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## Financial Market Special

### Post-FSAP agenda: Window of opportunity to complete financial market integration

- The integration of European financial markets is pivotal to revive growth in the EU and to deliver on the streamlined Lisbon objectives. Despite the almost full completion of the Financial Services Action Plan (FSAP) European financial markets in many aspects remain fragmented along national lines.
- In the short run, the post-FSAP agenda should focus on the implementation and enforcement of the recently passed legislation.
- Going forward, there are already at least four important initiatives on the legislative agenda. First, it is crucial that the transposition of Basel II is competitively neutral and, hence, the numerous discretions for member states are reduced significantly. Further on, the inefficiencies of existing clearing and settlement systems and EU payments systems should be addressed in a market-driven process as both fields are commercial services and legislators should treat them as such. Lastly, the Consumer Credit Directive should be built on the notion of the responsible citizen to ensure a balance between the rights and obligations of lenders and customers.
- In the medium term, targeted and carefully drafted legislative measures must be brought on their way in order to reap the full benefits of undivided financial markets.
  - In retail banking, cultural differences should not be overestimated as an obstacle to market integration nor should the willingness of customers to engage in cross-border transactions. To rapidly allow retail customers to benefit from a competitive single market, EU legislators should consider applying the mutual recognition principle for those aspects of a service that have not been deemed necessary to be fully harmonised.
  - While it is too early to pass a definite judgement on the Lamfalussy process, the procedure made it possible to foster supervisory convergence across the EU and to enhance the flexibility and pace of the legislative process. Nonetheless, there is still room for practical improvements.
  - While the lead supervisor concept is a useful interim solution, the creation of an efficient and effective structure for financial supervision in Europe can ultimately only be achieved by a process of Europeanisation of financial supervision, namely a European System of Financial Supervisory Authorities (ESFSA).
- EU financial market legislation must be streamlined and consolidated. At the same time, overregulation must be avoided. Both of these aims can be achieved by more frequent use of alternative policy tools, such as self-regulation, and by basing all regulatory activity on prudent cost-benefit analyses taking the methodological limits of regulatory impact assessments carefully into account.

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## Introduction

The recently published Kok Report pointed to the deficient implementation of the meanwhile streamlined Lisbon strategy and highlighted the vital importance of financial market integration for reviving growth in the EU. Integrated financial markets are not only to the benefit of customers and the financial services industry but eventually strengthen the competitiveness and growth prospects of the economy as whole. The Financial Services Action Plan (FSAP) has been a great step forward in this direction. Some 39 measures out of 42 have been adopted within the relative brief time frame of six years. Nonetheless, the EU is still far from having achieved truly integrated financial markets, which is to the severe detriment of Europe's competitiveness and growth prospects. The European Commission unveiled its policy priorities for further financial market regulation in a Green Paper on May 3, 2005. This paper aims at analysing the current state of European financial market integration and at providing an assessment of priorities for the post-FSAP period.

## The FSAP review process

In October 2003, the Commission launched the review process of the FSAP achievements by convoking four high-profile expert groups in the areas of banking, insurance, securities and asset management. The four subsequent reports on the state of financial market integration<sup>1</sup> as well as the report of the Council's Financial Services Committee (FSC) provided the Commission with a good foundation for elaborating the coming policy priorities in financial services legislation. At the end of the consultation period, over 60 comments on these reports were handed in by a wide variety of stakeholders. Amongst these contributors as well as between outgoing and incoming Commissioners, it was largely shared that the FSAP was conducive to the aim of a single European market for financial services, but, and this is also a common view, that European financial markets are still far from being truly integrated. The reasons for this poor state of affairs are multi-faceted.

## Inconsistent implementation in the member states

First, a variety of member states too often fail in the basic tasks of transposition, of coherent implementation and effective application of internal market legislation. Indeed, the Kok Report points out that "one of the most persistent obstacles is the failure of too many member states to act on the commitments they make in the Council within the agreed time limit." This reduces the benefits of market integration. Second, considering the various obstacles to integrated markets in the fields of tax, company law and consumer protection there seems to be a tremendous lack of willingness of member states to transfer national sovereignty to the European level. Obviously, the integration of financial markets is not on top of the priority list of national governments and the protection of national interests still seems to be ranked high by national policymakers.

In analysing the potential elements of a post-FSAP agenda it is useful to differentiate three dimensions: First, a brief examination of elements to be addressed in the short term; on these, there is almost universal agreement. Second, an evaluation of legislative projects already in the pipeline. Finally, more wide-ranging initiatives for the post-FSAP period.

<sup>1</sup> See [http://www.europa.eu.int/comm/internal\\_market/finances/actionplan/stocktaking\\_de.htm](http://www.europa.eu.int/comm/internal_market/finances/actionplan/stocktaking_de.htm).

