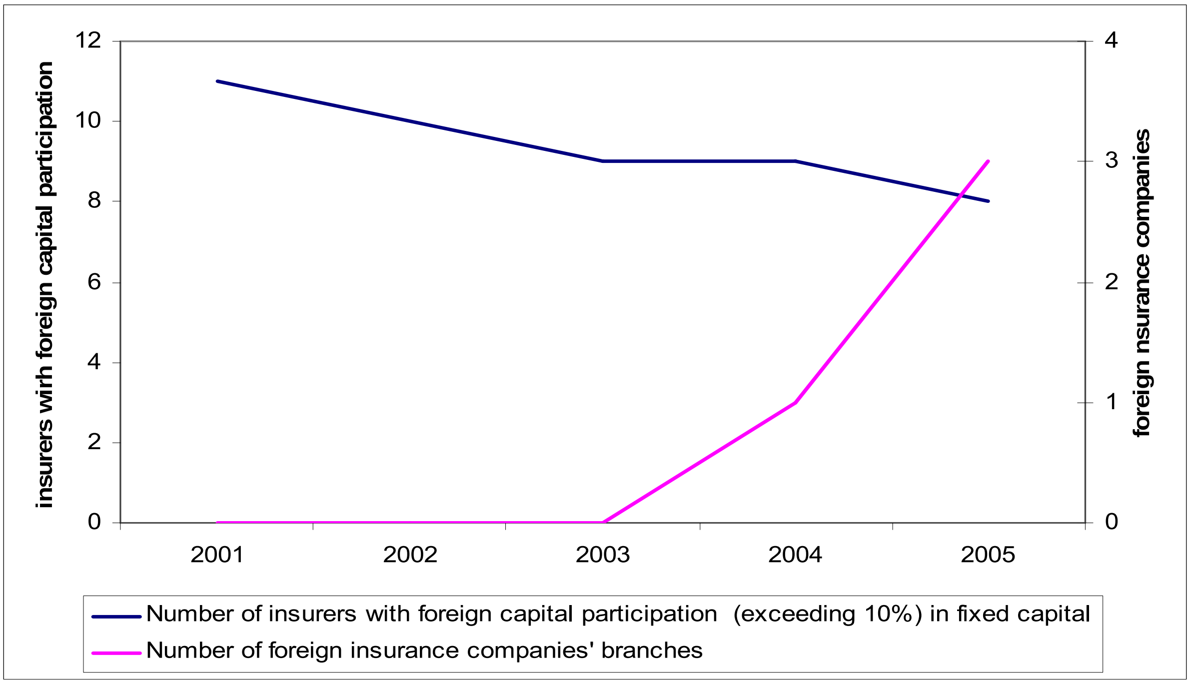
3.9 The fact that Balta simultaneously enjoys the status of being a member of the Royal & Sun Alliance global network and maintains the European Bank for Reconstruction and Development as a major shareholder illustrates both the potential of the Latvian insurance sector and its integration into the global market place, as well as its still somewhat embryonic, underdeveloped character.

International Entry

3.10 Figure 3.6 presents a divergent picture in terms of international entry. The number of foreign insurance companies' branches has increased since the FSAP measures were introduced, suggesting an increased level of international entry, while the number of insurers backed by foreign capital has declined over the same period, suggesting a reduced level of international entry. However, the fact that the number of notifications received by the Financial and Capital Market Commission from authorities of European Economic Area countries regarding the exercise of freedom to provide services in Latvia increased from zero in 2003 to 109 in 2004 and 192 in 2005 has to be borne in mind before any conclusions are drawn on international entry.

10 http://www.balta.lv/public/26099.php

Figure 3.6: Number of Insurers backed by Foreign Capital and Number of Foreign Insurance Companies' Branches

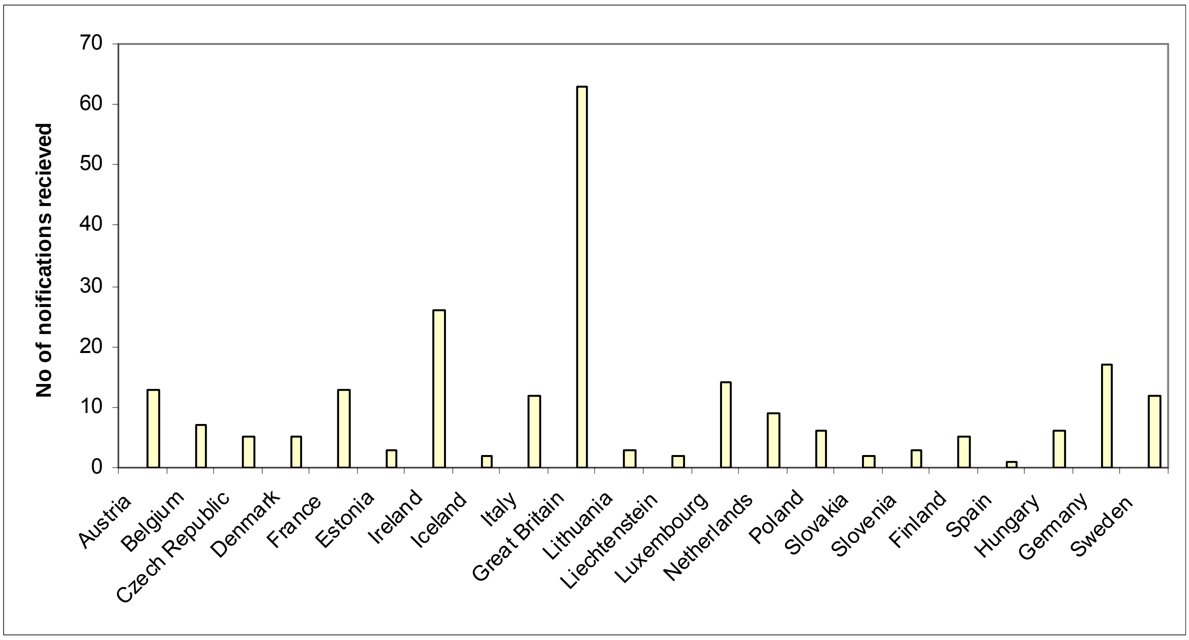


Source: The Financial and Capital Market Commission

3.11 Figure 3.7 illustrates where the much increased number of notifications received by the Financial and Capital Market Commission from supervisory authorities of European Economic Area countries regarding the exercise of the freedom to provide services in Latvia have been coming from.

3.12 Figure 3.7 shows that the potential of the Latvian insurance sector has been recognised throughout Europe. This recognition is not restricted to, nor dominated by, the Scandinavian countries. Indeed, the UK stands out as being a country from which far more notifications regarding the freedom to provide services in Latvia have been received than any other country. This suggests that the Latvian market is becoming integrated into a broader European market place rather than simply existing within itself or within a contained Baltic and Scandinavian regional market. Having said that, the fact that the UK stands out could also be a reflection of its dominance of financial services across Europe.

Figure 3.7: Origin of notifications received by the Financial and Capital Market Commission from supervisory authorities of European Economic Area countries in 2006 regarding the exercise of the freedom to provide services in Latvia



Source: The Financial and Capital Market Commission

Impact of the FSAP and FSWP Legislative Measures on the Latvian Insurance Sector

Level of Implementation

3.13 It appears that the FSAP measures have been largely implemented in Latvia and market participants have generally, though not completely, adapted to the new provisions.

Market entry, cross-border business and takeovers

3.14 Respondents to our survey concluded that the FSAP has reduced the legal barriers to entry in the insurance sector. They also concluded that the FSAP has reduced the technical barriers to entry in the insurance sector.

3.15 This perception of reduced barriers to international entry might be seen to be reflected in Figure 3.7. The number of notifications received by the Financial and Capital Market Commission from authorities of European Economic Area countries regarding the exercise of freedom to provide services in Latvia has shot up from a very low initial level. The integration within an EU wide insurance market which this trend suggests is reflected in the view held by respondents to our survey that previously cross-border trade occurred within the Baltic countries but now occurs across the EU. The expectation of a coming increase in e-commerce, which respondents to our survey have, may also encourage this trend.

3.16 Furthermore, respondents were of the view that international trade through branches has increased in recent years and is likely to go on increasing in coming years but neither would this increase have occurred or be likely to occur in the future in the absence of the FSAP. They are also of the view that international trade via mergers is likely to increase in coming years as a consequence of the FSAP.

3.17 Figure 3.3 suggests that takeover activity has already led to a concentration of the market, while the many small players illustrated in Figure 3.5 (as well as those too small to even merit illustration on Figure 3.5) seems to suggest that the coming years may be characterised by increasing takeover activity, particularly if the anticipated increase in cross-border trade yields the kind of competitive pressures that would be expected of this trend.

Competitiveness

3.18 Figure 3.1 and Figure 3.2 show that levels of profit and turnover have been growing very strongly in recent years, indicative of improved competitiveness.

3.19 Respondents to our survey consider insurer efficiency to have increased by more than 5 per cent in the past five years and they expect it to improve by more than 5 per cent in the next five years. However, in the absence of the FSAP, they think that no increase would have occurred in the past five years and that the anticipated increase in coming years will be more minimal. There is, therefore, a perception that the FSAP has acted to make the Latvian insurance sector more competitive.

Products variety, e-commerce and prices

3.20 The Financial and Capital Market Commission report that land vehicle insurance increased between 2001 and 2005 from 18.2 per cent to 32.3 per cent of gross premiums written by non-life insurers. Aircraft insurance increased from 12 per cent to 36.8 per cent of reinsurance business accepted by non-life insurers between 2004 and 2005, while transport ownership liability insurance declined from 37.8 per cent to 25 per cent of reinsurance business accepted by non-life insurers over the same period. These shifts suggest either changes in demand or improvements in products variety or quality causing consumers to alter their behaviour. Product variety is considered to have been constant in recent years by respondents to our survey, while an increase is expected in coming years but this is not attributed to the FSAP.

3.21 Figure 3.2 would not demonstrate such a strong growth in turnover if prices were prohibitively high. However, respondents to our survey expect prices to increase in coming years by a greater degree than they would otherwise have done as a consequence of the FSAP.

3.22 Likewise e-commerce is considered to have been constant in recent years by respondents to our survey, while an increase is expected in coming years but this is not attributed to the FSAP.

Consumer Protection

3.23 The supervisory requirements contained in the FSAP are reported to have improved awareness of companies regarding importance of corporate governance, which suggests that the FSAP can only have contributed positively to consumer protection.

3.24 Respondents to our survey were of the view that consumer protection has increased in recent years and is likely to continue to increase in coming years. However, they concluded that these increases would have happened irrespective of the FSAP.

3.25 Having said this, respondents to our survey did see the FSAP as having contributed to an improvement in corporate governance structures, which might be associated with increased consumer protection. The particular improvement in corporate governance that was citied was increased requirements of disclosure.

3.26 Respondents to our survey were, however, of the view that the FSAP has acted to make an increase in consumer awareness of insurance products likely to occur in future, a trend likely to minimise the risk of consumers falling victim to mis-selling.

Conclusions

3.27 From the above we can see that many of the trends that might be expected to have followed the FSAP, for example greater efficiency, greater concentration and reduced barriers to cross-border activity, have indeed occurred.

3.28 These effects have occurred in the context of a market that remains, as respondents to our survey pointed out, very small but very competitive.

3.29 The small and still maturing nature of the market is emphasised by the fact that the largest market player continued to count the European Bank for Reconstruction and Development amongst its largest shareholders, while the competitive nature of the market may well see some of the many very small players shaken out of the market in coming years as the FSAP contributes towards further encouraging competition.

3.30 The impact of the FSAP is clearly discernable and the Latvian insurance market continues to mature as it takes it place amongst not only the regional Baltic and Nordic market but within a pan-European market.

4 SECURITIES MARKETS

4.1 The Riga stock exchange, the only stock exchange in Latvia, is a part of the OMX group of exchanges, covering most of the Nordic and Baltic countries.

4.2 The company's 2005 annual report refers to global market trends as the driving forces for the OMX, all demanding more efficient securities transactions. The same report also referred to the opportunities and threats presented by self regulation and by the FSAP.[11]

4.3 The OMX expects the combined effect of measures such as the MiFID, self-regulation and the harmonisation of corporate governance structures to lead to increased competition across industry and national borders. The OMX expects the increased harmonisation in the EU to have a major impact on future financial infrastructure and competition, though it singled out technology as the main driving force for growth and efficiency.

4.4 OMX reports that between 2004 and 2005 the value of share trading in € million of the Riga Stock Exchange increased from 27.95 to 72.23, the value of share trading per business day in € million of the Riga Stock Exchange increased from 0.11 to 0.29, the number of share trades over the year on the Riga Stock Exchange increased from 16,180 to 30,054, the number of share trades per business day on the Riga Stock Exchange increased from 67.68 to 118.79 and total market capitalization in € million on the Riga Stock Exchange increased from 1068.81 to 1745.55.[12]

4.5 The introduction of the FSAP has, therefore, coincided with a period of much increased activity and strong growth on the Riga Stock Exchange. Nonetheless, the number of shares listed remained constant at 12 between 2004 and 2005. This is a very small number of shares and, judging by this measure, the Riga Stock Exchange is smaller than those in Tallinn (15 shares listed in 2005) and Vilnius (43 shares listed in 2005). Riga is also the smallest of the Baltic exchanges by total value.

Factors Specific to the Latvian Securities Market

4.6 In practical terms, investing in securities listed in the Baltic countries barely differs from buying assets in established European markets. This is because of a gradual consolidation of the region's stock exchanges, including the takeover of the Baltic markets by Sweden's OMX. Elsewhere in eastern Europe, the exchange scene remains fragmented.

4.7 However, the Riga Stock Exchange remains, as has been said, the smallest of the three Baltic exchanges, none of which are particularly significant by global or even European standards. Therefore, Latvia is really very small and, moreover, is dominated by three big players, two of which featured heavily in our previous discussion of the Latvian banking market.

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11 http://www.omxgroup.com/digitalAssets/937_OMX_2005_ENG_web.pdf

12 OMX, Baltic Stock Exchanges in Figures 2005.

4.8 Hansabank Group and SEB Group account for 22.62 per cent and 20.06 per cent of the turnover of the Riga Stock Exchange, respectively, and both are large, Swedish owned banks that feature significantly in the Latvian banking market. The largest player on the Riga Stock Exchange is, however, Suprema Group, which accounts for 33.71 per cent of the turnover of the Riga Stock Exchange. Suprema Group was the first full-service investment bank to be established in the Baltics and now accounts for more than half of all trading on the three Baltic exchanges.

4.9 In spite of being a small exchange, largely dominated by Scandinavian banks, there is some confidence amongst market operators that the growth of recent years can continue. Urmas Riiel, head of research at Hansapank, Latvia's biggest bank, said towards the end of 2004:

"A year ago we thought the boom was over but since then the Baltic market is up 29 per cent. It is difficult to say when prices will peak".

4.10 Market operators also consider the optimistic prospects for the Latvian securities market to be based not on proximity to Russia but on integration within European markets. Sven Künsing, head of research at Eesti Ü hispank asset management, has said:

"there's no relevant link" between Baltic markets and Russia. "Some companies might benefit from the Russian boom, but the effect is limited." [13]

The Impact of the FSAP on the Latvian Securities Market

Nature of implementation

4.11 There was a conscious policy decision made by the Latvian authorities, and matched by their counterparts in other Baltic and Nordic, countries to implement the FSAP measures in such a way as to deepen the Baltic and Nordic regional security market. This deepening is a stated and on-going policy goal. The implementation of the FSAP in Latvia has to be seen through the prism of this goal.

4.12 Criticisms have been voiced against the process of the FSAP implementation in Latvia with a sense prevailing amongst Latvian operators that the burden of implementation has fallen disproportionately on smaller entities.

4.13 The Financial Instruments Law has been subject to several amendments so as to make Latvia compliant with directives relating to prospectuses, take over bids and markets in financial instruments.

4.14 Respondents to our survey did not consider market expectations to have responded to the FSAP prior to implementation but to have responded after the FSAP was implemented.

[13] Financial Times, 20 October 2006.

Impact

4.15 Arguably the most important point of the MiFID is the expansion of cross-border activities to create a well-functioning single European market for securities.

4.16 The most recent entrants to the Riga Stock Exchange were Nordnet Securities Bank (Sweden), Finasta (Lithuania), SEB Vilniaus Bankas suggesting that the objectives of MiFID are being achieved.

4.17 The motivations and efforts of OMX and regulatory authorities throughout the Baltic and Nordic region ought not to be discounted when assessing developments in Latvia. In October 2005 the name structure for exchanges indexes in Copenhagen, Stockholm, Helsinki, Tallinn, Riga and Vilnius were harmonized and OMX exchanges have introduced a uniform international standard for sector classification of listed securities.

4.18 The Financial Times observes that "the Baltic States (are) now in the vanguard of euro accession among the new EU countries, they are fast becoming the region that is best integrated with the world economy".[14] The conscious policy decision to integrate Baltic and Nordic security markets has contributed towards this verdict being made and has allowed actors in the Latvian market to work with the grain of the objective of the FSAP with respect to securities markets. The consequence is that the Latvian securities market remains small but rapidly growing and ever more integrated with broader European markets.

4.19 Interestingly, respondents to our survey think that cross-border activity in the Latvian securities market will increase by up to 10 per cent in coming years but that this form of activity would remain constant in the absence of the FSAP. They also expect to see a significant expansion, over and above what would have occurred otherwise, in stock and derivative exchanges across national borders. Moreover, they consider the FSAP to be the cause of a coming slight increase in the electronic trading of securities across-borders. They also see the FSAP as likely to lead towards a significant improvement in ability to raise capital on an EU wide basis.

