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TOWARDS A SINGLE MARKET FOR
FINANCE: THE FINANCIAL SERVICES
ACTION PLAN

WITH EVIDENCE

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FORTY-FIFTH REPORT

By the Select Committee appointed to consider European Union documents and other matters relating to the European Union.

ORDERED TO REPORT

TOWARDS A SINGLE MARKET FOR FINANCE: THE FINANCIAL SERVICES ACTION PLAN

Abstract

The Desirability of a Single Market in Financial Services

We, and our witnesses, agree that a single market in financial services would benefit the European Union and the United Kingdom. It should lower the cost of capital and borrowing, increase the range of choice for borrowers and investors and ought to provide protection for the investor/consumer.

The Financial Services Action Plan (FSAP)

The FSAP provides a major impetus towards the creation of an internal market but it raises many important issues. We recognise that deadlines are important to achieve political milestones but we do not believe that they should be the determining factor. Quality of legislation is vital. Financial markets carry an inherent *systemic* risk. Over-regulation could stifle innovation and lead to higher costs.

There will be major burdens for the Commission, the Committee of European Securities Regulators (CESR), Member States and Companies in transposing the framework regulation. We do not think that the extent of the potential burden has been fully recognised.

The Global Context

It is essential that any changes to the regulatory system in Europe take account of the global nature of financial markets. Business can move elsewhere. We think this must be a key criterion against which to test all proposed EU regulation.

The Position of London

London attracts envy and admiration in other Member States. There has been a misunderstanding about the nature of the financial markets located in London. They are not an exclusive UK asset. London is a global market not a national one; it should be regarded as a EU asset. If over-regulation or poorly drafted legislation drives business away from London, it will not go elsewhere in the European Union but to international markets where the regulatory touch is lighter.

The Investment Services Directive (ISD)

The Council decision on 7 October 2003, when the UK and four other Member States were outvoted, represents a step backwards. We urge the Government to make every effort to achieve an acceptable outcome.

Implementation and Enforcement

The Lamfalussy process is designed to accelerate the creation and subsequent implementation of framework legislation and to provide appropriate detail and guidance for industry. There is tension at the heart of this system between the light touch need for flexibility and the desire and intention of the regulators to achieve as much harmonisation as possible in order to bring about a level playing field.

Abstract (continued)

Parliamentary Accountability

We support a “call-back” requirement for legislation at Level 2 to be scrutinised by the European Parliament. The Lamfalussy process relies on comitology to accelerate the implementation of legislation but this must not be accompanied by a loss of parliamentary accountability.

A Single European Regulator

While the Lamfalussy process faces enormous challenges, we believe that it must be given time to see if it will work effectively in providing the regulatory framework that will enable a European single market to flourish. We found no support for the concept of a single European regulator.

Clearing and Settlement

Although not part of the Financial Services Action Plan there is a need for a Europe-wide, cross-border, efficient and effective clearing and settlement system. We did not examine this in detail and cannot make a recommendation for a specific means of achieving this. We support the Giovannini process. We urge the European Union at all levels to consider quickly whether legislation is required or whether the markets can create a pan-European, cross-border clearing and settlement system without the need for EU legislation.

International Accountancy Standards (IAS)

Negotiations on these are moving ahead and the International Financial Reporting Standards (IFRS) are due to be implemented in 2005. It is essential that the remaining difficulties (on IAS 32 and 39) be resolved soon and that mutual acceptability be achieved with other international systems such as the United States Generally Accepted Accounting Principles (GAAP).

CHAPTER 1: BACKGROUND

1. A single market in financial services has been an important part of the long-standing European Union objective of an Internal Market which ensures the free movement of people, goods, services and capital. At a time when the Commission is celebrating ten years of the European internal market¹, this report considers issues relating to a single market in financial services.

2. A single market in financial services means that a financial services provider authorised to provide financial services in one Member State is able to offer the same services throughout the EU competing on an equal basis within a regulatory framework that is consistent across the Union. On the other side, the consumer would have access to a wider range of more competitively priced products and would be able to shop with confidence and safety in the market place.

ORIGIN OF THE FSAP

3. The Commission published a Financial Services Action Plan (FSAP) in May 1999². This Action Plan outlined three specific strategic objectives to improve the Single Market for financial services:

- **a genuine single market for wholesale financial services** including measures to enable corporate issuers to raise equity or debt on an EU-wide basis; to develop a common legal framework for integrated securities and derivatives markets; to work towards a single set of financial statements for listed companies; to provide legal security for cross-border securities trades; and to create a secure and transparent environment for cross-border restructuring.
- **open and secure retail markets** including measures to promote enhanced information, transparency and security for cross-border provision of retail financial services; to achieve speedy resolution of consumer disputes; and to develop balanced application of local consumer protection rules; and
- **clear, efficient prudential rules and supervision of financial services.**

¹ *The Internal Market – Ten Years Without Frontiers*, Commission paper.
http://europa.eu.int/comm/internal_market/10years/docs/workingdoc/workingdoc_en.pdf

² *Financial Services: Implementing the Framework for Financial Markets: Action Plan*.
http://europa.eu.int/comm/internal_market/en/finances/general/actionen.pdf

Political Endorsement

4. The Lisbon European Council in March 2000 gave new impetus to the Financial Services Action Plan as a key component of broader EU economic reform and as a means of making the EU the “most competitive and dynamic knowledge-based economy in the world”³. The Council reaffirmed the tight timetable for adopting FSAP measures by 2005 and set the deadline for the adoption of the Risk Capital Action Plan for 2003.

