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"European Banking System Integration Mitigating the structural differences via regulation?"

Policy Paper by Young Researcher WP II / III Theories: Team 3 (D110)

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Abstract

The European banking sector is among the least integrated in the European economy. The low degree of banking integration is attributed, inter alia, to the strong differences in the structures of the economic system, the financial system and the banking system's regulatory framework. The EU promotes the economic integration process, mainly, through monetary and regulatory integration. After the establishment of the EMU, regulatory integration is considered as the main strategy for facilitating banking integration in the EU. So, the EU financial integration process – with the banking sector in the core of it – could be described as a long-term EU effort for the mitigation of the member-states' structural diversity via financial regulation policy. The acceleration (or not) of this process is determined by private and public interests in both sides, which are closely related to the winners and losers of this financial integration process. The further analysis of these concerns creates a research field which could be labeled as the "political economy of the EU financial integration".

1. Introduction

European Union's (EU) phenomenon, during the first 50 years, is an integration process with periods of high-gear and low-gear developments. The rotation of low-gear (*stagnation*) and high-gear (*acceleration*) periods of European integration fed (*and keeps feeding*) academic research, especially during the low-gear periods, when scholars tried to explain the stagnation and to give "*way out*" policy proposals. The research is mainly focused on specific issues and segments of the integration process, as the study of the whole picture of the integration phenomenon is quiet difficult and complicated. Economy is the core of the integration process and constitutes a huge research field, focusing on "*problematic*" or less integrated sectors of the economy. One of these sectors seems to be the European banking system.

The important role of the banking system in the development process makes the integration of the European banking markets a high priority for the European Union. Nevertheless, the European banking sector is among the least integrated in the European economy. The low degree of banking integration is attributed, inter alia, to the strong differences in the structures of (1) the economic system, (2) the financial system and (3) the banking system's regulatory/supervisory framework, in the EU-27. The EU promotes the economic integration process, mainly, through monetary and regulatory integration. After the establishment of the European Monetary Union (*EMU*), regulatory integration is considered as the main strategy for facilitating banking integration in the EU. However, interesting policy questions and concerns emerge as to the policy's contribution to mitigating structural diversity in the EU banking markets.

Next (2) section attempts to deploy the theoretical and policy background of the European banking system integration while, the third (3) section examines the degree of integration of the European banking system and the factors that impede integration. Sections 4 and 5 explore the structural differences in the European economies and analyze the EU efforts and initiatives for the implementation of an integrated European regulatory/supervisory framework. Section 6 concludes and seeks to detect the theoretical questions and policy issues that arise from the Union's efforts to promote banking integration via regulatory initiatives.

2. Financial Integration and the European Union

The financial system is characterized as the "*heart*" of an economy, determining its viability and liveliness. In the EU, the basic financial system's component is still the banking system, the robustness, stability and efficiency of which contribute significantly to European economy's growth. This important role of banks makes the integration of the European banking markets a high priority for the EU[1]. Financial integration could be defined either by the aspect of the necessary preconditions for its facilitation, including removal of capital controls, legal (*regulation*) obstacles and tax barriers, or by the aspect of the testable consequences of the financial integration process – as the law of one price (Von Furstenberg, 1998). However, the benchmark definition is the one given by Baele *et al.* (2004), stating that *the market of a given financial instrument and/or service is considered fully integrated if all economic agents with the same relevant characteristics acting in that market face a single set of rules, have equal access and are treated equally*. The

[1] The important role of banks in the economic activity financing characterizes most of the European financial systems, mainly in Continental Europe, as bank-based systems. On the contrary, a financial system where the financing of the economic activity is based more on the capital and equity market than on the bank market is labelled as market-based system and is located mainly in USA and UK.

aforementioned situation, according to the Financial Services Action Plan (*FSAP*), describes the EU vision for an integrated European financial market.

The idea of an integrated financial market in the EU (*then EC*) has its roots decades before the planning of FSAP and is detected in the vision of a common European market based on the free movement of people, goods, capital and services. Nevertheless, financial market – and particularly the banking market – was the most regulated and closed sector of the national economy (*dependent central bank, government controlled interest rates, national rules, barriers and taxes to foreign capital, etc*) and the banking system functioned more as a government's tool for the implementation of its policies (*monetary, fiscal, exchange rate, etc*) and the realization of its goals (*investment, production, trade, etc*). Therefore, the initial prerequisite for the integration of the European financial system was its liberalization. As Tsoukalis (1997) points out, a) the large and rapidly growing size of the financial sector, b) the closed nature of the national markets, manifested through large price differentials, and c) the indirect effect on investment and growth, resulting from the expected lowering of the cost of financial services, are the main explanatory factors for the emphasis laid on the liberalization of this sector in the context of the internal market programme[2]. Thus, the financial integration process, in the context of the internal market programme, started by promoting, initially, the liberalization of the closed national financial markets and then proceeding to the re-regulation of the markets under the perspective of the implementation of an integrated financial system in the EU[3].

The main strategies that promote the financial integration process are the adoption of a single European currency and the harmonization of (*business*) law. The EMU on the one hand enforces the competition in the financial markets by eliminating the exchange rate risk[4] and the national currencies, which used to act as non-tariff barriers, while on the other hand enhances the economic and monetary stability of the EU member states. Meanwhile, the financial system's regulatory and supervisory unification creates the required institutional framework for the efficient, full compatible and insured function of the financial institutions in a European financial market. The "*common*" market would have the following characteristics: a) all Europeans investors have access to a wide range of low cost financial services and products, b) all European financial institutions, in a common institutional framework, have access to the markets of all the EU member states and realize cross-border transactions in an compatible environment for business activity, c) the reduction of the cross-border financial transactions cost, d) the enforcement of the capital allocation in the EU and the optimal utilisation of it, and e) the insurance of the european banking systems stability. But, why is financial integration so crucial for the development of an economy?

European financial integration is a dynamic process that causes multidimensional (*mainly positive*) impacts to the European economy, which are attributed a) to the reform initiatives of the process which affect strongly or trigger reforms to other sectors of the economy, causing structural effects, b) to the new institutional framework (*regime*) for the regulation and the supervision of the financial system which works as a "*safety net*" for the European markets, enforcing stability and causing major changes in the institutional structures – with further implications to

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[2] In this point, we must note that the notion of financial liberalization was a global trend, following the ideas of trade liberalisation and what later was characterized as globalization.

[3] The banking sector's liberalization in EC, after the complete liberalization of the capital movements, was based on the harmonization of essential rules, mutual recognition and the principle of the home country control (Tsoukalis, 1997).

