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

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The risks associated with market power are well known … Less obvious are the risks associated with too fragmented markets.

Mario Monti
European Commissioner for Competition Policy
1999

THE FINANCIAL SECTOR AND NATIONAL PROTECTIONISM IN THE EUROPEAN UNION

The financial sector is regarded as one of the core industries in modern societies. Therefore, efficient and well functioning banks, insurance companies and securities firms have been a core ambition of the European Union even prior to the Single European Act. The first attempts to develop a uniform banking regulation were made in the 1970s. The realisation of the free movement of goods, services, people and capital made the development of a truly European financial sector even more important. To be sure, the 1992 program was expected by some to lead to internal market restructuring in the face of threatened competition rather than cross border mergers (Dufey 1993) due to the fact that banks are embedded in national history, culture and language. More important, however, their national economic and political importance make it very difficult for governments to accept even a national exclusively market driven restructuring of this sector. Cross-border mergers and acquisitions seem to be even more difficult to accept.

Hence Monti's above-cited summing up of the Commission's dilemma in competition cases in the banking and financial services sector (Monti 1999). Although the advent of the Single European Market and Economic and Monetary Union has prompted considerable restructuring and concentrations in the financial services sector, most of this has taken place within rather than across national borders. Despite EU rules opening the sector to competition and stipulating both the free movement of capital and the right of establishment, most member states' financial services markets remain dominated by domestic institutions. The EU legal basis for this is that the Merger Control Regulation 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 sufficiently ambiguous to allow a range of protectionist measures that have diminished the scope for cross-border mergers and acquisitions in this sector, a number of recent cross-border mergers and acquisitions have been prevented. More have been discouraged by national rules or practices that render the such mergers difficult. In the light of often outspoken political opposition to acquisitions by foreign firms or support for mergers that would create 'national champions', there can be little doubt that a considerable number of politicians and regulators regard protectionism as both desirable and compatible with the Single Market. In pursuit of these goals, four main sets of tools have been employed. The results have been mixed, and suggest that one effect of 'Europeanisation' of regulation and competition policy has been to strengthen domestic competition authorities vis-à-vis their own governments.

First, most member states feature specific rules for the financial sector, sometimes divided into separate rules governing banking and insurance. These 'prudential rules', loosely governed by parameters laid down in EU directives and designed to ensure quality of services, are sometimes used to discourage foreign take-overs. Nation laws on supervision of financial institutions therefore provide for a degree of divergence that limits the single market (Horn). Several states feature restrictions on the amount of shares an investor can hold in a financial institution, and require permission form the supervisory authority, the central bank or government for acquisitions. This provides for a considerable degree of political discretion, which evidently has inhibited cross-border acquisitions into market such as the Italian financial sector.

Second, the powers of discretion enjoyed by regulatory or supervisory authorities in practice means that an interventionist authority can apply rules that are compatible with the Single Market in such a way as to prevent the development of a competitive market in the sector (Monti 1999). In this event, few of the institutions that are the target of the regulator are likely to complain to the European Commission unless there is a reasonable probability of success. In cases where national authorities seek to reverse or pre-empt a merger decision that falls under DG Competition's competence, the probability of a successful complaint may be greater inasmuch as the DG Competition is loath to see its decisions circumvented.

Third, a number of governments and politicians seek openly to interfere in the sector, criticising both the EU and their own regulatory authorities for acting against the 'national interest'. The fact that long-standing EU rules prohibit intervention based on national interest or designed to protect national firms against foreign competition has not prevented politicians in several states openly invoking national interest and the need to build or protect 'national champions' (Molyneux 1999).

Fourth and finally, state subsidies have long been recognised as an obstacle to a fully functioning Single Market. The financial sector is no exception. Here public ownership and guarantees for financial institutions may distort or inhibit competition and restructuring (Hurst, Peree & Fischbach 1999), and the Commission has recently taken actions against Germany based on complaints from private banks. Apart from potentially violating EU competition rules on state aid and distorting competition, these guarantees 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 conflict and appeals, the final authority lies with the European Court of Justice (through the Court of First Instance).

