

After the EU Financial Services Action Plan: A new strategic approach

May 2004



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CONTENTS

	Page
Executive Summary	3
Chapter 1 Introduction	5
Chapter 2 Better implementation and enforcement	15
Chapter 3 Alternatives to EU regulation	21
Chapter 4 Better regulation	25
Chapter 5 Making the Lamfalussy arrangements work well	29
Chapter 6 Recognising the global nature of financial services	33
Annex A Statistical information	41

EXECUTIVE SUMMARY

A Single Market in financial services would bring considerable benefits to the EU economy. Over the past five years the Financial Services Action Plan (FSAP) has been the vehicle for developing the Single Market in financial services. The FSAP has now been largely adopted. Nevertheless, some important barriers to cross-border integration and competition remain.

The EU institutions and the financial sector in Europe have begun to debate what the future strategy towards financial integration should be. The UK authorities – the Treasury, Financial Services Authority and Bank of England – welcome this debate. This document sets out their contribution to the discussions.

The UK authorities believe that there are five priorities which should guide further action:

- **better implementation and enforcement of EU measures affecting the financial sector.** A significant number of the FSAP measures that have been adopted have still to be implemented nationally. That should be a top priority, together with their subsequent enforcement;
- **alternatives to EU regulation.** In general, EU legislation should be a last resort, and alternative approaches to policy making, such as more use of EU competition policy, market-based solutions and initiatives at national level, should be considered first;
- **better regulation.** In some specific cases, market failure analysis may demonstrate that further new EU legislation in financial services could be necessary. When new EU legislation on financial services is being considered, a proper assessment of the costs and benefits should be undertaken, and financial market participants should be fully consulted;
- **making the Lamfalussy arrangements work well.** These new regulatory arrangements are now in place to supervise financial services across the EU. They have been shown to work for securities markets and are being extended to banking and insurance. They need to be further developed; and
- **recognising the global nature of financial services.** It is crucially important to remember that financial markets are global. A global perspective is needed when considering the impact of EU financial services regulation on the competitiveness of EU-based firms and financial centres. International action will sometimes be needed to tackle global issues.

INTRODUCTION

1.1 Developing a Single Market in financial services lies at the core of EU Member States' commitment to economic reform in Europe, designed to transform the EU into *"the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion."*¹

1.2 An effective, integrated financial services market would:

- reduce the cost of accessing capital and improve the allocation of capital across the EU;
- give firms increased opportunities to access markets in other Member States and to carry out business effectively on a cross-border basis; and
- give retail consumers access to a wider range of more competitively priced financial services products.

1.3 The EU Financial Services Action Plan (FSAP) has been the legislative framework for developing the Single Market in financial services. Between its endorsement by the European Council in Lisbon in March 2000 and the end of April 2004, 38 out of the 42 FSAP measures were adopted in the EU.

1.4 As the FSAP nears completion, policy makers, industry practitioners and users of financial services are discussing the extent to which the Single Market has been achieved and the next steps to financial services integration. This debate is timely as it takes place against the backdrop of:

- enlargement of the European Union from 15 to 25 Member States, expanding, in one step, the reach of the Single Market;
- a new European Parliament; and
- a new European Commission from 1 November 2004.

1.5 The debate on how the Single Market in financial services can be enhanced is taking place through two main routes:

- the Financial Services Committee (FSC), mainly comprising senior officials from EU finance ministries, will report to the June ECOFIN meeting of finance ministers on the state of financial integration with advice on the next steps in completing the Single Market in financial services. This work is expected to progress under the Dutch Presidency in the second half of 2004; and
- the Commission has established four expert groups of industry practitioners from the Banking, Securities, Insurance and Pensions, and Asset Management sectors². The UK authorities welcome this bottom-up consultation approach. These groups have published reports proposing how to advance financial market integration. Their reports are currently out for wider consultation. They will be discussed in depth at a high-level

¹ *Presidency Conclusions*, Lisbon European Council, 23-24 March 2000

² *Expert Group on Banking Final Report* (May 2004); *Securities Expert Group Final Report* (May 2004); *Expert Group on Insurance and Pensions Final Report* (May 2004); *Asset Management Expert Group Final Report* (May 2004)."

conference in Brussels on 22-23 June; and will be one of the main sources used to inform the work programme of the new Commission coming into office on 1 November.

1.6 This document, prepared by the Treasury, Financial Services Authority (FSA) and Bank of England, represents the UK authorities' contribution to this important debate. It takes into account the work on financial integration which has been undertaken by the FSC and the Commission's four expert groups. Financial supervisory authorities in Europe are also contributing to this debate.

1.7 The document is being published alongside a second document prepared by the Treasury, FSA and Bank of England entitled *The EU Financial Services Action Plan: Delivering the FSAP in the UK*, which looks at the challenge and opportunity facing the UK in implementing the FSAP.

1.8 The UK authorities would welcome comments on the contents of the document from market participants and users of financial services, both within the UK and in the rest of Europe and beyond.

FINANCIAL INTEGRATION – LEGISLATIVE DEVELOPMENTS

The FSAP

1.9 In June 1998, the European Council in Cardiff invited the European Commission to prepare a framework for action to develop the Single Market in financial services. In May 1999, the Commission published a Communication containing the Financial Services Action Plan, which was endorsed by the Lisbon European Council in March 2000. The FSAP consists of a set of 42 measures intended to improve the Single Market in financial services by filling gaps and removing remaining barriers to provide a legal and regulatory environment that supports the integration of financial markets across the EU.

1.10 Within the overall aim of completing a Single Market in financial services, as part of the wider need for economic reform in Europe, the FSAP has the following specific objectives:

- **a single wholesale market:** to enable corporate issuers to raise finance on competitive terms on an EU-wide basis; to provide investors and intermediaries with access to all markets from a single point of entry; to allow investment service providers to offer their services across borders without encountering unnecessary barriers; to establish a sound and well integrated prudential framework for investment by fund managers; and to create a climate of legal certainty so that the carrying out and settling of trading in securities are safe from counterparty risk;
- **an open and secure retail financial services market:** to give retail customers the information and safeguards they need to participate in the single financial market; to remove unjustified barriers to providing cross-border retail financial services; to create the legal conditions for electronic commerce on an EU scale; and to enable consumers to make small value cross-border payments without excessive charges; and
- **state-of-the-art prudential rules and supervision** that have the flexibility to evolve with changes to the regulatory environment and changes in industry risk management practice.

Box 1.1: FSAP – Recent developments

In the past few months, many of the remaining measures in the FSAP have been agreed. In particular:

- the **Investment Services Directive**³ has been adopted, including key amendments made by the European Parliament, supported by the Government;
- the **Transparency Directive**, which aims to increase transparency on EU capital markets, has received political agreement: it includes a recognition that mandatory quarterly reporting by firms with shares on EU markets is not necessarily the best way to achieve transparency of financial information, as the Government has argued;
- there has been political agreement to extending the so-called “**Lamfalussy arrangements**”, strongly promoted by the UK authorities (see Box 1.2), for taking decisions on financial services legislation from the field of securities to banking and insurance, and on the location of the new committees of supervisors of banking and insurance in London and Frankfurt respectively; and
- the Lamfalussy arrangements have been demonstrated to work effectively by the adoption of further implementing measures on the **Prospectus Directive** and the **Market Abuse Directive**, following extensive open consultation by the Committee of European Securities Regulators with a wide range of providers and users of financial services and greater transparency by the Commission.

Ongoing work 1.11 In the case of some other remaining FSAP and related measures, developments are continuing:

- the Commission has recently published a proposal for a **Reinsurance Directive** that would allow for greater integration of this sector in the EU economy while ensuring proper regulation of reinsurance firms;
- a proposal is expected shortly on the 3rd **Capital Adequacy Directive** that would apply the new international prudential capital regime being agreed by the G10 countries (called “Basel II”) to EU-based financial institutions; and
- final adoption of the remaining **International Accounting Standards** awaits the outcome of discussions between the Commission and the International Accounting Standards Board.