[4] In principle, therefore, savers don't have to worry about where the asset is issued as long as it is denominated in euros, and borrowers can tap the whole area by taking on euro-dominated debt (Baldwin and Wyplosz, 2004).

economic performance, and c) to the "*common*" financial market (*fully integrated*), by creating an efficient, competitive and stable financial environment for the market's participants (*investors, consumers and financial institutions*) – with further significant developmental and integration effects to the European economy. Generally, financial integration contributes significantly to the efficiency – regarding the implications in growth, productivity, unemployment, and monetary policy – and to the stability of the European economy – regarding the effects in risk diversity, confrontation of shocks, macroeconomic discipline, financial stability, and welfare gains. And as Rodrik (1998) concluded, capital controls are essentially uncorrelated with long-term economic performance. Closer financial integration strengthens financial systems and leads them to a) high competition, b) better exploitation of scale economies and reduction of the capital cost, c) high liquidity (*especially of banks*) and investment, and to d) more efficient capital allocation (Levine, 2001; Levine, 2004; Baldwin and Wyplosz, 2004). All the aforementioned integration's consequences contribute directly to economic growth and development.

For economies with segments heavily depended on external finance, like the fast-growing new and small-sized companies, the role of financial integration and development in fostering post-entry growth is significant and sometimes stronger than labour market flexibility (Aghion, 2006). This hypothesis becomes, more important in the case of EU, as the potentially fast-growing newly established European companies face obstacles and limitations in their access to finance and this constrains their growth ability (Inderst and Moller, 2006). This leads us to the discussion about the way financial integration contributes to growth, as the contribution might be located either on the (*decreased*) cost of capital or on the supply of funds to growing companies and their accessibility to capital or banking markets. Small and fast-growing firms do not benefit, directly at least, from an efficient and liquid corporate bond market, because the most important for these companies is the supply of credit and venture capital and the market's liquidity for equity at the time of initial public offering (Pisany-Ferry, 2006). Also, poorly capitalized firms do not seem to invest, while firms with intermediate levels of capitalization can invest only with the help of information-intensive external finance, pointing the important role of banking intermediation for the small and medium companies (Holstrom and Tirole, 1997; De Fiore and Uhlig, 2005). Concluding, the companies that benefit the most from financial integration, in terms of lowering capital cost, are the large and well capitalized firms as they can finance their investment directly from the market, relying on cheaper and less-information intensive finance. The direct result of this situation is the strengthening of the large firms' competitive advantage. According to Pisany-Ferry (2006), *the early-stage financing is the financial Achilles' heel of European growth*, because the size of the Euro-area venture-capital market is too low considering the same ratios in USA and UK (Hartmann et al, 2006)[5]. Another dimension of the "*problematic*" financing of the small and medium enterprises (SME) regards the viability of the small and medium sized banks of a financial system, which are SME's basic financiers, especially, after the implementation of the new Capital Adequacy Directive (CAD II) which seems to affect quite negatively the functions of small and medium sized EU banks (Westlake, 2002; Claessens, Underhill and Zhang, 2003). During the CAD II consultation period European Commission tried and partly achieved the "*protection*" of the small and medium sized banks in the new regulatory and competitive environment for the European banks, but scepticism over the viability and the competitive disadvantage of the small and medium sized banks remained (ECB, 2001).

[5] According to (Hartmann et al, 2006), the size of Euro-area capital market is about one-half the size of the US capital market, while the same size for the UK is the three-fourths of the US capital market. On the contrary, the European ratios about the venture capital considering US are one-fifth for the Euro-area and one-third for the UK.

Meanwhile, the financial integration reforms have the ability to trigger reforms in labour and product markets, aiming to the implementation of a more dynamic market. An integrated financial market generates pressures for reallocation of capital from inefficient sectors and companies to the more efficient and growing ones, creating the prerequisites and the need for reforms in labour and product markets, while the realization of the reallocation limits the socioeconomic cost of the economy's restructuring. Also, the inter-temporal pay-off from labour and product market reforms might be increased in an integrated financial market through alleviating liquidity constraints and accelerating their medium-term job creation effects (Pisany-Ferry, 2006). Moreover, financial integration seems to have positive effects on productivity, as capital inflows make possible investments in more productive projects, while the enhancement of portfolio insurance – as the result of risk diversity – fosters investments in risky projects with high expected return and productivity (Acemoglu and Zilibotti, 1997; Levine, 2001; Bonfiglioti, 2007). Last but not least, financial integration is also of key importance for the performance of the monetary policy in the Euro-area and the function of the Eurosystem, because a more homogenous and integrated banking sector will ensure a uniform and effective monetary policy transmission mechanism through the Euro-area (Sorensen and Gutierrez, 2006; Trichet, 2008)[6].

Integrated financial system contributes significantly to the stability of the European economy, as it helps coping with asymmetric shocks via risk diversification and shock adjustment. In an integrated context the holding of foreign assets of different markets is a way of risk diversification, preventing investors from correlation between fluctuations in labour and capital income, while cross-border financial transactions smooth fluctuations in consumption in case of an asymmetric shock in income. So, financial integration could partly substitute other channels of adjustment such as labour mobility (Pisany-Ferry, 2006). Furthermore, financial integration works as a cross-border "*mechanism of penalties*" for the undisciplined policymakers, as unsound policies or decisions related to the government financing, the fiscal policy and the banking regulation will induce capital outflows (Obstfeld, 1998). Also, the implementation of a tight and efficient regulatory/supervisory framework in the context of the financial integration process will provide a high degree of stability and robustness of the financial system, creating welfare gains that are associated with better credit assessment and the prevention of major disturbances (Pauer, 2005; Kaas, 2004). However, we must note that financial integration can contribute to the creation of problems and have negative impacts to the European economy, regarding the initial shock that led to the widening of current account deficits, the uneven integration of products and capital markets (Pisany-Ferry, 2006), the pro-cyclicality and volatility of short-term flows, and the high contagion of the capital markets (Dornbusch, Park and Claessens, 2000; Mihaylova, 2007). The above negative (*hypothetical*) impacts of the financial integration in the European economy enhance the need for adequate and effective supervision of the European financial system.

Therefore, we can come to the conclusion that the integration of the European financial market is a process of vital importance for the development and (*the further*) integration of the European economy, considering the significant impacts on competition, the ability to channel funds to new fast-growing firms, the contribution to economic restructuring, the enhancement of financial and economic stability and the ability to substitute the (*incomplete*) real integration. The effectiveness of the process, however, will be determined by the way and the degree of supervision of the integrated European markets and the efficiency of the reform initiatives[7].

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[6] Banks remain major players in the Euro-area financial system and hence play a key role in the transmission of monetary impulses to the real economy (Sorensen and Gutierrez, 2006).
[7] For further studying see Pagoulatos (2003).