DG Competition can only block a merger on competition grounds (i.e. a merger that would create or strengthen a dominant position and thus impede competition). However, the MCR contains three exemptions, one of which is of central relevance in the financial services sector. Article 21 of the MCR permits member states to take appropriate measures to protect legitimate interests other than those taken into consideration by the MCR, as long as these are compatible with EU law, and identifies three such areas of interest:

- Public security – primarily to defence interests, but also to public health.

- Plurality of the media – efforts to maintain diverse sources of information.

- Prudential rules – referring to rules for the financial sector enforced by national bodies for the surveillance of banks, stockbroking firms and insurance companies, e.g. regarding good repute of individuals, honesty of transactions and rules of solvency. Efforts are being made to harmonise these.

The latter – prudential rules – provides the catch in the banking and financial services sector, because it permits designated regulatory authorities to vet mergers in terms of the institutions' competencies in the sector. These were originally designed largely to avoid export of 'bad debt' (Whish 1993; Cook & Kerse 1996).

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 these seek to ensure that it will accommodate a series of different national rules, the EU legislation on the sector is somewhat ambiguous. Likewise, the Directorate General for the Internal Market has proven to be more concerned with establishing a single market with strong players than with individual cases of competition or lose interpretation of EU rules. Article 21 has only been tested once in the banking sector, in a case that saw the Commission take Portugal to the Court.

The main potential line of conflict therefore runs between the supranational competition authorities and the national financial sector regulators.

In the absence of a directive on take-over rules, there are no common procedural rules for mergers and acquisitions beyond the MCR.

Single Market Regulation – the Banking and Financial Services Sector

EU single market legislation is considerably more flexible and permissive than the EU competition policy regime. The competition policy regime developed over time as DG

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 agencies and central banks. However, Single Market legislation circumscribes the use of prudential rules to some extent.

A series of EU directives specific to the banking and insurance sector set out parameters for states' regulation of the sectors.

- 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 based on prudential principles (securing sound and prudent management) rather than national and/or economic interests.

- Likewise, a series of Banking Directives (esp. the Second Banking Directives – 89/646/EEC) provide for co-ordination of rules on prudential and financial supervision and a 'single passport' for banks.

- The Treaty articles on freedom of establishment (Article 43) and the free movement of capital (Article 56) prohibit all restrictions on the freedom of establishment (including agencies, branches or subsidiaries) and the movement of capital and payments between member states.

These two sets of directives governing banking and insurance are sufficiently broad to leave the states considerable discretion in interpretation and transposition. The result has been threefold.

First, no member state's legislation appears to violate or be incompatible with the EU directives. Partly because they accommodate existing national laws, and partly because the European central bankers (and thus the European Central Bank) tolerate or support states' efforts to promote the emergence of strong national firms in the sector, the directives are criticised for being too loosely cast to contribute to creating a single market for banking. Moreover, there have been very few complaints from firms about lacking implementation.

Second, although DG Internal Market is well aware that many member states probably invoke considerations that are not permitted (such as ownership, political and geographical concerns) when vetting mergers from a prudential perspective, existing EU law makes it difficult to confront member states over this. Inasmuch as the directives are imprecise and it is difficult to assess implementation, the Commission has accordingly proved reluctant to pursue such cases. Even where national politicians openly invoke 'national interest', which is clearly inappropriate if not illegal, it does not automatically result in a rebuke.

Third, this has proved an obstacle in the way of creating a single market for banking and financial services. The range of state-level authorities involved in this field of regulation, and the differences in their power and operation, testifies to this. The extent of foreign ownership varies considerably across states, and the assessments of the financial press indicate that some states' markets are still driven more by political preferences than market forces.