1.12 However, adoption of all the FSAP measures will not, on its own, bring about an integrated, competitive Single Market in financial services for several reasons, including:

- whilst the FSAP has been all but agreed at EU level, an immense challenge now lies in ensuring the FSAP is **implemented effectively in individual Member States** across the whole enlarged EU;
- although FSAP measures have, in many cases, opened up competition on a cross-border basis, it is now necessary to ensure that **the way these measures are implemented nationally** has a genuinely liberalising effect;

³ The Investment Services Directive was adopted in April 2004 under the title of the Markets in Financial Instruments Directive but is referred to in this document as the ISD as that is the name by which it is familiar.

- **legislation cannot remove all the barriers** to the integration and liberalisation of financial markets. However well it has been drafted, legislation cannot, by itself, secure changes in custom and practice. Barriers resulting from differences in language and culture will still remain. These differences, especially relevant for retail financial markets, continue to require diverse regulatory approaches in individual Member States;
- financial markets are dynamic and quick to adapt to changing market circumstances. So within the framework that the EU has created, rules will need **constant review and modification**, where necessary, to ensure that they keep pace with market developments; and
- **EU markets are part of global markets.** The EU can provide only a partial policy response to challenges that are global in scale: e.g. current discussions on International Accounting Standards. International problems require international solutions. So the EU needs to think and act in an international partnership.

1.13 Moreover, creating a truly competitive and integrated Single Market will not just require commitment from the EU institutions, but also from:

- Member States;
- financial supervisory authorities; and
- the financial services industry.

Box 1.2: The Lamfalussy arrangements

The Lamfalussy report proposed a new approach to European securities regulation. These new arrangements were introduced in 2001. The four-level approach is as follows:

- **Level 1** consists of legislative acts, namely directives or regulations proposed by the Commission following consultation and adopted under the “co-decision” procedure by the Council of Ministers and the European Parliament. In adopting each directive or regulation, the Council and the Parliament agree, on the basis of a Commission proposal, on the nature and extent of detailed technical implementing legislation to be decided at Level 2.
- At **Level 2**, the European Securities Committee (ESC) assists the Commission in adopting relevant implementing measures. Such measures will be used to ensure that technical provisions can be kept up to date with market developments.
- At **Level 3**, the Committee of European Securities Regulators (CESR) has the objective of improving the consistent implementation of Level 1 and Level 2 legislation across Member States. It also aims to improve enforcement by exchanging information on regulated bodies, and seeks to adopt best practice and ensure consistent regulatory approaches. CESR plays a significant role in providing technical advice to assist the Commission in its development of legislation at Level 2.
- At **Level 4**, the Commission, Member States and financial supervisory authorities work to ensure the implementation and enforcement of EU law.

In December 2002, ECOFIN agreed to extend the Lamfalussy arrangements from the securities sector to the banking, insurance and pensions, and asset management sectors; the European Parliament endorsed this approach in March 2004. Two new Level 2 committees are being created – the European Banking Committee (EBC) and the European Insurance and Occupational Pensions Committee (EIOPC). The new Level 3 banking and insurance committees have already been established, with the Committee of Banking Supervisors (CEBS) based in London, and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) based in Frankfurt. The existing Committee of European Securities Regulators (CESR) is based in Paris.

FINANCIAL INTEGRATION – MARKET DEVELOPMENTS

A changing landscape

1.14 Financial markets are dynamic, quick to respond to events and innovations in products and practices. A recent study⁴ on the location of financial activity identified five factors driving market developments and the location of financial activity. These are:

- **globalisation**, as evidenced by increased integration and the greater global reach of both suppliers of, and customers for, finance. Trends are becoming established more quickly and shocks can be transmitted more rapidly across national boundaries;
- a changing **business environment**, particularly in relation to the ongoing development of regulation and other aspects of public policy towards labour, products, tax and profits;

⁴ *The location of financial activity and the euro*, EMU Study, HM Treasury, June 2003.

- **supply-side determinants**, including the continuing impact of **changing technology** on business and their location choices. This has enabled some financial service providers to outsource parts of their customer-service functions to locations outside Europe, lower their cost base and further enhance their competitiveness;
- changing **business strategies**, in particular consolidation in the EU banking sector and market infrastructure; and
- the **introduction of the euro**, resulting in the abolition of a number of national currencies in Europe and the creation of a European currency which is more widely used internationally than any other, apart from the US dollar.

1.15 Financial market integration in the EU can take a number of forms, such as:

- **cross-border sales**: where a firm in Member State A may sell its products or services directly to users in Member State B;
- **networks of branches or subsidiaries**: where a firm in Member State A may distribute its products or services using its own network in Member State B. This network can be gained through merger or acquisition or could be developed from scratch; and
- **local distribution networks**; where products such as investment funds are produced and managed in Member State A by one institution, and sold in Member State B through the sales network of another institution.

The effect of integration

1.16 It is too early to determine precisely the contribution of the FSAP to financial market integration in the EU. Whilst most individual measures would appear to offer the potential for greater integration, it will be important in the future to measure the extent to which this potential has been realised. That said, it is already clear that wholesale financial markets in the EU are much more highly integrated than retail financial markets⁵ (see Box 1.3):

- in **wholesale financial markets**, the launch of the euro and technological change have acted as catalysts for integration. This has mainly been delivered through market initiatives, sometimes with official support (e.g. from the European Central Bank), rather than by FSAP measures as such. Where integration has not yet been achieved, this is partly due to the continuing fragmentation of the EU's financial infrastructure; and
- **retail financial services**, by contrast, are still largely segmented along national lines, with different products and divergent prices. US experience suggests that a fully integrated retail financial services market in Europe may never emerge. But the degree of integration in the US is much greater than in Europe. Progress towards further integration will take time, though there is some evidence developing in niche markets already.

⁵ This conclusion was endorsed in the Commission's "Financial Integration Monitor" published on 6 May 2004, which describes the outcomes of its work programme to assess economic indicators on financial market integration. For further details see: http://europa.eu.int/comm/internal_market/en/finances/cross-sector/fin-integration/sec-2004-559_en.pdf.

Box 1.3: Indicators of financial integration

In the euro-denominated wholesale markets, financial integration – as evidenced by uniform market prices – is greatest in the case of market products with agreed definitions, common conventions and common infrastructure, for example:

- in the unsecured interbank money market (using TARGET⁶);
- in the overnight interest rate swap markets (based on EONIA⁷);
- in the derivatives markets for money (based on EURIBOR⁸); and
- government bond futures (based on Bunds).

In the euro-denominated debt markets, yield spreads on government bonds are narrow, and in the corporate bond market underwriting fees are comparable in the euro sector to the dollar sector. There is less financial integration in those debt markets for which the financial infrastructure is still fragmented, for example:

- the secured money (i.e. repo) market;
- the short-term securities market; and
- the high-yield debt markets (where different national bankruptcy laws exist).

In equity markets in the EU, the primary market (IPOs and rights issues) is largely segmented nationally, though this may partly reflect the preferences of issuers and investors rather than the existence of barriers to integration. The secondary market (i.e. trading in existing securities) is effectively integrated from the perspective of wholesale investors by the investment banks which trade on their behalf, but investment banks themselves face a geographically segmented market in equity transaction services (e.g. exchanges, clearing and settlement).

In the case of retail financial services, prices (e.g. for consumer credit) and products (e.g. for long-term savings) vary substantially between different countries and sometimes also between different regions. There has been little cross-border retail or small business banking; a small amount of cross-border retail non-life insurance business; some cross-border selling of mutual funds; but very little cross-border life insurance or pensions business.

REMAINING BARRIERS IN THE SINGLE MARKET

1.17 Although wholesale financial markets are in large part already integrated, there are still some barriers to cross-border activity, which include in certain Member States:

- a requirement (e.g. for market makers or brokers) to establish a local presence;
- restrictions on foreign access to domestic trading, clearing and settlement systems; and
- different bankruptcy laws and collateral requirements, which make cross-border lending more difficult.