3. The Integration of the European Banking System

The last (*almost*) two decades can be characterized as the financial system's "*golden period*" in a global but, also, in a European context. The degree of financial integration and competition has increased, especially after the introduction of the single currency in the Euro-area. However, some sectors of the financial system seem to have made greater progress than others in terms of integration. Particularly, the degree of integration has accelerated in all markets (*money market, government-bond market, corporate-bond market, equity market*) except for the credit market. Though, the degree of integration varies in different segments of the banking sector. For the cross-border corporate lending market Baele *et al.* (2004) analysis' indicates that the medium-/long-term segment is more integrated than the short-term one, while the cross-border consumer credit market remains highly fragmented. Most of the cross-border banking activities in Europe are taking place via credit institution's mergers and acquisitions, while the de-novo banking entry is quite limited. Particularly, de-novo entry has been substantial in Portugal, Southern Italy and in the majority of the Central and Eastern European countries (Barros, 1995; Bonaccorsi di Patti and Gobbi, 2001; Kaas, 2004). In the case of the new EU member-states, the transition from the planned to market economy has led to great structural developments, which has been boosted by a strong foreign, mainly EU, banking presence (Baltzer *et al.*, 2007)[8]. However, the least integrated dimension of banking activities remains the direct cross-border credit (Baele *et al.*, 2004; Kaas, 2004).

During the last decade, the volume of cross-border mergers and acquisitions (M&A) of credit institutions in EMU countries has increased compared to previous decades. According to Table 1 for the period after the introduction of the euro, the share of EMU cross-border M&A (*with credit institutions of EU member-states*) in the total M&A activities in EMU remained stably above 20%, without any remarkable acceleration performance. Meanwhile, the volume of foreign subsidiaries assets in EMU was doubled in the last years, from 1470 billions € in 2001 to 3016 billions € in 2006, while the foreign subsidiaries assets' share in the total assets in EMU, in the last six years, was increased by 44,4% – from 8,37% in 2001 to 12,09% in 2006. However, the degree of direct cross-border credit was significantly low during the last years in Euro-area. Particularly, the presence of foreign (*from other EU member-states*) credit institution's branches and the volume of their assets in EMU recorded an extremely marginal growth. During the 2001-2006 period, the share of foreign credit institutions' branches in the total number of local branches in EMU increased only by 0,03 percentage units, while the rate of foreign branches' assets in total assets in EMU increased for about half a percentage point – from 3,37% in 2001 to 3,86% in 2006[9]. This marginal increase in direct credit to foreign institutions is attributed to wholesale and investment banking, the benefits of which are totally exploited by the large companies of the Euro-area and EU in general (Papaioannou, 2005). In contrast with wholesale banking, retail banking contribution in direct cross-border credit activities seems to be naught, as investors in retail and consumer banking markets show strong preference or "*home bias*" in local banking systems (Baele *et al.*, 2004; Bos and Schmiedel, 2006). A bigger indication of the significant low degree of retail banking integration is the spread of interest rates among Euro-

[8] According to Baltzer et al. (2007), the percentage of asset shares of foreign-owned bans (*relative to total bank sector assets*) increased from 30% in 1997 to around 75% in 2005.

[9] According to ECB report *EU Banking Structure 2006*, the share of domestic credit institutions' assets in total EU assets is 72,9% and the rest 27,1% is the assets' share of foreign branches and subsidiaries. This performance is attributed to the new EU Members States, where in 2006 61,2% of total assets were controlled by foreign subsidiaries and 6,5% by foreign branches.

area's credit institutions for retail products. The biggest spread, of about 120 basis points, was noticed in consumer loans during the first half of 2006 (ECB, 2006).

Table1: EMU and cross-border banking activities, 1997 – 2005

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Branches of credit institution's (CI's) from other European countries / Total number of local branches in EMU - 12	0,19%[1]	0,2%[1]	0,22%[1]	0,24%[1]	0,23%[2]	0,24%[2]	0,24%[2]	0,25%[2]	0,26%[2]	0,26%[2]
Total assets of branches of CI's from other European countries (bil. €)	461,4[1]	498,7[1]	518[1]	601,4[1]	591,9[2]	600,8[2]	594,8[2]	718,3[2]	853,8[2]	962,7[2]
Total assets of branches of CI's from other European countries (bil. €) / Total assets in EMU - 12	3,48%[1]	3,52%[1]	3,37%[1]	3,65%[1]	3,37%[2]	3,32%[2]	3,14%[2]	3,51%[2]	3,77%[2]	3,86%[2]
Number of subsidiaries of CI's from other European countries	360[1]	374[1]	373[1]	405[1]	394[2]	383[2]	359[2]	339[2]	345[2]	343[2]
Total assets of subsidiaries of CI's from other European countries (bil. €)	761,7[1]	885,7[1]	1038[1]	1262,8[1]	1470,2[2]	1637,8[2]	1717,1[2]	1994,5[2]	2654,7[2]	3016[2]
Total assets of subsidiaries of CI's from other European countries (bil. €) / Total assets in EMU - 12	5,75%[1]	6,26%[1]	6,75%[1]	7,66%[1]	8,37%[2]	9,06%[2]	9,09%[2]	9,76%[2]	11,72%[2]	12,09%[2]
Number of cross-border European Mergers and Acquisitions (M&A) between CI's in EMU - 12	8[1]	12[1]	30[1]	27[2]	17[2]	19[2]	18[2]	18[2]	21[2]	

Number of cross-border European Mergers and Acquisitions (M&A) between CI's in EMU / Total number of M&A between CI's in EMU - 12	7,5%¹	10,4%¹	20,8%¹	35,5%²	25,3%²	21,1%²	20,2%²	28,1%²	24,1%²	

Source: *ECB (2004), and (2007).*
¹ The term "European countries" refers to European Economic Area countries (*EEA 18 countries: EU-15 plus Norway, Iceland, and Liechtenstein*).
² The term "European countries" refers to European Union countries (*EU-25, after enlargement on 1 May 2004*).

The integration process of the EU banking system seems to be accelerated after the introduction of the common currency, but the degree of integration is still too low comparing to the other sectors of the financial market. Particularly, the less integrated segment is the retail/consumer banking, where the "*home bias*" phenomenon remains prevalent. The limited banking integration is attributed, mainly, to differences in local regulations[10], to structural diversity and to information asymmetries. Banking regulation and the quality of legal system are key driving forces of the volume of international bank flows and financial development, as well defined and protected investors' rights appear to be a prerequisite for liquid capital markets, merger and acquisition activity, and large project finance deals (La Porta, 1997; Rossi and Volpin, 2003; Schularick and Steger, 2007). Meanwhile, differences among regulatory institutions in EU banking system, and their weaknesses (Stiglitz, 2000), affects directly the proper function of the European financial markets in terms of market's stability, competition and efficiency. This has long been recognized by the EU, which promoted "*brave*" harmonization efforts, especially, during the last decade with the planning and implementation of the FSAP (*regulatory and supervisory integration*). Early evidences indicate that securities and banking law harmonization policies implemented by the European countries together with the minimizing of exchange rate risk, have spurred cross-border activities within the EU (Papaioannou, 2005). In addition to the theoretical approaches of a "s*ingle banking market*" in EU, several regulatory hurdles remain to be removed, releasing the integration dynamics of what we could, then, characterize as a single EU banking market (Baldwin and Wyplosz, 2004).