5. Successive European Councils have reiterated commitment to the FSAP and its deadlines. In its conclusion of the Brussels meeting on 16 and 17 October 2003, the European Council stated: “fully integrated and stable financial markets will play a crucial role in channelling savings into productive investment and enhancing economic growth”. The European Council also “reiterates its call for rapid progress on all the outstanding components of the Financial Services Action Plan with a view to finalisation in accordance with the agreed timetable”⁴.

The FSAP is only part of the Process

6. The FSAP is the main driver towards creating an internal market in financial services but it is only part of the process. For a market to function effectively, there also needs to be an unimpeded system for cross-border clearance and settlement. As the Bank of England points out (paragraph 18), legislation alone may be an ineffective instrument to secure changes in customer practice and FSAP measures have not always lived up to expectations whether in terms of their formulation or their implementation.

Progress to date

7. As we concluded this inquiry, thirty-five of the original forty-two measures outlined in the FSAP had been finalised⁵. The vast majority of the FSAP has therefore met the original deadline in the sense that they have been agreed in principle though most have yet to be implemented. It is uncertain whether all the FSAP measures can meet the 2005 deadline for implementation. There are three outstanding measures under negotiation at present: the Takeover Directive, the Investment Services Directive, and the Transparency Directive. The Proposals on the 10th and 14th Company Law Directives which cover cross-border mergers and allow companies to transfer their corporate seat to another Member State and the Directive on Risk-based Capital have yet to be brought forward by the Commission.

Implementation

8. The draft Directives issued by the Commission are subject to agreement between the Council of Ministers and the European Parliament under the co-decision procedure. Once agreement has been reached on a Directive, a date is stipulated for the measure to come into force. Member States are then given a period (usually 18 months) to implement the Directive by transposing the provisions into national law. To meet the stipulated deadline of 31 December 2005 and allow eighteen months for transposing the EU Directive into national law, the final date for adoption of measures at EU level is April 2004. This coincides with the end of the current European Parliament and elections for the new, post-enlargement Parliament. Such time pressure for the adoption and implementation of FSAP measures has led to claims that the “quality” of Directives is suffering. This report considers these claims in detail.

The Lamfalussy Process

9. The tight timeframe for adoption and implementation of FSAP measures agreed at the Lisbon Council in 2000 required a review of decision-making procedures for adopting EU legislation. In particular, the lengthy timetable for enacting previous legislation demonstrated that it would be difficult to review this round of primary legislation sufficiently quickly as and when circumstances change – as they inevitably will in such a fast-moving industry.

10. So a Committee of Wise Men was appointed, chaired by Baron Alexandre Lamfalussy, to address this problem. The Committee recommended a tiered decision-making process for EU legislation affecting securities markets⁶ which was endorsed by the Stockholm European Council in March 2001. In December 2002, ECOFIN agreed to extend the Lamfalussy Process to apply not only to legislation on securities, but also to legislation on banking, insurance and financial conglomerates. The European

³ Presidency Conclusions, Lisbon European Council, 23 and 24 March 2000.

⁴ Presidency Conclusions, Brussels European Council, 16 and 17 October 2003.

⁵ See Appendix 4 for a list of the expected timeline of key outstanding FSAP measures. *The EU Financial Services Action Plan: A Guide*. Paper prepared by HM Treasury, the Financial Services Authority and the Bank of England, 31 July 2003.

⁶ The Regulation of European Securities Markets, February 2001.

Parliament has not yet agreed to this proposal because it wishes to ensure that it has full co-decision powers with the Council under the proposed Constitutional Treaty.

11. The Lamfalussy Process distinguishes several levels of decision-making. The first level of legislation adopted by the Council and the European Parliament following a Commission proposal under the co-decision procedure should only relate to framework principles and the definition of Commission implementing powers. Technical details for adopting Level 1 framework principles should be agreed at a second level by the Commission and Member State experts under the so-called Comitology procedure. Level 3 and Level 4 of the Lamfalussy procedure cover supervision of Member State implementation of the Directives (see Box 1).