**Financial markets pivotal for reviving economic growth in the EU ...**

**... and for delivering on streamlined Lisbon objectives**

### Financial Services Action Plan

The Commission adopted the FSAP in May 1999 with the goal of creating an adequate framework for a single European market in financial services by adhering to three overarching objectives: a single wholesale market, an open and secure retail market and adequate prudential rules and supervision. The Heads of States and Government of member states demanded the full implementation of FSAP legislation by 2005.

**Deficient transposition ...**

**... risks to jeopardise overall benefits of market integration**

## Post-FSAP elements in the short term

In the short run, the agenda for the post-FSAP period should comprise four elements on whose indispensability most politicians, industry representatives and academics agree. First, against the background of deficient transposition of EU rules into national law, it is widely agreed that the initial emphasis in the post-FSAP period must be on the implementation and enforcement of the recently passed legislative measures. As the Inter-institutional Monitoring Group (IIMG) observed in its third report: "If that does not occur, as the non-transposition of the Market Abuse Directive by its deadline would unfortunately suggest, the momentum gained as a result of the Lamfalussy process will be seriously put at risk."

Second, there seems to be a broad consensus to base further legislative and regulatory action upon strict impact assessments. This demand is quite understandable, notably with regard to the international competitiveness of European financial markets, in particular vis-à-vis the US. Given the global nature of many market segments, all efforts by EU legislators and regulators should strengthen the efficiency of European financial markets and aim to increase the markets' international competitiveness. It is therefore to be welcomed that the recent FSC report on financial integration ("Asmussen report") highlighted the "need to prioritise areas for intervention so as to focus on actions which can deliver the largest efficiency and welfare benefits." The 2003 Inter-Institutional Agreement on "Better Law-Making" among Council, the European Parliament and the Commission also set out useful and important principles including emphasis on reasons for not legislating, for the use of co- and self-regulation or committing the Institutions to simplifying, even repealing legislation. However, notwithstanding the benefits of regulatory impact assessments in principle, it also needs to be acknowledged that, so far, there exists no generally accepted methodology to conduct impact assessments for financial regulatory measures. This is partly due to the significance of non-quantifiable benefits of regulation, such as financial stability, investor confidence and innovativeness. As a result of this, care should be taken to ensure that the call for regulatory impact assessments does not result in tactics that block further legislation nor become misused as a sophisticated form of window dressing for conclusions that are favoured anyway.

The third aspect refers to a comprehensive consolidation and streamlining of regulation. Over recent years, an extensive set of rules and regulations was developed which acts in many areas as a straitjacket, inhibiting market innovation and unnecessarily raising the costs of financial services. The recently announced initiatives of the European Commission and the British Financial Services Authority to systematically review burdensome regulations with little added value to consumers and stakeholders are an adequate step in the right direction. On EU level, it is also widely agreed that the FSAP produced various inconsistencies between legislative acts. Financial institutions' reporting obligations have in the meanwhile become extremely extensive and at times unfathomable, as the definitions of requested reporting items, the timetables, the addressees and the technical formats are not harmonised. In this regard, a fundamental purification and codification of the various legal situations following the example of the second Banking Coordination Directive should be pursued more proactively by policymakers. The possibility of consolidating the EU's securities market regulations into a single act, i.e. an EU Securities Markets Code, should be assessed thoroughly, as it could grant substantial benefits to investors and financial services providers.

Lastly, it is vital to recognise that achieving the benefits of integrated markets does not necessarily require new legislative acts – this is a

## Initial emphasis on implementation and enforcement

### Inter-institutional Monitoring Group

The IIMG was set up jointly by the Commission, the Parliament and the Council in July 2002. The Monitoring Group is mandated to observe the implementation of the Lamfalussy process and to identify possible inherent bottlenecks. The mandate of the IIMG was recently extended to the areas of banking, insurance and occupational pensions; the group will reconstitute soon.

### Regulatory impact assessment

In principle, regulatory impact assessments (RIAs) are a useful tool to enhance the quality of the political decision-making process and contribute to a more targeted approach to carefully drafted legislation. However, RIAs are not a panacea that by itself can halt a flow of burdensome regulation. The use of RIAs is constrained by a variety of methodological shortcomings, notably the quantification of benefits and costs in the field of financial market legislation is most difficult. Qualitative aspects such as financial market stability and investor and consumer confidence are difficult to take into account in a satisfying manner.

Against this background, the real value of RIA lies in the process of identifying benefits and costs of a piece of legislation rather than in its concrete results. RIAs constitute rather an add-on to the political decision-making process and cannot act as a substitute for a diligent political judgement.

