CENTRE FOR EUROPEAN REFORM *policy brief*

A half-finished job: the EU's financial services action plan

By Alasdair Murray

★ The EU's financial services action plan (FSAP) is reaching a critical phase with a raft of contentious legislation due to be completed in 2003. The EU should not let global stock market problems, or a diminishing appetite for economic reform, distract it from the goal of creating a single market in financial services by 2005.

★ The effective implementation of the Lamfalussy proposals should accelerate EU decision-making on financial services rules. The EU should enshrine the Lamfalussy principles in its new constitutional treaty and ensure that the European Parliament can play a proper scrutiny role.

★ It is premature to talk about a second FSAP. Some obstacles to cross-border trade in financial services are likely to remain after the completion of the existing plan. However, the EU's priority, particularly after enlargement, must be the effective implementation and enforcement of already agreed measures.

At the Lisbon summit in March 2000, EU heads of government signed up to an ambitious programme designed to achieve a viable single market in financial services by 2005. The financial services action plan (FSAP) is an attempt to reduce the legal obstacles which still prevent businesses – whether retail banks, insurance companies or stock exchanges – from selling their wares seamlessly across the EU.

A well-functioning financial services sector is vital for the competitiveness of the European economy. It ensures the efficient allocation of capital, mobilises savings and helps to discipline management. Access to low cost capital promotes the growth of new and innovative businesses, which the EU desperately needs if it is to reach its goal of becoming the world's most competitive economy by 2010.

A single market in financial services would also help European countries to overhaul their pensions systems, as ageing populations become a rising burden on state finances. Most EU member-states are likely to need to encourage the growth of equity-based private pension funds. Private pension funds will further stimulate the development of European equity markets, boosting liquidity and lowering the cost of capital. The recent European Financial Services Round Table report on the integration of European financial services – including banking, capital markets and insurance funds – estimates that the creation of a functioning single market in financial services would add around €43 billion annually to the EU economy. The EU would then raise its underlying economic growth by up to 0.7 percentage points each year.

The EU has so far signed off just over half of the financial services action plan's 44 measures – including important legislation such as the EU company statute and common rules on the distance selling of financial services. Moreover, EU heads of government underlined their commitment to completing the FSAP on time at the Barcelona summit in March 2002. However, the vast majority of the action points already completed are straightforward non-legislative measures, such as a review of corporate governance provisions in EU member-states. The Council of Ministers and the European Parliament are yet to begin discussions on many of the most complex – and politically controversial – aspects of the FSAP, such as the investment services directive, which establishes the ground-rules for investment banks and stock exchanges which trade across the EU (see box).

The coming year (2003) will show whether Europe can establish an efficient and flexible regulatory regime for the financial services sector. The

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Commission has worked hard in 2002 to prepare a draft of the investment services directive and a revised takeover directive. The implementation of the Lamfalussy recommendations – which are designed to speed up EU law-making for the financial services sector – should also help. But it is not clear that member-states will be as willing as the Commission to stick to the FSAP's tight timetable.

A waning appetite for reform?

The EU found it difficult to push forward the financial services reform programme in 2002, due to national elections in France and Germany. The Commission, for instance, deliberately held back a revised version of the takeover directive until after the German election was completed in September (see below).

Now that the electoral cycle is complete, the EU should in theory be able to speed up completion of the FSAP. But economic reform appears to have slipped down the EU's agenda. Member-states have focused their energies on the final preparations for enlargement and the related issue of reforming the EU budget and Common Agricultural Policy. Moreover, EU governments are pre-occupied with the debate about the future of the EU's Stability and Growth Pact – a number of eurozone countries, including France and Germany, look set to breach the terms of the pact in 2003.

As a result the FSAP does not appear to be one of the EU's priorities, despite the commitment made at Barcelona. Meanwhile, declining global stock markets and accounting scandals – such as those at Enron and Worldcom – have not helped the cause of liberalisers. They fear that the more protectionist-minded member-states, such as France and Italy, could exploit these problems to slow implementation of the FSAP in the name of 'investor protection'.

The Commission, for example, wants to remove the so-called 'concentration' provision from the investment services directive, which permits member-states to restrict trading in domestic shares to certain exchanges. Italy and some of the smaller member-states are keen to water-down any change to this provision to help protect their domestic stock exchanges from full-scale European competition.