4.20 Arguably the MiFID, the most important piece of the FSAP on securities markets, is mainly aimed at facilitating the expansion of cross-border activities to create a well-functioning single European market for securities. However, given that the Riga Stock Exchange is part of the OMX group, which also has exchanges in Stockholm, Helsinki, Copenhagen, Tallinn and Vilnius, it seems unlikely that the FSAP has had a significant direct impact on the integration of the Latvian securities market with other EU Member States.

4.21 Our view is that the Nordo-Baltic exchanges which are part of the OMX group are rather insulated, in the sense that they will probably not be affected by the migration of securities jobs to London (which may take advantage of its lead in systematic internalising). Similarly we do not expect to see any positive repercussions on the level of employment in the Latvian securities sector at an aggregate level, as the OMX has already had a positive impact on the level of employment.

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14 The Financial Times, 13 May 2005

4.22 Consumer protection issues are of relatively limited importance in the securities market. For this reason, the short-term impact of the FSAP on the Latvian securities market would be limited. However, if the market extends to a more general public, then there could be consumer protection issues, in that a broader range of users would imply more inexperienced users. That said, the MiFID is addressing that long term risk through extensive consumer protection provisions. Therefore, in our view the FSAP has so far had no significant impact on consumer protection in the Latvian securities market; but if more inexperienced market users were to use that market, the FSAP might have a positive impact.

Other objectives of the FSAP in the securities sector

4.23 The dominance of a small number of banks in the Latvian securities market by means that the FSAP, through making cross-border trading easier, has enabled greater consumer choice and, consequently, increased the ability of Latvian investors to diversify their investments and so act to insulate themselves from risk.

4.24 Respondents to our survey think that trade on the domestic primary exchange as a consequence of the FSAP have increased to a greater degree in recent years than they otherwise would have done.

4.25 They also expect that in coming years it will be more possible for Latvian investors to diversify risks as a consequence of the FSAP and they are of the view that the Market Abuse Directive has achieved its stated aim of reducing the incidence of market abuse. They also consider the FSAP to have improved cross-border and sector co-operation in dealing with market abuse.

4.26 They also see the Prospectus Directive as having achieved its stated objective of creating harmonization in relation to the contents and format of prospectuses.

Conclusions

4.27 The integration of the OMX markets is well established and it is hard to attribute specific mechanistic account of the way in which the FSAP has led to this. Nonetheless, the aspirational factors surrounding the FSAP in providing momentum to these trends suggests a more general contribution of the FSAP to the wider regional trends. However, it is unclear whether the FSAP has actually accelerated the process.

4.28 The strong praise for some aspects of the FSAP from stakeholders was matched by concern about the impacts of implementation on smaller market operators, many of which are to be found in Latvia, particularly by international standards. It might be that this reflects concerns in Latvia that improved mechanisms for cross-border trade will simply provide more opportunities for business beyond its small stock market. However, this may be an unjustified fear. The small size of the Riga market relative to Tallinn and Vilnius suggests that it still has significant scope for expansion before it adopts the position within the Baltic and Nordic market that it has the potential to.

5 FINANCIAL CONGLOMERATES

5.1 At the time of writing, we are not aware of any conglomerates the headquarters of which are located in Latvia, but those that operate in the country are shown in the Table 5.1 below.

Table 5.1: Conglomerates operating in Latvia

Name	Head office base	Characterization of Conglomerate
Allianz	Germany	Insurance group doing asset management and banking
Nordea	Sweden	Banking, Asset Management, Insurance. Contribution to net profit: Retail Banking 66%, corporate and institutional banking 25%, asset management 5%, life insurance 3%
Sampo	Finland	Banking and Insurance
SEB	Sweden	Banking firm doing insurance and asset management

Source: EC Mixed Technical Group on the Supervision of Financial Conglomerates, Europe Economics

5.2 Respondents to our survey do not exhibit awareness of the presence of financial conglomerates to be operating in Latvia. This is in spite of the fact that operators have significant roles in various financial markets — banking, insurance and securities. It might be that it is considered somewhat of an alien concept because none of the financial conglomerates operating in Latvia developed within the country, all have the majority of their operations outside Latvia and all of the regulators with ultimate regulatory responsibility for these financial conglomerates are not to be found in Latvia. Further, some of the conglomerates operating in Latvia have a reasonably small presence.

5.3 Sampo has a market share of only 0.7 per cent in the banking market but If Latvia, one of their subsidiaries, has a market share of 10 per cent in the insurance market and another Sampo subsidiary, AAS Sampo Dziviba, has a nominal stake in the relatively small Latvian life insurance market. Nordea also has only a 4.7 per cent market share in the banking market.

5.4 SEB is the exception amongst financial conglomerates in that it has a significant stake in several financial markets in Latvia. It has a market share of 16.5 per cent in the banking market and 19 per cent of the insurance market, through ownership of the market leader, Balta, and is responsible for 20.06 per cent of the turnover of Riga Stock Exchange.

The Impact of the FSAP on Latvian Financial Conglomerates

5.5 As we can see in Table 5.1, conglomerates in Latvia are engaged largely in banking and insurance. Thus, the conclusions for financial conglomerates in Latvia are somewhere between those for banking and insurance.

Openness to foreign firms

5.6 As our discussion of the banking sector argued, the market has developed in such a way since the introduction of the FSAP measures to the advantage of banks that are part of international banking groups. An illustration of this trend is that in 2005 Nordea, though a relatively small player in the banking market, opened a Customer Service Unit in Daugavpils, the second largest Latvian town, thus extending Nordea's Latvian coverage to all major Latvian districts. While in the insurance market the number of notifications received by the Financial and Capital Market Commission from authorities of European Economic Area countries regarding the exercise of freedom to provide insurance services in Latvia is indicative of a much increased openness to foreign firms in this market. We can conclude, therefore, that the FSAP has much improved openness to foreign conglomerates in Latvia.

Consumer Protection

5.7 There appears to be a consensus amongst stakeholders in both banking and insurance markets that the FSAP has improved standards of consumer protection but there is little evidence that the FSAP has improved upon the low levels of financial literacy seen in Latvia, which would seem a central challenge to achieving the best standards of consumer protection in Latvia.

5.8 Consumer protection issues are of relatively limited importance in the securities market. For this reason, the short-term impact of the FSAP on the Estonian securities market would be limited. However, if the market extends to a more general public, then there could be consumer protection issues, in that a broader range of users would imply more inexperienced users. That said, the MiFID is addressing that long term risk through extensive consumer protection provisions. Therefore, in our view the FSAP has so far had no significant impact on consumer protection in the Estonian securities market; but if more inexperienced market users were to use that market, the FSAP might have a positive impact.

Competitiveness

5.9 The increased market share of SEB in the Latvian banking market is indicative of a market that has become more advantageous to conglomerates operating in it, while SEB have also consolidated their position as the market leader in the insurance market in recent years. Therefore, competitiveness has improved in the years since the introduction of the FSAP for conglomerates operating in Latvia.

Employment

5.10 Since the introduction of the FSAP measures, the level of employment in the banking and the insurance sector has risen. Since the FSAP has had a positive impact on employment in the banking sector and since it has had a negligible one in the insurance sector, at this stage, it is unclear to establish what impact the FSAP has had on employment in the Latvian financial conglomerates.

6 CONCLUSION

Assessment

	Impact of FSAP on…				
	Openness to foreign firms	**Competition**	**Consumer Protection**	**Employment**	**Competitiveness**
Banking	Slightly positive	Positive	Slightly positive	Positive	Slightly positive
Insurance	Positive	Positive	Slightly positive	Negligible	Positive
Securities	Limited	Limited	Limited. Perhaps positive in the future	Limited	Limited
Financial Conglomerates	Positive	Positive	Slightly positive	Perhaps slightly positive in future	Positive in future

LITHUANIA

1 INTRODUCTORY OVERVIEW

Financial Services Regulation in Lithuania

1.1 In common with the other eight former Communist countries of Eastern Europe which joined the European Union (EU) in May 2004, several clear waves relating to the development of the Lithuanian financial sector can be identified. These developments should be seen in a wider context: the period after independence from the Soviet Union, which Lithuania declared in March 1990, saw rapid economic change across all sectors, not least in the financial sector.

1.2 Like the other former Communist Baltic countries, Estonia and Latvia, Lithuania was to suffer a banking crisis perhaps partly as a consequence of ill-advised decisions during this rapid change, which later necessitated improved regulation and prudent fiscal management. Lithuania was the last of these three countries to undergo this crisis - occurring in Lithuania in late 1995 (Estonia's occurred in 1992 and Latvia's earlier in 1995). The World Bank identified certain structural problems common in all three incidents. These incidents spurred subsequent financial reform in all three countries.

1.3 Their shared desire to join the European Union also encouraged reform in all three countries. Other international organisations, such as the World Bank and the International Monetary Fund, have also played roles in the development of market based systems in Lithuania. However, the final stages in the development of the Lithuanian financial system may be thought of as the steps needed to join the European Union and the impacts of membership. The Financial Services Action Plan (FSAP) is obviously a feature of this.

1.4 There are number of general features of Lithuanian's financial services industries which might be of non-trivial importance when conducting evaluation of FSAP. These include:

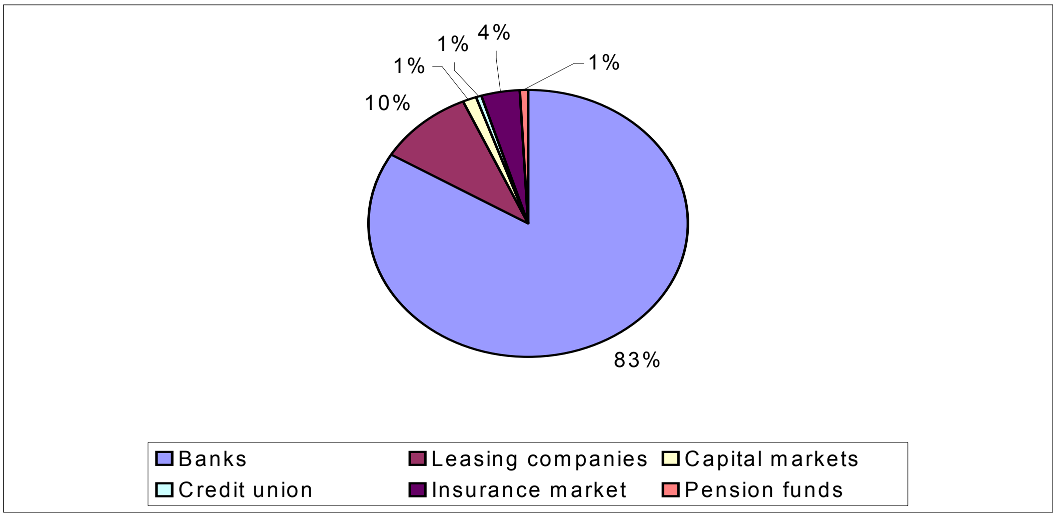
(a) The Lithuanian economy has grown in recent years, but remains small.

(b) There is a high exposure to external economies, particularly large neighbours such as Scandinavia, the Baltic countries, and Poland.

(c) The financial system is relatively small and unsophisticated. The system is dominated by banks with few sophisticated financial products and a large credit union presence.

(d) Lithuania levied a flat tax rate of 33 per cent on its citizens from 1994.

Figure 1.1: Composition of the financial system of Lithuania (2005)



Source: Bank of Lithuania

Division of responsibility

1.5 Responsibility for financial regulation and supervision of the banking, securities and insurance markets in Lithuania is spread across four authorities.

(a) **Bank of Lithuania (BoL):** this is responsible, within the European System of Central Banks, for monetary policy and its execution, as well as contributing to the stability of payment and financial systems.

(b) **Ministry of Finance:** this is responsible for the supervision of banks, other credit institutions and the securities market.

(c) **Securities Commission:** this is responsible for the supervision of the securities market.

(d) **Insurance Supervisory Commission**: this is responsible for the supervision of insurance and pension institutions.[1]

Key features of banking regulation

1.6 The main overseers of banking in Lithuania are the Ministry of Finance and the Bank of Lithuania.

1.7 The main legislation affecting the Lithuania banking system includes:

(a) Accounting and Financial Statements of Credit Institutions.

(b) Law on Insurance of Deposits and Liabilities to Investors (2002). This law lays down, among other things, the procedure for insurance of deposits, the procedure for insurance of liabilities and management undertakings to their investors and the level of insurance compensations.

(c) Law on Financial Institutions (2002). This Law defines financial services, sets forth requirements for founders, members and managers of financial and credit institutions,

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[1] In 2003 with the New Law on Insurance came into force and the State Insurance Supervision Authority – under the Ministry of Finance – became the Insurance Supervisory Commission of the Republic of Lithuania.

stipulates their rights and obligations, establishes the conditions, procedures, specific requirements for setting up, conducting business, winding up and restructuring financial institutions, also procedures and specific requirements for financial institutions engaged in the provision of licensing financial services and their supervision.

Key features of insurance regulation

1.8 The operations of insurance companies are overseen primarily by the Insurance Supervision Commission.

1.9 The main legislation affecting the Lithuanian insurance sector includes:

(a) Law on Insurance (2003). The main purpose of the new Law on Insurance was to remove existing limitations on entry of the insurance market of the Republic of Lithuania into the internal EU market, starting from the day of the accession to the EU.

(b) Law on the Supplementary Voluntary Accumulation of Pensions.

(c) Law on Pension Accumulation.

Key features of securities regulation

1.10 The Vilnius Stock Exchange (VSE) is the only regulated exchange operator in Lithuania, offering trading, listing and information services. Only VSE members – banks and brokerage companies – may trade on the VSE. OMX is the strategic owner of VSE.[2]

1.11 The main legislation affecting the Lithuanian Securities Market includes:

(a) Law on Collective Investment undertakings (2003). The purpose of the Law is to ensure protection of interests of the unit trust/common fund co-owners and shareholders of investment companies with variable capital.

(b) Law on Companies (2003). This law regulates the incorporation, management, activities, reorganisation, restructuring, division and liquidation of enterprises having the legal form of public or private limited liability companies, the rights and duties of the shareholders as well as the establishment of foreign state branches and termination of their activities.

(c) Law on Securities Market (2005). The Law provides a more detailed regulation of the public offering or listing of securities in a regulated market of another EU Member State and of the public offering or listing of securities in the regulated market of the Republic of Lithuania by an issuer with a registered office in the Republic of Lithuania.

1.12 On the basis of and in addition to legal acts, the VSE as a self-regulatory organization issues and enforces its own Rules and Regulations to ensure regular and lawful operation of the market.

[2] Through its exchanges in Copenhagen, Stockholm, Helsinki, Riga, Tallinn and Vilnius, OMX offers access to approximately 80 percent of the Nordic and Baltic securities markets with greater ease and value-adding services for trading members, listed companies, investors and other market participants. For more details see the Nordic case study in Lot 1.

The Implementation Process and General Effects of FSAP in Lithuania

Survey participants views about implementation

1.13 In the view of the participants in our survey the implementation process of the FSAP in Lithuania appears to have been smooth without particular difficulties and criticisms.

Consequences of the FSAP for the Regulatory Environment

1.14 Prior to the FSAP the Lithuanian regulatory framework was largely rule-based, though there may have been some scope for discretion in certain areas. What scope there was for regulatory discretion has not been reduced following FSAP measures.

1.15 Survey participants view the scale of change in domestic regulation as major and consider the level of FSAP implementation and level of regulation in Lithuania as broadly equivalent with that in other Member States.

1.16 Even though Regulation (EC) No 1606/2002 (IAS Regulation) created new tasks for the supervisor, relating to the financial statements prepared under IAS/IFRS Standards, the relationships between regulatory authorities have not changed.

1.17 The FSAP seems to have been regarded as increasing the interaction through regulator-industry relationships; regulatory authorities and industry are nowadays much more interactive. The activity and engagement of industry has increased after the FSAP. Ambiguous instead is the level of involvement of Lithuanian regulators with other MS regulators. However, this appears to have been increased.

1.18 Market expectations did not adjust to FSAP prior to its implementation, but did so after its implementation in response to FSAP.

2 THE LITHUANIAN BANKING SECTOR

Headline Overview

Number of players

2.1 There are six main categories of credit institutions on the Lithuanian market:

(a) Deposit money banks;

(b) Foreign banks' representative offices;

(c) Foreign banks' branches;

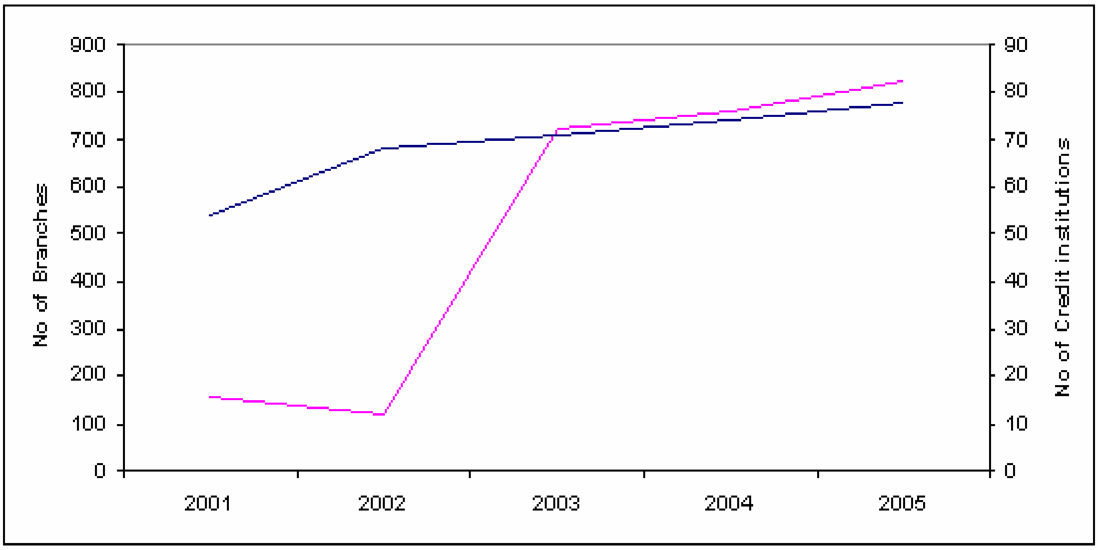
(d) Central credit unions;

(e) Credit unions; and

(f) European banks providing cross-border services without a branch.