## Consolidation and streamlining of legislation indispensable

## Horizontal inconsistencies in FSAP regulation ...



frequent misunderstanding. A wide variety of other instruments can often be applied more effectively, notably a more rigid use of Level 4 of the Lamfalussy procedure (i.e. Commission enforcement) as well as a more stringent application on competition policy. In this context, the recent announcements of the European Commission to investigate obstacles to cross-border mergers and acquisitions in the financial sector are very important. In addition, a closer alignment of regulatory and supervisory practices in member states would help to ensure a more coherent application of FSAP elements.

### Overarching principles for further regulatory action

Pan-European financial institutions face a large variety of different bodies of law and distinct national regulatory and supervisory practices in EU member states. The purpose of all national systems is identical, namely to protect the consumer and the stability of the system, but in practice this common goal is aspired to in 25 distinct ways. This situation burdens pan-European market participants with a voluminous amount of regulatory requirements that hinder the emergence of sizeable cross-border transactions in all banking markets. To foster the emergence of truly integrated financial markets further legislation should be based upon some overarching principles, for three reasons. First, these principles would help to ensure the horizontal consistency of individual regulatory measures and avoid a regulatory patchwork. Second, they would help to avoid overregulation and abolish duplicative and unnecessary rules and, third, these overarching principles would provide an anchor for both authorities and market participants when evaluating solutions to new regulatory issues. It was the Group of Wise Men that already in their final report in 2001 called for this type of conceptual framework. Such a framework should encompass the following six components.

- First, pan-European – as opposed to national – efficiency should be the goal of European financial market integration. Protectionist attitudes have been there for too long, to the detriment of Europe's growth prospects.
- Second, international competitiveness should serve as a benchmark for further legislative action. In the face of the global nature of financial markets, all regulatory efforts need to be focused on enhancing the EU markets' international competitiveness. EU policy-makers and regulators should evaluate more carefully how their actions affect the international competitiveness of EU financial markets.
- Third, legislators should attach more weight to self-regulation and the responsibility of the individual. Standards developed by market participants could serve as possible guidelines for legislation. As part of this process, it should be assessed carefully whether the regulatory objective can be achieved by means of self-regulatory codes in a more efficient manner.
- The fourth paramount rule refers to a strengthening of client confidence. The possibilities and benefits of a stable and integrated European financial market should be reflected in the daily transactions of consumers. They should be able to enjoy advantages in terms of product quality and pricing as well as greater product variety. To this end, simple consumer protection rules are needed that will facilitate cross-border supply of financial services.
- Fifth, regulation should promote competition rather than safeguard protective regimes. The same risks must be subject to the same rules irrespective of where an institution is incorporated in the EU, irrespective of its principal activity and irrespective of its individual characteristics.

### ... and unexplored potential of various policy tools

#### Rationale for overarching principles of further legislation

#### Pan-European efficiency

#### International competitiveness

#### Self-regulation

#### Client confidence

#### Competitive neutrality

- Sixth, financial market regulation should promote, not curb, the innovativeness of product providers and the introduction of new products. EU legislators and national authorities should avoid creating standards that slow the markets' innovation potential. Therefore, EU legislation should – notwithstanding the need to review and assess the effects of product innovations on financial market stability – allow sufficient time for market-driven competition in the development of new processes and products and not obstruct this process through premature standardisation and regulation.

## Post-FSAP initiatives already in the pipeline

The current legislative process is preponderated by inter alia four legislative initiatives, namely the Capital Requirement Directive, rules for clearing and settlement, the Consumer Credit Directive and the integration of European payments services.

### 1. Capital Requirement Directive (CRD)

The implementation of Basel II into EC law is one of the most important components of the current legislative agenda. The Ecofin Council agreed on two draft directives that aim to transpose the requirements of Basel II into EC law. It is crucial that Basel II, as a global standard, is transferred without major amendments into European and national bodies of law and, thus, avoids putting pan-European financial institutes at a competitive disadvantage to their international counterparts. Apart from this, the transposition process encompasses a number of other major challenges.

First, the transposition of Basel II is taking place under immense time pressure. Basel II must be transposed early enough to guarantee sufficient lead time and legal certainty for financial institutions and to avoid competitive disadvantages for EU institutions – yet, at the same time, the legislative process must remain flexible enough to incorporate last-minute changes in Basel, e.g. the determination of the so-called scaling factor.

As a matter of principle, the CRD should be competitively neutral. In this light, it is vital to reduce the discretions that the CRD leaves for the national administrations. The Committee of European Banking Supervisors, CEBS, has counted no less than 143 national discretions and has managed to cut only about 30 of them so far. This mix-up of national preferences will lead to a fragmented act of regulation that will eventually distort what market participants aspire to: competitive neutrality. In a similar way, banking supervisors must align pillar-2 rules and practices.

