CENTRE FOR EUROPEAN REFORM
policy brief

Over but far from finished – the EU's financial services action plan

By Alasdair Murray

★ The EU deserves credit for completing the legislative phase of its ambitious financial services action plan (FSAP) on time. However, doubts remain about the quality of some of the legislation. As a result, confidence in the EU's ability to deliver a competitive single market in financial services has waned.

★ The long-term success of the FSAP will depend on the effective implementation and enforcement of the new rules. In particular, the internal market directorate-general will need to devote more resources to ensuring that member-states fully implement the new legislation.

★ Demands for a further ambitious legislative agenda for retail financial services, or even the creation of a single regulator – a 'Euro SEC' (or 'Euro Fed') – may increase in the future. However, the EU must provide sufficient time for the current raft of reforms to bed down before it starts thinking about new work.

The EU has now all but completed the legislative phase of its financial services action plan (FSAP). The action plan is an attempt to reduce the legal obstacles which prevent businesses – whether banks, insurance companies or stock exchanges – from selling their services seamlessly across the EU.

A well-functioning financial services sector is vital for the competitiveness of the European economy. Its role is to ensure the efficient allocation of capital, mobilize savings and help to discipline company management. Access to low-cost capital promotes the growth of new and innovative businesses. London Economics, a UK consultancy, estimates that the benefits from integrating Europe's wholesale capital markets could amount to €130 billion, or 1.1 per cent of EU GDP, over the next decade.[1]

[1] *London Economics, 'Quantification of the macro-economic impact of integration of EU financial markets', November 2002.*

On paper, at least, the FSAP is a success. The EU has reached agreement on 39 of the plan's 42 measures. Of the three outstanding measures, only the capital adequacy directive – which sets the rules for how much money banks must set aside to help guard against insolvency – can be described as very important. And the EU is not to blame for the delay: the Commission was not able to issue a draft directive until July 2004, when discussions on global guidelines on bank capital (the so-called Basel II accord) were completed. Overall, the EU deserves credit for delivering such an ambitious legislative action plan on time.

However, financial services companies, particularly those based in the City of London, have become increasingly critical of the quality of the legislation. In a frantic effort to meet the 2005 deadline, member-states sometimes reached less than satisfactory compromises on key legislation. At other times, the EU has reneged on its commitment not to produce overly detailed or cumbersome legislation. Bogged down in endless rows over the fine print of new directives, the EU risks losing sight of the plan's potential economic gains. As a result, some firms, and even the British government, appear to have lost confidence in the EU's ability to deliver a competitive single market for financial services.

It is too soon to judge whether the legislative measures will prove a success, as the Commission admits in its latest progress report on the action plan. The

Centre for European Reform
29 Tufton Street
London SW1P 3QL UK
T: 00 44 20 7233 1199
F: 00 44 20 7233 1117
info@cer.org.uk / www.cer.org.uk

Commission, member-states and regulators must now focus on the effective implementation and enforcement of this raft of new legislation. In particular, the FSAP could still founder on residual protectionist behaviour by national regulators and governments.

A botched job?

The Commission, the Council of Ministers and the European Parliament displayed an unusual degree of political goodwill to ensure the FSAP was finished on schedule. Many of the measures contained in the plan were of a technical nature and provoked little controversy. But when member-states and MEPs discussed the most important directives, such as those on investment services, prospectus and takeovers, political differences soon re-emerged. As a result, EU governments are in danger of losing sight of the many positive elements of the FSAP, such as the pensions and collateral directives, which should help cut costs for firms doing cross-border business.

Member-states finally reached an agreement on the takeover directive in December 2003, after more than a decade of trying. The directive seeks to create a level playing field for corporate mergers and acquisitions. The Commission had proposed outlawing 'poison pill' defences against a takeover bid, such as the right of directors to sell off subsidiaries or issue new shares without the permission of shareholders. German businesses and politicians fought hard against this proposal. They feared that prominent German companies, such as Volkswagen, could become vulnerable to foreign takeovers. Heavy German government lobbying persuaded the European Parliament to vote down an earlier version of the directive in 2001. The final text of the directive does ban companies from taking defensive actions during a takeover battle without the express permission of shareholders. But all member-states retain the right to opt-out of this provision. Moreover, even companies from countries that have not opted out, may still use poison pills if the takeover bid comes from a country which allows such defences.

Another controversial clause in the directive seeks to ban multiple voting rights. Family-run firms often issue different classes of shares, some of which have greater voting rights, to ensure that the family retains control. But member-state lobbying, in this case led by Sweden, resulted in a provision that allows EU countries to opt out of the general ban on multiple voting rights. These opt-outs mean that there is little chance the directive will achieve its original aim of encouraging more cross-border mergers and takeovers within the EU.

Many financial services firms are equally disappointed with the final outcome of the investment services directive (ISD). The directive (now renamed the directive on markets in financial instruments) establishes common rules for firms wishing to compete across the EU. It is the cornerstone of the EU's drive to create a single market in financial services.