Box 1

Lamfalussy Process

Level 1

Community legislation adopted by the Council and the European Parliament, upon a proposal by the European Commission, under the co-decision procedure: should be based only on **framework principles** and definition of implementing powers for the Commission

Level 2

Community legislation adopted by the **Commission** to lay down the technical details for the principles agreed at Level 1 under the so-called Comitology Procedure. Particular features:

- **Technical advice** prepared by the Committee of European Securities Regulators (CESR); following mandates issued by the Commission and based on consultation with market users;
- **Favourable vote of Member States** (qualified majority) as represented in the European Securities Committee (ESC);
- **European Parliament** may adopt resolutions a) within three months on the draft implementing measure; b) within one month after the vote of the ESC if level 2 measures go beyond implementing powers

Level 3

Committee of European Securities Regulators (CESR) in which the national supervisory authorities are represented, to facilitate consistent day-to-day implementation of Community law. CESR may issue guidelines and common, but non-binding, standards.

Level 4

Commission checks compliance of Member State laws with the EU legislation. If necessary, it takes legal action against Member States before the Court of Justice.

Source: Inter-Institutional Monitoring Committee, First Interim Report, May 2003.

Structure of this Report

12. In Chapter 2, we describe the major concerns which we seek to address in this Report. In Chapters 3, we examine specific themes, in Chapter 4 the outstanding Directives, and in Chapter 5 implementation and enforcement. In Chapter 6 we list our conclusions and in Chapter 7, our recommendations.

Acknowledgements

13. We have received a heartening response to our Call for Evidence⁷. We are grateful to the many individuals and organisations who gave written and oral evidence⁸. In particular, we wish to thank the United Kingdom Permanent Representative to the European Union and his staff for helping us to meet witnesses in Brussels, and to H.M Ambassador and his staff at the British Embassy, Paris, for enabling us to meet a range of French witnesses. In Paris, we were particularly grateful to Senator Philippe Marini, the General Rapporteur of the Finance Committee in the French Senate, for making himself available to the Committee. Finally, we express our gratitude to our Specialist Advisers, Mr Graham Bishop, an independent consultant, and Mr Tom Troubridge, a partner in PricewaterhouseCoopers.

⁷ See Appendix 2.

⁸ See Appendix 3.

CHAPTER 2: A SINGLE MARKET IN FINANCIAL SERVICES

THE BENEFITS OF A SINGLE MARKET

14. A recent Report commissioned from London Economics by the European Commission⁹, which looked exclusively at the integration of bond and equity markets, calculated that the creation of a single European Union financial services market would, by itself, lead to significant economic benefits. The Report suggested that full integration of EU financial markets would reduce the real cost of capital by 50 basis points for EU businesses, and result in a one off 1.1 per cent increase in GDP, or Euro130 billion in 2002 prices, over ten years for the EU as a whole.

15. Dr Friedrich Heinemann of the Zentrum für Europäische Wirtschaftsforschung (ZEW) in a report for the European Financial Services Round Table entitled “The Benefits of a Working European Retail Market in Financial Services”, concluded that financial integration of retail financial markets between countries in the EU could result in an additional growth effect on EU GDP of at least Euro 43 billion annually (at 2002 prices).

16. The above research indicates substantial potential benefits from the full implementation of a single financial services market. The original Lamfalussy report itself concluded:

“it is not simple to quantify the net sum of these benefits, but potentially they are large”.

17. Most of the evidence we received came from organisations facing the private costs of securing the wider benefits. EU economies in general are expected to experience a large collective benefit when a truly liberal internal market in financial services is achieved.

The Financial Services Action Plan

18. The Financial Services Action Plan (FSAP) is the vehicle intended to deliver these benefits by:

- reducing the costs of accessing capital and improving the efficiency of its allocation;
- giving retail consumers access to a wider range of more competitively priced products;
- promoting broader and more liquid equity and bond markets permitting greater investment diversification and reduce risk; and
- putting the financial services sector in a strong position to win market share outside the EU¹⁰.

FSAP is only part of the process

19. However, the FSAP alone is only part of the process that will eventually lead to a single market in financial services. The Bank of England, for example, gives three reasons why the FSAP measures on their own are unlikely to deliver a single market in financial services (see paragraph 6):

- first, because legislation may not be an effective instrument to secure changes in customer practice;
- second, because the original FSAP does not cover some measures important to establishing a single market in financial services such as the removal of cross-border constraints on clearing and settlement (see paragraph 20 below); and
- third, because FSAP measures have not always lived up to expectations whether in terms of their formulation or their implementation¹¹.

Late Directives

20. Three elements of the FSAP have still to be brought forward by the Commission. They are:

- modernisation of the tenth and fourteenth Company Law Directives¹²,
- a Directive which addresses the issue of corporate governance¹³;

⁹ Quantification of the macro-economic impact of integration of EU Financial Markets – November 2002. Study by London Economics, in association with PricewaterhouseCoopers and Oxford Economic Forecasting.

¹⁰ Written evidence from HM Treasury – Page 156.

¹¹ Written evidence from the Bank of England – Pages 178 and 179.

¹² Written evidence from IMA – Page 204, written evidence from ProShare – Page 34, written evidence from FSA – Page 59 and written evidence from Prudential – Page 211.

- a revised Takeover Directive.