The supervisory architecture should reflect the way in which large financial institutions are managed today, i.e. on a consolidated basis with an integrated and centralised risk and capital management. Any duplication of model authorisation or supervision on a solo basis therefore only increases administrative costs – while at the same time yielding only little added value in terms of supervisory insight. The idea of a consolidated supervisor in Art. 129 of the CRD is therefore an absolute minimum and this provision should not be watered down. Likewise, it is questionable whether the provision in Art. 68 of the CRD, according to which capital requirements must be complied with on the individual bank's level, is meaningful for large banking groups. Rather, in light of group-wide risk and capital management, it would seem appropriate to apply the waiver rule allowed for in Art. 68 in all member states. Then, capital requirements and pillar-2 activities would be carried out on the group level – as, indeed, is already the practice in some member states.

## Promotion of innovation

### Capital Requirement Directive

The CRD will transpose the Basel Committee's revision of the Basel Accord into EC law. The new capital accord aims at aligning the capital measurement framework with sound contemporary practices in banking, to promote improvements in risk management and enhance financial stability.

## Immense time pressure

## Numerous national discretions endanger coherent application

## Consolidated supervision

## 2. Clearing and settlement

The field of clearing and settlement (C&S) systems has long been identified as one of the severest obstacles to greater cross-border integration of securities markets and to a greater European diversification of portfolios. In contrast to the settlement of domestic transactions, existing international C&S systems for securities, especially equities, operate rather inefficiently. Despite an incipient consolidation process, common technical platforms have not yet evolved, e.g. Clearstream still runs different systems in Germany and Luxemburg and the finalisation of an integrated single settlement system run by Euroclear for the Euronext markets is still far away. The consolidation of systems should evolve in a market-driven process because C&S are commercial services and, hence, regulators as well as legislators should treat them as such. In view of recent activities by the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) it should be emphasised that any redundancy in regulation of market participants should be avoided. Furthermore, it should be ensured that any interference in market mechanisms must adhere to the overarching principles of competition. However, to foster this process, the regulatory, legal and tax barriers, as identified in the Giovannini reports<sup>2</sup> and The Group of Thirty, need to be removed. Additionally, joint technical standards and measures for effective competition between providers need to be established. A model that could be built upon is the inter-linkage of Europe's large-value payment systems in analogy to the Target system of the ESCB. In a similar fashion, a Central Securities Settlement Institution could be set up that would inter-link (all) existing C&S systems for cross-border transactions as a starting point and evolve into a single integrated European system as the ultimate objective.

## 3. Consumer Credit Directive

The aim of the Consumer Credit Directive (CCD) is to foster the creation of a single market for consumer credits by following a twofold approach. First, financial institutions should be enabled to offer pan-European consumer loans on the basis of fully harmonised rules and secondly, consumers should be able to take out loans with a bank in another country while being safeguarded by a sufficient level of consumer protection. The first version of the CCD had raised serious concerns because certain provisions were included which would have been to the severe detriment of both consumers and financial services providers. It is not in the interest of consumers when well-meaning but inappropriate regulation leads to the termination of entire product lines and the de facto exclusion of whole customer segments. The latest draft constitutes an improvement but still contains, inter alia, the notorious clause on "responsible lending". Instead, EU financial market legislation should build on the notion of the responsible citizen – and that should be the guideline for all of the Commission's Directorates General, not just DG Internal Market. Market integration in retail banking has not yet advanced significantly and the directive must therefore be considered a trial run for further legislative action in this field – which is why it is all the more important to get the CCD right. As the directive appears not to harmonise all aspects of consumer credit, it is important to also allow the mutual recognition principle to come into play. Only on this basis can a product admitted in one member state be offered to customers in another member state and only then will a truly competitive single market emerge.

### Inefficiencies of existing C&S-systems ...

### ... pinpointed by two Giovannini reports

#### Giovannini reports

The first Giovannini report points to the complexity and fragmentation of the cross-border post-trading market whereas the second report outlines a strategy for removing obstacles to market integration. Building on the second report, the Commission released in July 2004 a Communication on improving European C&S regulations.

### CCD as trial run for market integration in retail banking

<sup>2</sup> See [http://www.europa.eu.int/comm/internal\\_market/financial-markets/clearing/index\\_de.htm#giovannini](http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/index_de.htm#giovannini).

#### 4. The integration of European payments services

Twelve member states now share the same legal tender, but various obstacles to cross-border payments remain in place. The infrastructure for cross-border retail payments is still dominated by isolated national retail payment systems. Several regulatory initiatives aiming to foster the integration of European payments markets have been launched.