2.2 Currently, nine commercial banks hold a license from the Bank of Lithuania, two foreign bank branches, three foreign banks representative offices, Central credit union of Lithuania and 64 credit unions are operating in the country. In 2005 the increase in banking institutions continued.

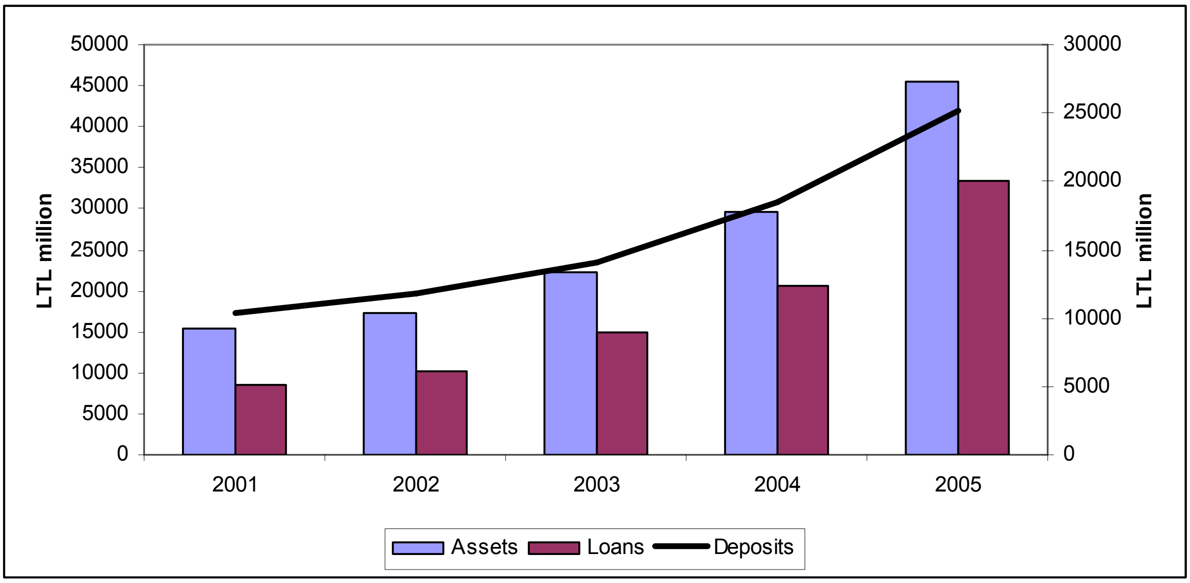
Figure 2.1: Banks in Lithuania, 2001-2004



Source: ECB

2.3 Recent years have seen a large growth of the assets of the domestic banking sector and in the portfolio of loans granted to customers, as seen in Figure 2.2 below. Moreover, the ratio of assets managed by banks to GDP increased by 47 to 63 per cent which may also reflect the increasing role of banks. Compared to the neighbouring Baltic States and other EU countries, this ratio is still relatively low (e.g. the ratio of assets managed by Latvian banks to Latvia's GDP makes up 134 per cent, and that of Estonia 116 per cent), but it shows the potential of domestic banks for the further development of their business.

Figure 2.2: Development of Assets, Loans and Deposits in the Banking system



Source: Bank of Lithuania 2005

2.4 Recent years have seen an increase in the size of commercial banks: Lithuanian banking may remain a small part of the EU banking market as a whole, but Lithuanian banks are growing in size, as seen in Table 2.1.

Table 2.1: Commercial Banks broken down by Size of Registered Share Capital

	1997	1998	1999	2000	2001	2002	2003	2004
Up to 30 LTL Million	3	2	2	2	0	1	1	1
30–50 LTL Million	1	2	3	2	4	3	3	2
50–100 LTL Million	4	3	2	2	1	2	1	1
more than 100 LTL Million	3	3	3	4	4	4	5	6

Source: Bank of Lithuania

2.5 Table 2.2 provides an illustration of the extent of the changes that have occurred in Lithuanian banking, in particular the decline in state ownership and rise in foreign ownership of commercial banks

Table 2.2: Composition of Share Capital of Commercial Banks by Form of Ownership

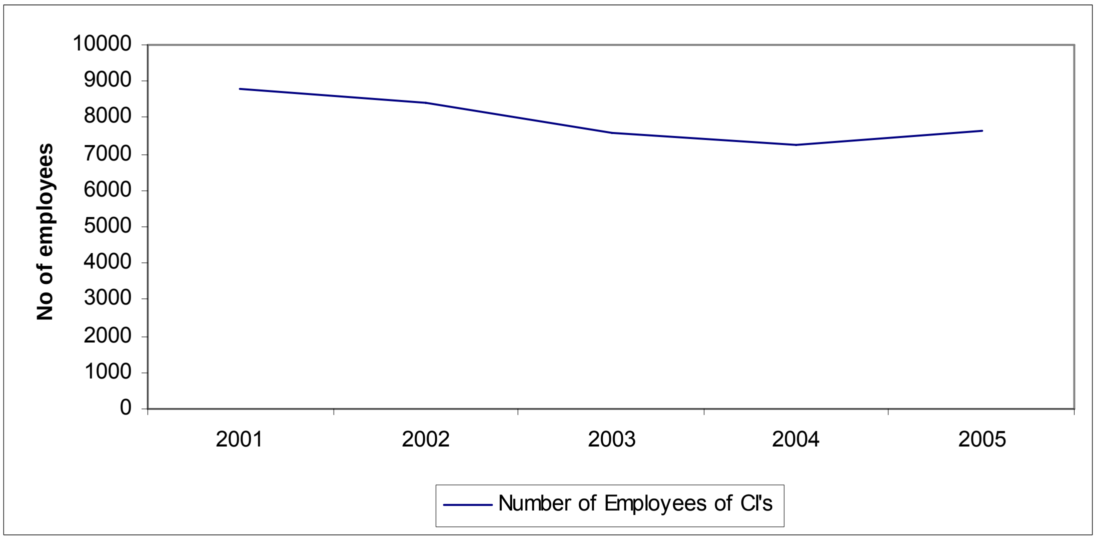
	1997	1998	1999	2000	2001	2002	2003	2004
Government and public enterprises	44.9	36.6	33.6	28.6	8.3	0.1	0.1	0.1
Lithuanian investors	22	25.8	31.8	13.7	10.6	11.8	11.2	12.6
Foreign investors	33.1	37.6	34.6	57.7	81.1	88.1	88.7	87.3

Source: Bank of Lithuania

2.6 Key factors for the development of Lithuanian economy, which contributed to the continuing strong demand for credit, have been the utilisation of EU funds, positive economic expectations and low interest rates.[3]

Turnover, employment and profitability

Figure 2.3: Employment in CI's



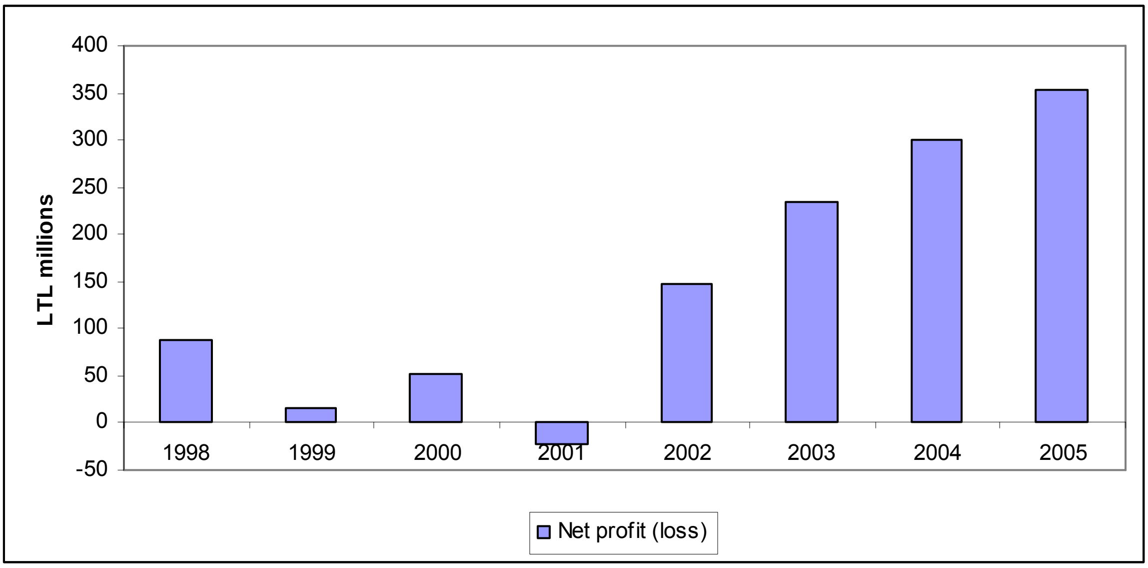
Source: ECB

2.7 As illustrated by Figure 2.3, employment declined between 2001 and 2004, but has subsequently recovered, somewhat.

2.8 In recent years the profitability of the Lithuanian banking system has increased reflecting the completion of the post-Communist reform programme and success in meeting the requirements of EU entry.[4]

[3] Bank of Lithuania Annual report 2005.
[4] In 2001 the performance results of the banking system were the following: the year was profitable for 6 banks and 1 foreign bank branch (they earned 117 million of profit). Whereas the situation with three banks — the Bank "Hansa-LTB", the PAREX BANK and the Sampo Bank — and three foreign branches — the Merita Bank Olc Vilnius Branch (which was renamed as from 2002 as Nordea Bank Finland Plc Lithuania Branch), Norddeutsche Landesbank Girozentrale Vilnius Branch and Vilnius Branch and VEREIS-UND WESTBANK AG Vilnius Branch — was contrary. During the same period they experienced a loss of LTL 139.5 million. Cfr. BoL Annual Report 2001.

Figure 2.4: Net Profit of Lithuanian Banks



Source: Bank of Lithuania, Amounts in LTL million

2.9 Growing income and improving cost efficiency have been the key factors strengthening the financial standing banking system — even though a further decrease of net interest margin (0.25 percentage point less in 2005 than in 2004) might be a source of concern for future development if there is an unfavourable economic cycle.[5]

2.10 *The Banker* has argued that these profits are attractive to foreign investors, leading to intense competition between capital rich foreign investors and Lithuanian operators with better local knowledge,[6] and more recently, the same magazine has suggested that the foreign owned banks are winning this competition due to their greater willingness to innovate and provide products wanted by an ever more demanding and sophisticated Lithuanian customer base.[7]

Market shares and concentration

2.11 As late as the end of 1998 majority state-owned banks represented 45.3 per cent of total bank assets, though complete privatisation was achieved by the end of 2001.[8] These two shifts in ownership contributed to increased concentration. The three biggest banks held 57 per cent of assets in 1997. The corresponding figure for May 2002 was 80.4 per cent.[9]

2.12 It should also be noted that Lithuania has a large number of credit unions, according to one source 65, with a combined membership of over 53,000.[10]

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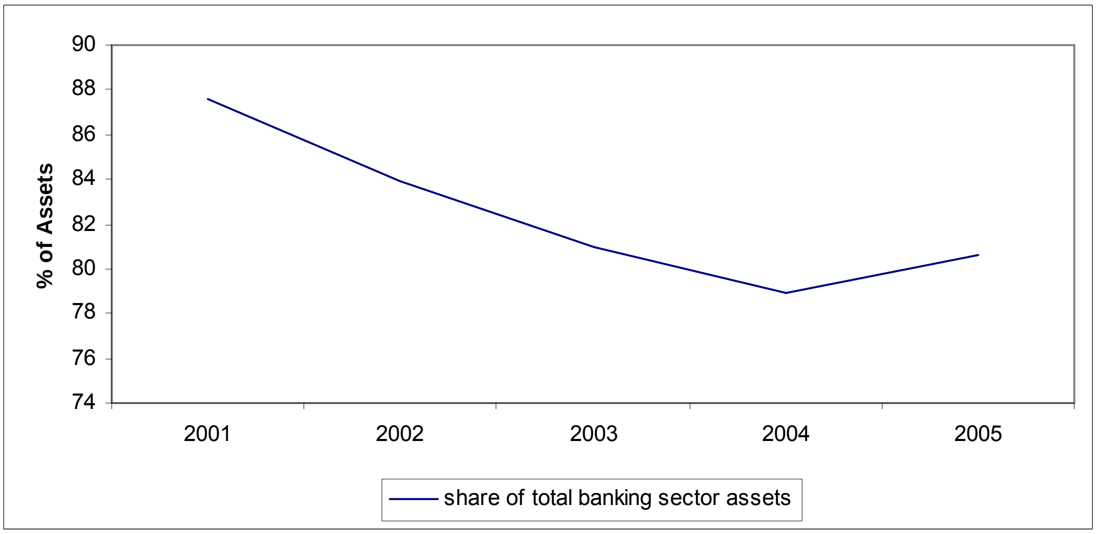
[5] Bank of Lithuania Financial Stability Report 2005.
[6] The Banker, 4 July 2005.
[7] The Banker, 3 April 2006.
[8] Regular Report from the Commission on Lithuania's Progress Towards Accession (2002).
[9] Regular Report from the Commission on Lithuania's Progress Towards Accession (2002).
[10] Lithuanian Credit Unions Network, http://www.lku.lt/index.php?option=content&task=section&id=13&Itemid=55.

2.13 One reason for the growth of credit unions was the closing of Lithuanian Savings Bank branches in rural areas. On 1 June 2001 AS Hansapank, acquired a 90.73 per cent state-controlled shareholding in the Lithuanian Savings Bank. This privatisation modernised banking services in many respects but rapidly impacted upon rural Lithuania which saw many former Lithuanian Savings Bank customers switch to local credit unions.

2.14 Figure 2.5 and Tables 2.3 and 2.4 illustrate how concentration has evolved since 2001.

Figure 2.5: Share of the 5 largest Lithuanian credit institutions in total assets



Source: ECB

Table 2.3: Herfindahl-Hirschman Index[11]

2001	2002	2003	2004	2005
2503	2240	2071	1854	1838

Source: ECB

Table 2.4: Number of Mergers and Acquisitions

	2000	2001	2002	2003	2004	2005	2006*
Domestic	2	0	0	0	0	0	0
Internal EU	3	1	1	0	1	0	0
Third country	0	0	0	1	0	0	0

*Source: ECB. * First half.*

[11] The Herfindalh Index ids defined in the Main Report.

Table 2.5: Number of non–Lithuanian branches and subsidiaries

	2001	2002	2003	2004	2005
Branches of CI's from EU area	3	3	2	2	2
Subsidiaries of CI's from EU area	2	3	3	5	5
Branches of CI's from third countries	1	1	1	0	0
Subsidiaries from third countries	2	2	2	0	0

Source: ECB

Perceptions of ease of switching, factors affecting competition, and consumer protection

Switching behaviour

2.15 Switching is notoriously difficult to assess, and subjective judgement by those close to the industry is often the main source of data. In the case of this report, our main data source is our opinion survey. Some respondents to that survey took the view that the effects on the switching behaviour of bank customers have so far been positive and is expected to increase in the future.

Consumer protection

2.16 The results of our survey suggest that consumer protection in Lithuania is widely regarded as having improved over the past five years and respondents envisage this continuing too.

Product variety, e-commerce, and prices

2.17 Participants in our survey believe that product variety, e-commerce and transparency have increased and will increase also in the future. However, they do not consider FSAP measures a major factor driving innovation in the Lithuanian banking system.

The potential future role of technology

2.18 The results of our survey suggest the number of products available on the market has increased over the recent years and the trend will be the same even in the future.

2.19 The transition in Lithuania has been dramatic. For example, Hansabankas, a leading Lithuanian bank, increased the number of electronic transactions from 66 percent to 76 percent of their total over 2004.[12]

2.20 Leasing, like credit unions, are another growing feature of Lithuanian banking and after launching its leasing operations in 2001 Snoras had 450,000 leasing contracts so that one Lithuanian in five is leasing something from Snoras. As Naglis Stancikas, deputy chairman of Snoras' board of directors, told *The Banker*:

> "It is a very profitable business, but the point is that we are able to handle nearly half a million contracts with only 30 staff members; the process is highly automated and it is still growing very rapidly."[13]

[12] The Banker, 5 September 2005.
[13] The Banker, 4 July 2005.

2.21 Innovations such as leasing are one means through which, despite switching amongst rural customers from banks to credit unions, Lithuanian banks have increased in deposits, profits and size, as the table below illustrates.