⁶ The European System of Central Banks (ESCB) real-time cross-border payment system in euro.

⁷ EONIA is the euro overnight index average.

⁸ EURIBOR is the euro interbank offer rate.

1.18 In retail financial services, the main barriers are more deep-seated. Research conducted by the UK financial sector in 2003 found evidence of a large number of practical barriers. Those that have been identified include:

- regulatory resistance to cross-border bank mergers which would enable banks to operate domestically in different Member States. As a result, very few cross-border bank mergers have taken place within the EU; the trend has been towards banking consolidation within countries rather than between them;
- obstacles such as: different consumer protection requirements; difficulties for consumers in moving from one financial services provider to another; fragmentation of retail payment systems; restrictions on provision of electronic financial services across borders; and national credit card restrictions;
- restrictions on products (e.g. rules on product specifications), or delays in authorising them, which pose particular difficulties for new entrants to national markets; and
- costs of registering and complying with regulatory or marketing requirements.

1.19 The EU's future strategy towards financial services should, at least in part, be based on clearly identifying and tackling such barriers.

A NEW STRATEGIC APPROACH

The UK's five priorities

1.20 With the completion of the FSAP now in prospect, the future approach to the integration of financial services in Europe is being discussed. The UK authorities (along with many other Member States and industry practitioners) firmly believe that a second raft of new legislation – or a FSAP “Mark II” – is neither required nor desirable. Instead, new EU legislation should be considered on a selective basis, and only where absolutely necessary. The UK is developing a new strategic approach to financial market integration in Europe. This approach is centred on five priorities:

- **better implementation and enforcement of EU measures affecting the financial sector.** A significant number of the FSAP measures that have been adopted have still to be implemented nationally. That should be a top priority, together with their subsequent enforcement;
- **alternatives to EU regulation.** In general, EU legislation should be a last resort. Alternative approaches to policy making, such as more use of EU competition policy, market-based solutions, and initiatives at national level, should be considered first;
- **better regulation.** In some specific cases, market failure analysis may demonstrate that further new EU legislation in financial services could be necessary. When new EU legislation is being considered, a proper assessment of the costs and benefits should be undertaken, and financial market participants should be fully consulted;

- **making the Lamfalussy arrangements work well.** These new regulatory arrangements are now in place to supervise financial services across the EU. They have been shown to work for securities markets and are being extended to banking and insurance. They need to be further developed; and
- **recognising the global nature of financial services.** Finally, it is crucially important to remember that financial markets are global. A global perspective is needed when considering the impact of EU financial services regulation on the competitiveness of EU-based firms and financial centres, and international action will sometimes be needed to tackle global issues.

1.21 The rest of this document sets out these priorities in more detail. Some additional statistical information is provided in Annex A.

2

BETTER IMPLEMENTATION AND ENFORCEMENT

What are implementation and enforcement?

2.1 As the adoption of the FSAP draws to a close, there is consensus among Member States and market practitioners that a top priority now should be the effective, proportionate and consistent implementation and enforcement of EU legislation.

2.2 Legislative measures in the EU are proposed by the European Commission and – in the case of nearly all the FSAP and related measures – are adopted by co-decision under which the Council of Ministers and the European Parliament consider, amend and agree on the final content of each legislative measure¹. They are published in the *Official Journal of the European Union* and can take the form of:

- **regulations** – rules that apply directly in each Member State, and which do not require transposition into the respective national laws (although there are often some associated legal changes in Member States’ law that are required to achieve the full effect of the regulation); or
- **directives** – rules that must be incorporated in the national law of each Member State, generally by introducing or amending national laws, within a deadline of usually 18-24 months after publication.

2.3 Converting this EU legislation into national law is the first element in implementation. The second is the putting into place of the relevant administrative arrangements on the ground, to ensure that the new rules are observed, again in a proportionate and consistent manner. Businesses must sometimes also change practices as part of the implementation process in a Member State. The third element, sometimes referred to as enforcement, is ensuring that the new rules work effectively and are complied with across the EU.

2.4 Enforcement is the task of ensuring that Member States meet their obligations in implementing EU measures. One route of enforcement is for the Commission to bring a case against a Member State, first as a warning, and then to the European Court of Justice (ECJ). However, individuals and businesses often have rights to ensure that Member States meet their obligations, by bringing cases themselves in the national courts, or ultimately to the ECJ. The Commission also inevitably relies on information from other sources, such as industry, when considering whether to launch enforcement action.

IMPLEMENTATION

The importance of implementation

2.5 Effective, proportionate and consistent implementation of the FSAP and other measures affecting the financial sector is key to delivering the potential benefits of economic integration from EU financial services legislation while avoiding costly burdens on business. This is the challenge that faces the authorities in the UK and the rest of the EU.

2.6 There is increasing recognition that effective implementation of all agreed FSAP and related legislation must precede any attempt to draw up further EU legislation for the financial services sector. By the same token, implementing recently agreed

¹ FSAP and related measures often provide for EU implementing measures (Level 2), which can be regulations or directives, to be adopted subsequently (see Box 1.2).

legislation effectively and enforcing legislation already in place will go a long way to reducing the need for further legislation in future.

Challenge 2.7 Implementation of the FSAP will involve changes to the existing regulatory regime in the UK and in other Member States. It will present a considerable challenge to the financial services industry. The cumulative impact on firms also needs to be considered.

2.8 The UK authorities are taking steps to help UK-based financial services firms to deal with the impact on their business and to prepare for compliance with the FSAP. Alongside this document, the Treasury, FSA and Bank of England have published jointly *The EU Financial Services Action Plan: Delivering the FSAP in the UK*. It focuses on the implementation of the FSAP and related measures in the UK.

2.9 To improve implementation of EU legislation affecting the financial services sector, action is needed:

- at Member State level;
- at EU level; and
- by business.

Action at Member State level

The challenge for Member States 2.10 The challenge for Member State authorities is to implement EU measures into national law in an effective, proportionate and consistent manner, working closely with their counterparts in other Member States. Given the number and complexity of the measures, the FSAP poses a particular challenge. Nevertheless the effective implementation of EU legislation in relation to financial services to date has not been given a high priority.

UK approach to implementation 2.11 To meet the challenge of improving implementation in the UK, the authorities have established internal arrangements, building on best practice, including:

- working closely together to ensure that implementation is handled as seamlessly as possible where more than one organisation (e.g. Treasury and FSA) has an interest;
- putting in place project management procedures to ensure that issues are handled well; and
- ensuring that expertise developed in the negotiation of directives is used in their implementation.

2.12 The UK authorities already lead their counterparts across the EU in the extent and nature of consultation with business. The Treasury, DTI, FSA and Bank of England have substantial contacts with business about EU financial services matters. These arrangements will continue to be developed. In particular concerning financial services measures, the Treasury and FSA will:

- continue to provide updated information about progress in implementing EU measures as well as in negotiating them;
- publish consultation documents jointly, where appropriate, and take account of industry concerns, while recognising that the authorities will be limited by directives and that there will sometimes be tensions between

different industry interests (e.g. between achieving legal certainty about the meaning of some rules and retaining flexibility in the way that business and the authorities can interpret them);

- develop and publish cost-benefit analyses of different approaches to implementation;
- encourage trade associations to work with their member firms to highlight possible difficulties of implementation, particularly those of a practical nature, as early as possible during the negotiation or implementation process; and
- continue to involve consumer representative bodies in the process of implementing EU legislation, as well as the negotiation of it, to ensure that the needs of consumers are taken fully into account.

2.13 While the arrangements in other Member States are a matter for their individual authorities, the UK authorities will encourage others to follow best practice in their own national or local arrangements. Examples of best practice include consultation, transparency and the use of cost-benefit analysis.