The Commission consulted industry representatives and member states on the New Legal Framework (NLF) for Payments in the Internal Market that not only aims to support payment services within the EU-25 but also seeks to include payments to and from third countries. The Commission intends to present an official proposal for a directive in September 2005. Besides encountering reluctance on the part of market participants to agree on the geographical scope of the NLF, the currently discussed fifth version of the draft raised various other concerns, such as the inclusion of small and medium-sized enterprises under the consumer protection regime and imbalances in liability between payment services providers and payment services users. These aspects might ultimately lead to higher costs for payment services. Furthermore, it is crucial that the regulatory regime ensures a level playing field for bank and non-bank payment services providers.

In parallel, the financial services industry, within the European Payments Council (EPC), aims to set up the necessary infrastructure for the creation of a Single Euro Payments Area (SEPA), i.e. to convert the eurozone into a truly integrated payments area. The EPC was set up by 42 European banks and credit associations in June 2002 and aims to develop a full body of pan-European payments standards. Despite the increased attention paid by the Commission to this area, the evolution of such a system should evolve in a market-driven process because payment services are commercial services and, hence, regulators as well as legislators should treat them as such. The EPC already identified milestones in its Roadmap 2004-2010 for the transformation of the European payments architecture. In a first step, the EPC intends to deliver two new pan-European payments frameworks for electronic credit transfers and for direct debits that are expected to be operational by January 2008.

#### Further contents for the post-FSAP agenda

It is obvious that implementation and enforcement are demanding tasks for both supervisors and the financial industry and that they will absorb substantial personnel and financial resources – that might be one of the reasons why some people are reluctant to contemplate new regulatory initiatives and are even calling for a legislative pause. However, given the enormous benefits of a single European financial market, the EU cannot afford a regulatory timeout nor can it focus on ironing out all existing deficiencies before addressing new issues. Instead, it needs steady work on a reasonable timeline to undo the remaining barriers. Targeted and carefully drafted legislative measures must be brought on their way in order for the EU to reap the full benefits of undivided financial markets.

#### Retail banking integration

The Commission's studies on financial market integration indicators clearly demonstrate that retail markets are the most fragmented segment in financial services. But, as a matter of principle, there is no reason to assume that consumers and suppliers of retail markets would not benefit as much from market opening as actors in wholesale markets. In the era of the internet, it is outdated and wrong to assume that consumers have a natural inclination to turn to their local and more familiar institutions, and even more so to assume that such an inclination entails a natural predisposition to eschew offers by non-local

#### **New Legal Framework for Payments in the Internal Market**

#### **SEPA aims to transform EUR payments into domestic ones**

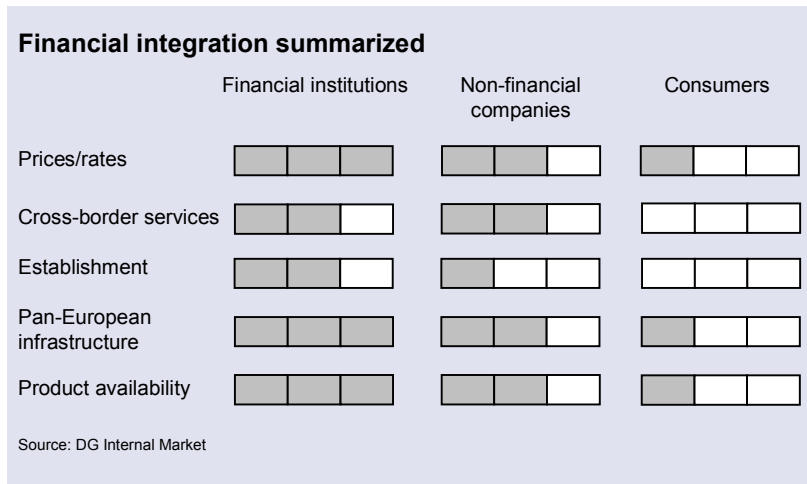
#### **Milestones identified by the EPC**

#### **No legislative pause given the benefits of market integration**

#### **Retail banking as most fragmented market segment**

institutions. Cultural differences should not be overestimated as an obstacle towards integration of retail markets, nor should the willingness of customers to engage in cross-border transactions. Besides, if even only ten percent of EU citizens engage in cross-border retail transactions this constitutes a retail market of around 45 million citizens. It should be up to the customer to decide whether to purchase local or cross-border financial products – and legislative action should enable consumers to do so.