Infringements in the Financial Services Sector

There have been relatively few serious infringements in the financial services sector. There is only one major case concerning violation of single market and competition rules in a manner that blocks foreign mergers or acquisitions, prompted by the Portuguese government's blocking Spain's BSCH taking over the Champalimaud group.

The limited number of important infringements in the sector derives partly from DG Internal Market's relatively unassertive stance on what is after all a rather ambiguous set of rules, and partly from financial institutions' reluctance to file complaints against national supervisory authorities. The most prominent exception is German private banks complaining to the Commission over illegal state aid to public banks, which has prompted a review of the relevant legislation.

The Commission has adopted an increasingly aggressive stance against state aid in the sector. Referring to the Crédit Lyonnais, Westdeutsche Landesbank and Banco di Napoli cases of state aid, Competition Commissioner Monti emphasises that "the Commission requires State aid to banks to be coupled with radical restructuring plans and reforms to corporate governance… either the unlawful State aid has to be repaid or divestments have to take place" (Monti 1999).

Limited cross-border consolidation in Europe's financial services sector means that DG Competition has generally not found problems with cross-border mergers. Rather, as Competition Commissioner Monti emphasised when discussing the sector, there are "risks associated with too fragmented markets" (Monti 1999). The main problem in the financial services sector appears to be fragmentation, and the potential for states to use national prudential rules to inhibit cross-border merges. Although there is relatively limited direct evidence of this taking place, there is little doubt in the Commission or in the financial press that a degree of such protection of is taking place.

The above-cited differences between EU competition and internal market policy mean that DG Competition remains a much stronger threat than DG Internal Market to state-level authorities that attempt to use national take-over codes or financial services rules to defend 'national champions' in the sector. Accordingly, when the Commission invoked both competition and single market rules against the Portuguese government's attempt to protect the banking sector, it pursued the case by way of competition policy (violation of Article 21 of the MCR).

This difference in policy also reflects the different priorities of the two DGs. DG Internal Market focuses more on medium-term efforts to create a single market in financial services (by 2005), and it adopted a Financial Services Action Plan to this effect in 1999. It has demonstrated less interest in specific cases of potentially problematic interpretations of the banking and insurance directives. By contrast, DG Competition resembles an independent agency, eager to assert its role as the only relevant competition authority in cases above the EU threshold.

Despite the powers vested in DG Competition, the national regulatory and supervisory authorities in the banking and financial services sector retain a great degree of discretion and influence as long as they avoid open confrontation with the Commission. Member 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 shaped, if not directed, by the Bank of Italy. The Italian Antitrust Authority (AA) rules on mergers, but has only consultative powers in the banking sector (though its preliminary opinion is required). The Bank of Italy acts as the antitrust authority for the sector, and must approve mergers and acquisitions. Approval is also required for any bank that wishes to increase its stake in an Italian bank across 5, 10, 20, 33 or 50% thresholds. Insurance company mergers require approval from ISVAP, but are subject to AA rulings. Consob, the stock exchange regulator, must also authorise bids and monitors transparency. The central bank prefers consensual mergers, and has intervened in deals in efforts to prevent competitive bidding wars. The result has been very limited foreign penetration of the market. In the words of the *European Banker* (18 July 2001) the central bank "has demonstrated extreme reluctance to sanction large-scale cross-border deals too often for anyone to believe that such a deal is practical. Attention has inevitably turned to the leading domestic players." As of December 2000, only three foreign banks had been able to acquire more than 5% in an Italian bank: Credit Agricole, ABN-AMRO, and Banco Bilbao Vizcaya Argentiaria. During that year alone, Italian banks acquired 14 foreign banks.