In November 2003, Italy – which at the time held the EU's rotating presidency – forced through a protectionist amendment to the text of the directive, despite the strong opposition of Britain, Ireland, Sweden, Finland and Luxembourg. This amendment threatened to impose costly disclosure rules on investment banks that trade shares on their own books, a practice known as 'internalisation'. The City of London claimed that such measures, which seemed designed to protect the Italian and other smaller stock exchanges from investment bank competition, would cost EU businesses up to €450 million a year due to higher share trading costs.

The European Parliament eventually succeeded in hammering out a compromise which went some way to addressing the concerns of financial services firms, in particular by exempting larger share trades from some of the disclosure rules. Whether the final directive will thus raise the costs of share trading and hamper innovation, as some investment firms claim, remains open to question. The Commission, for example, counters criticism coming from the City of London by insisting that the potential gains from the new legislation far outweigh the costs. The directive means that firms operating across the EU will no longer need to comply with 25 different sets of rules of conduct. The directive has successfully curbed protectionist rules, such as the 'concentration' principle which allowed governments to restrict trading in domestic shares to nominated exchanges. Moreover, the Commission argues that the directive as a whole is modelled on UK rules. Thus London-based firms – which are used to operating under the UK regulatory system – will gain a competitive advantage over their continental European rivals.

The dispute over the ISD has also overshadowed the economic gains that other parts of the EU's action plan will deliver. For example, the European Federation for Pension Retirement estimates that the pensions directive will save multinational companies as much as €10 billion a year. This directive will mean that firms can for the first time operate a single pension fund for all their European employees, and it will reduce restrictions on where such funds can invest. Similarly, the collateral directive will reduce the costs of cross-border financial transactions. This directive introduces common rules for how firms trade collateral, that is the provision of cash or shares as a form of deposit in financial transactions.

Ultimately, the real damage of the ISD affair is political as much as economic. Until the Italian amendments, the City of London had assumed that as the largest financial services centre in Europe its views would take precedence. But its defeat over the ISD has left a bitter taste, and many City firms now seem to have lost faith in the EU's ability to deliver a competitive single market in financial services.

Similarly, the British government, which was once the most enthusiastic proponent of the FSAP, has now come out against any further major EU legislative initiatives in financial services. The ISD row seems to have reinforced a latent scepticism within the powerful British Treasury – with potentially damaging repercussions for other aspects of the UK's fractious relationship with the EU.

Legislative indigestion

The FSAP will not be enough on its own to create a fully functioning single market in financial services. But the EU should pause to take stock before proposing a second action plan. Many financial firms fear that they will suffer from regulatory indigestion, while they spend the next few years implementing 14 major legislative measures.

Moreover, businesses are concerned that new institutional arrangements – based on recommendations made by the Lamfalussy group of experts – are not working as well as had been expected. The Lamfalussy group aimed to speed up the passage of financial services directives by reducing the volume of legislation which needed to pass through the EU's long-winded codecision procedure (where the Commission proposes draft legislation and the Council and European Parliament jointly decide). Now the Council and the European Parliament are supposed to concentrate on reaching agreement on the broad principles of new legislation. Meanwhile, the Commission – aided by a series of expert committees – prepares the detailed 'technical' rules necessary to implement the new directives. This system should ensure the EU can respond more swiftly to innovations in the financial services sector, such as new products, or resolve minor problems with rules and regulations.

However, firms complain that the Commission and the member-states still produce overly complex directives. Businesses also want the Committee for European Securities Regulators (CESR) – and the other 'Lamfalussy committees' recently established for the insurance and banking sectors – to consult more extensively with the private sector, before drawing up detailed rules for new legislation.

The Commission has begun a thorough review of the financial services action plan, indicating that its immediate priority is to ensure that member-states implement the legislation effectively. In particular, the Commission has promised to do more to help EU governments turn the new legislation into national rules and regulations. Commission officials have established a single point of contact in each finance ministry and will provide support through regular meetings.

The Commission's initiative to help member-states transpose the FSAP directives is welcome. But many financial services firms remain unconvinced that the Commission can prevent governments from adding protectionist measures when they implement key directives into national laws. For example, pension fund trade associations have expressed concern that some member-states are imposing extra restrictions on how company pension funds may invest, thereby limiting the benefits of the pensions directive.

Similarly, the CESR should carefully monitor implementation by the national regulators. The CESR should produce a report each year that examines the degree of regulatory convergence across the EU, and suggest areas where the Commission might need to take further action. This is particularly important in the far less developed capital markets of central and eastern Europe. The new members will struggle to implement the FSAP, given that many do not even comply with long-standing EU rules on financial services, such as those on capital adequacy requirements and deposit insurance. The CESR should encourage a system of exchanges between national regulators to help spread best practice throughout the member-states. Such a scheme should help raise standards not just in the new member-states but right across the EU.

The internal market directorate-general also needs to devote more resources to ensure all member-states fully enforce the new legislation. The Commission has recently set up a dedicated enforcement team to try and prevent member-states from bending the rules. However, many financial services firms argue that the Commission still does not see enforcement as a priority.

