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Single Market, National Companies? The Not-So-Single Market in Financial Services

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permits member states to protect legitimate national interests in certain areas like defence, media and financial services.

The aim of the present report is to investigate to what extent and how national political institutions tries to protect national interests in this sector, focusing in particular on cross border mergers. We therefore turn to national regulators and political authorities for explaining the obstacles to cross-border mergers in the EU financial services sector. Although some cross-border mergers have taken place over the last decade, several member state governments and regulators have sought to discourage or prevent acquisitions of national companies by foreign banks. In what follows, the central tools, practices and arguments that have been employed in efforts to limit cross-border mergers are investigated, with a view to mapping political and regulatory obstacles to cross-border mergers and acquisitions in the European financial services sector. Therefore, this report is less concerned with obstacles that result from ownership-structures in the private sector, labours laws and employment costs/restrictions, and the links between the sector, the central banks and industry – except inasmuch as this is used by the authorities in an effort to block or discourage cross-border mergers.

Seven cases – or countries – have been selected for closer scrutiny in the present report. This selection was driven by an effort to focus on the most potentially significant and problematic cases. It was therefore driven by the search for possible independent variables, i.e. potential obstacles to mergers and acquisition in the single market in financial services, but limited to politically driven factors. France, Germany and Italy were inevitably included as both large markets and markets where respectively political intervention in the economy, the structure of the banking sector and limited implementation of EU rules have long been identified as obstacles to the development of a fully competitive and open market in banking and financial services (Molyneux 1996). These three states have also been identified as featuring relatively low competition, compared to the Anglo-American models, with the advent EMU therefore expected to increase the competition (de Bandt & Davis 1999). The controversy surrounding the Champalimaud case rendered Portugal a more fruitful subject than Spain. Given the

considerable restructuring expected there, Greece was included as the second South European case. These were the two exceptions to the rule of general liberalisation of cross-border financial flows in the early 1990s. Two Nordic cases, one established and one recently privatised, were included in the shape of Denmark and Iceland. The report is therefore built up around these seven cases, or rather, the central cases that illustrate the main politically driven obstacles to cross-border mergers and acquisitions in these cases.

Despite a strong EU merger regime and the establishment of the Single European Market, the present report concludes that national regulations undermine the single market in financial services. Although the EU Merger Control Regulation of 1989 provides for a single EU merger regime that gives the European Commission’s Directorate General for Competition (DG Competition) the sole right to block or clear mergers above given thresholds, rules and practices particular to the banking and financial services sectors at member state level have obstructed the development of a fully functioning single market. Because the EU legislation that governs the range of permitted regulation and intervention in the sector is suff3l7i8e

inhibit take-overs of institution that would lose these subsidies or guarantees if their status changed.

Each of these four issues are addressed in more detail below, following a brief overview of the EU-level rules and actors pertaining to the single market in financial services.

THE EUROPEAN SINGLE MARKET IN THE FINANCIAL SECTOR

Because the Merger Control Regulation provides clear rules on mergers and acquisitions and a well-defined division of power and authority, there are few or no problems with implementation. However, the EU financial services directives are far more ambiguous. The result has been that national authorities have considerable powers of discretion that may be used to obstruct any reorganisation of the sector that they find unpalatable. On the other hand, a combination of 'spontaneous harmonisation' national competition authorities have been strengthened and are emerging as more than occasional allies of DG Competition (Sauter 2001).

The European Union Merger Rules

At the EU level, the central piece of legislation is the 1989 Mercer Control Regulation (MCR), under which the Commission's Directorate General for Competition vets mergers involving aggregate world turnover of € 5bn and EU turnover of € 250m. Below these thresholds, mergers are covered by national competition authorities, most of which have reformed or adopted merger rules along the lines of EU competition policy.