In March 1999 the Bank of Italy refused to approve bids for Banca Commerciale Italiana and Banca di Roma from Sanpaolo-IMI and UniCredito Italiano respectively, on procedural grounds (the bidders made the offers public before seeking the Bank of Italy's approval). However, criticism of the Bank of Italy's decisions centred on its well-known opposition to hostile mergers. In this context, but referring to national financial authorities in general, then Internal Market Commissioner Monti emphasised the need for such institutions to operate in a justifiable, objective and open manner (*Reuters* 3 June 1999). An executive at Spanish bank BBVA, which saw its plans to merge with UniCretio blocked by the Bank of Italy in 1999, recently called central bank governors "the biggest obstacle against the free movement of capital within the European Union" (*Financial Times* and *FT.com*, 12 March 2001).

The Bank of Italy does not restrict itself to approving and rejecting mergers, but intervenes actively in the market by negotiating deals. In 1999 it famously averted a 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 (BPI). Spain's BSCH controls 11% of the market.

The Portuguese authorities blocked the acquisition of Champalimaud by BSCH, party because the merger marked the end of a tacit agreement by Spanish and Portuguese banks to keep out of each other's markets. The Finance Minister's 'despacho' (suspending all voting rights in Champalimaud shares) was justified on the grounds of late and incomplete notification, absence of transparent structure and protection of the national interest. It was thus *largely* on supposedly prudential grounds. Taking place within 24 hours of the notification, it left no room for appeal, redress or supplying additional information. Given the high profile of the case and the speed with which it was dismissed, it could hardly escape the attention of the Commission (which cleared the merger as per MCR rules in August). Using its full range of tools, it took action based on 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 infringement procedures were based on both violations of single market rules and on failure to abide by the Commission's MCR decisions. In October it declared the 'despacho' incompatible with the MCR, prompting the Portuguese government to take the case to the Court of Justice. In the event, a compromise was worked out that saw BSCH take control of 40% of the Champalimaud group: Banca Totta i Acores and Banco de Credito Predial Purtugues. Following the Commission's clearance of this proposed merger in January 2000, the Portuguese government accepted it and withdrew its case against the Commission, thus precipitating closure of the infringement procedure.

This case illustrates the continuing reluctance of many member state governments to accept foreign ownership in the financial service sector, and the extent of their powers of discretion. When blocking the deal, the government alluded to an alternative offer, which soon came forth from BCP. Despite Prime Minister Guterres proclaiming that "the national interest must be defended" (*Times* 25 August 1999), the government maintained that its actions were perfectly compatible with EU law *because the decision was not taken on competition grounds*. It argued that because BSCH's non-compliance with Portuguese law raised doubts as to its ability to guarantee prudent management of Champalimaud. National interest and EU rules were therefore seen as fully compatible. In the words of Finance Minster Franco "the EU exists so inter-penetrations between economies can be achieved progressively, not so that vital sectors of national economies can be taken by assault" (*Financial Times* 20 June 1999). His ministry stressed that "the Government reaffirms its conviction of having acted in total conformity with national and EU law" (*European Report* 24 July 1999). In other words, using stock market and prudential rules to prevent a foreign acquisition was supposedly perfectly reasonable, a view the Commission hardly shared. Monti would later emphasis the need to ensure that member states "do not intervene against merger processes for protectionism reasons or to foster national interests" and that "the case BSCH/Champalimaud gave me a clear opportunity to show this determination" (Speech, MCR 10th anniversary, 15 September

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 legitimate opportunity."

The Competition Council investigates concentrations above a 25% domestic market and advises the Ministry of Economy and Finance, but specific authorisation is required in banking, investment service and insurance. The banking authority Cecei must approve acquisition of any financial institution, and the Ministry of Finance must approve acquisitions of insurance companies. The financial market regulator CMF authorises offers, and may reject offers that do not comply with French law. The stock exchange regulator COB supervises the quality of information and minority shareholders' rights, and must approve offers. The banking sector has seen a degree of concentration and consolidation driven by increased competition and liberalisation. In this context, the government has sought, albeit somewhat ineffectually, to promote mergers that would create strong national banks that can withstand foreign take-over threats. However, Banque Nationale de Paris' (BNP) failed attempt to acquire control of Paribas and Societe Generale (SG) illustrates the French government's fear of foreign control rather than success in protecting the markets. The sector is dominated by three groups, the BNP, SG and Credit Agricole. A merger of the first two would supposedly have created a bank that would not be "vulnerable to a take-over by a foreign institution" (*Financial Times* 30 August 1999). However, foreign banks already have a strong presence in the sector, and much of the share capital of French banks is in the hands of foreign financial institutions and institutional investors. 40% of all SG and Paribas shares are owned outside the country. This partly reflects the lack of domestic institutional investors such as pension funds.