**Cultural factors not to be overestimated**



The minimum harmonisation approach followed up to now, particularly in directives concerned with consumer and investor protection, has not proved effective. National implementing laws diverge too widely to enable consumers and suppliers in the internal market to benefit from them. Directives regulating consumer and investor protection often provide for exemptions permitting member states to introduce or retain diverging rules at national level “in the interests of the common good”. This option is misused as a mechanism for protecting the domestic market. In an internal market with cross-border banking and other financial services, it is essential, in the interests of consumers and banks alike, to eliminate the existing “artificial obstacles” to cross-border business and apply consistent, EU-wide solutions. A level playing field in the internal market should be achieved by the harmonisation of essential consumer protection aspects of a financial service. In order to allow product diversity within the single market, the principle of mutual recognition should apply to those aspects deemed unnecessary to harmonise. In the medium term, it would thus be worth carefully evaluating how to gradually and fully harmonise most important areas, followed by the development of a uniform body of European contractual law. From a market view, this horizontal approach is to be preferred to a strategy that aims at achieving market integration by creating regimes for individual product categories, for two reasons. First, it avoids the danger of creating a (non-compatible) patchwork of product-specific legislation and, second, it contributes to diminish any bias in singling out specific products that are deemed most suitable for harmonisation.

**Minimum harmonisation approach not always effective**

As a matter of principle, a more harmonised regulatory framework would allow financial institutions to streamline product development, product and risk management, and other back-office functions. Potential cost-savings thus achieved would not only enhance the competitiveness of Europe’s financial industry, but would also make cross-border consolidation easier to achieve, thereby deepening further EU financial market integration. A feasible starting point for further regulatory measures could be to permit online account opening and consumer loans using digital signatures.

Assuming that consumer confidence can be assured sustainably in the medium term across Europe by removing the main obstacles to retail market integration in the field of tax, civil law and financial supervision, retail customers could become major beneficiaries of truly integrated financial services markets in a manner that wholesale customers already are.

### **Mortgages markets**

Given the tremendous size and growth potential of European home loan markets the Commission attaches a high priority to the integration of this market segment. Whereas the European secondary markets for mortgage debt – covered bonds and Residential Mortgage Backed Securities (RMBS) – show a higher degree of integration, differences in civil law, taxes and regulation remain as major obstacles to cross-border mortgage lending on the origination side. This situation is aggravated by soft factors leaving a footprint on national markets: attitudes towards home ownership, age of household formation and preferred mortgage products. National differences in mortgage loans also feed through to funding instruments and, thus, secondary market liquidity. The Commission expects better refinancing conditions from a single European mortgage market, translating eventually into cheaper and better mortgage loans for all European citizens. A cost-benefit analysis evaluating the potential impact of mortgage market integration is scheduled to be published by mid-2005.

In order to assess current obstacles to cross-border mortgage business, the Commission summoned experts from industry and consumer groups – the Forum Group on Mortgage Credit. In their report published in December 2004<sup>3</sup>, they proposed 48 measures to overcome the obstacles identified. Their recommendations refer to the areas of consumer confidence, legal issues, collateral, distribution and finance. The Commission will probably take these recommendations into consideration when proposing legislative action to achieve a single mortgage market. A Green Paper for consultation with industry and other stakeholders is expected for July 2005.

## **The architecture of financial supervision**

### **The Lamfalussy process: Enhanced supervisory co-operation and legislative flexibility<sup>4</sup>**

The Lamfalussy process has proved to be an important mechanism to foster supervisory convergence across the EU as well as a valuable step to enhance the flexibility and pace of the legislative process. As of to date, it is too early to pass a definite judgement on the Lamfalussy process as only few pieces of legislation have been passed under the framework and no experience of amending Level-2 legislation in response to market changes has yet been gained. In addition, Level 4 remains largely untested in practice and, for obvious reasons, hardly any experience with the framework has yet been accumulated in banking and insurance. The extension of the Lamfalussy framework that was hitherto solely applied to securities markets for the areas of banking, occupational pensions and insurance is fully backed by market participants. The new architecture of “Level-3” committees – CESR, CEBS, and CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) – laid the foundation to develop an

### **Pan-European mortgage lending impeded by various obstacles**

### **The Forum Group on Mortgage Credit issued recommendations**

### **Green Paper expected in July 2005**

#### **The Lamfalussy process**

The Lamfalussy procedure is a four-step approach designed to speed up the legislative process and to foster supervisory cooperation. It was originally launched in the field of securities and also involves a consultation mechanism with market participants. It was designed by an expert panel chaired by Baron Lamfalussy.

<sup>3</sup> See [http://www.europa.eu.int/comm/internal\\_market/finservices-retail/docs/home-loans/2004-report-integration\\_en.pdf](http://www.europa.eu.int/comm/internal_market/finservices-retail/docs/home-loans/2004-report-integration_en.pdf).

<sup>4</sup> See also EU Monitor No. 4: Reform of EU regulatory and supervisory structures: progress report; available for download at [www.dbresearch.com](http://www.dbresearch.com).

unprecedented amount of co-operation amongst EU supervisors that needs to be fully explored.