The obstacles of further integration - especially in retail banking - are not attributed to the degree of regulatory or law harmonisation, but to the structural diversity of the European economies and financial systems, which affect significantly the implementation and effectiveness of the EU regulations (Goyer, 2006; Lutz and Eberle, 2007)[11]. According to Baele *et al.* (2004), integration in the Euro-area banking

[10] Differences in local regulation and the structural diversity affect negative the supply side of the banking market.

[11] Goyer's study (2006) about the important transformation of the French and the German systems of corporate governance and the different impacts of it concludes that the introduction of a profound institutional change in the ownership structure of French and German companies does not annul the theoretical importance of institutions, because substantial institutional differences remain in other areas (*in this case the different institutional arrangements of workplace organization and the power relations embodied in them*). So, these persisting cross-national structural diversity forms a distinctive constellation that

markets may be considered quite advanced from a legal perspective, but the low degree of integration in this segment suggests that there are other types of non-regulatory barriers to the process that have remained in place. The structural differences among the EU member-states are, mainly, detected in economic and financial systems, the role of politics, cultural characteristics and geographical thesis, and social capital.

The structure of the financial system, the tax treatment[12] and the degree of local competition are important determinants of bank efficiency, affecting heavily bank's decision to expand in new markets. The empirical results of Bos and Schmiedel (2006) suggest that the average cost and profit efficiency varies considerably across Europe. Therefore, banks that are very efficient in their home country may have a hard time being equally successful abroad, explaining partly the limited number of cross-border M&A in the European banking market since the inception of the single banking market. Furthermore, foreign banks expand to developing markets because they are more efficient than the incumbents, while the foreign-bank entry in developed economies is often attributed to the "*follow the costumer*" motive and not to efficiency differentials between entrants and incumbents (Kaas, 2004). Parallel, Claessens, Demirguc-Kunt, and Huizinga (2001) find that foreign banks are more profitable than local banks in developing economies, whereas the opposite happens in developed economies. Thereby, banks from the developed EU economies prefer to expand in developing and emerging markets because they are more efficient and profitable than the incumbents and have small or naught presence – even in the absence of any regulatory frictions – in the other developed EU countries (*Euro-area*) where local banks seems to be more efficient.

Another dimension of the structural diversity among the EU countries that determine financial development and integration is the role of politics and political decisions in an economy. Frequently, the political leadership of an EU member-state is characterized by a lack of political will for the forwarding of the banking system's integration process, which is translated into political interventionism (*like in the acquisition cases of Banco Nazionale del Lavoro and Banca Antoveneta in Italy, 2005*), and protectionism with unequal bureaucratic regime and tight regulations for foreign banks as an act (*or excuse*) of consumer and small investors protection (Cottrell, 2006). Furthermore, cultural characteristics and the geographical thesis seem to have an interesting role in the integration process of the European banking system, as banks – for several decades – were developed along diverse lines and the traditions in banking differ significantly from one country to another (Baldwin and Wyplosz, 2004). According to Stulz and Williamson (2003), cultural characteristics, like religion, societal composition and language, can explain better the financial patterns across the world. The geographical position is also a determinant factor for the enhancement of cross-border bank activities, as is more likely for a foreign bank to expand to a neighbouring market (Baltzer *et al.*, 2007). Finally, another structural factor which differs among EU member-states is the level of social capital and trust in a society, which determines significant the financial activities of the consumers and investors with the foreign and local credit institutions. According to Ekinci, Kalemli-Ozcan, and Sorensen (2007), the regions where the level of confidence and trust is high, are more financial integrated with each other than with other regions.

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produces different outcomes among countries. Also, Lutz and Eberle (2007) examining the implementation of the new accounting and corporate governance rules in Europe observed that the comparison of the two regulatory fields reveals significant differences in terms of the outcomes of the transformation as well as the driving the driving forces and the mechanisms.

[12] According to Baldwin and Wyplosz (2004), the tax treatment of savings differs across countries. Thus the choice of where to invest may be driven by tax purposes rather than by quality of banking services.

The differences in regulation and in financial (*economic*) structures affect restrictively the supply side of the retail banking integration process, because retail lending products are less exposed to international competition pressures, as proximity to customers is quite important. Parallel, from the demand side, the additional reason for less competitive and integrated retail banking market is asymmetric information (Baele *et al.*, 2004; Pebereau, 2005). The phenomenon of asymmetric information affects the economic activity of SME's and households, as the main participants of the retail banking market, by constraining their ability to invest (*or finance their investment with*) in higher-profit (*or lower-cost*) credit products than those of their local retail banking market. However, the effects of asymmetric information are not the same for the large companies (Koutsiaras, 2005).

After the implementation of the EU plan for the regulatory and supervisory harmonisation, the EU banking integration process is impeded by the structural differences of EU financial and economic systems. This hypothesis is enhanced by the assumption that the prerequisite of asymmetric information's elimination (*demand side*) is the depletion of regulatory and non-regulatory barriers (*supply side*). The major role, then, of structural diversity in the EU banking integration process is leading us to the discussion about the varieties of financial and economic models (*or systems*) in the EU, as we try to locate the core of the "*problem*".

4. Economic, financial and supervision models: How many in a Union?

After the collapse of the Soviet Union's economy and the China's turn to market, capitalism seems to be the prevalent model of economic organization in our times. However, according to the academic discussion about the varieties of capitalism, the model of economic organization is not the same in all "capitalistic" countries. Understanding capitalism and the structures of a capitalistic modern democracy requires the examination of the political bargains among key economic actors – land (farmers), labour, and capital (firms) – at critical moments of institutional change (Carney, 2007). The outcomes of these "collisions" or power-sharing coalitions[13], in relation with other major global or regional events (*wars, environmental destructions, etc*[14]), determine the state's, market's and institutions' role in an economy and affect the interrelationships and interactions among them. A key institutional feature in structuring national business systems and a critical factor in explaining varieties of capitalism (Hall and Soskice, 2001) is the financial system, which functions under a complex of state (*political*) and market interactions and affects directly the developmental process and socioeconomic stability of an economy (Whitley, 1998; Pagoulatos, 2003). Financial system's function and performance is determined by the financial system's regulatory and supervision regime, which insures the system's stability and viability. So, our analysis of the structural diversity among banking markets in the EU will focus on the differences among the EU economies, concerning their economic system, their financial system and their banking supervisory framework.