Negotiations for a friendly merger between the three, dating back to 1998, broke down when, in early 1999, SG and Paribas announced their intention to merge. This prompted a hostile bid from BNP for both banks, setting off a six-month process of bids and counter-bids that would draw in the three regulatory authorities and incite several cabinet ministers. When the dust settled, the CMF announced that the BNP had succeeded in acquiring 37.2% of the capital of SG and 31.8% of the attached voting rights, and 65.1% of the capital of Paribas and 65.2% of the attached voting rights. Cecei had stated that it would authorise a take-over of Paribas or SG without further ado if BNP was able to acquire 50.01% of voting rights, but that otherwise a 'clear and jointly worked out solution' agreed by the principal parties would be required. In its absence, Cecei had no alternative to declaring the BNP's bid for SG unsuccessful.

Given that the sector is already penetrated by foreign ownership, the government's central concern was to create large national institutions that would be able to resist foreign take-overs. However, the government's effective control of the sector has decreased considerably with privatisation and liberalisation. The case amply illustrates governments' continuing propensity to invoke the national interest even when this is not pertinent according to national legislation (if it were, that legislation would violate EU rules), making clear that foreign take-overs would be unwelcome. In the French case this caused several ministers to engage in public criticism of national regulatory agencies when their decisions ran counter to its desires. Interior Minister Chevenement was quoted by the *Financial Times* (30 August 1999) complaining that "the national interest was not taken into account. SG is exposed to a raid by foreign predators." Hardly a sentiment compatible with EU Treaty rules on the right of establishment. Reportedly in an effort to prevent a potential foreign take-over, Governor of the Bank of France and Cecei Chairman Trichet had earlier ordered BNP and SG to continue negotiations after they had broken these off (*Financial Times*, *Daily Telegraph* 30 August 1999). Even Finance Minister Strauss-Kahn, adopting a more neutral pose, made it clear that involvement of a foreign bank in the deal would be against 'the national interest' (*Financial Times* 23 June, 30 June 1999).

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 employ a series of defence mechanisms against hostile take-overs without consulting shareholders, which was a key reason for her opposition to the EU take-over directive. This reflects Germany's traditional 'stakeholder' approach to business, which is often contrasted with the Anglo-Saxon focus on shareholders. Although there are currently no rules (beyond anti-trust law) explicitly governing take-overs, the threat of EU legislation may prompt codification of the present German practices as laid out in a voluntary code. The sector contains three broad categories of banks: 1) private commercial banks, 2) co-operative banks (Volksbanken, Raiffeisenbanken) and local public savings banks and 3) Federal banks and Landesbanks & Girokassen (LBuGs). The private commercial banks are normally universal banks with considerable shares in industry and are traditionally entangled in an intricate web of cross ownership among financial institutions. The co-operative banks are associated with agriculture, local merchandising and crafts forming a strong network in rural areas. Because of the co-operative nature of these banks they can only merge with other co-operatives. The local public savings banks are municipally owned institutions with strong ties in the local population. The LBuGs have been established in order to provide banking services for the Lands' authorities and cover the savings banks' need for centralised services. Therefore, ownership is shared by the Lands and the savings banks, and they are covered by a system of public guarantees that has come under criticism. The federal banks are owned by the federal government and provide federal banking services.