Under this 'one-stop-shop' approach, DG Competition is the central player unless mergers fall below the threshold. Although the formal decision is taken by the full College of Commissioners, which sometimes proves reluctant to support DG Competition's more aggressive stance, DG Competition normally gets its way in competition cases (Eyre 1999). Compared to the Commission's other DGs it is by far the

most autonomous, having come to resemble the kind of independent federal agency found in Germany (Wilks 1992). Unsurprisingly, it therefore guards its exclusive merger powers jealously, and does not look kindly on states' efforts to block a merger that it has cleared. It not only interprets EU law, but evidently understands it far better than national authorities and companies (From 1999). The resulting vigilance and activism is particularly evident at the lower and intermediary levels of DG Competition. In case of

Because the MCR is enforced by DG Competition the question of member state transposition (implementation) is not directly relevant. Moreover, most states have reformed their national competition regimes, or created new ones, and these are increasingly being aligned with the EU regime. Without necessarily moving toward full convergence in terms of how the rules are interpreted or applied, the states thus feature regimes that are similar in terms of rules and structures (Eyre & Lodge 2000). This process has produced national competition authorities that tend to share DG Competition's goals and preferences, and there have been few conflicts between competition authorities on different levels.

However, most states have interpreted Article 21 to permit a range of 'prudential rules' regulating the banking and financial sector, which raises questions as to the compatibility of member state legislation and practices with EU law. Because the Single European Market has been created by the member states, and th

Competition gradually extended its reach and powers case by case with the backing of the European Court of Justice's broad rulings, driving the member states to agree on a strong merger regime in 1989. Single market legislation has accommodated national interest and institutions to a much greater degree. DG Internal Market is therefore more concerned with successfully promoting the extension and completion of the single market than with specific cases. At this stage, the directives that are relevant to mergers and acquisitions in the banking and financial services sector leave considerable discretion for national regulatory and supervisory authorities.

The 273-273 vote in the European Parliament on 4 July 2001 temporarily ended a 12-year effort to establish a framework for take-over rules in the European Union, leaving the EU without common take-over rules. In the words of diplomats cited by the *Financial Times* (4 July 2001), this reflected "blatant national manipulation". In the run-up to the vote the German government dropped its support for the proposed directive on the grounds that it would leave German companies vulnerable to hostile foreign take-overs (by banning defensive measures without shareholder consultation). However, a Group of High Level Experts has since been set up, and a new proposal is expected.

In the absence of a directive harmonising take-over rules, which upon British insistence was originally to follow soon after the MCR (Eyre 1999), a series of different national rules apply to take-overs in general. Although national competition policy regimes have much in common because a considerable degree of 'spontaneous harmonisation' has taken place over the last decade, considerable differences remain in terms of merger rules and permitted defences. The divergence in the banking and insurance sectors is even greater, given that most states have adopted special rules for these sectors and Article 21 of the MCR permits 'prudential rules'. Much the same applies to the powers of a host of

supervisory [illegible]

The Insurance Directives (esp. the Third Non-Life and Life Insurance Directives – 92/49/EEC and 92/96/EEC) require interventions by supervisory authorities to be

state governments have thereby retained a key tool for intervening in and shaping the restructuring of the sector, and in several cases their preferences have proven to be for protecting or strengthening national firms. In the event, DG Competition's main allies, and the main troublemakers for national governments, have turned out to be national competition authorities and the more independent minded of the regulators.

SECTOR-SPECIFIC REGULATIONS FOR FINANCIAL SERVICES: PRUDENTIAL RULES DISCOURAGING FOREIGN ACQUISITIONS

Several EU and European economic Area (EEA) states have adopted prudential rules that, while apparently not falling foul of Article 21, nevertheless inhibit foreign mergers and acquisitions. Italy is the clearest case in point of more or less undisguised politically driven used of prudential rules to shape the sector. Although there has not been any cases of direct confrontation between Italy and the European Commission over the government's intervention in the financial services sector, the country features a raft of rules that grant the Bank of Italy wide discretionary powers to shape developments in the banking sector. In practice, this has resulted in a sector that is hardly open to acquisitions by foreign institutions. Using procedural or prudential rules, Italian financial regulators have ensured that it is difficult for new actors, let alone foreign banks, to penetrate the market without the consent of the authorities. The Bank of Italy has drawn considerable criticism for such interventionist tendencies, notably over its opposition to hostile bids and its efforts to negotiate deals that prevent bidding wars. Commenting on the openness of the market to foreign acquisitions *Reuters* (11 October 1999) reported that "Italian banking stocks are now seen to have only limited upside potential because financial sector consolidation is being orchestrated by the Bank of Italy and not the market."