Action at EU level

2.14 Effective, proportionate and consistent implementation across the whole EU is necessary to realise the potential benefits of financial services legislation. This has often proved difficult in the past. The UK authorities welcome renewed efforts by all authorities in the EU to work together in implementing EU legislation, minimising unnecessary and costly differences in the process. This is particularly important as businesses want both to operate within a Single Market and to avoid unnecessarily burdensome regulation in their key markets. Sometimes there is a tension between achieving these two goals. Enhanced dialogue at EU level during the early stages of implementation should help to address some of these problems, as should considering implementation issues during negotiations.

Assisting implementation

2.15 The Government and the FSA have encouraged the development of mechanisms to improve implementation across the EU, including:

- pressing successfully for the establishment of the new Lamfalussy arrangements to allow enhanced co-operation, especially between financial supervisory authorities. The FSA is working together with its counterparts through these regulatory networks to ensure that joint action is taken to facilitate the smooth operation of the Lamfalussy arrangements (e.g. CESR has already established several panels and operational networks to help with this – see Box 5.1);
- supporting the voluntary use of “transposition tables”² that make the transposition of directives into national rules more transparent;
- pressing for the widespread use of “transposition groups” to discuss the implementation of individual directives such as the Market Abuse Directive; and

² Transposition “tables” or “notes” explain how the elements of a directive have been, or will be, transposed into national law.

- developing strong links with finance ministries and supervisors in the ten new EU Member States which will be critical to implementation in the Single Market.

2.16 Looking ahead, the UK authorities will press for the continued development of these and other mechanisms, such as:

- the effective cooperation of banking and insurance as well as securities supervisors at Level 3, to address different approaches to implementation and cooperation in the supervision of individual institutions as an alternative to more complex regulatory models of supervision;
- transparency in the way that such committees carry out these Level 3 activities; and
- ensuring that transposition groups operate effectively, involving all the key national authorities.

Role of business

Strategic and practical challenges

2.17 Business needs to be prepared for the changes that the implementation of these new EU measures will bring, both in the UK and other Member States. Broadly speaking, the challenge for business is to:

- **contribute to the process of implementation by the public authorities**, especially via consultation arrangements;
- **prepare for the strategic implications** of the changing market-place. A more integrated market should be more open to competition: this presents commercial opportunities for business, and benefits for customers, but is also a challenge. Measures will affect some business models and markets more than others. Firms need to consider these implications and assess how to take advantage of them; and
- ensure that **business practices and systems** are compliant with changing rules.

2.18 The impacts will vary between different sub-sectors, and from business to business. Businesses will need to form their own views about the steps that they will take, drawing on help from trade associations, public authorities and other sources. It is likely that the changes will require the involvement of senior management as well as staff in the compliance and operating departments. Key issues that businesses will often need to address include:

- **awareness of senior management** about forthcoming changes, in the UK and in other Member States in which firms operate or want to do so;
- **readiness of IT systems**; and
- **knowledge and training of staff**.

Involvement in consultation

2.19 Businesses will typically have at least three months of certainty in which to finalise their arrangements for dealing with the implementation of EU directives in the UK. An advantage to becoming involved earlier is that firms will be able to take the opportunity to influence and inform the implementation of EU measures in the UK, by responding to consultation exercises. Firms in other Member States should look to play similar roles.

2.20 Trade associations and other practitioners' groups have a pivotal role to play in assisting their members through the implementation phase. They will need to remain engaged in working with the public authorities throughout this period, to help inform their approach to implementing specific measures in the UK and elsewhere. They will want to work with their counterparts across the EU and provide evidence-based input to consultation processes. Trade associations should also keep the implementation pressures on their member firms under regular review and advise their respective authorities of any significant changes.

2.21 It is obviously important that consumer bodies are actively involved in the consultation process and are able to assess what the implementation of individual pieces of EU legislation will mean for retail customers and to highlight any potential problems at an appropriately early stage.

ENFORCEMENT

Ensuring effective enforcement

2.22 Effective and consistent implementation of the FSAP and related measures will make enforcement easier. The UK authorities believe that the Commission needs to transform enforcement into a credible tool that will increase the incentives for Member States to deliver effective implementation. This will require a reallocation of resources within the Commission.

2.23 Other organisations also have a vital role to play:

- financial supervisory authorities and Member States have certain obligations to report cases where they believe EU measures are not being implemented elsewhere. The Level 3 Committees also need to play a similar role; and
- businesses, trade associations and consumer bodies must be prepared to bring complaints about the lack of implementation to the attention of their national regulators and the Commission and to initiate their own legal challenges where justified.

3

ALTERNATIVES TO EU REGULATION

3.1 Agreeing regulation, in the form of EU legislation, does not automatically lead to an efficient, integrated Single Market in financial services. As already discussed, EU legislation needs to be properly implemented if it is to have real effects. More importantly, EU regulation will never be the most effective way of tackling all barriers in the Single Market. Reasons for this include the following:

- some **differences are not susceptible to regulation**. For example, businesses themselves must find ways to deal with cultural differences to finance across Europe. Another example is that access to financial infrastructure or ownership of financial institutions is often dealt with by competition policy, not simply regulation;
- EU legislation can sometimes **fail to be sufficiently tailored** to local market needs. It can sometimes be unduly burdensome, or can fail to tackle some localised issues; and
- EU legislation is sometimes **too slow to adapt** to innovation, where market-led developments may be quicker.

3.2 As a result, the UK authorities believe that it is clear that the Commission needs to be much more cautious about legislating on financial services in future. Another FSAP is neither necessary nor desirable. New EU legislation should only be considered when a thorough consideration of the alternatives to legislation has been exhausted; and only then when it can be demonstrated that the legislation in question will produce a clear net proportionate benefit.

3.3 Where significant cross-border barriers remain to be removed, it is necessary for the EU to consider the full range of alternatives to EU legislation. The rest of this chapter looks in greater detail at some of these alternatives:

- competition policy;
- market initiatives;
- measures to improve consumer confidence;
- co-operation between regulators; and
- national initiatives.

COMPETITION POLICY

3.4 The EU competition authorities have a vital role to play in identifying and investigating barriers to competition and instituting remedial action in financial markets. The Commission should always make full use of its competition powers to investigate and intervene in financial services markets where competition is not functioning effectively. In many cases, this could have more impact on helping to create a level playing field for financial institutions, without discrimination, than new directives.

Commission has the power to investigate **3.5** The Commission has the power to investigate not just individual cases, but competition in markets as a whole. This is known as its sectoral inquiry power. It is similar to the market investigations approach which, in the UK, has provided a flexible and powerful tool for improving competition in cases such as the inquiry into the supply of banking services to small and medium sized enterprises¹. In its recent Communication, *A Proactive Competition Policy for a Competitive Europe*², the Commission set out its intention to make more use of this approach in the future. The Government strongly supports this move, and believes that it could be valuable for a wide range of areas including financial services.

3.6 In its recent report on competition in the liberal professions³, the Commission has set out how Member States have responsibilities to ensure that they do not permit unnecessary and anti-competitive regulatory arrangements. The Government believes that this is the right approach and that Member States should seek to ensure that their own regulatory arrangements, in professional services more broadly, provide consumers with the full benefits of effective competition in the Single Market. It supports the Commission in seeking to ensure that Member States comply with their obligations in this regard.

Investigations **3.7** The UK authorities urge the Commission to make greater use of all of its competition powers to tackle barriers to competition, such as taking forward investigations into credit cards, credit bureaux, and market infrastructure – all areas where businesses appear to encounter difficulties in entering national markets in some Member States.

MARKET INITIATIVES

3.8 Market pressure, market-based initiatives and voluntary codes of conduct can also help to promote financial integration in the EU. The authorities also have a role to play in encouraging a market consensus to emerge (see Box 3.1).

¹ *Review of Banking Services in the UK*, Cruickshank Review, March 2000.

² COM (2004) 293.

³ *Report on Competition in Professional Services* European Commission, COM (2004) 83.