The Commission is currently working on a revised Directive embracing the tenth and fourteenth Company Law Directives and on a Directive on Corporate Governance, both of which are expected to be submitted to the Council and European Parliament by the end of this year. We discuss the problems surrounding the Takeover Directive in Chapter 3 (see paragraphs 69–75).

Other elements needed to create a single market

21. According to witnesses there are a number of other elements which are essential building bricks in the construction of an internal market:

- clearance and settlement¹⁴,
- some form of common principles for taxation [Q. 137 and Q. 148]¹⁵ (i.e. not rates of taxation) and;
- the proposed Directive on consumer credit¹⁶ [Q. 74].

Clearance and Settlement

22. Clearance and real-time settlement systems for equities, corporate government bonds and exchange traded funds are essential elements of an internal market in financial services. The Commission was expected to issue a document in the summer of 2003 to identify what action was needed to establish an integrated settlement infrastructure. In the meantime, the governing Council of the European Central Bank (ECB), the Committee of European Securities Regulators (CESR) and Member States' central banks have set-up a joint Working Party to look at establishing standards for securities clearing and settlement systems.

23. There are, today, around twenty separate systems for fifteen domestic markets in the European Union compared to, effectively, one in the United States for a market of about the same size. The services of these systems are largely tailored to domestic settlement needs.

24. While domestic settlement is cheap and efficient, cross-border settlement is expensive and inefficient.

25. The European Parliament, calling on the Commission to impose a Directive on the clearing and settlement industry, suggested the separation of “core” and “value added” settlement services when performed by the same organisation.

26. One witness, CrestCo Ltd, part of the Euroclear Group which operates the settlement system for UK and Irish equities, corporate and (UK) Government bonds and exchange traded funds, state in their evidence that:

“we are concerned that by forcing entities to separate “core” and “value added” services (however defined) the opportunity and momentum for delivering efficient structures to cope with the demands of cross-border settlement will be lostFurthermore, we do not believe that the case has been made for a specific Directive in this area. We believe that the implementation of the Giovannini recommendations, the work of the ESCB/CESR on strengthened and consistent regulatory standards across the clearing and settlement industry, and the presence of an active competition regulator should all help to create an efficient and low-cost market for settlement services in Europe without further intervention from legislators¹⁷”.

Giovannini Committee

27. The Giovannini Group, chaired by Dr Alberto Giovannini, was set up in 1996 to advise the Commission on issues relating to EU financial integration and the efficiency of euro-denominated financial markets. Its two most recent reports have focused on cross-border clearing and settlement

¹³ Written evidence from IMA – Page 204, written evidence from ProShare – Page 34, written evidence from FSA – Page 59 and written evidence from Prudential – Page 211.

¹⁴ Written evidence from the London Stock Exchange – Page 3, written evidence from FESE – Page 110, written evidence from CrestCo – Page 187 and written evidence from Euronext – Page 133.

¹⁵ Written evidence from Michel Prada – Page 207, written evidence from IMA – Page 203, written evidence from LSE – Page 3, written evidence from FESE – Page 110 and written evidence from FSPP – Page 196.

¹⁶ Written evidence from Lloyds TSB – Page 205.

¹⁷ Written evidence from CrestCo – Page 189.

arrangements in the EU securities markets. These reports found that EU infrastructure for clearing and settling cross-border transactions remained highly fragmented and were barriers to a single market in financial services. The Group's second report on EU cross-border clearing and settlements published in April 2003¹⁸ identified three main areas for removing barriers through convergence:

- national differences in technical requirements and market practice
- national differences in tax procedures; and
- issues relating to legal certainty.

28. The Committee did not examine these issues in detail in the course of this inquiry but we consider that an efficient and effective cross-border clearing and settlement system is a fundamental building block that has to be in place. We strongly support the work being done by the Giovannini Committee and we urge that an early decision be reached on whether EU legislation will be needed or whether the market alone could bring about a pan-European clearing and settlement system.

International Accounting Standards (See Box 2)

29. International Accounting Standards, also known as International Financial Reporting Standards (IFRS), are currently being negotiated¹⁹ and are a core objective of the FSAP. It is important that these standards should be in place in 2005. There are two difficult areas: IAS standards 32 and 39 (which cover hedging), which have run into significant opposition from the banking and insurance industries and in particular from France. The other unresolved issue is whether non-EU issuers will be allowed to use their own accounting standards to raise capital in the EU. It is important that compatible standards are achieved between the EU and the US. In this respect, we welcome the work being undertaken as a result of the Norwalk Agreement²⁰.

French concerns about aspects of IFRS

30. We heard evidence from the Deputy Governor of the Banque de France in which M Hannoun set out his concerns about IAS 32 and IAS 39 and the effect these standards might have on prudential supervision [Q. 425–428].

31. M Hannoun offered an illustrative example whereby a company in financial difficulties might seek to use the IAS 39 “fair value option” to calculate its liabilities and its debts. The company would show a reduction of the accounting value of its debt and a corresponding improvement in net income – an accounting sleight of hand that could confuse the market as to the company's true value. M Hannoun also had problems with consolidation and argued that the provisioning rules in IAS 39 had to be consistent with the Basel II Framework (See box 3).