Intervention through Prudential Rules – Successful Protection in Italy

The Italian banking and insurance markets are being concentrated through a series of mergers and acquisitions of minority stakes. However, this process is to a large extent

bidding war between Sanpaolo and the insurer Generali over the smaller insurer INA (which controlled Banco di Napoli, BN). The deal saw INA's banking and insurance assets go to the two companies respectively, in a deal criticised for setting aside the interest of minority shareholders, the INA and the other BN shareholder. In 1998, the Commission approved the Bank of Italy's aid to BN in the form of a capital increase, a tax break and advance payments, subject to 'cleaning-up, restructuring and privatising' the bank. In a further anti-state-aid case, in October 2000 the Commission opened a formal investigation into Italian measures under which banks that merge or undergo restructuring qualify for reduced tax rates.

PRUDENTIAL RULES AS MERGER CONTROL: TESTING ARTICLE 21

The question of the scope left by prudential rules for national protection in the financial services sector remained unanswered for a decade. Yet the Commission's swift response in the Portuguese 'Champalimaud case' indicates that rather than taking a lax view of bank sector mergers, it was increasingly keeping alert to potential cases to test the limits of Article 21 of the MCR. There was no secret that it had long suspected that national prudential rules were used across the EU in defence of government preferences that are incompatible with the Single Market. In the words of one Commission official suggesting this was an opportunity to clarify the rules where national discrimination inhibits the development of a single market in financial services: "the implications of this case will be like a bomb" (*Financial Times* 23 July 1999).

Intervention through Prudential Rules – unsuccessful Protection in Portugal

Portugal still provides the only case of legal action in the Court of Justice over a member state's violation of EU rules relevant to mergers and acquisitions in the financial services sector. The government's intervention in June 1999, when it blocked the acquisition of the Champalimaud group by the Spanish bank Banco Santander Central Hispano (BSCH), drew a sharp reaction from the Commission. It decided that the action violated

not only Article 21, but also single market rules. However, this tested the application of rules rather than transposition of EU directives and although the government was obliged to lift its blocking of the merger, the result was only a partial victory for BSCH.

The Portuguese rules governing mergers and acquisitions in the financial sector grants considerable powers of discretion to the Finance Minister, who makes the final decisions on mergers and acquisitions. Prudential rules lay down that bank mergers require approval by the Bank of Portugal, as do acquisitions of credit or financial institutions crossing 20, 33, or 50% thresholds of share capital and voting rights. Even before the Commission forced the government to reverse the Champalimaud/BSCH decision Portuguese authorities drew criticism for excessive interference. The Economist Intelligence Unit concluded that "Portuguese banks have been sheltered from foreign competition and have enjoyed the paternalistic guidance and protection of the government." (*EIU Country Profile* Portugal 1999/2000). The banking and insurance market is concentrated among a limited number of key players, with three of the four major banking institutions controlling the dominant insurers. The state-owned Caixa General de Depositos (CGD) owns Mundial Confianca; the Banco Comercial Portugues (BCP) controls Imperio; and the Banco Espirito Santo (BES) has a stake in Tranquilidade. The fourth major banking group is the Banco Portugues do Investimento

violation of competition rules, rules on the right of establishment and rules governing supervisory authorities in the insurance sector, and it adopted an interim measure suspending the Portuguese government's decision. The infri

2000). The transposition and application of EU rules are frequently open to interpretation, and the scope of prudential rules more so than most. Although they are evidently compatible with a degree of protection, the limits were established in the Champalimaud case.

POLITICAL INTERVENTION: BUILDING AND PROTECTING NATIONAL CHAMPIONS

While efforts to build national champions do not necessarily fall foul of EU legislation unless this involves discrimination or state aid, this does not prevent national politicians' protestations and proclamations of 'national interest'. The French financial services sector provides a good illustration of the low regard in which free-market EU rules are held, or at least the ease with which they are conveniently forgotten when they clash with governments' preferences for building or defending 'national champions'. Like the Portuguese case discussed above, it illustrates the legitimacy some politicians attach to defence of the national interest, even when this explicitly violates the principles behind the Single European Market. Nevertheless, in the case discussed below, the French government's invoking the national interest had little effect on the outcome. As in a similar Icelandic case, the evidence suggests that governments run the danger of being over-ruled by their own national regulators, adhering to the letter of the law and to some extent fighting the same battle as DG Competition, even in the face of outspoken government criticism.