Box 3.1: Market-based initiatives for financial integration

Government debt issuance. Since the launch of the euro, government debt management offices have had to compete to attract demand from institutional investors across the euro area as a whole and beyond. As a result of market pressure, government debt issuance has tended to converge on best practice.

Market conventions. The integration of euro wholesale markets has been encouraged by the use of common market conventions sponsored by market associations: e.g. EONIA and EURIBOR (when the euro was launched); and (more recently) EUREPO⁴.

Short-term securities. A group of market participants in the ACI (Financial Market Association) has, with the encouragement of the ECB, begun work on achieving de facto integration of national markets for short-term securities by devising a common set of standards, acceptable in all EU jurisdictions: the “Short-Term Euro Paper (STEP) initiative”. With a STEP label, an issuer should be able to access the short-term European capital market more widely.

Consolidation of financial infrastructure. As a result of market pressure, consolidation of some of the large number of stock exchanges, clearing houses and securities settlement systems in Europe has begun, encouraging a greater degree of financial integration.

3.9 The UK authorities believe there is further scope for market-based initiatives in the future, with or without intervention on the part of the authorities. For example:

- exchanges and information providers working together could help ensure that **financial information** is distributed more effectively on a pan-European basis in real time;
- market associations could continue to produce **standard documentation** for financial transactions, either at European or global level, as the International Swaps and Derivatives Association has already done in the case of derivatives; and user groups could agree common standards, as currently being contemplated in the case of a global standard for security identification; and
- there is an opportunity for non-legislative action by regulators and industry working together to develop **common data standards** for regulatory reporting and publication of price transparency information. This would facilitate market integration through the emergence of consolidated tape and montage services by the private sector, allowing better information to investors and facilitating best execution of securities trades.

MEASURES TO IMPROVE CONSUMER CONFIDENCE

Ombudsman schemes

3.10 Cross-border ombudsman schemes, such as FIN-NET, can sometimes provide dispute resolution procedures without the need for legislation. They also have a major role to play in helping to facilitate a Single Market by giving consumers confidence to buy products on a cross-border basis. However, ombudsman networks would need to be strengthened and consumers made more aware of them, in order for them to be truly effective.

⁴ EUREPO is the rate at which one prime bank offers euro funds to another prime bank against eligible assets as collateral.

Voluntary codes **3.11** Voluntary codes of conduct can also be effective in ensuring a level playing field across Member States. UK experience of codes is that they take some time to become operational and then need fine-tuning to iron out difficulties, including dealing with issues such as coverage and visibility or relevance to consumers.

CO-OPERATION BETWEEN SUPERVISORS

3.12 National supervisors in the banking, securities and insurance sectors meet regularly in the Lamfalussy Level 3 committees (CEBS, CESR, and CEIOPS). The role of these committees is to promote supervisory convergence where appropriate and to improve the consistency and effectiveness of cooperation and enforcement across the EU. This also involves exchanging regulatory information on particular cases.

3.13 When identifying and promoting best supervisory practice, the Lamfalussy Level 3 committees devise common guidelines and non-binding standards. Peer reviews also assist regulators with implementation. The Lamfalussy Level 3 committees issue public consultation documents and have established their own industry and consumer panels, or are about to do so.

3.14 By operating in this way it is possible for regulators to support the Single Market by minimising unnecessary supervisory differences and by ensuring that existing EU legislation is enforced effectively. It may be possible for effective activity at Lamfalussy Level 3 to achieve the same results more quickly and more consistently, than would previously have been secured through the introduction of new EU legislation.

NATIONAL INITIATIVES

3.15 In many cases, progress towards a Single Market in financial services – including the removal of cross-border barriers – can be made through legislative and other initiatives at national level. In practice, considerable progress has already been made through national legislation in Member States over the past few years.

3.16 National initiatives have been diverse, reflecting local needs. Nevertheless some important themes can be detected:

- **reforms to supervisory architecture**, typically consolidating responsibility for supervising financial institutions into one or a reduced number of agencies;
- **modernising and liberalising laws to cope with innovation** in the financial markets, through new products and technological change; and
- **adapting to other developments**, such as the free movement of capital and the introduction of the euro.

4

BETTER REGULATION

4.1 Chapter 3 outlined the need for a full range of non-legislative solutions to market barriers to be used, with EU legislation being used only where alternatives are not suitable. This Chapter looks at those instances where, after a full consideration of the alternatives, EU regulation may be considered necessary.

4.2 Examples of proposals currently under discussion that need to follow this better regulatory approach include:

- the **3rd Capital Adequacy Directive** – a draft proposal has been prepared for a Directive to modernise the framework under which the capital requirements imposed on banks and investment firms are calculated, to implement Basel II in the EU. The UK authorities welcome the fact that there has already been consultation, including with industry, and impact assessments of this directive. They call for this approach to continue throughout the negotiations;
- the **2nd Insurance Solvency Directive** – work is under way to amend the regime governing the minimum solvency margin for insurance companies (the “Solvency 2” project). This will need to be subject to a thorough impact assessment and to “competitiveness proofing” before such a proposal can proceed; and
- **clearing and settlement** – the Commission has recently published a Communication suggesting a series of initiatives including a Framework Directive on Clearing and Settlement. More comprehensive market failure and cost-benefit assessments are required, and any proposal should be prepared in draft form and issued on a consultation basis.

MARKET FAILURE AND COST-BENEFIT ANALYSIS

4.3 The UK authorities believe that, before intervening in financial markets, analysis of the alleged market failure is required. This analysis should be done on an EU-wide basis in order to produce an objective assessment of what, if any, failures exist in a given area of financial services, their nature and extent.

4.4 Financial services policy proposals should be based on such analysis. Proposals should then be subject to cost-benefit analysis. The rule of thumb in determining whether EU legislation is appropriate should be that the market failure analysis clearly identifies a need for it, and the cost-benefit analysis of the policy proposals that flow from this analysis demonstrates that the benefits of regulation outweigh the costs.

QUALITY LEGISLATION

4.5 When new EU legislation is needed, its quality is critical. To improve the quality of EU legislation two important steps include:

- the Commission’s Better Regulation Action Plan in 2002; and
- the Joint Initiative on Regulatory Reform in January 2004 by the Finance Ministers of the current and three succeeding EU Presidencies.

Better Regulation Action Plan

4.6 In 2002, the Commission adopted a Better Regulation Action Plan, which introduces:

- a system of impact assessments, with extended assessments for all significant proposals;
- a programme of simplification and modernisation of existing legislation with the objective of removing unused or outdated legislation as well as unnecessary complexity; and
- an eight-week consultation period for legislative change.

Joint Initiative on Regulatory Reform

4.7 To build on the momentum of the 2002 initiative, the Finance Ministers of Ireland, the Netherlands, Luxembourg and UK – the current and three succeeding EU Presidencies – published in January 2004 a Joint Initiative on Regulatory Reform¹, which aims, among other things, to:

- enhance the quality of impact assessments by continuing efforts to develop capacity to produce and evaluate these assessments;
- use impact assessments to “competitiveness-proof” all proposals by the Competitiveness Council;
- ensure that the analysis provided by impact assessments actually influences the decision-making process;
- encourage the Council, Commission and the European Parliament to make greater use of imaginative, outcome-based approaches to legislation: for example, mutual recognition can, in many areas, allow for greater progress in delivering shared objectives; and
- encourage the Commission to make greater use of review clauses in legislation (to provide triggers for evaluating the impact of legislation over time), extending them to a significant proportion of all new EU legislation.

4.8 Improving the quality of new legislation is an important step in the right direction. But it will do little to improve the stock of existing legislation. So the UK welcomes the Commission’s attempts to address this area in its 2002 Better Regulation Action Plan. As part of the Joint Initiative on Regulatory Reform, the Government has called for:

- agreement to a targeted process to simplify EU regulation during 2004 and 2005, including the Council and Commission agreeing a specific timetable for the process, focusing on those areas in which the impact on business and competitiveness is greatest;
- Member States to provide the Commission with examples of legislation that their companies find particularly burdensome, thereby allowing the Commission to consider including such legislation in its current simplification programme (and allow the potential benefits of this programme to be maximised); and

¹ *Joint Initiative on Regulatory Reform. An initiative by the Irish, Dutch, Luxembourg and UK Presidencies of the EU, January 2004.*

- the Inter-Institutional Agreement on Better Law Making² to be implemented, and the Council of Ministers and European Parliament to come to an agreement to modify their working methods to help simplify legislation.

