The EU's Financial Services Action Plan

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INTRODUCTION

The work to establish a single market for financial services in the EU was initiated in the 1970s but only really gathered momentum in connection with the capital liberalisation and the 2nd generation directives in the late 1980s. The introduction of the euro as the single currency has strengthened this process. The European Commission's Financial Services Action Plan was introduced in 1999 and includes 47 proposals aimed at removing the remaining legislative and regulatory barriers to a single financial market in the EU. The proposals must be adopted at the latest by April 2004 and implemented by the member states by 2005. Presently 36 proposals have been finally adopted. In 2001 a new decision-making procedure, the Lamfalussy process, was introduced in order to make the regulation process for securities markets more efficient.

This article takes stock of the work of creating a framework for financial integration in the EU, focusing on the following three areas: the key measures in the Financial Services Action Plan, the Lamfalussy process and future work.

FINANCIAL INTEGRATION

Financial integration implies that previously separate national financial markets start functioning as one integrated market. An integrated financial market, as in the USA, offers a number of advantages. The first is more liquid financial markets and a wider product range. This enables investors to diversify their investments. Furthermore, competition is intensified within the group of banks and other financial intermediaries, resulting in a wider range of financial products and lower prices. Finally, with the improved diversification possibilities, the supply of risk capital increases. A study by London Economics, PricewaterhouseCoopers and Oxford Economic Forecasting at the request of the European Commission concludes that due to lower funding costs in banks and on the financial markets, financial integration will in the longer term lead to an increase in the EU-wide real GDP by 1.1 per cent.[1]

The EU creates the overall legislative and regulatory framework for an integrated financial market. Subsequently the degree of financial integration is primarily determined by the market participants' behaviour. Barriers in the form of language and cultural differences, high non-recurring costs when entering a new market, insufficient knowledge of markets and business enterprises in other countries and the need for personal contacts may lead to a low degree of financial integration even though the legislative framework is in place. Thus wholesale markets are generally more integrated than retail markets because the retail markets are characterised by cultural and language differences across countries and by a greater need for personal contacts. Furthermore retail markets may be more influenced by national consumer legislation, tax rules, etc.

The study by London Economics and others estimates that the financial integration in the EU has increased significantly during recent years as a result of the work of establishing a single financial market in the EU, the introduction of the euro, technological advances and globalisation. This has led to *inter alia* the development of more financial products and a gradual shift in business enterprises' sources of financing from traditional bank-based financing and towards an increasingly market-based approach to raising capital. Another effect is that households have become increasingly active in the stock markets.

The financial integration in the EU has not yet reached the level in the USA, however.

STATUS OF THE FINANCIAL SERVICES ACTION PLAN

Since the work of establishing an internal financial market started in the 1970s a large number of measures has been implemented in order to create secure and uniform conditions with regard to supervision and regulation to enable financial institutions to trade across national borders.

The introduction of the euro has accelerated the integration process and increased the authorities' and market participants' focus on removing the remaining barriers. At the European Council in Cardiff in 1998 it was decided to request that the European Commission table an

[1] London Economics in association with PricewaterhouseCoopers and Oxford Economic Forecasting, *Quantification of the Macro-Economic Impact of Integration of EU Financial Markets*, November 2002. Other similar studies include Friedrich Heinemann, Mathias Jopp, The Benefits of a Working Retail Market for Financial Services, Report to the European Financial Services Round Table, 2002, as well as Paolo Cecchini, *The European Challenge 1992. The Benefits of a Single Market*, 1988.

action plan which could bring the EU to completion of a single financial market.

In 1999 the European Commission launched the Financial Services Action Plan. The Action Plan prioritises the work of implementing the single financial market and aims to remove legislative and regulatory barriers that prevent the establishment of secure and integrated financial markets within the EU. The Action Plan contains 42 original and 5 supplementary proposals to be implemented by 2005. A key element is to refine and expand the common rules for providers of financial services, the "European passport" for financial services. The European passport enables financial providers who are approved in one EU member state to provide the same financial products in another EU member state without a new approval. The Action Plan seeks to ensure financial stability in a world of integrated financial markets and with financial providers operating across industries and national borders. This includes clear and uniform supervision rules and very close cooperation between supervisory authorities across national borders. The contents and status of the key measures are described in Box 1.

Presently 36 of the 47 proposals in the Action Plan have been adopted[1]. The European Council has decided that all proposals must be adopted by April 2004 at the latest. This gives the member states at least 18 months until the implementation deadline in 2005, taking account of the elections to the European Parliament in the summer of 2004. Initially, proposals regarding the securities market should have been implemented in 2003, but some proposals are expected to be adopted only in 2004. The IAS Regulation, the Financial Conglomerates Directive and the directive on insider dealing and market manipulation were adopted during the Danish EU Presidency, and political agreement was reached on the Prospectus Directive.