The first and basic dichotomy of the capitalistic organization model is between two types of capitalism. The "*Anglo-Saxon*" model, which defines free-market capitalism and is located in Anglophone countries, and the "*Rhenish*" model, which is characterized by long-term major decisions that maximize certain collective rather than individual goods and is quite common to the riparian of Rhine countries, like Germany, the Netherlands, Switzerland and with some reservations France (Albert, 1993; Crouch, 2005). These two models can also be characterized as "*stockholder*"

[13] According to Carney (2007), these "collisions" or power-sharing coalitions may take place in four levels, a) rural versus urban politics, b) class conflict, c) voice versus property, and d) social contract.
[14] As the structural institutional change after the Second World War in France.

and "*stakeholder*", referring to the Anglo-Saxon and Rhenish respectively. The market-oriented stockholder model describes an economic system of individual success' priority, short-term financial profits, loosely defined relations between finance and corporate management, supremacy of shareholder control, reinforced competitive behavior, widely unregulated capital and money markets, and flexible labor markets. To the contrary, the consensus stakeholder model is characterized by networks of interrelationships among corporations, worker unions, and banks that determine the corporation's performance in a context of long-term and collective interests (Rhodes and van Apeldoorn, 1997; Rozo, 2001). According to Hall and Soskice's approach of *Varieties of Capitalism* (2001), the basic two models of capitalism are characterized as "*liberal market economy*" (*LME*) and "*coordinated market economy*" (*CME*). The first one (*LME*) is related with neo-liberal policies, development in new sectors of the economy, strong stock market, radical innovation, and many of the characteristics of the stockholder model as it is located in the Anglophone countries (*Australia, Canada, New Zealand, UK, US*). The second type (*CME*) is linked to social democracy, incremental innovation, outdated economic sectors, and directly engagement of political and economic institutions in the planning of the economic process. The CME model is detected in Germany, Japan, Switzerland, the Netherlands, Belgium, Sweden, Norway, Denmark, Finland, and Austria (Hall and Soskice, 2001; Crouch, 2005).

The structural differences of France with the CME model and the similarities with the structures of southern European economies led Hall and Soskice (2001) to the formation of a new model between the LME and CME, labeled as the "*Mediterranean*" model. This third model of economic organization includes the state-led and post-agrarian economies of south Europe, where the state played a key role in the process of national economic development. This third model is located in France, Italy, Spain, Portugal, Greece, and Turkey. Beyond the *Varieties of Capitalism* approach, there are also other studies which point out more than two model of economic organization. Schmidt (2002) focuses on the background role of the state in the capitalist organization of an economy and distinguishes the models of capitalism in Europe in three types, a) the "*market*" model, which is very similar to the LME model, b) the "*managed*" model, which includes an active and auxiliary for the economic actors state (*like the CME model*), and c) the "*state*" model, which is related with an interventionist state (*like the model in France*). According to Crouch's literature review (2005), Esping-Andersen (1990) – taking into account the outcomes of political struggle and the dominance of political traditions – added a forth[15] type of economic system labeled as the "*social-democratic*" model of the Scandinavian countries. Furthermore, Ebbinghaus' analysis (2001) of the welfare regimes, which was concentrated on labor market policies, has added a fifth model based on "*Japan*". Finally, Amable's study (2003) based of OECD's country data about the product markets, the labor markets, the financial systems, and the social protection systems pointed out five types of capitalistic organization which are similar in geographical terms with the above. Particularly, Amable's types are a) the "*market-based*" (*Anglophone countries*), b) the "*social democratic*" (*Nordic countries*), c) the "*Asian*" (*Japan and Korea*), d) the "*Mediterranean*" (*southern European countries*), and e) the "*Continental European*" (*continental Western European countries most*).

The above core distinction between liberal market and cooperation market economic systems is reflected also to the financial structural diversity. Financial systems are basically categorized in "*market-based*" and "*credit-based*" systems, considering the way economic activity is financed in a capitalistic economy. The market-based model is referred to systems where stock and capital market are the major financier of the economic activity and is located in the countries of the Anglo-

[15] The other three types are the liberal model, the conservative continental European model and the southern European welfare state model.

Saxon model, while, the systems where the financing of economic activity is based on the banks, are characterized as credit-based systems and can be detected in Continental Europe (Cernat, 2001). Another important distinction between credit- and market-based financial models concerns the degree of monetary and political authorities' intervention in the function of the financial system. Credit-based models seem to be more exposed to government intervention and regulation, especially in the fields of interest rates setting and credit allocation. In the contrary, market-based systems are less exposed to government involvement (Grabel, 1997; Zysman, 1983; Cernat, 2001). Zysman (1983) identified three different times of financial systems, the "*capital market-based*" system (US and UK), the "*state-led credit based*" system (France and Japan), and "*bank-led credit-based*" system (Germany). In the first model, finance resources are allocated according prices established in competitive financial markets, mainly stock and capital markets. The state-led credit based model characterizes the financial systems where banks play a major role and the critical prices are controlled by the state, which is more interventionist than in the other two models. The third type is referred to the credit-based system, dominated by financial institutions (*especially by banks*) with a prominent role in corporate finance and control[16]. Considering the degree of government's intervention in the financial system, Zysman (1983) characterized the above three model as "*company-led*", "*state-led*", and "*negotiated*" respectively. Nevertheless, the analyses of Walter (1994) and Story and Walter (1997), focused on the role of political government and the structure of the financial system, categorizes financial models into "*equity-market*" system (in US and UK), "*bank-based*" system (in Germany), "*bank-industrial cross-holding*" system (in Japan), and "*state-centered*" system (in France).

Between the economic and the financial system, we can locate the regulatory and supervisory regime, as an outcome of the financial system's interrelationships with the market and the state, and a significant factor concerning the financial structure and the economic development and stability. Moreover, La Porta *et al.* (2000) argued that the legal framework is the primary determinant of the financial system's effectiveness in promoting the innovation and growth in an economic system. Structural differences are also detected in the banking supervision frameworks of the European financial systems. The diversities of the banking supervision frameworks consider the relationship between the supervisory agency and the state (*government*), the jurisdictions of the supervisory agency, and the financing of the supervisory agency.

The supervisor's relationship with the political government categorizes the supervision regime of a banking system in four types, according to the "*official supervision view*", the "*politically/regulatory capture view*", the "*independent supervision view*", and the "p*rivate empowerment view*" (Beck, Demirguc-Kunt and Levine, 2003). The official supervision view is referred to a banking model with a powerful and state (*or government*) controlled supervisory agency which will promote corporate governance of banks, improve the bank managers' incentives, and increase the efficiency with which banks intermediate society's savings (Atkinson and Stiglitz, 1980), as private agencies lack of information, incentives, and capabilities to monitor and supervise large banks (Becker and Stigler, 1974). According to the second type of supervision regime, the direct official supervision of banks may constrain the efficient function of the banking systems in terms of social welfare and economic development, because powerful banks may possibly "*capture*" politicians and pressure the official supervisory agency to act for the maximization of their own welfare (Rajan and Zingales, 2003). The answer to the question of "*who guards the*

[16] In the continental capitalism model banks have a prominent role in corporate governance and finance, as banks own significant proportions of shares in their portfolio in a way to control the economic activities and decisions of their bigger clients (Dittus and Prowse, 1996; Cernat, 2001).

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guardians" - as the politically/regulatory capture view underlines - is the creation of mechanisms that constrain politicians' activism and enhance the official agencies' incentives to promote social welfare. The independent supervision view argues that the above political failures can be confronted with the creation of an independent supervisory agency, which is not affected by political pressures and can, also, face market failures and pressures. Lastly, the private empowerment view describes the enhancement of private agencies concerning the monitoring and supervision of banks, with a parallel limitation of official supervisors' power (Beck, Demirguc-Kunt and Levine, 2003).