Table 2.6: Deposits in Lithuanian Banks

LTL Million	1997	1998	1999	2000	2001	2002	2003	2004
Total deposits	6,006.40	6,669.50	7,450.10	9,175.70	11,658.90	13,484.10	16,985.40	22,372.60
Resident deposits	5,452.70	6,078.10	6,789.90	8,422.00	10,188.90	11,418.60	13,309.00	17,243.30
Public non-financial enterprises	214.9	184.9	164.8	184.7	303.3	412.6	435	454.3
Private enterprises	2,056.60	1,939.00	1,752.50	2,245.20	2,741.10	3,336.30	4,064.60	5,549.60
Individuals	2,177.30	2,938.50	3,913.80	4,947.80	6,225.20	6,741.50	7,721.40	9,619.10
Other	1,003.90	1,015.80	958.7	1,044.30	919.3	928.3	1,088.00	1,620.30
Non-resident deposits	553.7	591.4	660.3	753.8	1,470.00	2,065.50	3,676.40	5,129.30

Source: Bank of Lithuania

2.22 Between 1997 and 2004 there was an increase in deposits by private enterprises of 170 per cent. Demand for banking services also increased amongst individual Lithuanian customers whose deposits rose by about 340 per cent. This is partly a function of the strength of the Lithuanian economy, as well as, perhaps, a shift over time away from the servicing of corporate clients towards retail banking where the greatest profit margins are to be found. *The Banker* has argued that such a switch is discernable.[14]

Trade and international penetration

2.23 As noted earlier in Table 2.2 two shifts in bank ownership are striking: less state ownership and more foreign ownership.

2.24 Foreign ownership stood at 32 per cent of total capital in 1997, compared to 87.8 per cent in early 2002.[15]

2.25 In 2004, when Lithuania joined the EU, simplified licensing procedures for Member State credit institutions intending to provide services in other EU states came into effect making it easier for the Lithuanian banks to operate in other EU countries, as well as increasing opportunities for the banks of other EU Member States to provide services in Lithuania.

Competitiveness

2.26 Overall the cost-to-income ratio (calculated as the ratio of fixed expenses and the profit from the main banking activities) improved in 2005 by 6 percentage points and at the end of the year made up 54 per cent. However, this was mainly driven by growing incomes.

2.27 Figure 2.6 gives the cost to income ratio of Lithuanian banks.

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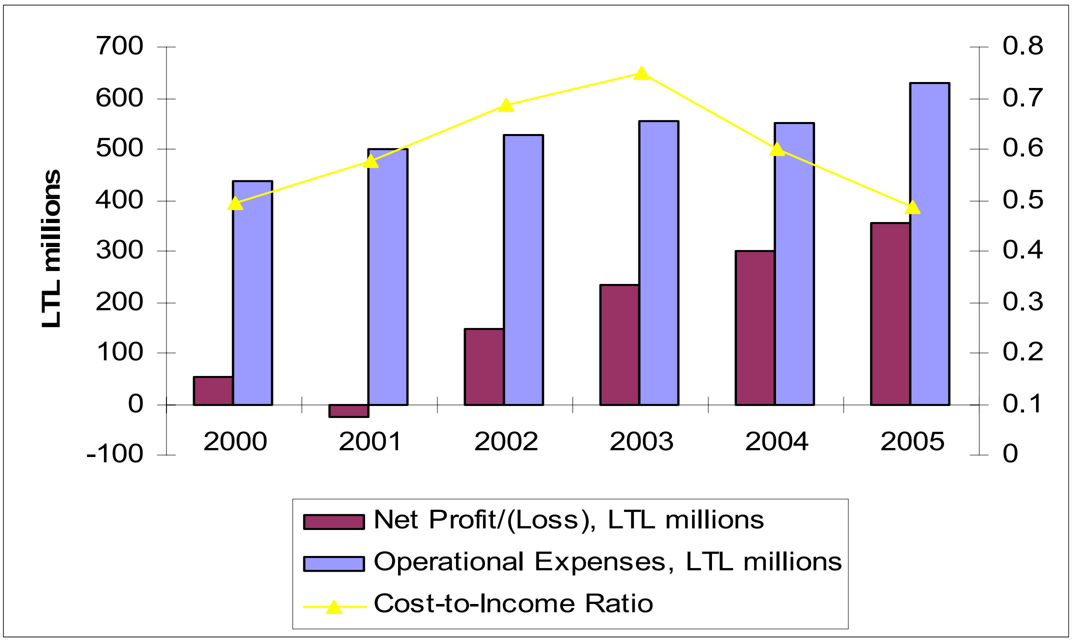
[14] The Banker, 4 July 2005.
[15] Regular Report from the Commission on Lithuania's Progress Towards Accession (2002).

Figure 2.6: Profit of main activity, fixed expenses and depreciation, Cost-to-income ratio (2000-2005)



Source: Bank of Lithuania, Europe Economics

Factors specific to Lithuania

2.28 We have identified the following factors as being important unusual features of the Lithuanian banking sector:

(a) The relative immaturity of the banking market. It is little more than 15 years since Lithuania gained independence, little more than 10 since the banking crisis of 1995 and just two since Lithuania joined the EU.

(b) The high concentration ratio.

(c) The extent of foreign ownership.

(d) The high incidence of practices now considered dated in other parts of the EU – credit unions and leasing

(e) Risk aversion of banks following the Russian crisis of 1995.

Impact of the FSAP and FSWP Legislative Measures on the Lithuanian Banking Sector

Assessment by category

Cross-border business, takeovers and the development of a regional market

2.29 Cross-border activities in the banking sector have increased and seem likely to do so in the future. The increase is mainly due to the use of international branches. Indeed, in recent years Lithuanian banks have had the opportunity to expand beyond its borders as the development of a pan–Nordic and Baltic area financial market gathers pace.

2.30 Taking into account both the effects of the FSAP and Accession is appears that the overall effect on cross-border activity has been positive in the banking sector. While this trend has, in part, been encouraged by local factors and institutions that predated the FSAP the latter should have facilitated the further reduction in both the regulatory and technical barriers to cross-border trade and the Single Passport afforded by Accession will have contributed to this.

2.31 Our econometric study suggests that the impact of the FSAP on trade has been a 1.3 per cent increase in imports of financial services other than insurance and pensions, and a rise of 1.6 per cent in exports. Full implementation of the FSAP and FSWP legislative measures is projected to lead to a further 1 per cent rise in imports and 2 per cent in exports.[16]

2.32 On the side of *cross-border cooperation between regulators*, the Bank of Lithuania highlights its intention to cooperate with foreign financial institutions. In the Annual Report 2005 it reports that:

(a) The year 2005 was marked with particularly intensive development of cooperation with the competent supervisory authorities of Sweden, Finland, and Estonia from which most of the capital in the Lithuanian banking sector comes.

(b) There were adjustments to the current bilateral agreements aiming at the supervision of particular financial groups that comprise credit institutions operating in Lithuania.

(c) In January 2006, the Memorandum of Understanding between the Financial Supervisory Authority of Finland and the Bank of Lithuania regarding the cooperation in the supervision of the Nordea Bank Finland PLC Lithuania Branch was concluded.

(d) Additionally, at the start of 2006, the draft Memorandum of Understanding with the Financial Supervisory Authority of Finland regarding cooperation in the supervision of the AB Sampo bankas in Lithuania was considered.

(e) Cooperation provisions pertaining to the recognition of the capital adequacy calculation methods and the procedure on granting permissions for the application of these methods to internationally operating financial groups which include AB SEB Vilniaus bankas, AB bankas Hansabankas, and AB Sampo bankas were agreed in 2005.

(f) Negotiations with the National Bank of Ukraine regarding the conclusion of a cooperation agreement were held over the reporting year.

[16] Note that these effects are additional to any associated with membership of the EU or other global or domestic trends towards openness.

Competition

2.33 Figure 2.5 illustrates that the concentration of Lithuanian banking has fallen during the period of the FSAP. However, the sector remains highly concentrated.

2.34 The apparent greater ease of entry of foreign banks into Lithuania, combined with the fact that a number of such banks have actually set up an increasing number of branches suggests that the market may have become slightly more contestable in recent years. Additionally, given the rapid change of the Lithuanian banking system due to the recent entrance into the EU it seems likely that this is a development attributable at least partly to the FSAP. Alternatively (but not entirely separately) this might be considered one of the final stages in the development of the Lithuanian financial system needed to join the European Union and the impacts of membership.

2.35 As discussed earlier, the FSAP is regarded to have played a positive role in increasing the frequency of cross-border activity and thus foreign penetration of the Lithuanian banking sector. To this extent, it would appear that the FSAP will have also had a relatively positive effect the intensity of competition in the Lithuanian banking sector by increasing the level of contestability in the market.

2.36 It is interesting to note that respondents to our survey suggest that the degree of switching behaviour has been affected by the FSAP and that this will be true of the future also (however, the expected increase in switching in the future is thought attributable to other factors than the FSAP). An increase in the level of switching is generally indicative of an increase in the intensity of competition in the market.

2.37 Lithuanian banks have become more efficient in recent years but trends and factors beyond the FSAP probably dominate the impact of the FSAP.

Consumer protection

2.38 It is likely that the FSAP will have made a positive contribution to increasing the strength and confidence in the consumer protection regime and indeed foster greater consumer trust in the system.

2.39 As mentioned above, it appears that switching behaviour has increased over the period of the FSAP. In addition to suggesting that competition levels have improved, it also serves in suggesting that the level of consumer protection may have improved. Greater ease of switching provides for greater choice and protection for the consumer from being locked into inappropriate contracts.

2.40 Respondents to our survey took the view that the FSAP has had a positive effect on consumer protection and that effects in the future will also be positive.

Competitiveness

2.41 As illustrated in Figure 2.6, cost-to-income ratios have been quite variable with a decreasing trend in more recent years. However, the improvement in efficiency was driven mainly by growing income. The reduction in operating expenses and amortization were mainly due to no longer amortising goodwill. The impact on competitiveness may be limited.

Conclusions

2.42 Directly observable impacts of the FSAP (as compared to the broader process of the achievement of the internal market) are limited.

2.43 We can see for instance decreasing concentration until 2004 and reduced profitability.

2.44 It is difficult to disentangle the impact of FSAP from the broader trend towards a higher level of financial development and wider economic growth. Penetration from operators from other Member States remains fairly limited.

2.45 However, foreign ownership of Lithuanian banks has grown significantly assisted by internal market rules.

2.46 Lithuanian competitiveness versus Baltic States and Poland has been increasing as have the value of banking assets. However, these results on competitiveness might be dependent on differences in the method of measuring competitiveness according to cost-to-income ratios, since efficiency improvements have been driven more by higher income than by decreasing operational costs.

3 INSURANCE

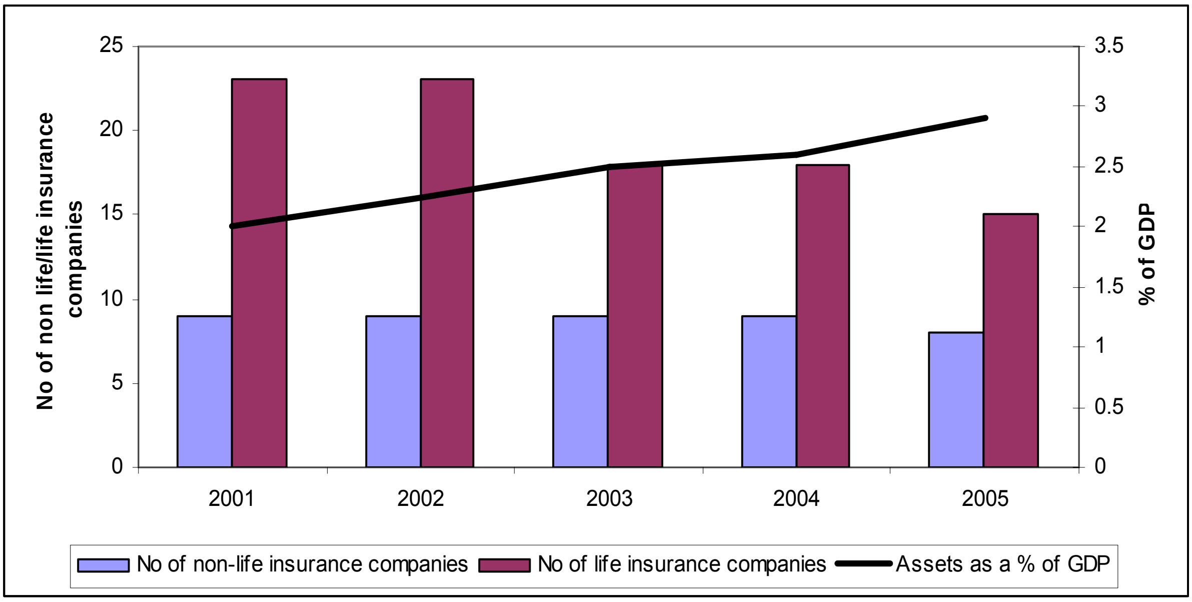
Headline Overview

Number of players

3.1 The insurance market in Lithuania is small, even compared to other economies joining the EU in May 2004. The insurance sectors in Poland, the Czech Republic and Slovakia represent between 7 and 10 per cent of GDP. This compares with an average of 55 per cent in the EU15 and 2.5 per cent in Lithuania.[17]

3.2 The Lithuanian insurance sector did not start to form until 1991 and continues to grow strongly. Figure 3.1 shows that the assets of Lithuanian insurance companies more than doubled between 2000 and 2004 and, unlike in other EU Member States, did not suffer a downturn in 2000 or 2001.

Figure 3.1: Number of insurance companies (life and non-life), assets of Lithuanian insurance companies as a percentage of GDP



Source: Bank of Lithuania

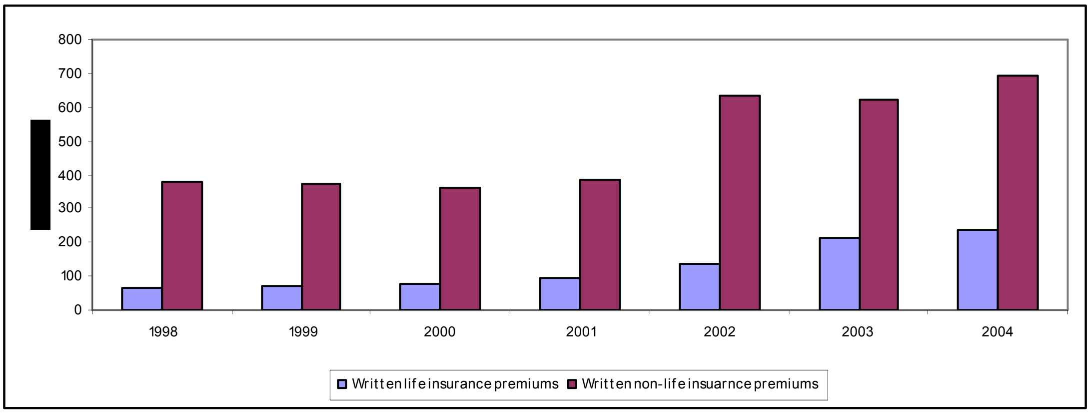
3.3 The Lithuanian insurance market is (unusually) dominated by non-life insurance activity. Non-life written insurance premiums in 2004 amounted to 74.7 per cent of total written premiums, whereas written life assurance premiums made up 25.3 per cent.[18]

Turnover

3.4 Figures 3.2 and 3.3 give the development of life and non-life insurance gross premiums in Lithuania from 1998 to 2004.

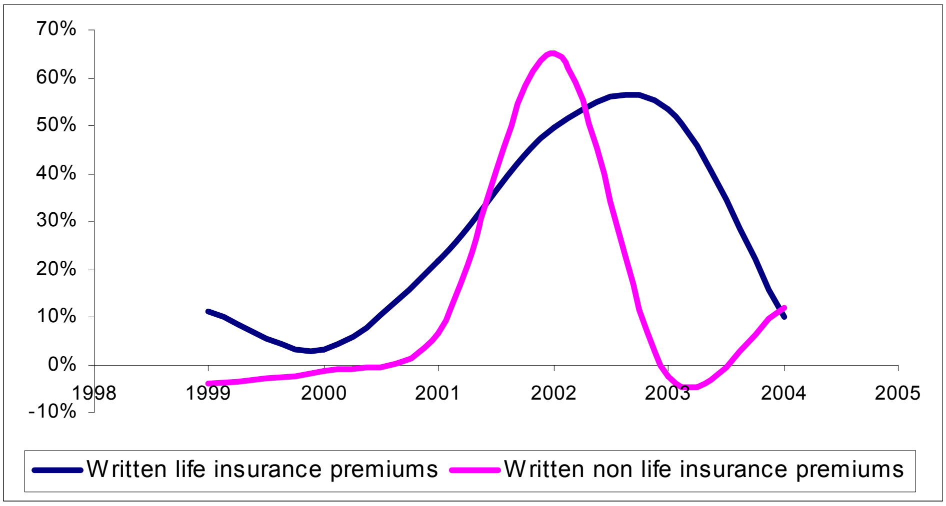
[17] European Commission, Financial Integration, Background Document, June 2005.
[18] Swiss Re's sigma study 2005.

Figure 3.2: Written life and non-life insurance premiums in Lithuania (LTL m), 1998-2004



Source: Insurance Supervisory Commission of Republic of Lithuania Annual Report, 1998-2004

Figure 3.3: Yearly change of written premiums



Source: Insurance Supervisory Commission of Republic of Lithuania Annual Report, 1998-2004

3.5 It can be seen that the written premiums yearly change had their peak in 2002: non-life assurance increased by 65 per cent during 2002, life assurance by 54 per cent during 2003.