The Commission also intends to amend the investment services directive to allow all banks in the EU to trade shares on their own books – a practice known as internalisation. At present, Britain, Germany and the Netherlands permit internalisation – and it is only commonplace in the former. The Commission argues that allowing banks to internalise will increase competition across Europe and lower the cost of equity trading – provided suitable investor protection rules are also in place. But smaller exchanges, which fear the major investment banks will steal their business, are already lobbying EU governments hard to outlaw, or at least impose costly restrictions on banks, which adopt this practice.

The Commission will also face an uphill task in pushing through the takeover directive. In 2001, the European Parliament voted against a previous version of the directive – which seeks to establish minimum standards for the conduct of takeover bids – after a concerted lobbying campaign by the German government.

In the autumn of 2002, the Commission published a revised version of the directive, which attempted to redress some of the German grievances. In particular, the new draft would allow the state of Lower Saxony to maintain voting control over car-maker Volkswagen.

The omens for the successful passage of the new directive are not good. German business groups and politicians complain that the directive would still discriminate against German companies because it would outlaw 'poison pill' defences – such as the right of directors to sell off subsidiaries of the company without the prior approval of shareholders. On the other hand, the Commission's new draft does not attempt to ban shares which carry different voting rights – used to preserve family control of businesses on the stock markets in some member-states, most notably in Sweden.

The EU should not link these two issues. The former relates to the freedom of directors to break-up or sell important parts of a business without the consent of the investors who own the company. The latter is a matter of long-standing property rights – the EU would undoubtedly face a challenge from family shareholders over the appropriation of their rights if it attempted to outlaw multiple voting structures. However, Klaus-Heiner Lehne, the European Parliament's rapporteur for the directive, has already said that he may seek to amend the directive to encompass a crackdown on multiple voting rights. Sweden, which is one of the most enthusiastic supporters of the Commission's version of the directive, is likely to find such a move unacceptable. A cynic might suppose that the German government will pursue a more radical version of the takeover directive in order to ensure that it fails.

Making Lamfalussy work

Up until the Lamfalussy high-level committee reported in 2001, the Council and the European Parliament needed to agree every last detail of financial services legislation – a time-consuming process. The EU took seven years to pass an earlier version of the investment services directive, while member-states have still not reached agreement on the takeover directive after more than a decade of trying. Under the Lamfalussy plan, however, the Council and the Parliament are supposed to agree only the broad political principles of the new legislation. Two new expert committees – the European Securities Committee, consisting of finance ministry representatives, and the Committee of European Securities Regulators (CESR) – are charged

with working alongside the Commission to fill in the detailed 'technical' elements of the directive.

The European Parliament initially expressed concern that the new arrangements would diminish scrutiny of important legislation, and even lead to the new committees disguising important political decisions as 'technical' matters. However, in the spring of 2002 the Commission succeeded in brokering a compromise: the Parliament would enjoy 'equivalent treatment' to the Council of Ministers, meaning that it can now recommend changes to proposals produced by the expert committees during a three month scrutiny period. The Parliament also persuaded the Commission that a 'sunset' clause should be written into the new procedures: the Commission's powers to use the Lamfalussy method will lapse after four years, unless all institutions agree to extend them.

In October 2002, EU finance ministers agreed to extend the Lamfalussy model to the banking and insurance sectors. The European Parliament, however, has again expressed concern that its powers may be curtailed by this reform. MEPs are calling on the Council and the Commission to guarantee their rights to 'call-back' rules and regulations produced by these new committees.

The dispute between Parliament and the Commission means that the Lamfalussy method is only now being applied to capital market legislation. EU financial services companies are broadly supportive of the new measures, but there is concern that too much power might become concentrated in inscrutable expert committees. For instance, CESR has interpreted a clause in the market abuse directive, which was originally intended to force investment analysts to declare their share-holdings, as also applicable to financial journalists. Media groups claim the new rules are unworkable and were never intended to apply to journalists in the first place.

The European Parliament may also continue to hold up some pieces of legislation – despite the agreement over its role in scrutinising directives. Some MEPs remain concerned that the expert committees could decide on too many important points of principle. They would prefer to take a 'safety-first' approach and suggest detailed amendments to the original directive, rather than rely on the more restricted powers of scrutiny permitted under the Lamfalussy agreement. For instance, MEPs proposed around 100, often highly detailed, amendments to the market abuse directive, delaying the passage of that important piece of legislation.