4.9 The joint initiative has been widely welcomed. At the Spring European Council, Heads of State and Government called for a programme of action to drive it forward. The European Council will return to the subject in November, providing an opportunity to assess progress, and the Government is committed to translating this high-level mandate into real change.

4.10 These disciplines and initiatives need to be applied to all areas of EU legislation, including financial services. The UK authorities will work to ensure that these proposals are applied in practice to financial services policy-making in the EU. A number of characteristics of financial markets make this especially important, such as:

- their **complexity**, and the consequent complexity of regulation which means policy decisions need to be well informed by real market expertise;
- the **speed of innovation and change** which means regulation can become obstructive or outdated;
- their **global nature**, referred to in Chapter 6, that emphasises the need for competitiveness-testing; and
- the **opportunities for mutual recognition** around core standards, where Member States have used different methods to achieve broadly similar results.

THE ROLE OF CONSULTATION

Role of the authorities

4.11 As discussed above, consultation and transparent decision-making is critical to producing good legislation, especially in fast-moving, complex fields such as financial services. The UK authorities welcome the steps taken by the Commission and CESR in this respect in the past year or so.

4.12 However, they also believe that improvements can continue to be made, including:

- better feedback on the results of consultation and especially why views have been rejected;
- more time scheduled for consultation in the EU processes and in national levels for implementation; and
- the swift introduction of effective consultation arrangements by CEIOPS and CEBS.

² See the following: <http://www.cabinet-office.gov.uk/regulation/Europe/beteureg/comact/interint.asp>.

Role of business 4.13 Business must also play its part in this process, both in formal consultation and as proposals for legislation are negotiated. In particular:

- business and trade associations must **organise themselves** to contribute effectively. They must work together through EU groupings where possible. Pan-EU firms need to speak with a consistent message. Senior executives need to give EU issues a high priority;
- they must provide **evidence, facts and figures** to influence the policy process; and
- the need to **prioritise** their concerns clearly.

5

MAKING THE LAMFALUSSY ARRANGEMENTS WORK WELL

5.1 New regulatory structures, set up under the Lamfalussy framework (see Box 1.2) designed to make the regulatory process more effective and transparent are now in place. Although relatively recent in formation, they appear to be working well. However, the priority now is to ensure the Lamfalussy arrangements truly deliver a more efficient framework for the introduction and delivery of financial services legislation, and for cooperation on the supervision of individual firms.

THE LAMFALUSSY ARRANGEMENTS

5.2 The Lamfalussy arrangements are explicitly designed to improve the quality of new legislation, promote consistent interpretation and ensure convergence in national supervisory practices, so that co-ordination between the network of national regulators can be made more effective without stifling financial innovation or imposing unnecessary costs¹.

5.3 Initially, the Lamfalussy arrangements applied only to the regulation of the securities market (through CESR). Now it has been extended to the regulation of banking (through CEBS) and insurance and occupational pensions (through CEIOPS) as well, and CESR has taken on the role of asset management too². The recent decision to locate the three Lamfalussy Level 3 committees in separate national financial centres reinforces the decentralised nature of EU financial services regulation and supervision.

5.4 The Lamfalussy arrangements have had an encouraging start³. But there are a number of issues that need to be addressed if it is going to work well in practice:

- where the balance should lie, in future, between regulations and directives;
- which regulations and directives should be taken through the Lamfalussy arrangements and which should not;
- how much detail needs to be specified in regulations and directives at Level 1, rather than in Level 2 measures;
- whether the Commission, when it proposes technical implementing measures at Level 2, should be obliged to explain publicly any departure from the technical advice it has received;
- how to ensure effective, proportionate and consistent implementation of Level 1 and 2 measures, including through the network of national regulators at Level 3; and
- whether the process is being followed as efficiently as possible and the extent to which the consultation processes are effective.

¹ The network of national regulators also provides a forum in which to investigate market complaints.

² The Committee of European Securities Regulators (CESR) was set up on 6 June 2001. The Committee of European Banking Supervisors (CEBS) and Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) were set up on 5 November 2003, with effect from 1 January 2004 and 24 November 2003 respectively.

³ The first and second reports of the Inter-Institutional Monitoring Group on *Monitoring the Lamfalussy process* have been largely positive. The second report says that "the Lamfalussy process is proving to be a viable instrument for improving the efficiency and speed of financial market legislation and regulation in the EU" (December 2003).

LEGISLATION

5.5 The UK authorities believe that the Lamfalussy framework needs to be further developed, to ensure that the legislation it introduces is as targeted as possible. This suggests that, going forward, the Lamfalussy arrangements need to encompass:

- enhanced **consultation** with business;
- greater **transparency**; and
- **better regulation principles**.

Consultation during legislation **5.6** One of the main lessons of the FSAP is that there are benefits both for legislators and regulators in consulting market participants at each stage in the process, and publishing the results. To be effective under the Lamfalussy arrangements, this requires a genuine dialogue, which cannot be rushed. But by taking market soundings on whether legislation is really necessary, and improving the quality of legislation that results, time and costs will be saved in the longer run.

Transparency **5.7** Greater transparency in the legislative process is also central to the new arrangements. Open exchange of information and ideas enables greater scope to learn from best practice and enables as full as possible consideration of all the issues and legislative options.

Better regulatory principles **5.8** As set out in Chapter 4, there is broad agreement in the EU that new legislation proposed needs to closely follow the “better regulation” principles as set out in the Joint Initiative on Regulatory Reform to ensure that, among other things, future EU legislation on financial services going forward is better targeted at reducing specific market barriers.

IMPLEMENTATION AND ENFORCEMENT

5.9 The Lamfalussy arrangements have a significant role to play in implementation and enforcement, described in Chapter 2. With the legislative process at Levels 1 and 2 now in place and functioning broadly as intended, more attention needs to be focused on turning the legislative layer into reality through effective implementation and enforcement. The FSA is working together with other regulators through the regulatory networks (CEBS, CESR, CEIOPS) in ensuring that all joint action taken at Level 3 facilitates smooth operation of the new legal framework.

5.10 The Level 3 committees are well placed to help to carry forward work on transposition of EU law. This should ensure that implementation issues are not allowed to develop into enforcement problems. To help with this, CESR has already established a number of panels and networks (see Box 5.1), some of which are already operational. CEBS and CEIOPS are expected to adopt a similar approach to overseeing the implementation process in the banking, insurance and pensions sectors.

Box 5.1: Panels and operational networks established by the Committee of European Securities Regulators

CESR has to date established several arrangements to encourage co-operation:

- **Market Participants Panel** – has an explicit obligation to alert CESR to regulatory inconsistencies in the Single Market.
- **Review Panel process** – involves a self-assessment of the status of implementation of CESR's own standards. The plan is to extend it to self-assessment of the implementation of EU measures. The assessments will be published to allow market forces to bring pressure for improvements.
- **Operational networks** (e.g. CESRpol, CESRfin) – encouraging greater discussion between regulators on how they deal with individual cases should produce a much better understanding of the day-to-day implementation of the legal framework.

SUPERVISION

Supervisory convergence

5.11 Making the Lamfalussy arrangements work is likely to be easier to achieve if – as originally argued – there is a degree of convergence between national models of regulation, although these models are, of course, a matter for national decisions. Integration of the supervision of different parts of the financial sector into one organisation has been greatest in the UK, Sweden, Denmark, Germany, Austria, Ireland and Belgium. There is also a considerable degree of integration of financial services regulation in the Netherlands, Finland and Luxembourg – and prospectively in Italy, though not in France⁴. However, the distribution of powers and competence between government and regulators in different Member States varies considerably.