3.6 The increase, in terms of written premiums, in the non-life insurance market was caused by larger premiums of motor third party liability insurance (MTPL): 18.9 per cent and those of land vehicles other than railway rolling stock insurance by 26.6 per cent. The rapid growth of life insurance instead was observed in the group of life assurance where the policyholders bear the investment risk.

Profitability

3.7 However, the growth of both life and non-life insurance slowed down in 2004: the compulsory MTPL, according to SIC, was unprofitable for all companies engaged in this activity. According to the Bank of Lithuania, this was mainly due to an assumption about a mismatch between contribution premiums and the assumed risk in the entire system rather then the operational risk of individual companies.[19]

3.8 Due to fierce competition for a larger share of the market, the overall profitability of insurance participants has been low; some companies even incurred losses (and one non-life insurer went bankrupt).

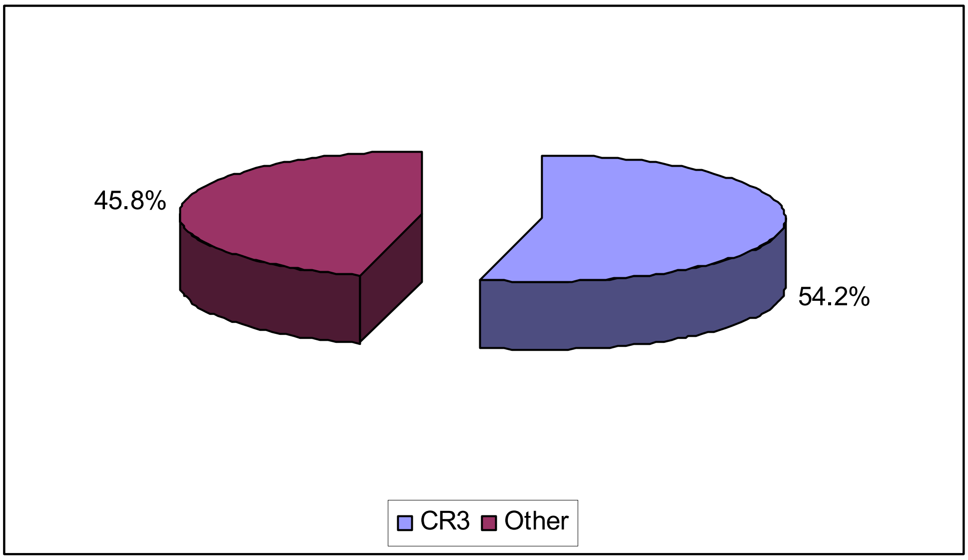
Market shares and concentration

3.9 The Lithuanian insurance market is still very concentrated; however, its concentration is decreasing.

3.10 There has been a consolidation trend of the insurance market characterised by mergers and acquisitions evident from the decreasing number of insurance market participants, both life and non-life; in 2005, there were 24 insurance undertakings operating in Lithuania: 8 life insurance undertakings and 16 non-life insurance undertakings.

3.11 Figures 3.4 and 3.5 set out CR3 concentration ratio for both life and non-life insurance companies in Lithuania.

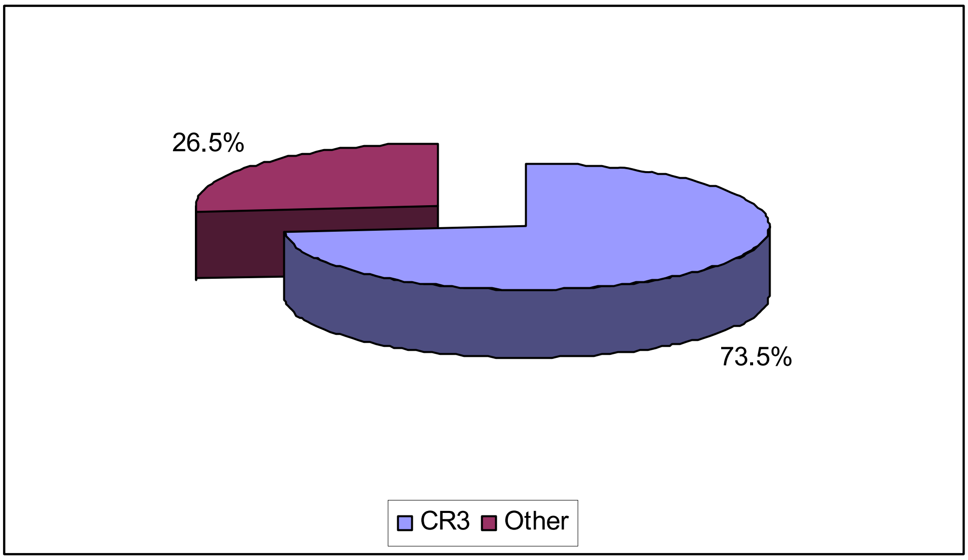
Figure 3.4: Concentration Ratio 3 (CR3), Life insurance (2004)



Source: Insurance Supervisory Commission of Republic of Lithuania Annual Report, 1998-2004. The top 3 are AB Lietuvos Draudimos (30% share of market), UAB Hansa Lietuva (14%) and UAB DK PZU Lietuva (10%).

[19] Bank of Lithuania Financial Stability report 2005

Figure 3.5: Concentration Ratio 3 (CR3), non-life insurance (2004)



Source: Insurance Supervisory Commission of Republic of Lithuania Annual Report, 1998-2004. The top three are UAB Hansa Lietuva Gyuybes Draudimas (39% share of market), UAB ERGO Lietuva Gyuybes Draudimas (18%) and UAB SEBVB Lietuva Gyuybes Draudimas (17%).

Consumer protection

3.12 The Law on Insurance sets out the core provisions for the settlement of disputes between consumers and insurers. The adopted Insurance Law established a new function of the insurance supervisory institution the settlement of disputes between consumers and insurers.

3.13 As the Insurance Supervision Commission reported:

> There is no doubt that expansion of the competence of the insurance supervisory institution in this direction will contribute to more efficient implementation of its objective, which is to ensure the credibility, efficiency, safety and stability of the insurance system and to safeguard the interests and rights of policyholders, insured persons, beneficiaries and injured third parties. [20]

[20] In 2004, 42 disputes between consumers and insurers were settled, of which: consumer claims were satisfied in 4 cases, consumer claims were partly satisfied in 3 cases, consumer claims were rejected in 16 cases, and there were 19 disputes that were not settled or the settlement of which was terminated. A total of 67 complaints by natural and legal persons were settled, of which violations of legal acts were established in 9 cases and no violations of legal acts were found in 58 cases. Insurance Supervisory Commission of the Republic of Lithuania, Annual report 2004.

Trade and international trade

3.14 One of the most significant events in the field of legal regulation of the insurance activity was the adoption of the Law on Insurance 2003. This Law provides the right for insurance undertakings of the EU Member States to provide services without being established in the Republic of Lithuania (i.e. without having established either a branch or a representative office). Additionally, EU Member State undertakings may have the right to establish subsidiaries and representative offices in the Republic of Lithuania, the supervision of which will be carried out by supervisory institutions of the EU Member State. Analogous rights to access the Member States of the European Union are granted to Lithuanian undertakings as well.[21]

3.15 As of August 2005, 163 insurance undertakings and 2 subsidiaries from other Member States had the right to provide insurance services in the Republic of Lithuania. Details are in the table below.

Table 3.1: Foreign insurance undertakings operating in Lithuania (2005)

	UK	IRE	DE	ITA , SW	FR	AU	NT LU	HU	BG, CZ	DN, PO	FN	ES, ICE, ES, LAT, LI, SL, SK
International undertakings	42	25	13	11	10	9	7	5	4	3	2	1

Source: Insurance Supervisory Commission of Republic of Lithuania Annual Report, 1998-2004

Unusual Features of the Lithuanian Insurance Market

3.16 The following factors may be identified as being important unusual features of the Lithuanian insurance sector. [22] These are:

(a) rapidly developing and has high growth potential;

(b) is dominated by non-life insurance — transport and property insurance prevails in the non-life insurance market, and accumulative insurance with a guaranteed interest rate prevails in the life insurance market;

(c) very concentrated, but with a steady downward trend in concentration;

(d) is dominated by foreign capital;

(e) high average solvency coefficient of insurance undertakings; and

(f) increasing role of insurance intermediaries.

[21] Insurance Supervisory Commission of the Republic of Lithuania, Annual report 2004.
[22] Insurance Supervisory Commission of Republic of Lithuania Annual Report, 2004

Impact of the FSAP and FSWP Legislative Measures on the Lithuanian Insurance Sector

Assessment of impact by category

Market entry, cross-border business and takeovers

3.17 The main changes into insurance market entry in Lithuania were due to the adoption of the Law on Insurance 2003 that came into force in 2004. This Law enhanced the level of foreign entry into the market, effects occurring alongside the accession into the EU. The latter effects are likely to have played a more prominent role in encouraging greater cross-border activities. However, the effects of the FSAP in providing further momentum to this, such as reducing technical and regulatory barriers to cross-border activities and improving the confidence of the regulatory regime, can entirely be divorced of this.

Consumer protection

3.18 The level of consumer protection in insurance markets seems to have increased over the last two years. Enhanced consumer protection is anticipated in the future, but respondents to our survey tended to take the view that there is no evidence of a direct effect of the FSAP.

3.19 We are more sanguine about the role of the FSAP here. In our view, without certain of the FSAP measures, there may have been some pressure for Lithuania to be a regulatory outlier, to tempt firms wishing to avoid sound regulation but also wishing to locate within the EU. Thus we assess the impact of the FSAP as positive, relative to a counterfactual in which Lithuanian consumer protection tended to become undermined over time.

Conclusions

3.20 We can see that the Lithuanian insurance sector has experienced strong asset growth during the period of this study. Further there is evidence that the market is becoming more competitive as profitability has been squeezed and concentration levels are being reduced.

3.21 Further, other EU Member States, in particular the UK, have now established undertakings in Lithuania, suggesting that the FSAP and wider Community obligations have provided regulatory certainty for investors. In these respects we can see that some of the direct expected impacts of the FSAP process are being felt in the market.

3.22 It can also be argued that this greater regulatory certainty is also creating a more advanced financial development with a rise in the number of insurance intermediaries.

4 SECURITIES MARKETS

Lithuanian Securities Markets

4.1 The Vilnius Stock Exchange (VSE) is a part of the OMX group exchanges, covering most of the Nordic and Baltic countries. Tallinn, Riga and Vilnius stock exchanges have formed a joint Baltic market to simplify access and minimize investment barriers when operating on Estonian, Latvian and Lithuanian markets. The main idea of the joint Baltic market is to minimize the differences between the three markets, bringing a new offering to investors as well as brokers, listed companies and information vendors alike.

4.2 The integration of the Lithuanian securities market (2005) into the common Nordic capital market has been an impetus of equal importance to the accession of the Lithuania into the European Union in May 2004. The Lithuanian securities market has become considerably more open and attractive to both local and foreign investors.

4.3 The total turnover the Stock Exchange amounted to LTL 4.0 billion representing an increase by 21.6 per cent of the figures 2004 (LTL 3.295 billion).[23] The main data describing the Lithuanian securities market in 2001-2005 are presented in Table 4.1.

Table 4.1: Lithuania's securities market indicators

	2001	2002	2003	2004	2005
Average annual inflation rate	1.3	0.3	-1.2	1.2	2.7
Exchange capitalization	6.8	7.6	12.9	19.6	28.2
Capitalization/GDP ratio, %	8.7	14.6	22.7	31.4	39.8
Exchange Turnover, LTL m	1,841	2,025	1,980	3,486	4,009
Exchange Turnover/capitalization ratio, %	27.1	26.6	25.3	17.8	14.2
OMX Vilnius index, points at year end	75.56	84.78	174.48	293.44	448.76
Total listed companies	46	45	45	43	43
Number of FBF and FBU of CB	28	30	27	25	22
Number of financial brokers	179	171	173	188	223
Number of issuers	1,032	851	719	626	569
Issue value of shares distributed from additional contributions, LTL m	483.7	1,853.1	282.3	609.5	754.2
Issue value of shares distributed from additional contributions, LTL m	461.4	619.59	253.9	497.8	733.1
Capital increase from the company's own funds, LTL m	224.8	216.2	150.1	24.5	395.3

Source: Securities Commission Annual Report 2005

[23] Securities Commission Republic of Lithuania - Annual report and trends of the Securities market development 2006.

Factors Specific to Lithuanian Securities Markets

(a) Small size of the market. The Lithuanian securities market is still relatively small in comparison with other European markets: its turnover and share of capitalisation as compared to GDP it is similar to the markets of other New MS, such as Latvia, Slovenia or Slovakia. Also, it accounts for a small share of the national economy;

(b) Liquidity is among the lowest in the EU: according to the World Bank data, it amounted to two per cent of GDP in 2004 (compared to 175 per cent in the UK, 165 per cent in US and 115 per cent in the EU);

(c) The Vilnius Stock Exchange (VSE) is a part of the OMX group exchanges, and continuing the integration started in May 2005 into the OMX Group the VSE also joined the common Nordic and Baltic States Exchange trading system SAXESS (following the implementation of the SAXESS system 8 foreign participants joined the VSE) ;

(d) Major changes in the Lithuanian primary securities market have been caused by the enacted amendments in the regulations governing the securities offering a drawing up of prospectus and disclosure of information as instruments implementing the provisions of Directive 2003/71/EC.

Impact of the FSAP and FSWP Legislative Measures on the Securities market

4.4 As the Securities Commission has reported, the inclusion of the Lithuanian securities market into the common North European capital area had a significant impact on market development by making securities more liquid and easily accessible to foreign investors.

4.5 Arguably the MiFID, the most important piece of the FSAP on securities markets, is mainly aimed at facilitating the expansion of cross-border activities to create a well-functioning single European market for securities. However, given that the Vilnius Stock Exchange is part of the OMX group, which also has exchanges in Stockholm, Helsinki, Copenhagen, Tallinn and Riga, it seems unlikely that the FSAP has had a significant direct impact on the integration of the Lithuanian securities market with other EU Member States.

4.6 Our view is that the Nordo-Baltic exchanges which are part of the OMX group are rather insulated, in the sense that they will probably not be affected by the migration of securities jobs to London (which may take advantage of its lead in systematic internalising). Similarly we do not expect to see any positive repercussions on the level of employment in the Lithuania securities sector at an aggregate level, as the OMX has already had a positive impact on the level of employment.

4.7 Consumer protection issues are of relatively limited importance in the securities market. For this reason, the short-term impact of the FSAP on the Lithuanian securities market would be limited. However, if the market extends to a more general public, then there could be consumer protection issues, in that a broader range of users would imply more inexperienced users. That said, the MiFID is addressing that long term risk through extensive consumer protection provisions. Therefore, in our view the FSAP has so far had no significant impact on consumer protection in the Lithuanian securities market; but if more inexperienced market users were to use that market, the FSAP might have a positive impact.

Conclusions

4.8 The internal market process is likely to create increased cross-border activity in securities markets, although the FSAP does not appear to be the key agent of this process. However, it appears that FSAP may be lowering the cost of capital for businesses.

4.9 The internal market process appears to have facilitated a significant rise in activities in the securities market. Exchange capitalization has risen more than fourfold, and there have been significant rises in the issue value of shares.

4.10 These trends suggest a rapid increase in the level of financial development in Lithuania which should become more established as the integration of the Nordic exchanges proceeds.

5 FINANCIAL CONGLOMERATES

Table 5.1: Main financial conglomerates operating in Lithuania

Name	Head office base	Characterization of Conglomerate	Characterization of Subsidiary
Allianz	Germany	Insurance with some banking	Insurance with some banking
Nordea	Sweden	Banking, Asset Management, Insurance. Contribution to net profit: Retail Banking 66%, corporate and institutional banking 25%, asset management 5%, life insurance 3%	Banking
Sampo	Finland	Banking and Insurance	Banking with some insurance
SEB	Sweden	Banking firm doing insurance and asset management	Private Banking

Source: EU Mixed Technical Group on Supervision of Financial Conglomerates, Europe Economics

Impact of the FSAP and FSWP Legislative Measures on Financial Conglomerates

5.1 As we can see in Tables 5.1, some conglomerates operating in Lithuania do engage in insurance and banking activities. Both banking and insurance appear to be of relatively equal importance in conglomerate activity in Lithuania. Thus, the conclusions for financial conglomerates in Lithuania are close to those for both banking and insurance.

Assessment by category

Openness

5.2 We have seen that the form of entry by banks into Lithuania has been affected, and that openness in the insurance sector has probably increased. In addition, the FSAP measures for regulation of Financial Conglomerates should create a more standardized regulatory environment, reducing costs of compliance for large firms operating across multiple jurisdictions.

5.3 Further, we should, in general, expect a programme such as the FSAP to be of greater short-term benefit to existing larger players than smaller players, since larger players will more obviously gain from a standardized cross-border environment.

5.4 Thus our assessment is that the FSAP will encourage greater openness.

Competition

5.5 We have seen that competition is expected to be slightly enhanced in both banking but negative in insurance. Thus overall, the impact on competition is likely to be limited.

Consumer protection

5.6 Effects on consumer protection in both banking and insurance are expected to be positive.

Employment

5.7 We assess the effects on employment in the banking sector as negligible and there is limited data available for the insurance sector. Thus, our view is that the FSAP may only play a limited role in the employment in financial conglomerates.

Competitiveness

5.8 As pressures of competition from abroad and domestically are expected to be limited by the FSAP, we would expect this to lead to a limited impact on the competitiveness of Lithuania conglomerates.

6 CONCLUSIONS

6.1 Lithuania has clearly benefited from the move to a certain and harmonised regulation across the EU Member States. This has provided a catalyst for growth in the financial services sector, increased foreign investment and increased financial development.