The French Case

Although French competition rules and regulatory practices were aligned with EU competition law in the mid-1980s, this has not prevented efforts on the part of politicians to intervene in and shape the resulting restructuring of the financial sector. Although there is little direct evidence of successful intervention in the sector designed to keep out foreign institutions, there is little doubt that the government (like many others) sometimes seeks to circumvent the spirit if not the letter of the law as regards non-discrimination in

these sectors. *International Money Management* commented (6 August 2001): “Certain EU member states, especially France, pay only lip service to the [insurance] directive and overtly, in a protectionist manner, continue to thwart the efforts of many product providers and non-French advisers to capitalise on this legi

bids that would draw in th

The Icelandic Case

Upon accepting the European Economic Area agreement, Iceland adopted a competition law compatible with the EU regime in 1993. The Competition Council vets mergers that do not have an EU dimension, including the financial services sector. In 1999 the three supervisory authorities for banking, insurance and financial operations merged to form the Financial Supervisory Authority. Its main task is enforcement of prudential rules. The major banks and the government have made it clear that they share concerns that Icelandic banks may have problems in the face of larger foreign competitors. Hence the similarity with the French case, down to and including their defeat at the hands of national regulatory authorities. Nevertheless, the successful blocking of a Swedish bid during the privatisation process (see below) indicates that Icelandic authorities are somewhat more effectual due to their remaining shares in the banking sector. Disputes about whether or not Icelandic banks are subject to potential competition from banks in the EEA should be resolved quite soon as Icelandic banks are increasing their presence internationally.

The Icelandic banking sector was dominated by state-owned banks until these were transformed into limited liability companies in 1997, with the treasury as the only shareholder. The same year the four state-owned investment funds merged into the Industrial Investment Bank, which in turn merged with the commercial bank Islansbanki in 2000. In response, the two banks remaining in state hands (Landsbanki – the National Bank – and Bunadarbanki – the agricultural bank) proposed a merger, which was supported by the government but blocked by the Competition Council. The Icelandic banking sector is thus characterised by increasing consolidation, but it remains thoroughly ‘over-banked’ indicating a need for further consolidation.

STATE AID AND GUARANTEES: DISTORTING COMPETITION

Some obstacles to restructuring the banking sector lie in its structures rather than in transposition of EU directives or protectionist use of prudential rules. Although the private part of the sector may be consolidating by way of mergers, public arrangements sometimes limit restructuring. The municipal and co-operative banks in Germany banks are by and large immune to mergers with any other type of organisation, which precludes foreign acquisitions (the legal changes required at regional level are a considerable obstacle). Although this is compatible with EU law, the effect has been a financial services sector relatively impenetrable to investors. Moreover, the municipally owned banks have benefited from what amounts to illegal state aid. (France has repeatedly given state aid to Credit Lyonnais, which was approved by the Commission in 1995, 1996 and 1998 because it was considered compatible with the single market on the light of the bank's restructuring and privatisation.) Along similar lines, an Icelandic case illustrates the state's interventionist options in the short term, e.g. by simply delaying privatisation in the case of an unwelcome foreign bidder.

Public Ownership and State Aid in Germany

The German case illustrates a more subtle form of protection of banking markets from competition, through state aid in the public sector (i.e. municipally owned banks) and a 'stakeholder' tradition that eschews hostile take-overs, rather than by invoking prudential rules. Only the former qualifies as a politically driven obstacle to mergers and acquisitions. German merger control provisions are enforced by the Federal Cartel Office (BKA), an independent agency. Decisions may be appealed to the courts or the Minister of Economics. Approval is required for acquisitions that lead to control of 'considerable shares' of a financial institution, and the evaluation is carried out with reference to prudential rules and in cooperation with relevant foreign authorities. The initial threshold is 20%, but, as in Italy, the procedure is repeated for higher thresholds, in this case 33%, 50% and 100%. However, the main obstacles lie in German law's permitting managers to