5.12 Following the success of CESR in securities, CEBS and CEIOPS are now taking the lead in bringing about the convergence of supervisory practice in banking and insurance respectively across the EU. In addition, the Brouwer reports have examined the arrangements for ensuring financial stability – and in particular crisis management – across borders in the EU. These are regularly reviewed. The UK authorities support the need for flexible, responsive arrangements across Europe and internationally to deal with crises reflecting financial markets. They support:

- greater use of **memoranda of understanding** between authorities;
- the need for effective, joined up arrangements **within individual Member States** (such as the UK's tripartite approach⁵); and
- more **practical testing** of systems, scenarios and back-up arrangements by authorities.

⁴ *Creating a single financial market in Europe: what do we mean?* Speech by Sir Howard Davies at the London School of Economics, 3 February 2004.

⁵ Close co-operation between the UK finance ministry (HM Treasury), central bank (Bank of England) and financial regulatory authority (FSA).

6

RECOGNISING THE GLOBAL NATURE OF FINANCIAL SERVICES

Global markets 6.1

Financial markets are becoming increasingly global:

- the leading market firms in wholesale financial markets are all global;
- capital moves globally;
- many of the challenges of financial supervision and financial crime are global in nature; and
- even retail financial services are being outsourced on a global basis.

6.2 The Chancellor of the Exchequer recently reiterated the case for a Europe that:

*“recognises that it is no longer a trade bloc isolated from the rest of the world but a Europe that must be outward looking ...and must radically reform to meet the global competitive challenge.”*¹

Given the role that financial services play in the economy, this should apply to financial services as much, if not more, than other activities.

THE GLOBAL CHALLENGE

6.3 The challenge posed by the global nature of financial markets is three-fold:

- the **global nature of some financial problems**, such as financial crime, requires policy makers in the EU to work with others elsewhere. Solving a problem in one country, or even across the EU, will often lead to its re-emergence elsewhere. As a result of the connections between financial markets, solving a problem in one location does not necessarily remove the risks in others;
- global policies towards financial services need to help promote greater **openness and integration**, so as to contribute globally to achieving the same objectives as the FSAP: reducing the costs of capital, improving the efficiency of allocating capital and risk, and improving choice and competition. Yet they must also recognise the need for proportionate protection of financial market users; and
- EU-based institutions and EU financial centres are **competing internationally in a global economy**, in a line of business that can rapidly move location in response to unfavourable regulatory developments (see Box 6.1). This is an additional reason why the principles of better regulation need to be followed in financial services. Moreover, the regulation of financial markets can have indirect effects on the competitiveness of the wider economy – if, for example, costs of capital for investment are increased.

¹ Speech by the Chancellor of the Exchequer for the opening of Lehman Brothers European Headquarters, London, 5 April 2004.

Box 6.1: Competition among international financial centres.

Financial centres in the EU face competition from centres elsewhere. London is Europe's largest financial centre and there are key advantages to the rest of Europe from retaining its international role. Its main competition is New York, especially in wholesale market business such as corporate finance. But it is also subject to competition from specialist centres outside the EU, such as Bermuda (insurance) and Zurich and Geneva (personal wealth management). Independent research² suggests that London is perceived to have one of the most favourable regulatory environments, and that this is expected to remain in five years time.

In this respect, London scores very highly, beating other major financial centres. In particular, London scored 4.18, compared with New York's 3.84 (on a scale of 1-5) in an assessment of regulatory environments. Looking ahead, London also scores best, with 50 per cent more people believing that it will have a better regulatory environment in five years than New York will. But the UK authorities believe that there is no room for complacency, because this gap can always be closed. The fact that such a high proportion of London's financial regulation is driven by EU developments shows the importance of getting EU regulation right to sustain this essential component in Europe's economy. The UK authorities will work to ensure that London remains an open, appropriately regulated, global financial centre.

6.4 This chapter considers how the EU should tackle these issues, in four key areas:

- the transatlantic relationship;
- other bilateral relationships;
- world trade; and
- working with the industry.

THE TRANSATLANTIC RELATIONSHIP

The importance of the transatlantic relationship

6.5 The EU Single Market can and should benefit from open dialogue between the key parties in the EU and the US. The EU and the US are the two largest economies in the world, accounting together for about half the GDP of the world economy. Transatlantic flows of trade and investment amount to over \$1 billion every day. Increasing competitiveness in these key markets is a priority and where some of the largest benefits will be achieved. These benefits can, and must, then be extended to others, and the lessons learnt through this co-operation extended globally.

6.6 Other key stakeholders see the importance of this key relationship. In a recent speech the Danish Prime Minister, Anders Fogh Rasmussen, stated that:

*“There is a clear need for co-operation to be strengthened, and a starting point could be the actual and difficult challenges facing both parties.”*³

² *Sizing up the City – London's Ranking as a Financial Centre*, Centre for the Study of Financial Innovation (CSFI), June 2003.

³ Speech to the Danish Institute for International Studies, 9 March 2004.

The Commission President, Romano Prodi, has also reiterated the need for close co-operation:

*“Ever-greater openness and integration between our economies translate into greater well-being, more jobs and better-quality products and services. Substantial ground has already been covered. I am thinking of financial services, civil aviation, competition policy and issues relating to the development of the E-economy.”*⁴

Box 6.2: The transatlantic relationship – key facts

- The transatlantic relationship accounts for up to \$2.5 trillion of commercial transactions each year, including \$500 billion of foreign trade, and provides employment to over 12 million people on both sides of the Atlantic⁵.
- In 2002, 17.1 per cent of EU goods imports were from the US, while 24.4 per cent of exports were to the US. Roughly 40 per cent of all EU trade in services was with the US.
- Over half of US foreign direct investment in the banking and finance sector is located in Europe and around three-quarters of EU foreign direct investment in banking and insurance is invested in the US.
- It has been estimated that the full liberalisation of transatlantic trade would lead to an annual income gain to the EU of up to 2 per cent of GDP and for the US of up to 1 per cent of GDP – with the additional benefit to the EU arising from the positive impact that openness to US competition would have on economic reform in Europe⁶.

**Strong EU-US
financial
market co-
operation**

6.7 Progress is being made through dialogues between EU and US bodies (see Box 6.3) on several issues. Continuing dialogue is critical to ensuring that the implications of regulation for both US firms in the EU and EU firms in the US are fully understood. A key goal of such dialogues to date has been providing information and increasing awareness of legislation to uncover potential problems at an earlier stage. This has been successful: relationships and communications networks have been built between key stakeholders such as the European Commission and the US Treasury; the SEC and CESR; and the European Parliament and both the Senate and the House of Representatives.

⁴ Speech to the International Advisory Board - Paris, 12 March 2004.

⁵ *Drifting Apart or Growing Together? The Primacy of the Transatlantic Economy*, Center for Transatlantic Relations, Johns Hopkins University, 2003.

⁶ *Enhancing Economic Co-operation Between the EU and the Americas: An Economic Assessment*, Centre for Economic Policy Research, May 2003.

Box 6.3: EU–US financial services dialogues currently in progress			
	EU involvement	US involvement	Objectives
Financial markets regulatory dialogue	European Commission	US Treasury; Securities and Exchange Commission; Federal Reserve Board	Informal discussion of current regulatory problems
Insurance dialogue	European Commission	National Association of Insurance Commissioners	Information exchange on regulatory and supervisory practices
Mixed Technical Group	European Commission desk officers, Member State experts	Securities and Exchange Commission; Federal Reserve Board	Appropriate supervision of financial conglomerates
Securities regulators' dialogue	Committee of European Securities Regulators	Securities and Exchange Commission	No formal objectives Information sharing
Insurance regulators' dialogue	Committee of European Insurance and Occupational Pensions Supervisors	National Association of Insurance Commissioners	No formal objectives information sharing
Legislators' information exchange	European Parliament's Economic and Monetary Affairs Committee	House of Representatives Financial Services Committee	No formal objectives Information sharing
Accounting standards dialogue	International Accounting Standards Board	Financial Accounting Standards Board	Convergence between US and International Accounting Standards

6.8 A number of current issues are being discussed through these channels. These issues will have significant effects on financial institutions. They include:

- risk management through **Basel II**;
- convergence in **accounting standards** between US GAAP and IAS;
- **credit rating agencies**;
- **International Organisation of Securities Commissions'** (IOSCO) standards;
- **auditor registration**; and
- supervision of **financial conglomerates**.