6.2 As a key part of this process, we can expect that FSAP measures have generally been beneficial for Lithuania.

6.3 Further, the process of the incorporation of internal market rules and FSAP measures has helped to prevent a repeat of previous market instability.

6.4 Expected impacts of the FSAP can be seen in market developments, for example in greater competition in the markets and strong growth in market segments. In this sense we can see that the FSAP process has helped Lithuania to achieve some of its potential financial services growth (as financial development increases).

6.5 Further it can be argued that the likely future impact of the development of a Nordic regional market, facilitated by common rules across the Nordic Member States, will be very significant in Lithuania as potential market growth in areas such as securities is realised.

Assessment

	Impact of FSAP on…				
	Openness to foreign firms	**Competition**	**Consumer Protection**	**Competitive-ness**	**Employment**
Banking	Positive	Positive	Positive	Limited	N/A
Insurance	Positive	Negligible	Positive	N/A	Negligible
Securities	Positive	Slightly positive	Positive	Limited so far. Positive in the future	Slightly positive
Financial Conglomerates	Positive	Limited	Positive	Limited	Limited

LUXEMBOURG

1 INTRODUCTORY OVERVIEW

1.1 Luxembourg is one of the world's richest countries. It is Europe's principal centre for mutual funds and a major force in the banking and insurance industries. Financial services play a highly significant role in the economy, accounting for approximately a third of total GDP.

1.2 The importance of financial services was not always the case. Following the steel crisis of the 1970s, Luxembourg managed a deliberate transition to a financial services-based economy because of its (i) advantageous tax and regulatory regime; (ii) early financial market liberalisation; and (iii) responsible financial policies. Relying to a considerable extent on foreign labour and capital, Luxembourg's profile in the global financial system grew steadily from this point. The development of financial services was aided by the lack of restrictions applicable to foreign investors. Today the liberal regulatory structure is widely regarded as fair and transparent.

1.3 Luxembourg's international banking industry is comparable in size to those of Hong Kong SAR and Singapore, while its investment fund industry has grown to become the second largest in the world. However, the contribution of these industries to the economy is waning, although overall growth remains well above the EU average. The rate of growth has declined since 2000 to an annual average rate of 3 per cent (compared to 5 per cent in the 1980s and 1990s). This reflects in part the slowdown following the bursting of the equity bubble in 2000.

Financial Services Regulation in Luxembourg

Division of responsibility

1.4 In January 1999 the Commission de Surveillance du Secteur Financier (CSSF) became the main regulatory body for financial services in Luxembourg. The recent institutional changes in the structure and the practice of prudential supervision have not altered the existing legal and regulatory framework.

1.5 The CSSF examines all applications made by undertakings or persons seeking to carry out a financial activity in the Grand Duchy of Luxembourg and requiring the authorisation of the Minister for Treasury and Budget.

1.6 It aims to ensure that laws and regulations on the financial sector are enforced and observed and that international agreements and European Directives in the fields under its responsibility are implemented.

1.7 The Commission de Surveillance du Secteur Financier is responsible for the prudential supervision of: credit institutions, other professionals of the financial sector, undertakings for collective investment, pension funds, SICARs, securitisation vehicles issuing securities to the public on a continuous basis, stock exchanges, payment and securities settlement systems, operators of payment or securities settlement systems and securities markets.

1.8 The law on the financial sector came into force 5 April 1993; this is the pillar of the Luxembourg banking legislation and regulations.

Key features of banking regulation

1.9 Banks must comply with a certain number of regulatory provisions, as well as existing professional standards. These standards are both quantitative and qualitative. Qualitative standards refer to the professional experience and repute of the managers and administrators, the quality of the shareholders and their transparent structure, sound accounting and administrative organisation, adequate internal audit procedures and an adequate risk management and monitoring system.

1.10 The regulator (CSSF) continuously supervises banks (and other entities) by analysing financial information periodically communicated by banks, on-site inspections and the analysis of reports and evaluations transmitted by external and internal auditors. In addition, the CSSF hosts regular meetings with banks and scrutinises applications for authorisation.

1.11 The Banque Centrale du Luxembourg (BCL) also has an indirect role by discharging duties pertaining to monetary policy, the issuing of banknotes, financial stability, payment systems and even economic analysis.

Key features of insurance regulation

1.12 The body responsible for insurance supervision is the Commissariat aux Assurances. The supervision of insurance undertakings is based on the examination of the closing documents, as well as on the reports issued in this context by external auditors. Furthermore, the prudential supervision is based on the analysis of quarterly financial reporting or actuarial reports submitted, where applicable, by the liability managers.

Key features of securities regulation

1.13 The CSSF has a general mission to supervise the securities markets. This involves analysing insider dealings and other breaches of stock exchange regulations, reporting major stockholdings in listed companies, analysing information on the external audit of listed Luxembourg companies and reporting transactions on transferable securities. The regulator must also approve the prospectuses drawn up for offers of securities to the public and admission of securities to trading on a regulated market.

1.14 The regulator also has a specific mission of prudential supervision of any person carrying out stock exchange activities at a professional level: this allows the competent supervision of the proper functioning of the Luxembourg Stock Exchange.

Key features of financial conglomerates regulation

1.15 Supervision of financial conglomerates is not limited to compliance with legal texts, but extends to their own management rules or statutes, prospectuses and agreements. Prudential supervision includes financial reporting, on-site inspections, as well as reports provided by external auditors. These assessments cover capital requirements, repute and professional experience of the management, administrative and accounting organisation and shareholders as well as the granting of authorisations.

1.16 If the firm benefits from a European passport, the conditions cover, inter alia, sound administrative and accounting, capital requirements, repute and experience of the managing bodies. The CSSF supervises conglomerates having subsidiaries or financial participations in or outside Luxembourg on an individual as well as on a consolidated basis. With regards to the latter, these are designed to assess the risk exposure of banking or financial groups: the organisations concerned must transmit consolidated financial data and control reports of their subsidiaries.

2 BANKING

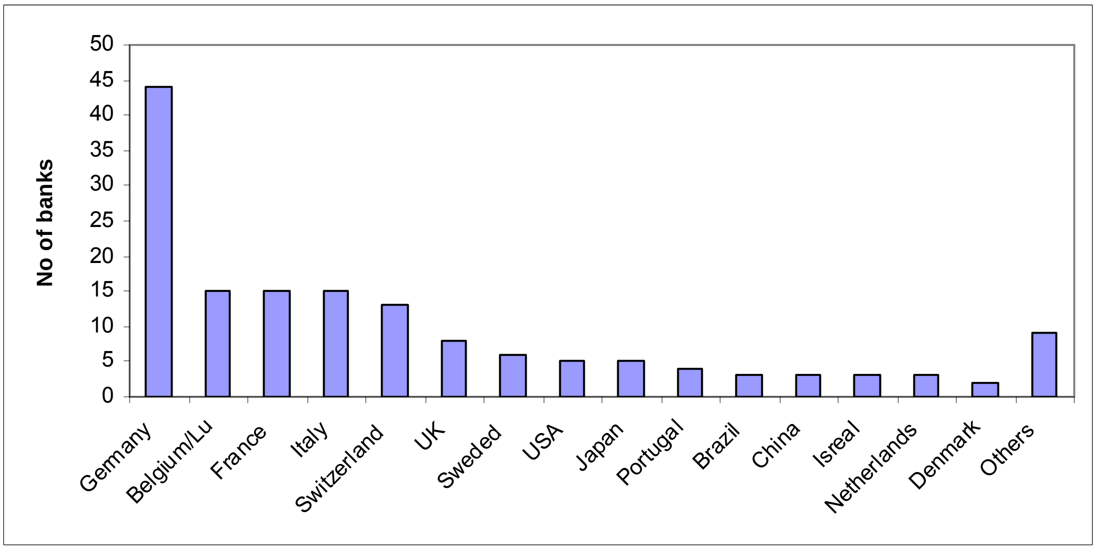
Headline Overview

Features of the industry

Number of players

2.1 Geographical proximity plays a key role in the sector: 52 per cent of banks in Luxembourg come from the surrounding countries. Swiss, American and Scandinavian banks also have a strong presence. In addition, more than a third of all banks are from countries other than these.

Figure 2.1: Number of banks by country of origin



Source: CSSF

2.2 The number of foreign banks in Luxembourg has grown not continuously but in waves, as third-party countries have implemented tax and regulatory measures and other policies which are unfavourable to their own citizens (thereby making Luxembourg more attractive). Luxembourg's preferential fiscal and regulatory treatment of the banking sector has also made it a popular destination for foreign banks, and there have been considerable inflows of private funds.

2.3 The sector now has a large international clientele seeking to benefit from an expansive range of financial and investment products. Although there are few reliable statistics available, a 1998 study of individuals with financial assets of over USD 1 million concluded that 6 per cent to 8 per cent of offshore private banking is located in Luxembourg, compared to 30 per cent to 35 per cent in Switzerland.

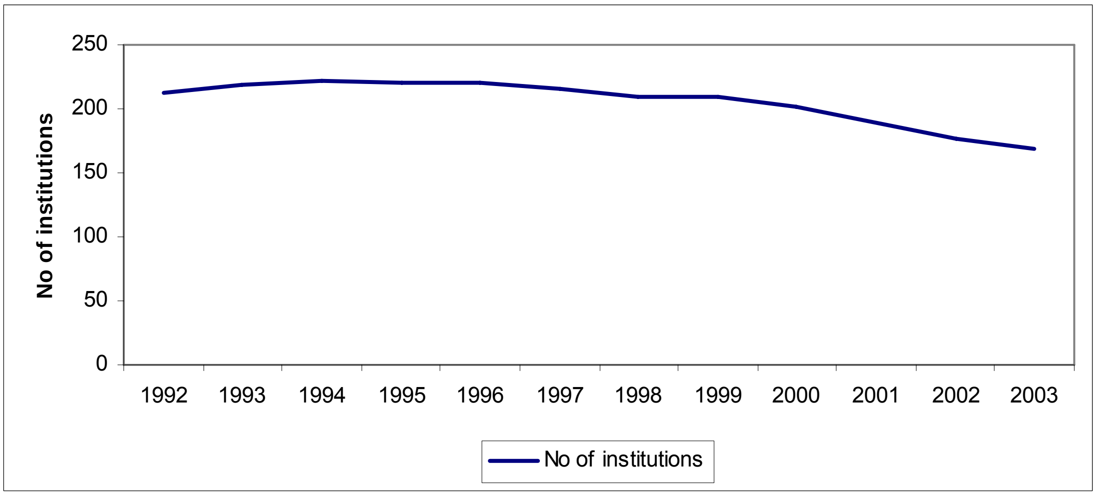
2.4 Over the years, large amounts of capital have been deposited in Luxembourg. Given the small size of the domestic market, this capital is subsequently placed abroad, particularly with other banks. Luxembourg is currently Europe's fourth largest inter-bank market, and the world's ninth largest in terms of external positions vis-à-vis the banking sector.

2.5 An analysis of new bank setups and bank asset volumes clearly shows how Luxembourg's legal and fiscal environment has benefited the growth of local and foreign banks.

2.6 From 1992 onwards, a new wave of German bank start-ups occurred after the re-introduction of savings tax deductions at source in Germany.

2.7 Since 1995, however, the number of banks in Luxembourg has declined. This is not because the country had become any less attractive as a financial centre but because of the wave of mergers and acquisitions which has affected all of Europe. Thus, although the number of banks has fallen, their total assets have continued to rise.

Figure 2.2: Number of credit institutions in Luxembourg



Source: OECD

Note: Data for number of branches missing for most years, so series excluded.

Turnover, employment and profitability

2.8 Results of banks in Luxembourg were relatively stable in recent years including an upsurge in 2005.

Table 2.1: Aggregated presentation of banks' results

Items (€m)	**2001**	**2002**	**2003**	**2004**	**2005**
Interest-rate margin	4 382	4 141	4 080	3 913	3 914
Commissions income	2 792	2 615	2 533	2 771	3 203
Other net income	765	1 305	978	766	1 152
Banking income	7 939	8 061	7 590	7 450	8 269
Staff costs	1 758	1 809	1 752	1 798	1 941
Other operating expenses *(1)*	1 865	1 681	1 632	1 663	1 736
Result before provisions	4 316	4 571	4 206	3 989	4 592
Net creation of provisions	536	1 166	638	345	240
Taxes	920	685	694	778	804
Net profit	2 861	2 720	2 874	2 866	3 548

(1) Including value adjustments on fixed assets (depreciation)

Since the figures, notably as regards provisions and taxes, have not yet been finalised, aggregate amounts for these items, and thus net result, cannot be provided.

Source: CSSF 18/5/06

2.9 The banking sector of Luxembourg is extremely large compared to the size of Luxembourg. In 2004, over 22,000 employees worked for banks in Luxembourg. This equates to Luxembourg having 5,000 bank employees per 100,000 inhabitants, against the EU15 average of around 700 employees per 100,000 inhabitants. This reflects the international nature of the banking industry.

2.10 Indeed, this observation on the international nature of the industry is confirmed by more than two thirds of these employees being foreign employees working for banks in Luxembourg. Nonetheless, even if one takes only the employees from Luxembourg into account, the banking sector of Luxembourg has more than 1,500 employees per 100,000 or more than double the EU15 average.[1]

2.11 From 2000 to 2004 employment in banking has slightly decreased from 23,000 to 22,500 but has increased back to previous levels since then.

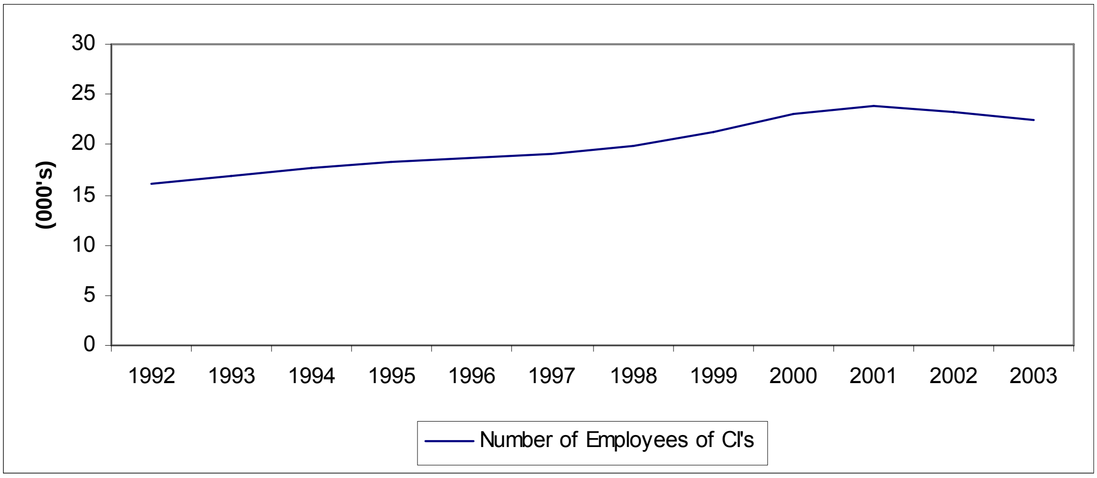
Table 2.2: Employees in Luxembourg Finance Sector

	1980	**1990**	**2000**	**2001**	**2002**	**2003**	**2004**
All Finance Sector	7600	16335	26539	28093	27693	26949	29067
Luxembourgian Employees	5224	8607	8340	8361	8097	7752	8018
Foreign Employees	2376	7728	18199	19732	19596	19197	21049
Banking Sector	…	…	23035	23894	23300	22513	22549
Luxembourgian Employees	…	…	7833	7718	7402	7116	6998
Foreign Employees	…	…	15202	16176	15898	15397	15551
Non-Banking Sector	…	…	3504	4199	4393	4436	6518
Luxembourgian Employees	…	…	507	643	695	636	1020
Foreign Employees	…	…	2997	3556	3698	3800	5498

Source: Le Portail des Statistiques du Luxembourg. Note : detailed data not available for 1980 and 1990.

[1] From ECB survey 2003.

Figure 2.3: Employment in CI's



Source: OECD

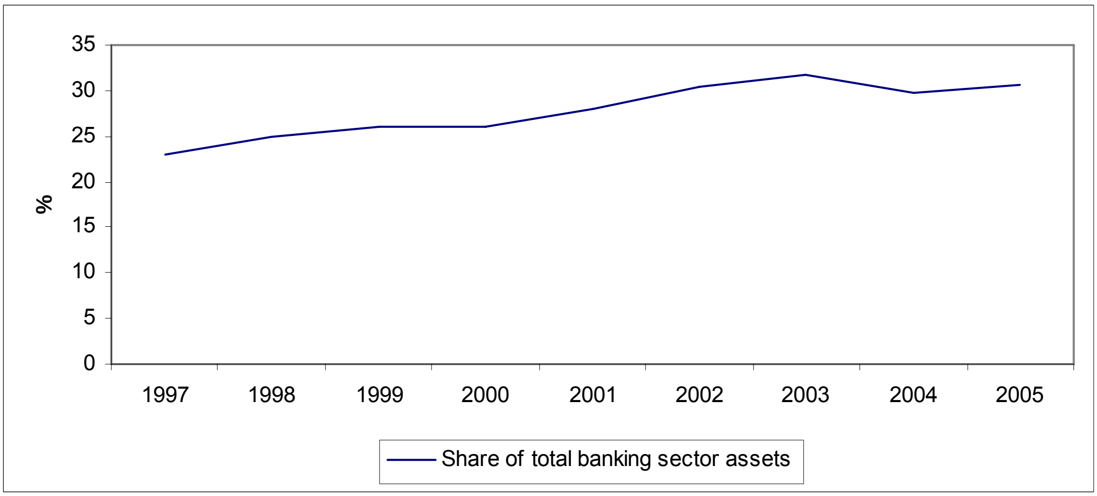
Dimensions of price and quality competition

2.12 Since 1995, the number of banks in Luxembourg began to decline, largely as a result of a wave of mergers and acquisitions which affected Europe as a whole. For this reason, although the number of banks has fallen, their total assets have continued to rise.