THE LAMFALUSSY PROCESS

The Lamfalussy process is a decision-making procedure introduced on securities markets in 2001. In 2002 it was proposed that the process be extended to the entire financial area (credit institutions, insurance and pensions, and securities). The introduction of the Lamfalussy process aimed at ensuring more efficient regulation on securities markets in order to keep up with the rapid development and to provide for implementation of the extensive financial services action plan within the time limit. Previously, the legislative process tended to be slow and the

[1] European Commission, *Progress on the Financial Services Action Plan*, Annex, 25 November 2003.

CONTENTS AND STATUS OF KEY MEASURES Box 1

In the following the contents of the key measuress are summarised, and the status of the individual measures appears from the Table.

The financial markets

Directive on insider dealing and market manipulation contains common rules to combat market abuse in the EU. The directive updates the existing EU rules on insider dealing, which are 10 years old, so that new financial products are included. Common rules on regulation of market manipulation have been added as well.

Directive on takeover bids aims at harmonising rules for cross-border acquisitions of listed companies in the EU. The purpose is to strengthen the legal certainty of cross-border takeover bids and to ensure protection for the minority shareholders.

The IAS Regulation stipulates that listed companies prepare their consolidated accounts in accordance with the international accounting standards. The provisions will enter into force on 1 January 2005. The regulation, among other things, contributes to removing barriers to cross-border securities trading as the companies' financial information becomes more transparent and comparable.

The Investment Services Directive should promote the creation of transparent, efficient and integrated financial markets by requirements of increased transparency on the markets and harmonisation of the rules concerning the various types of marketplace[1]. Furthermore the protection of investors in the EU member states is sought enhanced through harmonising the conduct of business rules and ensuring the best execution of a securities deal for the client. The directive replaces the current directive from 1993 which is out of date in areas such as investor protection, types of investment services on the market and the market structure.

The Prospectus Directive is to create better and more uniform conditions for investing and raising capital in the EU. This implies e.g. that a prospectus which has been approved in one member state can freely be listed and offered in all other member states and thus obtain a European passport for prospectuses. Another objective is to enhance consumer protection for investing in securities. The directive thus contains a number of provisions on the contents of prospectuses to make them more uniform.

The objective of *the Transparency Directive* is to lay down minimum requirements to harmonise the information to be published by issuers of securities listed in a regulated market, e.g. a stock exchange. The information on the issuers of the securities should contribute to better investment decisions.

The UCITS directives include provisions on e.g. authorisation, supervision, investment policy and transparency requirements for investment funds (UCITS) and management companies. An important element is to enable the management companies to achieve a European passport that gives access to operate in other member states. In addition, the directives adjust the current UCITS directive to the market development as regards the included products.

Financial supervision

The Capital Adequacy Directive comprises capital-adequacy provisions for banks, other credit institutions and investment undertakings and is to a large extent based on the standards of the Basel Committee, Basel II[2]. The existing capital-adequacy rules, the Basel I Accord, from 1988 have contributed to ensuring a level playing field for banks

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with cross-border activities. However, new financial products and more sophisticated risk management in the credit institutions have called for more up-to-date rules. The objective of the new Basel II Accord is for the capital requirement to reflect more clearly the risks incurred by the individual credit institution.

The Financial Conglomerates Directive aims at ensuring a level playing field for different types of financial groups by imposing a number of obligations that transcend sector divides and national borders. Furthermore, coordination of supervision across borders is stated. The directive seeks to take account of a number of group risks, including ensuring that capital is solely used to meet capital requirements in one company within the group; that group structures are transparent; that intra-group transactions take place on market terms; and that risks in one company do not contaminate other entities of the group.

STATUS OF MEASURES IN THE FINANCIAL SERVICES ACTION PLAN Table

Pending proposals	*Plan for proposal*
Reinsurance Supervision Directive	1st quarter 2004
3rd Money Laundering Directive	2nd quarter 2004
Directive on risk-based capital (capital adequacy)	2nd quarter 2004
Legal framework for payments	2nd quarter 2004
14th Company Law Directive	3rd quarter 2004
Directive on insurance solvency II (capital adequacy)	2005
Presented proposals which are not adopted	*Plan for adoption*
Directive on Take Over Bids	1st quarter 2004
10th Company Law Directive	1st quarter 2004
Transparency Directive	1st quarter 2004
Investment Services Directive	2nd quarter 2004
Adopted proposals which are not implemented	*Implementation deadline*
Directives on UCITS (amendments)	1st quarter 2004
Directive on fair value accounting	1st quarter 2004
Directive on the taxation of savings income	1st quarter 2004
Directive on winding-up of credit institutions	2nd quarter 2005
Financial Conglomerates Directive	3rd quarter 2004
Directive on distance marketing of consumer financial services	4th quarter 2004
European Company Statute	4th quarter 2004
Directive on insider dealing and market manipulation	4th quarter 2004
Regulation on international accounting standards	1st quarter 2005
Directive on modernising of the accounting provisions	1st quarter 2005
Directive on insurance mediation	1st quarter 2005
Directive on prospectuses	2nd quarter 2005
Directive on institutions for occupational retirement provision	3rd quarter 2005

Source: European Commission, Progress on the Financial Services Action Plan, Annex, 25 November 2003 and European Commission, The FSAP enters the Home Straight, Ninth progress report, 25 November 2003.