Another distinction of the financial supervision regime concerns the scope of the supervisory agency's jurisdictions. Di Giorgio, Di Noia and Piatti (2000) categorized the supervision regimes in four models. The first one is the traditional "*institutional supervision*" model, according to which a distinct agency is responsible for the entire complex of activities in each of the financial market's segments (*banks, financial intermediaries and mutual funds, and insurance companies*). The second type is characterized as "*supervisory model by objectives*" and indicates that more than one agency are accountable for the supervision of the financial market, while each single agency is responsible for one objective of regulation regardless the legal form and the activities of the intermediary institution. The "*functional supervision*" or "*supervision by activity*" is the third regulatory model, where authorities focus their supervision on specific functions or activities of the financial intermediaries[17]. The "*single-regulator supervisory model*" indicates one supervision authority, which is separated from the central bank and is responsible for the financial system as a whole, including all financial segments, objectives and activities (Di Giorgio, Di Noia and Piatti, 2000). However, Masciandaro, Nieto and Prast (2007) distinguishes the supervision regime of the financial system into three models, a) the "*traditional model*" of one authority for each financial sector (Greece, Portugal and Spain), b) the "*one goal based model*", where the organization of the regime is determined by the objectives (the Netherlands), and c) the "*single financial authority model*", in which one agency is responsible for the three financial sectors (Austria, Germany, Japan, Sweden and UK). A last distinction among the supervisory regimes concerns the source of financing of banking supervision. The supervision authority of a banking system can be financed a) "*directly from the taxpayers*" with funds assigned by the government budget, b) "*indirectly from the taxpayers*" with public funding, c) totally from the supervised institutions or "*private funding*", and d) partly from the supervised institutions or "*mixed funding*" (Masciandaro, Nieto and Prast, 2007).

[17] According to Merton and Bodie (1995), the six basic functions of a financial system are: a) to provide ways of clearing and settling payments in order to facilitate trade, b) to provide a mechanism for the pooling of recourses and for portfolio diversification, c) to provide was of transferring economic resources through time, across borders, and among industries, d)to provide ways of managing risks, e) to provide price information to help coordinate decentralized decision making in the various sectors of the economy, and f) to provide ways of dealing with the incentive problems created when one party in a transaction has information that the other party does not have or when party acts as agent for another (Di Giorgio, Di Noia and Piatti, 2000).

Table 2: Supervision authorities in European countries

Country	Banking Sector	Securities Sector	Insurance Sector
Austria	U	U	U
Belarus	CB	S	I
Belgium	U	U	U
Bulgaria	CB	S	I
Cyprus	CB	S	I
Czech Republic	CB	S	I
Denmark	U	U	U
Estonia	U	U	U
Finland	BS	BS	I
France	BC, B1, B2, B3	CB, S	I
Germany	U	U	U
Greece	CB	S	I
Hungary	U	U	U
Ireland	CB	CB	CB
Italy	CB, S	CB, S	I
Latvia	U	U	U
Lithuania	CB	S	I
Luxembourg	BS	BS	I
Malta	U	U	U
Norway	U	U	U
Poland	CB	BC, S	I
Portugal	CB	CB, S	I
Romania	CB	S	I
Slovak Republic	CB	SI	SI
Slovenia	CB	S	I
Spain	CB	CB, S	I
Sweden	U	U	U
Switzerland	BS	BS	I
Turkey	B	S	I
UK	U	U	U
USA	CB,B	S, Ss**	I, Is(**)

The initials have the following meaning: B=authority specialized in the banking sector; BI=authority specialized in the banking sector and insurance sector; CB= central bank; I= authority specialized in the insurance sector; S= authority specialized in the securities markets; U= single authority for all sectors; BS= authority specialized in the banking sector and securities markets; SI= authority specialized in the insurance sector and securities markets.
(**) state or regional agencies

Source: *Masciandaro (2005)*

Summing up our discussion about the structural diversity of the European economic, financial and supervision models, we may come to a quite cursory conclusion about the diversity of the banking supervision systems within the EU, which requires further and deeper research. From the above analysis, we observe a distinction between Central and Northern European (CNE), and Southern European (SE) banking systems considering their supervision framework, as the market-based and credit-based systems of the CNE seem to have more similarities with each other than with the state-led credit-based systems of the SE. Particularly, in the most CNE banking supervision frameworks, a) the supervision agency is not the national Central Bank anymore, b) the adopted supervisory model is the *single financial authority* one, and c) the supervisory authority is financed totally by the supervised institutions (*private financing*)[18]. In the contrary, in the most SE banking supervision frameworks, a) the banking supervision authority remains the national Central Bank, b) the adopted supervisory model is the traditional model of one authority for each financial segment (*or institutional supervision*), and c) Central Bank as banking supervisor is financed by the government budget (*public funding*). This observation in combination with studies that suggest either the different degree of homogeneity between the Southern Euro-area countries, and Western and Central Euro-area countries (Sorensen and Gutierrez, 2006)[19], or the slight (*or bigger*) convergence of the Rhenish or Continental to the Anglo-Saxon model (Dore, Lazonick and O'Sullivan, 1999; Roso, 2001; Lutz and Eberle, 2007)[20], creates the field where interesting questions for further academic research arise. Questions concerning on the one hand the degree and the level of structural convergence between the Continental European credit-based model and Anglo-Saxon market-based model (*continental Europe's systems are heading to the Anglo-Saxon model or both are converging to a new – mixed model?*), and on the other hand the reasons of Southern European state-led credit-based systems' denial (*or delay?*) to follow the convergence process of the other European systems (t*he state remains strong in South Europe?*).

[18] According to the study of Masciandaro, Nieto and Prast (2007), full public financing is the most common budgetary arrangement for central banks as banking supervisors, while single financial authorities and specialized banking authorities are most financed by supervised entities.

[19] The study of Sorensen and Gutierrez (2006) suggests that Euro-area countries, concerning their banking sectors, seem to have become more homogeneous after the introduction of the common currency. This homogeneity, however, is detected in two different groups. The one group includes the Western and Central European countries like Germany, France, Belgium, and to some extent also Austria, Italy and the Netherlands (*and lately Ireland*), which tend to cluster together. The other group includes to Southern countries like Spain, Portugal and Greece, which are more homogeneous with each other than with the other Euro-area countries.

[20] According to Dore, Lazonic and O'Sallival (1999), by the end of the post-war golden age, there were signs of convergence on similar forms of managerial capitalism, while the crucial question is how far the transition to shareholder capitalism in Britain and America over the last two decades will be duplicated in Germany. Rozo (2001) suggested that the transformation which is taking place implies a degree of convergence in corporate governance that necessarily weakens the traditional coordinative relations in the German consensual industrial relations network. Nevertheless, he underlines that neither the stakeholder model nor the shareholder model can remain unscathed under the impetus of globalization. Moreover, Lutz and Eberle (2007) points out that the German regulation has moved towards Anglo-Saxon standards on transparency, supervisory board independence and accountability to all shareholders, although the German provisions on board independence are considerably less stringent than those applied in the US and the UK.