The Level-3 body for securities, CESR, has, inter alia, set up scoreboards to monitor implementation of EU rules whereas CEBS, the banking supervisory committee, is working on designing a joint technical format for banks' reporting requirements, the XBRL standard. Besides these initiatives, the CRD and the Prospectus Directive provide further stimulus to enhance supervisory co-operation. The CRD foresees in Art. 129 the role of a "consolidated supervisor" and the Prospectus Directive provides the possibility for the competent home authority to voluntarily transfer the approval of a prospectus to another CESR member.

**First practical experiences gained**

	<b>Securities (including UCITS)</b>	<b>Banking</b>	<b>Insurance &amp; Occupational Pensions</b>
Level 2	European Securities Committee (ESC)	European Banking Committee (EBC)	European Insurance & Occupational Pensions Committee (EIOPC)
	Chair: Commission	Chair: Commission	Chair: Commission
	Location: Brussels	Location: Brussels	Location: Brussels
Level 3	Committee of European Securities Regulators (CESR)	Committee of European Banking Supervisors (CEBS)	Committee of European Insurance & Occupational Pensions Supervisors (CEIOPS)
	Chair: Arthur Docters van Leeuwen	Chair: Jose-Maria Roldán	Chair: Henrik Bjerre-Nielsen
	Location: Paris	Location: London	Location: Frankfurt

Against the overall positive assessment of the process, there still exists room for practical improvement. As a matter of principle, when evaluating the process it is crucial to carefully distinguish between content-related drawbacks of individual directives that were adopted under the Lamfalussy framework and shortcomings inherent to the Lamfalussy process itself. Three are probably particularly relevant from a market participant point of view.

- First, the trend to incorporate excessive details in Level-1 legislation needs to be addressed. This is partly due to a lack of trust amongst the Institutions; partly due to uncertainty – reflecting a lack of experience – on the side of market participants about the policies that will be followed by the institutions responsible for Level-2 and Level-3 measures. Institutions and Level-3 committees should fully adhere to assigned boundaries and functions of each layer of the Lamfalussy framework.
- Second, the consultation procedure displays various shortcomings, notably timetables for consultation are too tight, implying the risk of lowering the quality of consultations and excluding some market participants by disproportionately burdening their resources. It is obvious that tight timetables partly resulted from the high pace of FSAP legislation. In general, the consultation process can be improved by providing consultees with regular meaningful feedback

**Room for practical improvement**

**Excessive detail at Level 1**

**Shortcomings of the consultation process**

on their input and by extending consultation periods to a minimum period of three months.

- Third, the rising use of "soft law" techniques at level 3 risks a situation in which political accountability is unclear and market participants are faced with legal uncertainty. Despite that market participants fully back the enhanced supervisory co-operation at Level 3, the accountability problems of level-3 committees de facto setting legally binding rules without possessing a legal and institutional mandate to do so need to be clarified.

Whereas the first two aspects are probably transitory and expected to gradually dissolve over time, the third aspect constitutes a systemic drawback of the Lamfalussy process which is not easily amendable.

### **Supervision to evolve in line with EU financial markets**

While the structures described above evolved on the institutional side, financial markets also evolved in a very dynamic manner. On the one hand, cross-border consolidation increased with Santander's acquisition of Abbey being only the most prominent example. On the other hand, it has become the norm for internationally active banks in the EU to rely on fully integrated capital, risk and liquidity management on a group wide basis. In addition to that, the enlargement of the EU to 25 member states has broadened the spectrum of regulatory practice further. With the FSAP now almost completed and the start of Basel II visible, financial supervision in the EU is increasingly based on a common legal foundation.

Notwithstanding the usefulness of an approach that adapts supervisory tools in response to the evolving nature of the EU financial markets, it should not be forgotten that the relation between the degree of market integration and the supervisory structure is a circular one: The structure must respond to changes in financial markets, but the pace and direction of market integration also depends on the structure and characteristics of the supervisory framework, as market participants, for example, may be prevented from expanding across borders owing to high costs caused by non-harmonised regulatory practices. The current regime for prudential supervision constrains financial institutions to provide services across member states' borders. Financial supervision must evolve in line with market integration – which, in turn, can ultimately only be achieved by a Europeanisation of the supervisory structure. Consequently, work on the supervisory structure should also be fore-sighted and guided by the overarching aim of creating a truly integrated financial market in Europe.