[1] The Investment Services Directive is described in Birgitte Bundgaard and Anne Reinhold Pedersen, The Investment Services Directive – a New Basis for Securities Trading in Europe, Danmarks Nationalbank, *Monetary Review*, 4th Quarter 2003.

[2] The Basel Committee's proposal for new standards is described in Lisbeth Borup and Morten Lykke, New Capital-Adequacy Rules for Credit Institutions, Danmarks Nationalbank, *Monetary Review*, 3rd Quarter 2003.

THE LAMFALUSSY PROCESS Box 2

The Lamfalussy process was established at the recommendation of the Committee of Wise Men on the Regulation of European securities markets chaired by Professor Alexandre Lamfalussy, former President of the European Monetary Institute. The Committee of Wise Men was set up by the Ecofin Council in July 2000 with a view to making regulation in the securities markets more efficient. The Lamfalussy process in the securities area was adopted by the European Council in Stockholm in March 2001 and includes:

- Level 1: The European Commission presents proposals for legislation based on advice from a number of committees, cf. below. The proposals lay down the key general principles and are adopted in co-decision by the Ecofin Council and the European Parliament.
- Level 2: The technical details laid down within the framework of level 1 are considered under the comitology procedure. Here the European Securities Committee (ESC) together with the European Commission lay down the rules following advice by the Committee of European Securities Regulators (CESR).
- Level 3: The CESR proposes consistent implementation of specified rules. The CESR can provide voluntary guidelines and common standards. The supervisory authorities also cooperate in the CESR.
- Level 4: The European Commission supervises that the member states comply with the provisions. If necessary, the European Commission can bring action against the member states at the European Court of Justice.

In December 2002 the Ecofin Council decided to extend the Lamfalussy process to the remaining financial area (credit institutions, insurance and pensions). In connection with the extension a number of new committees are established with a view to advising the European Commission under level 1, participating in the comitology procedure under level 2 and ensuring uniform implementation of the provisions (supervision) under level 3 in the new areas as regards the Lamfalussy process. The proposed committee structure for the entire financial service sector is summarised in the Chart and the Table overleaf.

The advisory and comitology committees are composed of high-level representatives from the relevant national ministries, while the supervisory committees are composed of high-level representatives from the national supervisory authorities. Central banks without supervisory responsibilities are also represented in the Committee of

result could reflect some legal uncertainty, e.g. due to political disagreement which gave room for national interpretation.

Under the Lamfalussy process the Ecofin Council and the European Parliament adopt the legal framework that lays down key principles in the area in question (level 1). The technical measures are adopted under the so-called comitology procedure whereby the European Commission, assisted by senior representatives from the relevant national ministries, prepares detailed rules within the given framework (level 2). Further-

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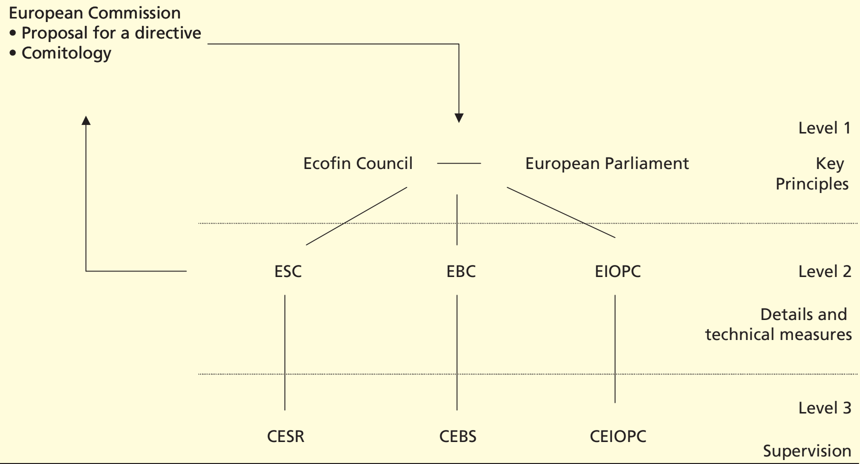
European Banking Supervisors (CEBS). The directive on insurance solvency II is considered under CEIOPS as the first directive in this structure.