6.9 Good progress has been made. In particular, dialogue has brought both sides close to an agreement on auditor registration and there has been significant movement on accounting standards issues.

Opportunities to move co-operation forward

6.10 The present dialogues are a good start, and provide a structure through which current issues can be discussed as and when necessary. However, a long-term goal should be for parties to work together not just on specific problems, but to make global financial services deeper, broader and more efficient. To achieve this goal, the UK authorities believe that there is opportunity to progress the dialogue to enable both sides to:

- **understand each other's approach to regulation** still further, enabling issues to be resolved as early as possible; and
- **identify key drivers for change in the global financial system**, and consider a shared approach to these.

6.11 The UK authorities believe that there are a number of steps that can be taken in the short and medium term towards these objectives:

- **widening the dialogue** to include relevant and timely input from other key stakeholders such as the Financial Services Committee, CEBS and CEIOPS, and the financial sector and its users; and
- creating a **more forward-looking agenda** by consulting earlier on proposed changes to regulation, and considering longer term strategies towards convergence to improve market efficiency.

6.12 A more forward-looking agenda could be advanced by considering a broader range of topics that, while not yet critical, might raise issues for the future, such as:

- opportunities for integrating capital markets;
- future approaches to the supervision of clearing and settlement;
- potential convergence of listing and delisting rules;
- development of common approaches to recognising mutual funds; and
- opportunities for forging an international supervisory regime for reinsurance.

OTHER BILATERAL RELATIONSHIPS

6.13 Looking forward, there is also opportunity to learn from EU-US co-operation to enhance collaboration between the EU and other countries and regions. There are examples of where this is starting.

Canada 6.14 A Trade and Investment Enhancement Agreement was signed between Canada and the EU in March 2004. This is committed to looking at, amongst others, enhanced regulatory co-operation across all sectors and financial services in particular. Apart from the benefits of increasing co-operation with an important EU trading partner, any increased co-operation should help increase incentives on other key regions to do likewise, with economic benefits in turn.

Australia 6.15 Other EU trade partners also offer an opportunity to enhance regulatory co-operation. Australia, for example, counts the EU as its biggest trade partner: financial services have become an increasing export in recent years. Increased co-operation, possibly through mutual recognition agreements (and through reciprocal recognition of Australian firms), could provide better access to EU firms, enhanced competition and better choice for EU customers.

6.16 The UK authorities believe that these and other bilateral relationships deserve to be developed further.

WORLD TRADE

6.17 Whilst realising that supervisory issues are not trade issues and should not be brought into trade negotiations, there are several areas of the global financial services marketplace that could be enhanced through successful multilateral trade negotiations. Current barriers in terms of anti-competitive practices that inflate consumer prices and thus benefit the few at the expense of the many, can be targeted and ended through global negotiations and increased liberalisation.

6.18 The Government is a strong supporter of, and committed to, the World Trade Organisation (WTO) and the Doha Development round of negotiations. There are many benefits to multilateral negotiations, overall and specifically for financial services:

- it is estimated that the current WTO round will boost developing countries' income by \$150 billion a year, stimulating all economies, industrialised and developing;
- more than half of all global flows of foreign direct investment are in the services sector. Access to modern services (e.g. financial and professional) is essential to growth, development and increased stability. WTO commitments are vital to attracting this investment: providing transparency, continuity and stability in trade rules;
- the UK financial sector exports significantly. In 2002 financial services' net exports stood at £17.8 billion. Further multilateral liberalisation would increase this figure: the financial services expertise in London is renowned and can be well utilised in developing countries to help the progress of their financial sectors, and to encourage increased stability; and
- they enable liberalisation to be secured for all WTO members, thus avoiding the risk of excluding some countries that are most in need.

WORKING WITH INDUSTRY

6.19 To understand the effects of regulation on global competitiveness it is important to consult and work alongside the financial services industry. Issues and potential solutions as seen on the ground can then be fed into the dialogue early. This will enable comprehensive solutions to be found, through a wider understanding of the issues, from both regulatory and industry expert standpoints.

6.20 The Transatlantic Business Dialogue (TABD) has recently set out its principles for enhancing transatlantic co-operation. A key principle is that governments should establish processes that will strongly encourage and enable regulatory bodies on both sides of the Atlantic to work together, including with the private sector, in a collaborative way, to ensure that new barriers to trade and investment are not created. Although the TABD is looking across all business sectors, the financial sector is key, especially given its complexity and its importance to the rest of the economy.

6.21 The UK authorities encourage the financial sector internationally – and its users – to work together constructively to identify the opportunities for, and quantify the benefits from, greater international co-operation. Cross-border trade and business associations in Europe have contributed to the development of a Single Market in

financial services in the EU: similar international groupings could provide more leadership internationally.

SECURITIES

The stock of international securities issued in the EU rose from €746 billion at end-1993 to €5,615 billion at end-2003 (source: BIS).

Gross corporate (and other non-government) bond issuance in euro grew from €184 billion (in legacy currency) in 1998 to €471 billion in 1999 and €766 billion in 2003 (source: Dealogic).

The share of bonds in euro-area corporate financing grew from 4.7% at end-Q1 2000, at the height of the equity market upswing, to 8.7% at end-Q3 2003 (source: ECB).

Gross equity issuance by euro-area companies (other than financial institutions) fell, reflecting the equity market downturn, from €213 billion in 2000 to €43 billion in 2002 and €42 billion in 2003 (source: ECB).

BANKING

The number of banks in the EU fell by 15% from 9,077 in 1997 to 7,756 in 2002. There are 0.51 bank branches per inhabitant in the EU compared to 0.26 in the US (source: Deutsche Bank Research (2003), quoted in Expert Group on Banking).

Around 25% of EU bank deposits and 30% of life assurance premiums are with financial conglomerates (source: Expert Group on Banking).

The share of EU banks' non-interest income (as a proportion of gross income) rose from 28.3% in 1992 to 42.5% in 2001 (source: Expert Group on Banking).

Between 1993 and 2002, the time needed to make a cross-border cash transfer of €100 within the EU fell from 4.5 to just under 3 days. The fee charged fell from €24 to €17 (source: Commission).

INSURANCE

EU insurance premium income amounted to €822 billion in 2001. Over 1991-2001, life business grew from 3.0% to 5.4% of GDP, while non-life business remained at 3.2% (source: Expert Group on Insurance and Pensions).

The number of insurance companies operating in the EU fell from 4,974 to 4,608 between 1991 and 2001 (source: Expert Group on Insurance and Pensions).

The EU insurance industry employs 900,000 people directly, and 460,000 people indirectly in distribution (source: Expert Group on Insurance and Pensions).

ASSET MANAGEMENT

The European asset management industry manages over €10 trillion for employees, households and private investors: roughly equivalent to EU GDP (source: Expert Group on Asset Management).

The total assets of euro-area pension funds and insurance companies grew from €2.4 trillion (with 17% invested in equities) at the end of 1997 to €3.7 trillion (with 17% invested in equities) at the end of the third quarter of 2003 (source: ECB).

Net assets held in EU investment funds (both UCITS and non-UCITS) increased from €1.3 trillion in 1993 to over €4.6 trillion in 2003 (source: Expert Group on Asset Management).

Private equity investment in Europe rose from €4 billion in 1993 to €27.6 billion in 2002 (source: European Venture Capital Association (2003)).

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