### **Medium and long-term options**

Last year, the European Financial Services Roundtable (EFR), presented the proposal for a so-called lead supervisor. The lead supervisor concept is designed to reduce the duplication of supervisory activities to the greatest extent possible under the confines of existing EU legislation. The task of the lead supervisor is to act as the single point of contact for pan-European financial institutions within the prudential supervisory framework. This means that the lead supervisor would be in charge of all reporting schemes, of the validation of internal models and approval of capital and liquidity allocation. In addition, this body would be responsible for supervision on the consolidated level as well as on the local level. Local supervisors of those countries in which a pan-European financial institution has establishments would execute local inspections, based on a delegation by the lead supervisor. Furthermore they, together with the lead supervisor, would form a college of supervisors for a specific group. The main role of this college would be to advise the lead supervisor and discuss proposals of involved local supervisors.

### **"Soft law" techniques at level 3 entail uncertainties**

### **Supervision needs to keep up with market dynamics**

### **Circular relation between market integration and supervisory structure**

### **The concept of lead supervision ...**

#### **The European Financial Services Roundtable**

The European Financial Services Round Table (EFR) was set up in March 2001 by major financial institutions in Europe. The EFR aims to support the completion of the single European market in financial services by actively participating in the debate on European financial market legislation.

While the lead supervisor concept is a useful interim solution and a stepping stone towards a more efficient structure of financial supervision, truly integrated and stable financial markets in Europe cannot be reached by continuing to operate the existing, nation-based system of financial supervision. The latest reports of the IIMG and CESR's so-called Himalaya report both already pinpoint to the accountability problem that arises from the uncertain legal status of Level-3 committees.

In the long-term, the creation of an efficient and effective structure for financial supervision in Europe, which will overcome all of the sources of concern that mark the current setup, can ultimately only be achieved by a process of Europeanisation of financial supervision, namely a European System of Financial Supervisory Authorities (ESFSA), similar to the ESCB. Such a structure for financial supervision would include, but would not be limited to a new EU-level institution (a European Financial Supervisory Authority, EFSA) which would supervise the systemically relevant financial institutions that operate on a pan-European basis and would be the final authority on interpretation and implementation of EU financial market rules in cases of conflicts between national regulators. Small and domestically-oriented institutions would continue to be supervised by national authorities, acting on the basis of common rules and subject to the final say of the EFSA.

### **The Constitutional Treaty**

It is ought to be borne in mind that the European Parliament's original agreement on the Lamfalussy process was largely conditional on the introduction of a call-back right for the Parliament for Level-2 legislation in future treaty amendments. As of today, the Lamfalussy framework is legally based on a temporary agreement among the three Institutions that led to the introduction of so-called sunset clauses in Level-1 legislation. Sunset clauses authorise the Commission to enact Level-2 measures for a confined period of time and are intended to preserve the Parliament's wishes to monitor the Commission in the exercise of comitology powers in a satisfying manner. After the expiration of a sunset clause, the Commission is no longer able to issue Level-2 measures on the grounds of underlying Level-1 legislation, unless the Parliament and the Council renew the delegated power. The first sunset clause of the Market Abuse Directive is due to expire on April 12, 2007, which is only briefly after the intended ratification of the Constitutional Treaty. The new provisions of the Constitutional Treaty that the Heads of State or Government of member states adopted in June 2004 would provide the European Parliament with a call-back right for Level-2 legislation. However, in the case of non-ratification of the Constitutional Treaty, it would be crucial to find alternative ways to address the Parliament's concerns to ensure to the long-term future of the Lamfalussy process.

### **Conclusion**

The FSAP was neither the end nor the beginning of financial rule-making in the EU. As long as financial markets and the financial industry remain innovative and dynamic, it is necessary that the regulatory framework can be adjusted to reflect changes in the market. Financial regulation that is not commensurate with market practice is neither in the interest of financial stability nor conducive to the aim of global competitiveness of European financial markets and firms. In any case, the EU is far from having achieved a truly integrated market for financial services and this is to the severe detriment of Europe's financial services providers as well as Europe's competitiveness and growth prospects. Consequently, the EU cannot afford a legislative pause, nor can it afford to iron out all existing deficiencies before

### **... as useful interim solution**

#### **CESR's Himalaya report**

CESR's released its preliminary report on the supervision of securities activities in Europe (so called Himalaya report) with a twofold purpose in mind. First, to evaluate in the field of securities the progress made by FSAP legislation for market integration. Second, to identify and analyse the supervisory tools necessary to implement FSAP measures and to anticipate the developments in the next five years so as to allow securities regulators to evolve effectively and ensure they can fully play their role in maintaining transparent and secure securities markets.

### **European system of financial supervision in the long-term**

### **Current legal status of the Lamfalussy framework**

### **Constitutional Treaty to provide Parliament with a call back right**

addressing new issues; instead, it needs steady work to undo the remaining barriers. This includes bold reforms, such as reforming the structure of financial supervision. A “pragmatic case-by-case approach” will not create the sort of highly competitive and efficient capital market that matches the ambitious goals of the revised Lisbon Agenda.

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