PROPOSED FINANCIAL SERVICES COMMITTEE STRUCTURE



PROPOSED FINANCIAL SERVICES COMMITTEE STRUCTURE Table

	Banking	Insurance and pensions	Securities
Advisory function for level 1, Comitology function under level 2	The European Banking Committee (EBC)	The European Insurance and Occupational Pensions Committee (EIOPC)	The European Securities Committee (ESC)
Supervisory function under level 3	The Committee of European Banking Supervisors (CEBS)	The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)[1]	The Committee of European Securities Regulators (CESR)

Source: The Commission of the European Communities, Proposal for a directive of the European Parliament and of the Council amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 93/6/EEC and 94/19/EC and Directives 2000/12/EC, 2002/83/EC and 2002/87/EC of the European Parliament and of the Council, in order to establish a new financial services committee organisational structure.

[1] Henrik Bjerre-Nielsen, Director General, Danish Financial Supervisory Authority, is the chairman of CEIOPS.

more, a number of supervisory committees have been appointed in order to e.g. advise the European Commission and the regulatory committees on supervision issues and ensure uniform implementation of the rules (level 3). In many ways the process is similar to the Danish legislative process in the financial area where the Folketing (Parliament) promulgates acts with the overall framework, while the Danish Financial Supervisory Authority lays down the technical rules in executive orders. The Lamfalussy process is described in detail in Box 2.

A special committee, the Financial Services Committee, FSC, has been appointed. The committee consists of senior officials from the national ministries of finance and economic affairs. FSC advises the Ecofin Council and the European Commission on financial integration issues. The tasks of the FSC include supervision of implementation of the Action Plan, clearing and settlement as well as corporate governance in relation to financial markets. The FSC also advises on coordination and cooperation between national authorities in the areas of crisis management and financial stability.

Experience with the Lamfalussy process

The Lamfalussy process distinguishes between political legal framework principles (level 1) and technical measures (level 2) in order to make the legislative process more efficient. It is important to strike the right balance between the two levels. The legal framework under level 1 must be of a general nature to give the European Commission and the national officials room to develop the technical details. At the same time the legal framework should settle the most important political differences so that these are not left for the European Commission and the officials to resolve.

The initial measures in connection with the Lamfalussy process are the directive on insider dealing and market manipulation, the Prospectus Directive, the Investment Services Directive and the Transparency Directive. A group appointed by the European Commission, the Ecofin Council and the European Parliament assesses that generally the process is faster and more efficient than the previous practice[1]. For example, it took less than one year to adopt the second Investment Services Directive, whereas it took six years to adopt the first one in 1993. However, experience also shows that it has been difficult to strike the right balance between level 1 and level 2 in the legislative process. There are incidences of too detailed framework principles that leave insufficient room for the comitology procedure[2], and incidences where political differences were not resolved satisfactorily under level 1. Finally, it is generally agreed that the national implementation of the directives is not always uniform.

FUTURE WORK TOWARDS FINANCIAL INTEGRATION

The legislative part of the Action Plan is now in its final phase. As the last proposals are adopted focus will shift towards timely and uniform

[1] Inter-Institutional Monitoring Group, Second Interim Report Monitoring the Lamfalussy Process, December 2003.

[2] ECB, *Monthly Bulletin*, October 2003, The integration of Europe's financial markets.

implementation of the directives in the individual member states, including the acceding countries, and adjustment of legislation in line with the development in the financial markets. Also, the dialogue on regulation of the financial markets with authorities outside the EU, e.g. in the USA, will be enhanced.

The European Commission has set up four expert groups within the areas of banking, insurance, securities and asset management to assess the effectiveness of the measures in the Action Plan and the status of financial integration in the EU. The expert groups' reports will be published for consultation during the summer of 2004.

There are strong indications that the decision-making process within the financial area will be changed with the new constitutional Treaty for the EU. Negotiations on the draft Treaty Establishing a Constitution for Europe broke down at the EU Summit in Brussels in December 2003, so the development is still uncertain. The draft Treaty presented at the EU Summit in Brussels in December 2003 suggests a decision-making process similar to the Lamfalussy process. However, the essential difference is that the proposed decision-making process does not contain a comitology procedure in which national experts are consulted. On the other hand, it is acknowledged that the comitology procedure can be maintained as a voluntary consultation procedure. The Irish Presidency has not yet indicated how negotiations on the constitutional Treaty will be continued.

FURTHER INFORMATION ON THE FINANCIAL SERVICES ACTION PLAN

Further information on the EU's Financial Services Action Plan can be found using the following links:

- The European Commission: http://europa.eu.int/comm/internal_market/finances_en.htm
- The European Parliament, the Committee on Economic and Monetary Affairs: www.europarl.eu.int/committees/econ_home.htm
- The Committee of European Securities Regulators (CESR): www.europefesco.org
- Federation of European Securities Exchanges (FESE): www.fese.be/initiatives/european_representation/index.htm