Market shares and concentration

2.13 The large size of the Luxembourg banking sector can also be evidenced by the lack of concentration. Normally small markets or countries tend to have higher concentration rates compared to big markets as the market does not allow a great number of companies to exist to exploit economies of scale. However in Luxembourg the five biggest companies have relatively low market share of 32 per cent which is significantly below the EU15 average of 53 per cent. The figure below charts the evolving share of the largest five credit institutions in Luxembourg. Since 2000 it exhibited a consistent upward trend, before declining in 2004.

Figure 2.4: CR5 market share of the largest five credit institutions



Source: ECB

2.14 Similarly, the Herfindahl-Hirschman index is low.

Table 2.3: Herfindahl-Hirschman Index[2]

1997	1998	1999	2000	2001	2002	2003	2004	2005
210	222	236	242	275	296	315	304	312

Source: ECB

2.15 It should be noted that given so much of banking business is outside lending, the Herfindahl-Hirschman Index is less meaningful than in most cases.

Perceptions of ease of switching, factors affecting competition, and consumer protection

Switching behaviour

2.16 Switching is notoriously difficult to assess, and subjective judgement by those close to the industry is often the main source of data.

Consumer protection

2.17 Both the public and private sectors are making considerable efforts to prevent money laundering and financial crime, which should improve Luxembourg's image abroad and make it even more competitive. One important example is the law of 1998, which expanded the criminalisation of money laundering beyond drug trafficking and banks, and the institutionalisation in February 2002 of an anti-laundering steering committee. Luxembourg also conforms strictly with the recommendations of the Financial Action Task Force on Money Laundering.

The potential future role of technology

2.18 By their very nature, financial products lend themselves particularly well to distance selling. According to a study carried out in late 2002, 38 per cent of banks in Luxembourg have a presence on the internet and fifteen online banking sites have been identified. It is probable that this figure has significantly risen since 2002. Luxembourg was the first European country to create a specific, clearly defined and secure legal framework for e-commerce.

Trade and international penetration

2.19 As mentioned before international banks are very significant in the banking sector.

Table 2.4: Non-Luxembourg Credit Institutions

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Branches of CI's from EU area	61	61	60	55	55	48	41	38	36
Subsidiaries of CI's from EU area	97	96	99	96	86	82	80	79	75
Branches of CI's from third countries	7	7	8	8	8	7	9	9	8
Subsidiaries from third countries	45	41	39	39	40	36	35	32	32

Source: ECB

[2] The Herfindahl-Hirschman index is defined in the Main Report.

2.20 Table 2.5 shows merger and acquisition activity tailing off since 2002.

Table 2.5: Mergers and Acquisitions by purchaser

	2000	2001	2002	2003	2004	2005	2006*
Domestic	2	4	5	0	1	1	0
Internal EU	2	2	2	0	0	2	0
Third country	0	1	0	0	0	0	0

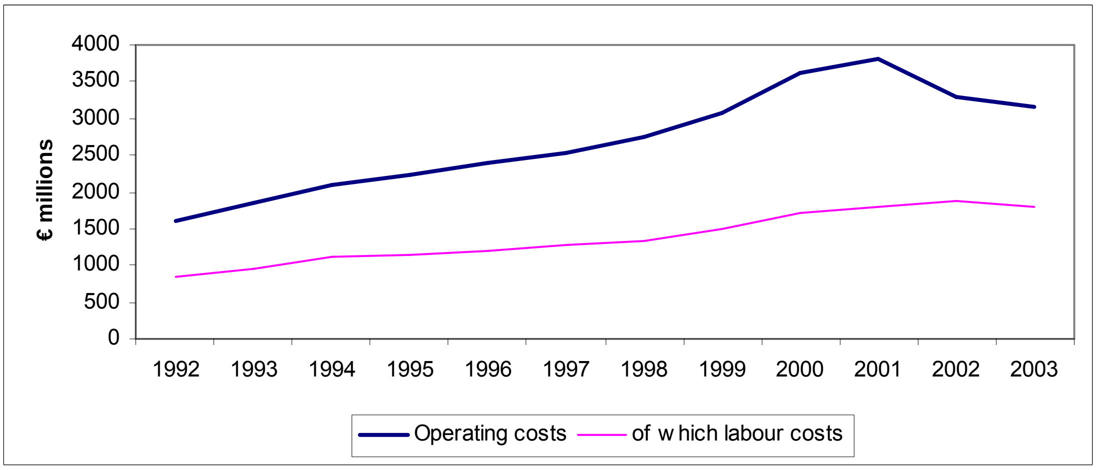
*Source: ECB. *first half*

Competitiveness

2.21 The government set up a committee for the development of the Luxembourg financial sector in April 2000. This is responsible for defining a development strategy for the sector, and is supported by Profil, a body created by the Association des Banques et Banquiers.

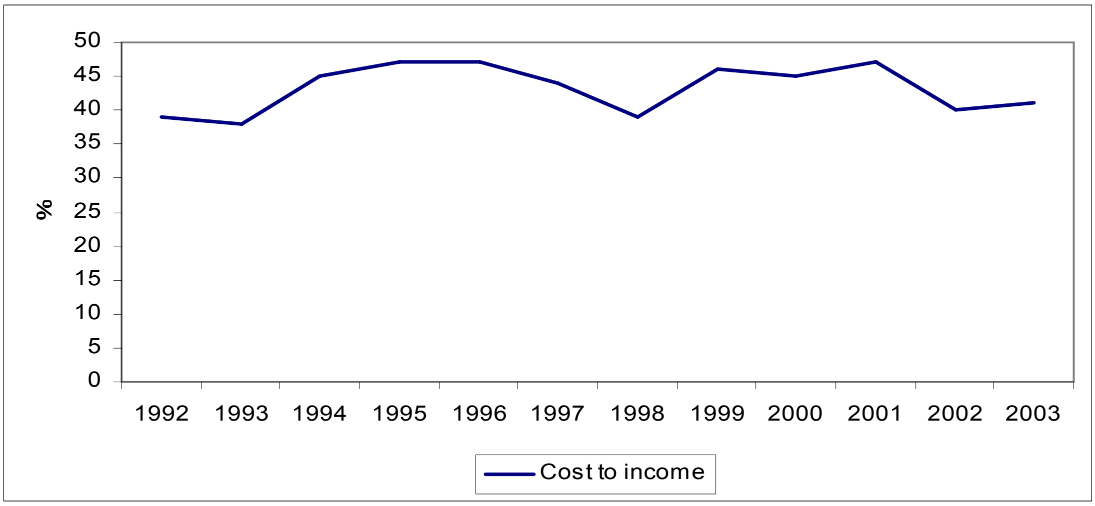
2.22 The figure below shows operating costs declining from 2002 (though labour costs are fairly constant). This will have a positive impact on competitiveness.

Figure 2.5: Operating costs



Source: OECD

Figure 2.6: Cost to Income ratio (expressed as a %)



Source: OECD, ECB, Europe Economics

Table 2.6: Key performance indicators of the banking sector (%)

Year	Net interest margin[a]	ROA[b]	ROE[c]
1992	0.8	0.3	11.2
1993	0.8	0.5	18.9
1994	0.7	0.5	20.9
1995	0.7	0.5	19.9
1996	0.7	0.6	22.3
1997	0.6	0.5	22.8
1998	0.6	0.6	24.7
1999	0.6	0.5	19.6
2000	0.6	0.6	20.5
2001	0.6	0.5	18.5
2002	0.6	0.5	12.4
2003	0.6	0.5	12.8

a: Ratio of net interest income to average total assets.
b: Ratio of net income before tax to average total assets.
c: Ratio of net income before tax to average capital and reserves.

Impact of the FSAP and FSWP Legislative Measures on the Banking Sector in Luxembourg

Assessment by category

Cross-border business and the development of a regional market

2.23 Our econometric study suggests that the impact of the FSAP on trade has been a rise of 1.1 per cent in imports of financial services other than insurance and pensions, and a rise of 1.4 per cent in exports. Full implementation of the FSAP and FSWP legislative measures is projected to lead to a further 1.1 per cent rise in imports and 2.2 per cent in exports.[3]

2.24 An advantageous tax and regulatory regime, early financial market liberalization, and responsible financial polices, coupled with minimal restrictions on foreign investors have come to characterize Luxemburg's financial–services based economy. The result has been that the profile of Luxemburg's banking system was already high and was foreign dominated before the inception of the FSAP. It is thus unsurprising that the FSAP has had, in our view, a limited impact on opening this sector further to foreign firms.

3 Note that these effects are additional to any associated with membership of the EU or other global or domestic trends towards openness.

Competition

2.25 Competition in Luxembourg's banking sector has changed in recent years because of the wave of mergers and acquisitions that had started to affect Europe as a whole. The number of banks in Luxembourg has decreased by one quarter since 2000.

2.26 Overall we regard the effect of the FSAP on competition as likely to be relatively limited in Luxembourg given the degree of openness, and the resulting domination of the sector by foreign companies, which predated the inception of the FSAP. Any further effects of synchronisation brought about by the FSAP and FSWP legislative measures will be probably small.

Competitiveness

2.27 It is likely, that taken as a whole, FSAP legislation will have a very strong effect on the competitiveness of the banking sector in Luxembourg as it is so dependent on foreign banks. However, it is not clear which direction this influence might have in the future:

(a) It is plausible to think that with rising synchronisation between other member states one key advantage of the Luxembourg banking sector (its openness and intergration) will decrease vis-à-vis other countries, damaging the relative competitiveness of the sector.

(b) On the other hand one could argue that due to its size and experience, the Luxembourg financial centre will be able to increase its business in other countries if the financial markets of these countries become more open due to the FSAP.

2.28 It is too early to tell which factor will be dominant.

Employment

2.29 In the banking sector, the number of employees rose steadily from 1994 until 2001. After a decline in 2002 and 2003 due to the adverse economic climate following September 11th, employment in the banking sector has once again risen continuously since 2004 despite the recent trend of mergers. Given that employment in the banking sector is traditionally strong in Luxembourg, it is unlikely that FSAP is accountable for the recent improvements. To the extent that the FSAP legislation may adversely affect the competitiveness of this sector in the future, as discussed above, the spill over effect of this on employment may also prove negative.

Consumer protection

2.30 With regards to customer protection, the number of new complaints handled by the CSSF in 2004 increased considerably. This rise is mainly due to the fact that customers are better informed about the CSSF's functions regarding complaint handling. In this way, it should be seen as an improvement in customer protection services that more complaints are now being handled rather than a decrease in customer satisfaction. Furthermore, the efforts made towards the prevention of money laundering and financial crime, both falling under the scope of the FSAP and FSWP legislative measures, may serve in improving the degree of consumer protection and in further instilling greater confidence in the banking system as a whole, both domestically and internationally.

2.31 However, the banking system in Luxemburg is a particularly developed one and there already had existed a comprehensive system pertaining to the protection of consumers prior to the inception of the FSAP. Assessments of consumer protection are especially positive in Luxembourg. Eurobarometer found out that net confidence in consumer protection was 29 per cent in Luxembourg (58 per cent positive and 29 negative) compared to only minus 7 per cent average in the EU15 (34 positive and 41 negative) in 2003. Since 1999 consumer confidence has decreased slightly in Luxembourg (net confidence of 36 per cent in 1999) but not as strongly as in the EU15 (plus 9 in 1999).

2.32 Overall, our view is that the FSAP has had limited, if any, effect on improving consumer protection in the banking sector.

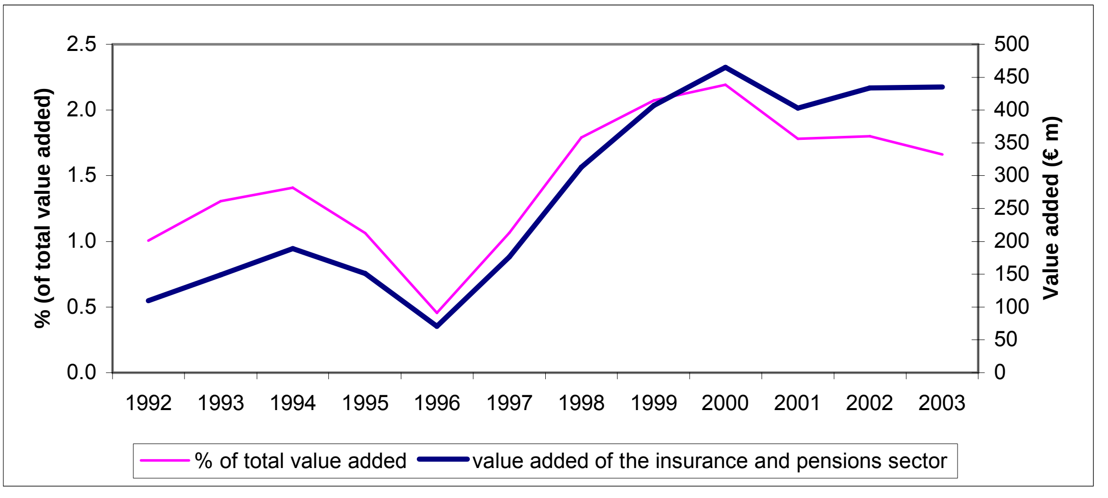
3 INSURANCE

The Insurance Sector in Luxembourg

Turnover and Employment

3.1 Despite two recessions in the mid-80s and mid-90s, the contribution of value added to total GDP of the insurance industry in Luxembourg grew strongly, on average, from 1990 to 2000. Since 2000, value added has stayed largely constant.

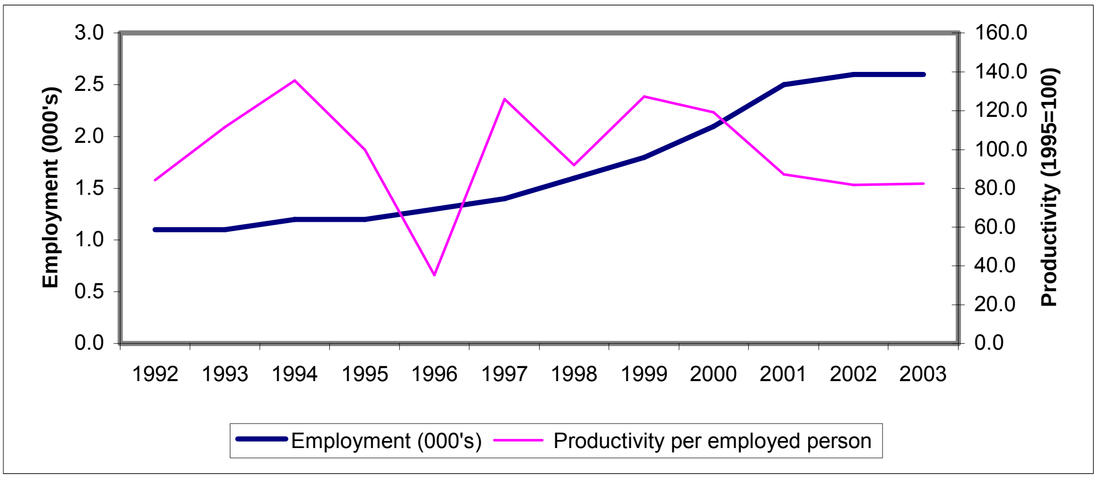
Figure 3.1: Value added in the insurance sector



Source: University of Groningen

3.2 As in the banking sector three quarters of the employment of the sector are foreign. These figures, however, do not reflect the large majority of some 7,000 people benefiting from an administrative agreement such as insurance agents who have status as independent producers.

Figure 3.2: Employment and productivity in the Insurance sector



Source: University of Groningen

Market participants and shares

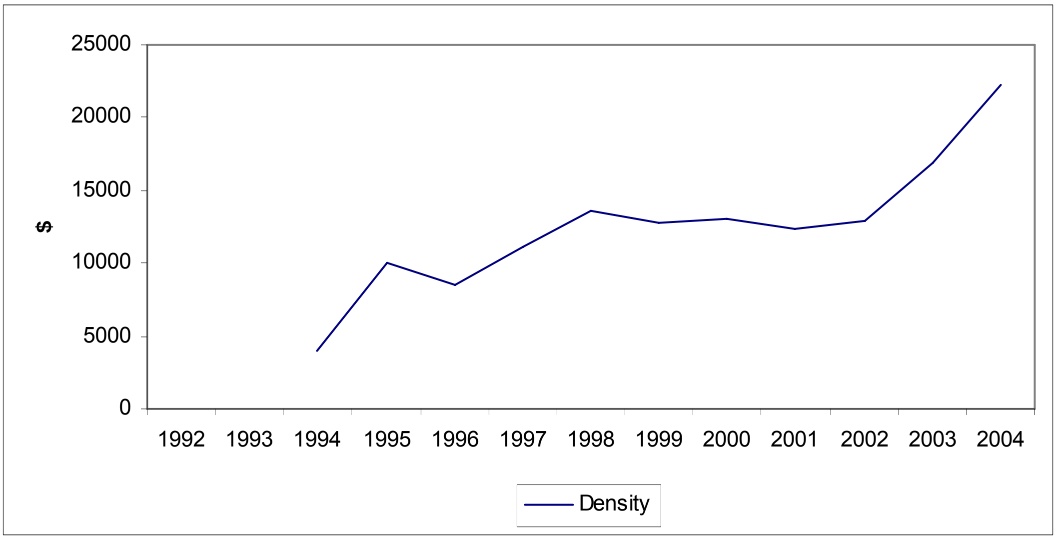
3.3 Until the 1980s, Luxembourg's insurance sector concentrated exclusively on the domestic market. It did not acquire an international focus until 1984, with the creation of a legal framework for reinsurance companies and the development of a free provision of services. The small size of the market, and the need to share risk, led many foreign insurance companies to establish operations in Luxembourg.