Germany's more than 500 municipally owned savings banks, which control half the market, and are shielded from mergers and acquisitions by legislation, constitute a formidable obstacle to restructuring of the bank sector, let alone foreign acquisitions. Under the 'mainteneance obligation' (Anstaltslast) the public sector owner is required to keep the institution financially viable. The Commission argues that this requirement is the equivalent of illegal state aid because "the measures are based on State resources and favour certain groups of undertakings, they distort competition and affect trade within the community" (European Commission, 8 May 2001). These rules also imply that these savings banks can only be sold by changing the savings bank law, a considerable impediment to restructuring. The public guarantee system for municipally owned savings 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 cooperative banks (Volks-, Raiffeisenbanks). This development came as a consequence of reduced earnings and increased risk provisions in DG and after a failed merger attempt with the Dutch Rabobank. The new bank will be named DZ Bank and will act as central bank for 80% of Germany's cooperative banks. WGZ, which was initially taking part in the merger talks but withdrew for unclear reasons, has purchased the smaller bank WestHyp and entered into a cooperative agreement with Rabobank. Yet there are very few cases of foreign banks attempting to merge with or acquire a German financial institution. Recent negotiations between Commerzbank and Italy's Unicredito were abandoned after their stock values crashed as a consequence of recent turmoil on the global financial markets.

Icelandic Delayed Privatisation

The Icelandic bank sector went through a restructuring process driven by privatisation and liberalisation in the late 1990s. The formerly state-owned banks have engaged in a series of mergers, supported by the government. Although government and industry welcome this process as leading to the emergence of stronger banks that can withstand competitive pressure from their larger foreign rivals, the competition authority's blocking one such merger (see above) suggests that there is some disagreement as to the extent and significance of foreign competition. Some Scandinavian banks have shown interest in the sector, e.g. in the form of Svenska Enskilda Banken's (SEB) bid for a majority of the state-owned (68%) Landsbanki Islands in 1998. Increasing foreign interest is also exemplified with First Union National Bank's 4% share in Landsbanki Islands.

Although the Icelandic financial sector appears to be open to foreign competition in principle, the SEB's attempt at entering the market was blocked by Government by simply delaying the privatisation process. This delay was motivated partly by Government facing a complete restructuring of their domestic banking sector as three banks were to be privatised simultaneously, partly because SEB wanted a majority stake in Landsbanki, and partly because of worries about the potential effects on voters just prior to a national election. Distorting privatisation in favour of domestic firms, while 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 Nordic countries" (Speech to European Banking Congress, 19 November 1999).

Until 2000 Danish competition law featured no provisions for merger control, partly because this was seen as redundant given that DG Competition would deal with big merges, and rules on abuse of dominant position could be invoked. Under the new rules, drawing heavily on EU and Swedish rules, the Competition Council vets mergers that do not have an EU dimension. The financial services sector is supervised by a single regulator, the Financial Authority. Two dominant players emerged from the process of consolidation in the banking sector in the early 1990s, Unibank and Den Danske Bank (DDB). Together with BG Bank and Jyske Bank, they account for some 90% of the market. While Danish banks have focused on the Nordic market, with DDB acquiring Norway's Fokus Bank in 1998, the Swedish-Finnish MeritaNordbanken (now Nordea) acquired UniDanmark in 2000 (soon followed by Norway's Christiania Bank), thereby creating the largest bank in the Nordic region. *Financial Times* has since identified ABN Amro and Deutsche Bank as likely future predators in the Danish market (15 April 2001).

Brining in a Southern Europe case of limited intervention, the Greek bank sector is going through a restructuring process driven by its membership of European Economic and Monetary Union but this has yet to be extended to large-scale cross-border mergers. Potential opposition to such mergers is therefore untested. However, the interest expressed by some foreign banks may soon change this. Several Greek banks have recently discussed strategic alliances with foreign banks, and some foreign banks have taken minority stakes in the Greek sector. Foreign banks' interest in take-overs has been somewhat limited, partly due to a combination of rigid labour laws that represent an obstacle to restructuring unprofitable institutions, some opting to access the market directly rather than through mergers and acquisitions. However, these are structural obstacles to mergers and acquisitions that reduce the attractiveness of the market (Dufey 1993; Hurst, Peree & Fischbach 1999), rather than the politically driven obstacles that are the subject of the present report.