32. We put his concerns to the Financial Secretary to the Treasury. Mrs Kelly said:

“international accounting standards may have an impact on financial stability but it is certainly not the only way in which this impact would be felt. They have a huge impact on investment opportunities in Europe as well, and it would be wrong to look at just one aspect of their impact without looking at the broader picture” [Q. 508].

¹⁸http://europa.eu.int/comm/economy_finance/publications/giovannini/clearing_settlement_arrangements140403.pdf

¹⁹ Written evidence from ICAEW – Pages 197–201.

²⁰ **Norwalk Agreement**

This agreement was reached between the US based Financial Accounting Standards Board (FASB) and the UK based International Accounting Standards Board (IASB) in Norwalk Connecticut on September 18 2002. In this agreement both the FASB and the IASB pledged to use their best efforts to:

- make their existing financial reporting standards fully compatible as soon as is practicable; and
- to coordinate their future work programmes to ensure that once achieved, compatibility is maintained.

The agreement sets out as matters of priority to achieve compatibility:

- undertake a short-term project to remove variety of individual differences between US GAAP and International Financial Reporting Standards (IFRS, which include International Accounting Standards);
- remove other differences between US GAAP and IFRS still remaining on 1 January 2005 through coordination of future work programmes;
- continued progress on joint projects already underway;
- encourage their respective interpretive bodies to coordinate their activities.

Box 2*International Accounting Standards ("IAS")*

IAS, or International Financial Reporting Standards ("IFRS") as they are now named, are accounting standards which have been evolving over many years. The intention is that IFRS should be used and accepted internationally by the world's capital markets. This is subject to acceptance by individual countries. IFRS is promulgated by the International Accounting Standards Board (IASB).

The European Parliament and Council of Ministers passed IAS 2005 regulation requiring endorsed IFRS for accounting periods commencing on or after 1 January 2005 for EU incorporated and EU listed companies.

The endorsement process involves a proposal to endorse each IFRS standard in each official language of Member States by the Accounting Regulatory Committee (ARC). The private sector sponsored the creation of the European Financial Reporting Advisory Group (EFRAG) to provide advice to the European Commission and to the ARC.

IAS 2005 regulation contained a requirement to endorse all existing IFRS by December 2002, which has not yet been completed. The delay is due to absence of all necessary translations plus concerns over the acceptability of IAS 39 which would restrict hedge accounting in particular by banks.

EFRAG has reviewed all current standards and has publicly recommended that the ARC adopt them in full.

The ARC have now endorsed all standards except IAS 32 and IAS 39 both relating to (financial instruments). These standards are undergoing significant revisions, particularly in the area of hedge accounting. The IASB has been consulting very widely and held round tables with constituents so that it could learn about the concerns face to face.

The IASB has a very full agenda and currently is targeting to issue many revised standards and some new standards by the end of March 2004. These will be all mandatory standards that will be in force at 31 December 2005. Examples include new standards on business combinations, insurance and share based payments. Revised standards include pensions and deferred taxes.

The implementation of IFRS is a core part of the FSAP as it will mean that all listed companies in the EU will prepare financial statements on the same basis for the first time.

Source: specialist adviser

33. We are grateful to the Banque de France for explaining their concerns but **we urge all parties to consider the importance of common accounting standards, not only in the interests of achieving an internal market in financial services in the European Union, but also in order to bring about compatibility of standards with the American and Asia-Pacific markets.**

Consumer Credit

34. Lloyds TSB Group say in their evidence:

"the Commission did not consider this proposal [i.e. consumer credit] as a financial service issue but as a consumer protection issue. As a result, European parliamentarians generally believe this proposal is seriously flawed as it does not acknowledge sufficiently the practicalities of the markets"²¹.

35. In his oral evidence, Mr Ian Mullen, Chief Executive of the British Bankers' Association acknowledged that the Consumer-Credit Directive was not part of the FSAP though it was allied to it. It was complicated by seeking to combine mortgages and financial services. He thought the Directive might be divided in two [Q. 74].

²¹ References to Lloyds TSB written evidence, paragraph 10.

36. This was not an area that we looked into.

Taxation

37. A number of witnesses argued that inherent in any effective cross-border trading within a single market in financial services was some form of agreement on the principles of taxation²². Again, the Committee did not examine this issue in this inquiry.

The Committee's decision to examine the FSAP

38. Nevertheless, even accepting the need for these additional measures, there is no doubt that the FSAP represents a considerable effort of political will on the part of the European Council, the Commission and the European Parliament to drive through the basic structure of a single market in financial services. Markets are dynamic and one witness argued that it was important to make the breakthrough in the form offered by the Financial Services Action Plan [Q. 136]. For this reason, the Committee concluded that it should concentrate on the progress achieved by the FSAP, consider the main issues that the process had thrown up, and ask whether or not these measures would be adopted on time.