3.4 By the late 1980s, the number of Luxembourg companies overtook that of branches of foreign companies as the free provision of services expanded. However, even today, the market is dominated by companies set up with foreign capital.

3.5 Since the late 1980s, total premiums issued have continued to grow at a very steady rate. This very significant premium growth is mainly due to the expansion of FPS (free provision of services) life insurance. Although non-life business also expanded beyond national frontiers, it is cross-border FPS life insurance which currently dominates the market covered by Luxembourg insurers. The increasing diversity of FPS products meant that they remained attractive to the public. Luxembourg currently has a 47 % share of the FPS market, closely followed by Ireland. More than 90% of cross-border premiums in the European Economic Area come from these two countries.

3.6 Figure 3.3 below charts gross premiums per person in Luxembourg since the early 1990s – this has been on an upward trajectory.

Figure 3.3: Insurance Density (gross direct premiums/population, $ per capita)



Source: OECD

3.7 The table below shows total investments held by insurance companies. One notes that since 1997, this figure has more than doubled.

Table 3.1: Total Investments of Insurance Corporations in €m

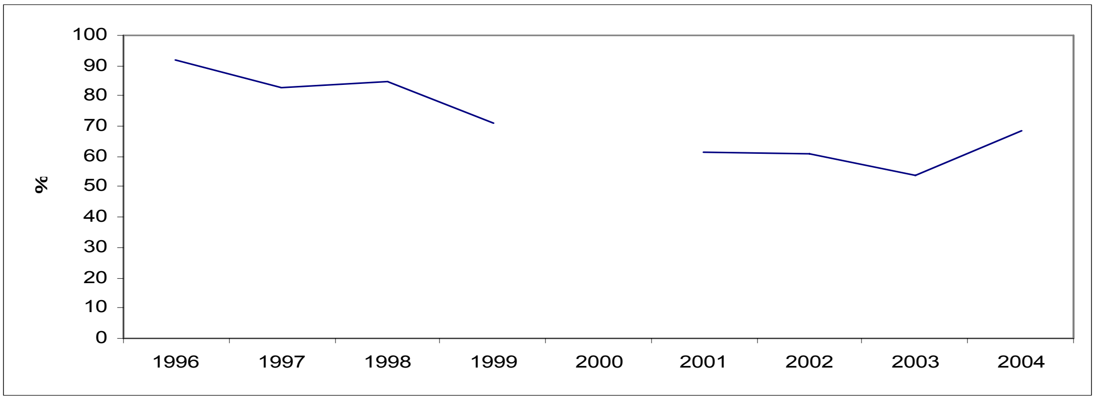
1997	1998	1999	2000	2001	2002	2003
14,103	17,384	22,482	26,428	28,631	28,941	33,448

Source: ECB

International entry

3.8 In 2004 there were a total of 537 foreign insurance companies authorised to work with free provision of services in Luxembourg. 154 of these were UK companies and there are also at least 50 companies from each of Germany, Belgium, France and Ireland. The remaining companies are from EU countries and also Iceland and Lichtenstein.

Figure 3.4: Market share of branches/agencies of foreign undertakings as a % of total domestic business



Source: OECD[4]

3.9 While Figure 3.4 illustrates a declining trend in the level of foreign penetration since the mid 1990's, it has been on the up since 2004 and the level of this penetration remains relatively high level compared to the other older EU member states.

3.10 In 2001, 78 Luxembourg insurance companies were authorised to operate on a free provision of services (FPS) basis. 43 per cent of the country's FPS life premiums came from Belgian residents. The second major external market is France, where the tax treatment of life insurance has become considerably tougher as a result of legislative changes. Thus Luxembourg products offer many benefits to French citizens, particularly in terms of asset transmission, and are covered by banking confidentiality.

3.11 On average, however, only 1.3 per cent of premiums issued in the EEA come from FPS business. This figure illustrates the fact that the single market in insurance still has not been completed. There have been particular problems connected with the diversity of languages in Europe, and special regulations that make it difficult or impossible to sign insurance contracts. Also, in certain circumstances, regulations not strictly forming part of insurance legislation can be regarded as an obstacle to international insurance operations. The FPS market therefore has considerable potential for expansion over the coming years.

[4] The OECD does not have reliable data for 2000.

Impact of the FSAP and FSWP Legislative Measures on the Insurance Sector in Luxembourg

Assessment of impact by category

Market entry, cross-border business and takeovers

3.12 Luxembourg's insurance sector makes up a less significant proportion of the financial services sector than banking or securities. The expansion of FPS (free provision of services) life insurance in 2001 has had a large impact on the sector. It is cross-border FPS life insurance that currently dominates the market covered by Luxembourg insurers.

3.13 Like the banking sector, the insurance sector is dominated by companies set up by foreign capital and so far, the FSAP seems to have had a limited effect in furthering this.

3.14 As highlighted earlier, Luxemburg currently has a 47 per cant share of the FPS market, however, on average, only 1.3 per cent of premiums issues in the EEA come from FPS. This suggests there is still significant scope for bringing about an internal market in insurance. Coupled with the growing appeal FPS give given the diversity of its products suggests to us that the FSAP will have a positive effect on the openness of this sector and thus the insurance market in Luxemburg in terms of making cross-border operations easier.

Competitiveness

3.15 The competitiveness of the sector is likely improve, by virtue of the mechanism described above, and thus partly facilitated by the FSAP.

3.16 On the other hand, similarly to the banking sector, the increased synchronisation of markets will take away some of the competitive advantages of Luxembourg companies against their competitors.

3.17 Overall it is more likely that the loss in competitive advantage through the increased synchronisation of markets, for example with the respect to taxation differential, will dominate. Thus it is expected that the effects of the FSAP on the degree of competitiveness of this market is perhaps likely to be negative over the longer term.

Products variety, e-commerce, and prices

3.18 According to survey respondents, there has been an increase in insurance product variety between 1999 and 2005. However, this increase is not attributed to the FSAP, rather general market trends and product innovation. This is expected to continue in the future.

3.19 However, the FSAP was regarded as promoting the development of e-commerce in insurance, and this is expected to continue.

3.20 Survey respondents stated that insurance product prices have increased during the period, but independently of the FSAP.

Consumer protection

3.21 The insurance market in Luxemburg is a developed one and prior to the inception of the FSAP, a comprehensive system of consumer protection was already in place and has tended to be influenced more by established trends than the FSAP in particular. As such, we believe the impacts of the FSAP on the degree of consumer protection in this sector to have been relatively limited.

3.22 Indeed, respondents to our survey stated that they did not believe that the FSAP had had any impact on consumer complaints in the insurance sector. The typical view is that provisions of the FSAP did not play a primary role in the determination of the historical trend, but instead attribute it to general market developments.

3.23 On measures of complaints, understanding and protection, the FSAP was said to have had no effect.

Switching

3.24 The view of respondents to our survey was that the FSAP did have a positive impact on increasing switching behaviour among insurance products and insurers. This is expected to continue.

4 SECURITIES

Securities Markets

4.1 Luxembourg's attraction as a financial hub is not limited to firms from countries outside the European Union seeking to benefit from the "European passport", such as the United States and Switzerland. Even within the EU, the country has become a centre for administration and, more recently, funds distribution, and over the years it has acquired very specific experience in these areas. It is the undisputed leader in cross-border sales of investment funds: of the twenty promoters distributing their funds in more than one EU country in July 2000, eighteen were based in Luxembourg. These figures are still modest, showing that the single market in investment funds has yet to become a reality and there is considerable scope for development.

4.2 Luxembourg has specialised in what are known as Part I funds under the 1988 law. Part II funds are closed for repurchase and not promoted in the European Union, or are sold to the public only in countries outside the EU. This categorisation is largely the same as that operated in other European countries.

Table 4.1: The world investment fund market as at 31 December 2001

Resident country	Value in €m	% of total
United States	7 914 417	59.9
Luxembourg	851 060	6.4
France	800 200	6.1
Italy	403 678	3.1
Japan	390 227	3
United Kingdom	389 441	2.9
Australia	379 004	2.9
Canada	303 941	2.3
Germany	239 666	1.8
Ireland	215 188	1.6
Hong Kong	192 980	1.5
Various	1 102 043	8.5

Source: Fédération Européenne des Fonds et Sociétés d'Investissement (FESSI)

4.3 In the space of only a few years Luxembourg has become the world's second largest centre for investment funds after the United States, having recently overtaken France. It has a European market share of over 22 %, and Luxembourg assets account for over 16 per cent of the world total excluding the US.

4.4 In 1983, anticipating forthcoming Community regulation of undertakings for collective investment in transferable securities (UCITs), Luxembourg set up a modern and flexible legislative framework granting separate tax status to UCIs and also creating the legal concept of the "Société d'investissement à capital variable" (SICAV).

4.5 Further impetus came in March 1988 with the transposition into national law of the December 1985 European directive on UCITs. This granted a "European passport" to Luxembourg SICAVs: a single licensing procedure whereby once a harmonised fund had been licensed in a member state, it could sell its shares in any other member state simply by giving notice that it intended to do so.

Factors Specific to the Securities Markets in Luxembourg

4.6 As in other areas of financial services the Luxembourg market is peculiar in that way that the home market does not have the same importance as in other countries. A securities market the size of Luxembourg's is unlikely to be sustained by the trading of shares and bonds of solely Luxembourg origin. Therefore by definition the market is much more dependent on making business for foreign companies as easy as possible.

4.7 The Luxembourg Stock Exchange pays careful attention to the implementation of a number of EU directives which impact the securities markets. Special attention was given to the transposition of the Prospectus Directive which became Luxembourg law on July 10, 2005 when the so-called Prospectus Law was passed by Luxembourg parliament, and led to a transfer of competences from the Luxembourg Stock Exchange to the *Commission de Surveillance du Secteur Financier* (CSSF) with regard to the approval of prospectuses. As a result CSSF now is the competent authority for approving prospectuses with public offers of securities and admission to a regulated market.

4.8 In this connection the Luxembourg Stock Exchange launched the Euro MTF market on July 18, 2005. The Euro MTF is becoming more popular internationally, in particular among non-EU issuers of securities placed with institutional investors and which have no requirement for a European passport but desire a listing in Europe. Well-rated issuers have decided to opt for this market, which meets a very high eligibility level within a domestic and international legal framework.

Impact of the FSAP and FSWP Legislative Measures on the Securities Markets in Luxembourg

Impact

4.9 As mentioned earlier in other chapters the FSAP measures can, potentially, have a greater impact in Luxembourg than in other Member States (due to the new market opportunities they provide) but they can also increase the competitive pressure on Luxembourg companies (due to the freeing up of other companies).

4.10 As the market is dominated by companies from other Member States the implementation of the measures into the Luxembourg law is only as important as the implementation in other Member States.

4.11 In medium term, a portion of securities jobs are likely to migrate to London and Luxembourg, as systematic internalisers take advantage of the opportunities MiFID brings and as London and Luxembourg take advantage of their lead in systematic internalising.

4.12 Consumer protection issues are of relatively limited importance in the securities market. For this reason, the short-term impact of the FSAP on the Luxembourg securities market would be limited. However, if the market extends to a more general public, then there could be consumer protection issues, in that a broader range of users would imply more inexperienced users. That said, the MiFID is addressing that long term risk through extensive consumer protection provisions. Therefore, in our view the FSAP has so far had no significant impact on consumer protection in the Luxembourg securities market; but if less experienced market users were in the future to begin to use that market, the FSAP might have a positive impact.

Other objectives of the FSAP in the securities sector

4.13 The subscription tax payable by compartments of institutional funds was reduced from 0.06 per cent to 0.05 per cent with effect from 1 January 2002, in another example of the efforts being made to keep Luxembourg competitive with new financial centres such as Dublin.

4.14 The law of 1997 on mortgage bond issuing banks allows banks established in Luxembourg to issue a new type of debt security providing bearers with special extra-sound guarantees. Only three such banks had been set up by mid-2002, but the law aims to exploit a gap in the market which shows considerable potential, and to ensure that Luxembourg becomes a specialist centre for this type of product within the European Community.

4.15 A number of promotion initiatives have also been carried out by the private sector over the last few years. For example the "Association Luxembourgeoise des Fonds d'Investissement" (ALFI) recently launched such an international campaign, aimed particularly at Hedge Funds.

Table 4.2: Total assets under management by investment funds (€ million)

1997	1998	1999	2000	2001	2002	2003
349,706	433,036	707,927	837,346	854,000	725,781	818,462

Source: ECB

4.16 These initiatives appear not to be directly related to the FSAP.

MiFID, MTFs and systematic internalising

4.17 As we have argued elsewhere, our view is that MiFID, the new clearing and settlement framework, and other FSAP measures, will probably contribute positively to an enhanced role for equity in a number of Member States and hence to an expansion in equity generally. In addition, since MiFID allows and facilitates systematic internalising and the use of multilateral trading facilities where previously they had been forbidden or found matters difficult, it is plausible that more companies will seek listings through multilateral trading facilities than in the past and that systematic internalising will expand.

4.18 Luxembourg seems well-placed to take advantage of all these trends, with its historically strong financial services sector, and our view is that Luxembourg is a likely gainer relative in volume terms to other Member States, as well as gaining from the general expansion of activity — perhaps in certain niche areas.

4.19 On the other hand, enhanced development in equities (and securities generally) may undermine some of Luxembourg's advantages in its existing market base — meaning that there may be material structural changes as a consequence of the FSAP.

5 FINANCIAL CONGLOMERATES

Financial Conglomerates in Luxembourg

Table 5.1: Financial Conglomerates operating in Luxembourg

Name	Head office base	Characterization of Conglomerate	Characterization of Subsidiary
Allianz	Germany	Insurance group doing asset management and banking	Insurance with some banking
Barclays	UK	Banking and insurance	Banking
BNP Paribas	France	Equal focus on retail, corporate and investment banking, asset management	Equal focus on Securities, Insurance, and Private and Corporate Banking
Danske Bank	Norway	Insurance, mortgage finance, asset management, brokerage, real estate and leasing services - mostly banking	Banking
DZ Bank Gruppe	Germany	Investment Banking	Investment Banking
Fortis	Belgium	Banking and Insurance: Contribution to net Profit: Retail Banking 23%, Merchant Banking 27%, Commercial/Private Banking 13%, Insurance Belgium and Netherlands 28%, International Insurance 6%	Banking
Grupo Santander	Spain	Insurance, Banking, Asset Management	Banking
Gruppo Banca Intesa	Italy	Banking	Banking
ING	Netherlands	Banking, insurance and asset management	Banking
Mediolanum	Italy	Pensions, investments, loans, banking, insurance	Investment Banking
Nordea	Sweden	Banking, Asset Management, Insurance. Contribution to net profit: Retail Banking 66%, corporate and institutional banking 25%, asset management 5%, life insurance 3%	Private and Investment Banking
SEB	Sweden	Banking firm doing insurance and asset management	Banking
Svenska	Sweden	Banking and Insurance	Banking

Source: EU Mixed Technical Group on the Supervision of Financial Conglomerates, Europe-Economics

Impact of the FSAP and FSWP Legislative Measures on Financial Conglomerates

Openness to foreign firms

5.1 Our assessments for other sectors have suggested that the effects of the FSAP on openness were limited for banking, insurance, and securities. As Luxembourg conglomerates mainly incorporate banking activity, we conclude that the influence of the FSAP is limited.

Competition

5.2 Among the other sectors, in banking, securities and insurance the effect of the FSAP was assessed as being limited. For financial conglomerates we would see the overall impact as limited.

Consumer protection

5.3 The effects of the FSAP on consumer protection in the banking, insurance and securities sector were assessed as limited. For conglomerates we conclude that the overall impact is likely to be limited.

Employment

5.4 Earlier sections assessed that the main change in employment was limited in the short term and unclear in the long term in the banking sector, limited in the short term and perhaps positive in the long term in the securities. Since conglomerates mainly incorporate elements of banking, we assess the net effect as limited in the short term and unclear in the long term.

Competitiveness

5.5 Earlier sections assessed that the main change in competitiveness was limited in the short term and unclear in the long term in the banking sector, limited in the short term and perhaps positive in the long term in the securities. Our overall assessment is that the impact is likely to be limited in the short term and unclear in the long term.

6 CONCLUSIONS

Assessment

	Impact of FSAP on…				
	Openness to foreign firms	**Competition**	**Consumer Protection**	**Competitiveness**	**Employment**
Banking	Limited	Limited	Limited	Limited in short term. Unclear in long term.	Limited in short term. Unclear in long term.
Insurance	Limited	Limited	Limited	Limited in short term. Perhaps negative in long term.	Limited in short term. Perhaps negative in long term.
Securities	Limited	Limited	Limited	Limited in short term. Possibly positive in long term.	Limited in short term. Perhaps positive in long term.
Financial Conglomerates	Limited	Limited	Limited	Limited in the short term and unclear in the long term.	Limited in the short term and unclear in the long term.