banks and Landesbanken attracted the Commission's attention in December 1999, following complaints from the European Banking Federation targeted at the whole system of guarantees and exemplified by Westdeutsche Landesbank, Stadtsparkasse Köln and Westdeutsche Immobilienbank. The basis for the complaint was that the public guarantees for Landesbanken and Girozentralen (LBuGs) give these banks a better credit rating and risk profile and a corresponding reduction in their capital costs. Consequently, the Commission sent a preliminary opinion to German authorities on 26 January stating that it considered the guarantee system as constituting illegal state aid. Its formal request that Germany to bring State guarantees in line with EU law followed on 8 May 2001, and although the legislation in question is currently under review, it is unclear to what extent German authorities are willing to amend the existing system. Reports suggest that there is serious opposition to fundamentally altering the regime, and there are indications that the government will merely seek to adjust the law so as to be EU compatible rather than abolish this practice. Resistance by Land authorities against an initiative by the Helaba Landesbank (Landesbank Hessen-Thüringen) to create a mutual fund for the savings banks and Landesbanks to replace the Anstaltslast and improve German bank's credit ratings (*Die Welt*, 24 Sept. 2001) bears this out.

Although cross-ownership (bank-industry) and banks' roles in managing investors' accounts renders the sector all but impenetrable to hostile cross-border take-overs, the private sector is less problematic as far as politically driven obstacles are concerned. However, one interesting development is the emergence of so-called "allfinanz" institutions, i.e. the merging of universal banks with insurance institutions (also known as bankassurance). Examples include Allianz' merger with Dresdner (cleared by the Commission in July), Hypo-Vereinsbank's expected merger with Munich Re and the possible joint-venture between Deutsche Bank and French insurer Axa (*Institutional Investor*, May 2001). A study by the German Banking Group Sal. Oppenheim also predicts that the number of Landesbanken will be reduced from twelve to two or three in the next five years. Other key aspects of restructuring include the emergence of Deutsche Bank as a world class player, taking over Bankers Trust, in the US. Merger talks are also going on between DG, GZ and WGZ, three regional central banks for almost 2000 local

remaining within the letter of the law is of course not limited to the EEA. In a somewhat similar case in France in 1998, Finance Minister Strauss-Kahn had rejected Dutch bank ABN AMRO's bid for Credit Industriel et Commercial when it was being privatised, reportedly in favour of a lower bid from Credit Mutuel that offered better job assurances (*Financial Times* 12 March 1999).

OPEN COMPETITION – THE NOT-SO-ROTTEN STATE OF DENMARK (AND GREECE)?

Compared to the other states reviewed here, Denmark is unproblematic as far as implementation of EU rules and lack of politically driven obstacles to cross-border mergers is concerned. This confirms the Commission's general praise for the openness of the Scandinavian and Benelux EU member states. As Competition Commissioner Monti's observed, "the consolidation that has so far taken place in Europe in this sector has been almost exclusively within Member States, with the exception of the Benelux and

Brining in a Southern Europe

CONCLUSIONS

The present study has been driven by a combination of independent variables and cases. The cases were selected as much on the basis of expected findings, i.e. an effort to cover the main cases that feature politically driven obstacles to cross-border deals. Although

question of the compatibility of EU and national law was hotly contested by the

competitors. As in France, this concern seems to produce more noise than results. Disputes about the significance of foreign competition EEA should be resolved quite soon because Icelandic banks are increasing their presence internationally.

Greece remains a somewhat untested case, partly because of its labour laws and market structure. Although the financial sector has undergone considerable domestic restructuring, this has yet to be extended to large-scale cross-border mergers. This demonstrates some of the limits to the attractiveness of cross-border deals in the sector. Potential opposition to such mergers is therefore untested, although the interest expressed by some foreign banks may soon change this.

Denmark has never exhibited a strong inclination toward state ownership of or intervention in industry. Although the state has exercised some control over public services and the type of industries traditionally regarded as strategic by West European governments, a broad privatisation programme got underway in the early 1990s. In line with Monti's praising the Nordic countries, the Danish banking sector appears not to have been the subject of state intervention, let alone political protection against foreign mergers or acquisitions.

These finding suggest that most state are not prepared to entertain full competition and loss of political control (let alone national sovereignty) of central aspects of the economy such as banking and other financial institutions. Although the exceptions under the MCR

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