5. The regulatory framework of EU banking market

The framework under which a banking market functions is characterized by two elements, regulation and supervision. Regulation deals with the formation of rules that are, on the one side, part of the legislation and thus approved by national Parliaments, and on the other side, rules that are implemented by administrative bodies, while, supervision is responsible for the enhancement of such rules, either ex ante in the form of monitoring and control or ex post in the form of penalties (Kammel, 2006). In terms of political economy, the formation of regulation is attributed either on private-interests or on public-interests (Benmelech and Moskowitz, 2006). According to the private-interests approach, regulation is the outcome of a process in which interest groups use the coercive power of the state to extract rents at the expense of other social-economic groups (Becker, 1983; Peltzman, 1989). As Benmelech and Moskowitz (2006) underline, economic historians argue that suffrage laws are primarily driven by private interests and less affected by general economic conditions (Engerman, Haber and Sokoloff, 2000; Sokoloff and Engerman, 2000), describing regulation as a game where incumbent interest groups have the major determinant role. Simplifying a financial market model, we can approach the promotion (*or the level*) of regulation as an interest game among actors within an economic sector (*ex. banking sector*[21]) or among actors of different economic sectors (*ex. banking versus industrial sector*[22]), from which the powerless socioeconomic groups are left out. The contrary approach is the public-interest one[23]. According to public-interest view the formation of financial regulation is a process of government intervention in order to correct market inefficiencies and maximize social welfare (Jockow and Holl, 1981). Theoretically, public intervention in the economy is traditionally based on the need to correct market failure and unfair distribution of the resources, considering, especially the pursuit of stability, equity in the distribution of resources and efficient use of those resources (Di Giorgio and Di Noia, 2001). Consequently, the main objectives of the financial market's regulation are a) the pursuit of microeconomic and macroeconomic stability, b) the market's and intermediaries' transparency, enhancing consumer and investor protection, and c) the insurance and facilitation of competition in the financial sector (Di Giorgio and Di Noia, 2001; Kammel, 2006). Summing up, the formation of regulation in the financial sector – especially concerning the integration process – can be approached as an interest game between economic actors as protectors of their own interests and the state as the protector of social welfare, the outcomes of which, substantially, reveal the winner of this game.

The regulation of the European financial system can be described as an evolutionary process from national autonomous regulation and supervision towards

[21] In an interest game for the formation of rules which promote banking integration within the EU, two actors of the banking sector may have different views and theses about the integration process. From the one side are the large banks which approach the integration as a way to develop scale economies and to expand to other markets, while on the other side small and medium banks feel threatened from the new competitive environment in an integrated EU banking market.

[22] In the same interest game of regulation for the promotion of banking integration within the EU, two different economic sectors may have different theses. From the one side is the industrial sector which wants the banking integration as way of the reduction the cost of investment capital, while on the other side is the banking sector, which's monopolies and interest spreads are threatened by the new competitive environment in an integrated EU banking market.

[23] According to Benmelech and Moskowitz (2006), the same determinants of financial regulation that seem to favor a particular interest group and constrain the interests of others, are also associated with lower future economic growth rates, perhaps highlighting the endogenous relation between financial development and growth.

an intensive regulatory harmonization and supervisory coordination, which may finally lead to the full unification of the European regulatory and supervisory framework. The basic turning-point of this process was the developments in 1999, while, after the recent developments, the EU financial regulation process may have covered half way.

The financial sector is a traditional sensitive area of the member-states' economies, as it is demonstrated by the fact that, despite the overall success of the Single Market Project complementation, financial market integration lagged behind, while most of the regulatory initiatives were on the basis of "negative" integration and focused on achieving a smooth changeover to the single European currency (Thomopoulos, 2006). The European regulation policy during the pre-1999 period was based on three core principles, a) mutual recognition, b) minimum harmonization through EU rules and c) home country control supervision (Padoa-Schioppa, 1999; Lastra, 2003; Quaglia, 2005), leaving too much discretion in the agencies of the member-states. Particularly, the process of European financial regulation convergence started twenty years after the Treaty of Rome with the First Banking Directive, which set the base for the recognition of the competitive financial system as a primary objective, and continued with the Second Banking Directive (1989), which enhanced the efforts for a competitive market with the provisions of principles such as home country control, harmonization of prudential supervision and mutual recognition (Cervellati, 2003). The following years, the main regulatory initiatives were the Capital Adequacy Directive (CAD) and the Investment Services Directive (ISD). Both established the legal basis for financial institutions and investment firms to obtain a "*European passport*" to provide their services freely throughout EU. Furthermore, it was a regulatory "step" towards the other two segments of the financial system. ISD specified how, once an investment firm is appropriately authorized in its home member-state, should also be allowed to offer its services in all other member-states without needing further authorization, while CAD determined the minimum capital requirements that banks and securities firms must have in order to obtain a passport to operate their trading businesses throughout the EU (Dale and Wolfe, 1996; Mertzanis, 2003).

Once the single currency was successfully introduced, the EU attention shifted to improving the functioning of the single EU financial market. However, the principles of the pre-1999 period – which kept different financial regulations and supervisory rules (*institutional diversity*) in each member-state – were barriers to further financial integration. Minimum harmonization and mutual recognition, although, originally thought to be able to naturally induce over time a convergence of regulatory behavior and more uniform rules, seem to have helped only as a first stage of financial integration process (*like an intermediate objective*) and afterwards were more an obstacle than an aid. Moreover, there was an obvious regulatory and supervisory gap considering ways, tools and responsibilities to counter or manage financial instability and crisis in a monetary union (Di Giorgio and Di Noia, 2001; Cervellati, 2003). The aforementioned gaps were detected by the EU and the turn of regulation policy to new principles for the EU regulatory and supervisory unification was decided in 1999. The principles of the new regulation policy were the maximum regulatory harmonization and the strong supervisory cooperation and coordination. The first EU initiative was the 1999 – 2005 Financial Services Action Plan (FSAP), which was approved at the Lisbon summit in 2000 and was the inauguration of a genuine European financial market by 2005. The main objectives of the FSAP were a) the establishment of a single market in wholesale services, based on a unique legal securities and derivatives markets framework, takeovers and cross-border mergers, b) the integration and access for all consumers to a pan-European retail financial market, and c) the harmonization of prudential rules, notably those concerning insurance and reinsurance solvency and capital adequacy (Girard-Vasseur and Vergnaud, 2006). Parallel, in July 2000 Ecofin introduced a structural reform process for the EU regulatory framework by appointing to an ad hoc Committee of Wise Men under Baron Lamfalussy, to discuss to best means to adopt the Commission's financial integration plan and adapt the regulation of the member-states in a countiniously changing financial enviroment. Particularly, Lamfalussy Committee's task was to create a framework under which could a) assess the conditions for the implementation of the securities market's regulation in EU, b) assess how the mechanism for regulating the EU securities markets can best respond to developments underway in the markets, and c) propose scenarios for adapting practises in order to ensure greater convergence and cooperation in day to day implementation, taking into account new developments in the markets (Girard-Vasseur and Vergnaud, 2006; Kammel 2006).