The Greek 1977 anti-trust law was modelled on EU rules. The Competition Committee vets mergers and acquisitions, though further specific rules govern the banking (banks must merger if the absorbed company's assets in the acquiring company exceeds 10%) and insurance sector (no acquisition of companies with a higher premium income). Its decisions may be appealed through the courts. Room for political discretion is limited, although a blocked merger may be permitted by the Ministers of National Economy and Development on the grounds of general economic interest. The sector is dominated by the state owned National Bank and Commercial Bank, and private Alpha Bank, EFG Eurobank Ergasias, and Piraeus Bank, the last three of which are the products of mergers in the last few years. Strategic co-operation includes Commercial's links to France's Credit Agricole and EFG's links to Deutsche Bank. Greek insurance group Interamerican formed the joint venture Nova Bank with Banco Comemrcial Portugues in 2000.

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 most state legislation appears not to violate or be incompatible with EU law, the Commission is well aware that many government invoke inappropriate or illegal considerations in merger cases. This has allowed several types of obstacles to the creation of a single market for financial services. . The findings show that the main tool employed by member states in protection of national markets are i) special rules governing the financial sector; ii) questionable exercise of discretionary power by regulatory or supervisory national authorities when applying otherwise EU-compatible rules; iii) open political intervention; iv) state subsidies and public ownerhsip systems that distort competition. Of course a range of other factors inhibit cross-border activity, such as culture, language and traditions that render expansion risky, as well as market structures (cross-ownership, market structures, competitiveness etc.) and labour laws and regulations. However, the present report has focussed on the political obstacles in the seven cases selected.

Although the Italian authorities have avoided appearing openly hostile to foreign mergers and acquisitions, they have demonstrated considerable concern for national control in the banking sector and, through intervention, kept control of mergers. Using procedural or prudential rules, they have ensured that it is difficult for foreign banks to penetrate the market. The Bank of Italy's antipathy toward hostile take-overs imposes a limit on the scope for foreign acquisitions, which critics argue has deterred and prevented cross-border mergers.

Although Portugal is hardly the only case of national authorities expressing concern over potential foreign incursion in their markets, it provides the most dramatic evidence of how far some member states are prepared to go in defence of 'the national interest'. The question of the compatibility of EU and national law was hotly contested by the Commission and the Portuguese government in the Champalimaud case, and it remains the central test of the scope for using prudential rules to block cross-border mergers. The result may have been a partial victory for BSCH in terms of its targets, but represented a central test case with the right result as far as DG Competition was concerned. Protectionism received as major setback.

The French financial services sector is 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, 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 event the French government's invoking the national interest had little effect on the outcome. The final conclusion must therefore be that this is a case of national regulators proving their independence and adherence to the letter of the law, even in the face of outspoken government criticism.

The obstacles to restructuring the German banking sector lie in its structures rather than in transposition of EU directives or protectionist use of prudential rules. Although the private sector is consolidating by way of mergers, the public sector arrangements limit restructuring. The municipal and co-operative banks are by and large immune to mergers with any other type of organisation, which precludes foreign acquisitions. 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.

The Icelandic financial sector appears to be open to foreign competition, at least in principle, although the government's blocking SEB's attempt at entering the market was motivated partly by Government concerns about the effects on voters prior to a national election. 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. 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 were originally designed to prevent export of bad debt, and the deal envisaged speedy adoption of EU take-over rules, they have apparently been interpreted as classify financial services alongside language, culture, national security and defence beyond the remit of the Single European Market's laissez-faire regime.

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