MAJOR THEMES FROM OUR INQUIRY

Cultural Differences

39. We were struck by the different administrative traditions across Europe distinguishing between those Member States where state regulation of markets has been customary and those that have favoured flexibility and where the regulators have sought to maintain as light a touch as possible consistent with the need to protect investors. These cultural differences can be seen in a purely technical form in the tension between the need for maximum harmonisation in some Directives and for flexibility, or subsidiarity, in others. We discuss this balance in Chapter 5.

Wholesale/Retail

40. The division between these two sectors of the market is often blurred but does raise the question as to whether there is a need to regulate the wholesale capital markets in a different way from the regulation of the retail markets. There appears to be a consensus that the need for consumer protection measures is probably greater in the retail markets and that the creation of a single market will take longer in this area. All Member States have retail financial services; only a few are host to the global capital markets. **There is a problem, too, in that it is difficult to define what is meant by wholesale and retail in the context of financial services. More effort should go into seeking to clarify this distinction.**

41. The fear, particularly among UK witnesses, was that the EU might try to extend the comprehensive regulation desirable for the retail market to the wholesale market, where many contend there was less need for it and where the imposition of such regulation could easily stifle the wholesale capital markets. Some witnesses suggested that certain Member States saw close regulation of the retail *and* wholesale markets as a means of protecting national champions²³. If this were to occur, the EU would be the loser because the cost of capital would fall more slowly and there would be a risk that non-EU issuers would move elsewhere. It is likely to take many years before a true single market in retail financial services emerges. In the meantime, we expect change to be driven by the markets and we remain optimistic that many of today's perceived cultural barriers in this field will be eroded by the force of economic advantage.

After the FSAP

42. The Commission has indicated [Q. 321] that its major task after the adoption of the FSAP will be to concentrate on monitoring implementation and enforcing the Directives. This is an area we address in detail in Chapter 4 where we also consider the case for a European Regulator – "EUROSEC".

SPEED VERSUS QUALITY AND THE 2004 DEADLINE

43. In support of their written evidence, the Association of Private Client Investment Managers and Stockbrokers (APCIMS) attached a list of twelve of the key measures affecting retail and wholesale markets in the FSAP which were outstanding. At the time the evidence was submitted – 26 June 2003 –

²² Written evidence from Michel Prada – Page 207, written evidence from IMA – Page 203, written evidence from LSE – Page 3, written evidence from FESE – Page 110 and written evidence from FSPP – Page 196.

²³ Written evidence from LSE – Page 2 and written evidence from LIBA – Page 16.

not one of the measures had been adopted and implemented and the original deadline of 2003 for achieving the goals for wholesale markets had not been met. The Investment Management Association (IMA) thought that in terms of enacting FSAP legislation by 2005, it was likely that the programme would be met if not then, at least shortly afterwards.

“However, IMA is concerned that this focuses too much attention on the *speed* with which legislation is enacted and insufficient attention on the *quality* of that legislation. In particular, we would not wish the quality of highly sensitive impending legislation to be compromised by an unnecessarily tight deadline (e.g. the Investment Services Directive, Capital Adequacy Directive, Transparency Obligations Directive, the Takeover Directive and Prospectuses Directive)”.

44. This is a view echoed by other witnesses²⁴. It was a question which the Committee addressed to witnesses whose oral evidence was heard²⁵. The overall tenor of replies was that important legislation was being rushed. Some thought that because the FSAP was working to a politically-driven timetable²⁶, this was, perhaps, inevitable. Support for the timetable came from the users of the capital markets²⁷. There was sense among UK witnesses that few other Member States were sufficiently close to the sophisticated capital markets to understand that bad legislation conceived to meet political deadlines could have serious repercussions and could impede the setting up of a single European market in financial services. **We were, therefore, pleased to hear the Financial Secretary to the Treasury argue robustly for quality of legislation, “we are very aware that it is much more important to get it right than to meet a deadline [Q. 494]”. However, success remains a hostage to political fortunes as we have seen in the matter of the Investment Services Directive (paragraphs 53–55).**

45. Some witnesses attributed the slow start at the beginning of the process²⁸ to allegations of poor quality in the drafting of some of the earlier Directives combined with the Commission’s failure to take expert advice [Q. 61]²⁹. This was particularly the case for the Prospectus Directive. This was recognised and the Lamfalussy process was the EU’s response. The Wise Men, in their report, underlined the paramount need for proper consultation. Lamfalussy is, in practice, just beginning its work in speeding-up the process of implementation. While some witnesses expressed doubts about whether or not the FSAP’s current deadlines could be met, most thought that the important outstanding Directives, in particular, the Investment Services Directive, would go to the tape. It was not thought that delay on say, the Takeovers Directive, would substantively affect the outcome of the Financial Services Action Plan.

Commission’s Resources

46. When we took oral evidence from the Director-General of DG Internal Market, Dr Alexander Schaub, he said that part of the problem for the uneven performance to date had been a lack of resources in his Directorate General. This lack of resources would become more acute when the Commission moved on to monitoring implementation and enforcing Directives. A surprising number of other witnesses also referred to what they considered to be a critical lack of adequate resources in DG Internal Market. These included Christopher Huhne MEP, the Secretary-General of the Federation of European Securities Exchanges, the Corporation of London, the FSA, Barclays Bank, London Investment Bankers Association, Aviva and the Institute of Chartered Accountants of England and Wales.