For all these potential problems, Lamfalussy does represent a major step forward and should help the EU to at least come close to meeting the FSAP deadline of 2005. The EU should enshrine the Lamfalussy principles in the constitutional treaty which is under discussion in the Convention on the Future of Europe – and extend them to all expert committees, not just those working on financial services issues. Thus the EU should give the European Parliament three months to formally scrutinise all measures produced by expert committees, if it so chooses. MEPs should then be able to exercise a veto if the legislation is of poor quality, or if the Commission and the expert committees have exceeded their implementing powers. But the Commission should be able to appeal to the Council to override a Parliamentary veto. The expert committees should also be subject to the same consultation and transparency procedures as the Commission, so that, businesses and other interested parties are able to participate in the development of detailed EU rules and regulations.

After the FSAP: enforcement is the priority

The EU may only be half-way towards the completion of the action plan, but some officials and businesses are already talking about the need for a second FSAP. The existing FSAP will probably not create a perfect single market in financial services: a number of legal obstacles to effective cross-border competition are likely to remain in place, particularly in the retail sector. For example, the very different fiscal and legal treatment of pensions in member-states means that progress on creating a single market place is likely to be painfully slow. Moreover, the sheer pace of change in financial services means that some FSAP measures risk becoming out of date by the time they are transposed into law in all the member-states.

But many businesses are already complaining of the burden of implementing the new directives. Rather than rushing ahead with a second FSAP, the EU should give the financial services sector a chance to adjust to the new rules.

In reality, the remaining obstacles to a fully functioning single market are as likely to arise from improper implementation or enforcement of FSAP measures as from the absence of appropriate rules. EU enlargement will only add to the difficulties of ensuring the even implementation and enforcement of EU rules and regulations: many of the ten new member-states possess inexperienced, and under-resourced, financial regulatory bodies. The EU's priority immediately after the completion of the existing FSAP should be effective enforcement.

The Commission does recognise that proper enforcement is a problem. It only has a small staff (120) working on financial services and is already struggling to meet the FSAP's legislative timetable. Moreover, the Commission often finds it difficult to prepare clear-cut infringement cases. EU financial services legislation is complex and sometimes ambiguous, although taking some test cases to the European Court of Justice could help to clarify

matters. Businesses have also been reluctant to bring their own complaints to the Commission, because of fears they could face discrimination from member-state regulators.

The Commission should increase the resources devoted to enforcement efforts and ask the Council for extra financial help to do this. The Commission should also pursue cases in a more systematic manner: at present, it is free to choose whether to begin infringement procedures or not. Uneven enforcement of rules causes resentment between member-states and damages the EU's credibility. The Commission should set down clear guidelines, complete with a timetable on how it intends to deal with infringement cases. For instance, it should review member-state implementation of a new directive after six months and launch infringement proceedings, if necessary, within a year.

The Commission could also ensure that future directives contain non-compliance penalty clauses, so that member-states are forewarned of the costs of failing to implement new legislation. Finally the Commission should press for a new fast-track infringement procedure. The Commission should be able to ask the Court to levy a fine as soon as the system of formal warnings is exhausted. This reform would effectively halve the time it takes to fine a member-state. Member-states would have the right to appeal, and consequently have the fine repaid. However, governments would lose the incentive to drag out infringement proceedings unless they had strong grounds for appeal.

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Key elements of the financial services plan

Market abuse directive: This directive seeks to ensure that EU member-states have suitable laws in place against illegal behaviour such as insider trading. The first piece of legislation agreed using the Lamfalussy principles, the directive has raised concerns about the extent of the powers given to the EU's new expert committees. Despite these problems, the market abuse directive should become law by the end of 2002.

Prospectus directive: This legislation, which establishes common rules for companies wishing to raise capital across the EU, is likely to be adopted early next year. EU member-states agreed a common position on the directive in November 2002. However, many financial services companies complain the compromise means they cannot choose where they are regulated, except in the case of large bond issues.

Taxation of savings income: Rather than introduce a minimum 'witholding' tax on savings, the EU is working towards a system of sharing information between tax authorities on savers' income. However, non-EU countries, particularly Switzerland and the United States, have not yet agreed to an EU request to provide information on the overseas savings of EU nationals. This may undermine the proposed system.

Investment services directive: The 'cornerstone' of the single market in equities, the investment services directive provides the legal framework for stock exchanges and investment banks which conduct cross-border business. After an extensive consultation period, the Commission is shortly expected to publish draft proposals for the revision of the existing directive.

Takeover directive: The European Parliament in 2001 rejected an earlier version of this directive, which would provide minimum standards for the conduct of cross-border takeover bids. The Commission published a revised version in September 2002 but faces strong opposition from some member-states, most notably Germany.

Capital Adequacy Directive: The Bank of International Settlements in Basle is making new recommendations about how banks should guard against financial collapse. The EU intends to prepare new legislation based on the Basle agreement in 2004.

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