The outcome was the adoption of the "*Lamfalussy framework*", which is based on a complex four-level process of rule making and enhanced cooperation among the members-states' supervisory agencies in EU, while the new regulatory architecture is based on newly established and reformed Committees. Substantially, the so-called "*fast track Lamfalussy process*" is designed to cater for Directives being framed at a high level of principles allowing more detailed implementing measures and rules to be legislated in a faster procedure by the Commission, based on the advice of the relative Committees (Mertzanis, 2007). Furthermore, in December 2002 Ecofin approved the proposal of the Economic and Financial Committe for the extension of the Lamfalussy framework to the banking and insurance sectors. The expansion of the Lamfalussy framework to the EU banking sector resulted to the creation of the Committee of European Banking Supervisors, the role of which is to provide advice to the Commission, ensure the consistent implementation of regulation and the convergence of supervisory practises in EU, and promote supervisory cooperation and exchanges of information (Thomopoulos, 2006). The implementation of the process has started to yield significant benefits, as it contributed to a) the improvement of the financial services sector performance, b) the enhancement of liquidity, c) the strengthening of finacial competition, profitability and stability, and d) the supervisory convergence (Girard-Vasseur and Vergnaud, 2006; Thomopoulos, 2006).

The two basic regulatory initiatives of the post-1999 period is the Capital Adequancy Directive II (CAD II), which particularly constitutes the introduction of Basel II rule to the EU financial regulatory framework, and the Markets in Financial Instruments Directive (MiFID), which constitutes an important update of the ISD, providing a harmonised regulatory regime and enhancing competition and consumer protection in investment services in EU. After the successful implementation of the FSAP and the Lamfalussy framework, Commission designed the Financial Services Policy for the 2005 – 2010 period[24], the basic objectives of which are a) the dynamic "consolidation" of progress already made in the creation of an integrated open, inclusive, competitive and economically efficient European financial market, b) the elimination of the remaining barrier to the free movement of financial services and capital within the EU, and c) the safeguarding of the existing legislation and the integration of "legislation" principles in future initiatives. These "*future*" regulatory and supervisory initiatives are focused on rules about the VAT on financial services, further harmonisation of the EU's regulatory and supervisory structures, international standards, cooperation of the supervisory authorities, and promotion of retail banking integration. About the retail banking – which is the most fragmented segment of the fianacial system – the EU regulation policy's attention is on consumer credit, mortgage credit and payment services (Girard-Vasseur and Vergnaud, 2006; Thomopoulos, 2006).

The post-1999 period of EU financial regulation policy could be characterized as a turn to "positive" integration, as the main elements of the policy were the

[24] Commission's white paper on Financial Services Policy 2005 – 2010

maximum regulatory harmonization with detailed rules, and the strong supervisory coordination. However, the post-1999 regulation policy creates questions and skepticism about the effectiveness of the current policy framework, which focus on a) the marked unwillingness to delegate much law-making power (Levin, 2004), as it is indicated by the (*very*) detailed directives of the Lamfalussy framework, and the need for greater political integration (Di Giorgio and Di Noia, 2001), b) the target-setting of the EU financial regulation process to a core set of reform priorities to which financial integration and reforms could contribute (Pisany-Ferry, 2006), c) the "losers" of the EU financial regulation process, as the medium-sized and small banks in the case of CAD II (Triantopoulos, 2008), d) the difficulty of having one size fits all regulation in a community where markets remain different (*structural and institutional*), e) the scepticism about the quality of the regulations in the context of maximum regulatory harmonization and hurriedness to regulatory unification, f) the difficulty to estimate the micro- and macro-economic consequences of the implemented EU regulatory initiatives, especially concerning the effects in risk transfer/sharing of the continuously increased homogeneity in behaviour (*for MiFID see* Mertzanis, 2007), and g) the remaining supervisory gap in cases of financial instability and crisis (Cervellati, 2003). A further analysis of the skepticism considering the effectiveness of the EU financial regulation policy – *initially based on the aforementioned issues* – will probably lead us to the fundamental question of the kind (*private or public*) of interests that determine the decision of the further EU financial markets integration.

6. Conclusions

The EU financial integration process – a central factor in deepening the integration of the EMU – seems to collide on the structural diversity of the European financial systems, as the differences in economic, financial and supervisory structures seem to diversify the effects of the EU integration initiatives (Goyer, 2006; Lutz and Eberle, 2007). The fragmentation is stronger in the banking sector, which is among the least integrated in the European economy. The further integration of the banking sector is a high priority for the EU, as banks are still the core of the European financial systems and the basic element of the member-states' economic and business organisation. Therefore, the EU promotes the economic integration process, mainly, through monetary and regulatory integration. After the establishment of the EMU, regulatory integration is considered as the main strategy for facilitating banking integration in the EU. So, we can approach the EU financial integration process as a long-term effort for the mitigation of the member-states' structural diversity via the EU financial regulation policy.

This financial regulation process towards the mitigation of structural differences, substantially, establishes a field where interesting policy questions and concerns emerge. From the one side, the creation and the persistence of the EU financial structural diversity, through a complex of interactions and interrelationships among socioeconomic actors and groups, generate questions concerning the factors that determine interests, thesis and reactions in the EU financial integration process. These factors may act either as obstacles for the implementation of the single financial market, as promoters to convergence or divergence with other financial systems, or as supporters of the financial integration project. Their stance to the maintenance (*or not*) of structural differences is shaped by the benefits or losses that are caused by several EU financial regulation policy initiatives or from the overall integration project. From the other side, the turn of the EU financial regulatory policy to "*positive integration*" initiatives have created concerns about the effectiveness of the "*maximum harmonization*" and "*strong coordination*" policy in the current level of financial integration. These concerns are based to the EU regulation policy's diversified effects among economic actors, groups and sectors, which lead us to questions about the "motives" of the regulation policy acceleration and the promotion of financial integration. The formation of regulation in the financial sector – especially concerning the integration process – can be approached as an interest game between economic actors as protectors of their own interests and the state as the protector of social welfare, the outcomes of which, substantially, reveal the winner of this game.

Summing up, the EU financial integration process – with the banking sector in the core of it – could be described as a long-term EU effort for the mitigation of the member-states' structural diversity via financial regulation policy. The acceleration (*or not*) of this process is determined by private and public interests in both sides, which are closely related to the winners and losers of this financial integration process. The further analysis of these concerns and the pursuit of answers to the aforementioned questions create a research field which could be labeled as the "*political economy of the EU financial integration*".

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