47. In her evidence, the Financial Secretary, while acknowledging that the issue of resource allocation was one for the Commission, said “we would argue pretty strongly that they should focus more resources on the implementation and enforcement procedure in the future, as well as thinking, as I said, about non-legislative ways of opening up opportunities for business across Europe.” [Q. 525].

48. There would appear to be a serious matter of concern here which could affect how the single market in financial services develops. As Dr Schaub pointed out, the real key to success of the FSAP will come at the stage when Directives are implemented through transposition to national legislation and later in the matter of enforcement. **The Commission’s Directorate General for the Internal Market will have an important role to play in monitoring implementation and enforcement and should be properly resourced to do the job effectively.**

²⁴ Written evidence from Prudential – Page 210, written evidence from Fidelity – Page 193, written evidence from the Corporation of London – Page 180 and written evidence from Stephen Revell – Page 214.

²⁵ Q.15, Q.60, Q.201, Q.219, Q.300, Q.329, Q.397, Q.434, Q.464 and Q494.

²⁶ Written evidence from FSPP – Page 195.

²⁷ Written evidence from European Financial Services Roundtable/Aviva – Pages 41 and 42 and written evidence from Unilever – Page 68.

²⁸ Written evidence from Lachlan Burn – Page 75

²⁹ Written evidence from QCA – Page 213, written evidence from the Bank of England – Pages 178 and 179 and written evidence from the London Stock Exchange – Pages 1 to 3.

Burden on companies

49. Finally, in a corollary to the issue of the pressure to complete the legislative process by the spring of 2004, the incoming Chairman of the United Kingdom FSA, Mr Callum McCarthy, reminded Government and the market of the existing and impending burden on companies as they scramble to adapt to the flood of legislation³⁰. The Committee became aware of Mr McCarthy's speech late in the inquiry but in time for us to ask the Financial Secretary to the Treasury for her reaction to the issues Mr McCarthy had raised. Mrs Kelly said:

“In a way, Callum McCarthy was making some very sensible points about the implementation process we are committed to particular Directives to which we have signed up, but obviously we want to see them implemented in a sensitive way” [Q. 529-530].

50. We endorse the Minister's sentiments that the Directives should be sensitively implemented and that quality of regulation was more important than deadlines in the creation of a single market.

³⁰ Mr McCarthy's speech at Ditchley Park. <http://www.fsa.gov.uk/pubs/speeches/sp.154html>.

CHAPTER 3: THE REMAINING DIRECTIVES

What remains to be done?

51. Many witnesses have confirmed at various times during the course of this inquiry that the critical outstanding Directives are the Investment Services Directive, the Directive on transparency obligations for securities issuers – the “Transparency Directive”, the Prospectus Directive (has since completed the Level 1 process, so it is no longer outstanding), the Capital Adequacy Directive³¹ and the Takeover Directive³².

52. The Commission has yet to bring forward its Capital Adequacy Directive, (in her evidence, the Financial Secretary to the Treasury suggested that this Directive did not form part of the FSAP³³ [Q. 499]), the new compromise on the Takeover Directive, a new Directive on Corporate Governance or the new Company Law Directive amending the 10th and 14th Company Law Directives. Most attention has, therefore, been focussed on the Investment Services Directive. This is because it is regarded as the “centrepiece of the FSAP” [Q. 524].

Investment Services Directive

53. A major concern for the UK has been to preserve the compromise reached in the European Parliament’s first reading debate. In particular, Article 25 would allow major investment banks to continue to do business direct without having to use the local stock exchanges. The Committee visited Brussels the day that the Council (ECOFIN) voted to amend Article 25 by ten votes for and five against. The latter included the United Kingdom, Ireland, Luxembourg, Sweden and Finland. The dissenters included the largest equity capital market in Europe (the UK) covering about 40% of all EU business and the largest debt markets (UK and Luxembourg). This was a marked change from the normal way in which matters of this importance have been dealt with at ECOFIN [Q. 374]; it is rather as though the Agricultural Council had forced a vote on the European wine industry in the teeth of opposition from France, Spain, Portugal, Italy and Greece!

54. It is alleged that the Council amendment introduces covert protectionism by *requiring* investors to use exchanges by making obstacles to competition from investment banks sufficiently onerous as to dissuade them from doing off-exchange business as they currently do in London. In effect, the amendment reintroduces the pre-trade transparency requirement that was lost in the Commission proposal abolishing concentration rules [Q. 495]. Inevitably, this will raise costs. The Chief Secretary to the Treasury estimated the potential loss through less competitive pricing for institutional clients might be as much as around £300 million a year. A recent report³⁴ also suggested a similar figure of potential loss for institutional clients and questioned the true extent of off-exchange trading. The Financial Secretary wished to see the Council amendment to Article 25 reversed, although she noted that there had been important benefits secured through the ISD as it currently stood [Q495]. One witness thought that costs would be quite substantial [Q. 374]. Among the reasons said to have been given by the Presidency for proceeding to a vote on this occasion before a “common position” had been reached, was the need for the preliminary linguistic and juridical work to be put in hand in order to meet the spring 2004 deadline.