The internal market DG, which leads the Commission's work on the single market, is the epitome of a legislative department. Thus the most able officials secure promotion by working hard on new legislation, and then move on to drafting fresh directives, leaving the less glamorous work of helping member-states with transposition or enforcement to others. Charlie McCreevy, the new commissioner for the internal market and services, should make clear that that the tasks of implementation and enforcement are just as valuable as that of drafting directives.

The Commission also needs evidence of wrongdoing before it can take action. At the moment, firms fear they will face reprisals from national regulators or government officials if they bring forward cases of inconsistent or protectionist behaviour.

The Federation of European Securities Exchanges (FESE) has proposed the creation of a European ombudsman for financial services companies. Such an ombudsman would examine a grievance and anonymously transmit an appraisal of the case to the CESR. The ombudsman would then pass more serious cases onto the Commission for consideration should the CESR fail to reach a satisfactory resolution.

However, the FESE proposal would involve the CESR signing up to a binding ombudsman statute, a requirement which is likely to take a considerable amount of negotiation. In the meantime, the Commission should encourage national ombudsmen to seek out and pass on cases with a cross-border element more actively.

An ambitious new agenda?

In May 2004, four expert groups reported to the Commission with suggestions for the post-FSAP agenda. The consensus was that businesses have little appetite for further legislation. This view is echoed in a recent report from the British Treasury which insists that the Commission "needs to be much more cautious about legislating on financial services in the future. Another FSAP is neither necessary nor desirable."

In the immediate future, the Commission is proposing only modest further legislation for the financial services sector. Aside from completing the outstanding elements of the action plan, the Commission has proposed two new directives designed to open up clearing and settlement systems – the 'back-office' tasks of paying for shares and transferring paperwork – to more competition. Cross-border clearing and settlement services undoubtedly remain too expensive. However, some analysts question whether the EU needs to resort to legislation, as opposed to deploying its competition powers. For example, the Commission recently used those powers to force Clearstream, a subsidiary of Deutsche Börse, to open up its clearing and settlement systems to cross-border trades and to refrain from discriminatory pricing.

The Commission may also propose legislation designed to create a pan-EU market in retail investment funds (known in EU jargon as UCITS). The industry complains that existing EU rules have failed to create a single market. Funds still need to be registered in every member-state where they are sold, while national taxation rules often penalise the cross-border merger of funds. As a result, the sector remains fragmented and EU investors pay higher charges than their US counterparts.

In the longer term, the Commission may find it difficult to resist pressure to bring forward a more ambitious legislative agenda, if not a fully-fledged 'FSAP II'. The existing FSAP has focused on the securities markets and has not done a great deal to shake-up the EU's sheltered retail financial services sector.

Some banks are now proposing that the EU should adopt a retail financial sector action plan. EU leaders are likely to find this idea attractive: any measure that cuts costs in the personal banking sector would appeal directly to voters. And retail markets are considerably less integrated than securities markets, with products and consumer protection rules varying widely across the EU.

However, this lack of integration means that any harmonisation will be even more complex and politically contentious. Firms operating in relatively liberal markets, such as the UK, fear that any attempt to harmonise rules would result in the EU introducing more restrictive regulations in the guise of protecting consumers.

Before taking any action in the retail sector, or any other financial sector, the Commission must conduct a proper cost-benefit analysis. The Commission has just started to publish a financial services integration monitor, which employs a series of statistical measures to determine the degree of integration in Europe's financial services sector. In theory, the monitor should help the EU to decide where it might need to take further action to encourage greater integration. In practice, however, the quality of the data is poor and it yields little information about where further legislation might be appropriate (as the Commission privately admits). The Commission should ask the private sector for further help in defining and collating a meaningful set of financial services indicators.

In the meantime, the Commission could propose a modest step towards encouraging greater integration within the EU's retail banking sector. Financial services firms complain that some national banking regulators abuse prudential supervision rules, which are designed to protect a member-state's banking system from collapse, to block any cross-border mergers or takeovers. The EU should define these prudential rules more tightly to help curb such protectionist tendencies. The EU should also oblige banking regulators to act in a more transparent fashion and state publicly when and why they have intervened in a banking merger or takeover.

Some governments, most notably that of Germany, have indicated that they would like to see the EU working towards the creation of a single European regulator: a 'Euro SEC' or 'Euro-Fed' (ideally located in Frankfurt). They see the CESR, and the new banking and insurance committees, as a step towards this goal. The assumption is that the EU's new financial services regulatory framework will encourage some harmonisation but will not remove all the barriers to an effective single market. In particular, regulatory supervision will remain highly fragmented, with 60 bodies responsible for overseeing EU and national securities market rules in the 25 member-states. Thus, at some point in the future, businesses and governments could conclude that this relatively informal regulatory system is insufficient, and that the Union needs a permanent central body to oversee national regulators and police the single market.

However, the case for a single European regulator is far from proven, while the technical and political obstacles to its creation mean there is little hope of progress in the immediate future. The establishment of the CESR, and the other Lamfalussy committees, should help to drive gradual regulatory convergence across the EU. The private sector may also support integration by choosing to base operations in those member-states where regulators are most attuned to the market's needs. The EU should postpone any grand new ambitions and focus on delivering its existing promises.

Alasdair Murray is the director of the business and social policy unit at the CER.
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