55. The Treasury Minister believed that much could still change between now and the adoption of the Directive [Q498], although other witnesses expressed doubt on that point [Q.374, 375 and 397]³⁵. **The Committee regrets that an issue of some importance was decided in ECOFIN by Qualified Majority Vote (QMV) in the face of opposition from important financial centres and urges the Government to make every effort to ensure that an acceptable outcome be reached.**

³¹ Written evidence from BBA – Page 24, written evidence from Barclays Bank – Page 48, written evidence from ACPIMS – Pages 173 and 174, written evidence from IMA – Page 202, written evidence from LIBA – Pages 14 and 15, written evidence from FESE – Page 110, written evidence from ICAEW – Page 199, written evidence from FSA – Page 58, written evidence from ProShare – Page 34, written evidence from Stephen Revell – Page 215, written evidence from HM Treasury – Page 159 and written evidence from Euronext – Page 133.

³² The Committee has reported earlier on EU Takeover legislation – “*Takeover Bids*” – 13th Report, 95–96, HL Paper 100 and “*If at first you don’t succeed Takeover Bids Again*”. 28th Report, 2002–03, HL Paper 128.

³³ The Basel Committee’s findings will be transposed into an EU Directive – Capital Adequacy Directive 3. The Basle timetable has slipped, so the timetable for CAD3 will too. Current target is that this Directive will be implemented by the end of 2006.

³⁴ The Potential Impacts of ISD2, Article 25” - OC & C Consultants, August 2003.

³⁵ See “Where next for the ISD” by Theresa Villiers, MEP, the Parliament Magazine, 3 November 2003

Capital Adequacy Directive

56. In its evidence, Association of Private Client Investment Managers and Stockbrokers (APCIMS) writes: “a financial company that falls within the Investment Services Directive also falls within the Capital Adequacy Directive which designates the amount of capital that a firm has to hold if it is to be allowed to operate. The amount of capital varies from type of firm to type of firm and is substantial”³⁶. The Capital Adequacy Directive is now being revised (and also renamed as the **Risk-Based Regulatory Capital Directive**) to accommodate changes affected by the Basel II negotiations^{37, 38} (see Box 3). The Basel Committee is proposing to change the way internationally active banks assess risks and apply capital according to these risks. The European Commission proposes to take that work and apply it to every firm that falls within the Investment Services Directive (ISD). According to APCIMS, studies to date have shown that this could result in huge increases for investment firms wholly disproportionate to the amount of risks that they run. Other witnesses have observed³⁹:

“without substantial modification in European rules to take account of the risk profile of investment business, EU firms would need to hold significantly more regulatory capital than non-EU banks with a similar risk profile outside the EU, putting them” [i.e. the non-EU banks] “at a major competitive advantage”.

57. The European Commission has still to bring forward the revised Directive. Dr Schaub, recognising that there had been concern, said that,

“the Commission is technically ready for the necessary steps to be launched next spring” [Q. 313]”.

³⁶ Written evidence from APCIMS – Page 173.

³⁷ See the article by the Chairman of the Basel II Committee, the Governor of the Bank of Spain – Financial Times, 30 October 2003.

³⁸ See the fears expressed by EUROCHAMBRES about implementing costs especially for SMEs – EU Reporter (27-31 October 2003).

³⁹ Written evidence from LIBA – Page 14.

Box 3*The Basel 2 Accord on Capital Adequacy*

The Accord covers proposals for new requirements that improve banks' stability by tying their capital more closely to the risk of their assets.

The new accord's proposals are divided into three pillars:

1. minimum capital requirements;
2. supervisory review of capital adequacy and
3. public disclosure.

First Pillar: Minimum capital requirements:

The accord proposes:

- a new measure for calculating risk-weighted assets to provide improved bank assessments of risks and to make capital ratios more meaningful.
- introduces three distinct options for calculating credit risk and three others for operational risk to avoid a one-size fits all approach.
- introduces a requirement for explicit treatment of operational risk making the bank's capital ratio more reliable.

Second Pillar: Supervisory Review:

The second pillar of the new accord is based on a series of guiding principles for

- banks to assess their capital adequacy positions relative to their overall risks; and
- for supervisors to review and take appropriate actions in response to those assessments.

If there is a capital shortfall, supervisors may for example require a bank to reduce its risks so that existing capital resources are available to cover its minimum requirements.

Third Pillar: Market Discipline

The third pillar proposes a set of disclosure requirements that allow market participants to assess key information about a bank's risk profile and level of capitalisation. The New Accord places strong reliance on banks' internal methodologies which gives them greater discretion in determining their capital needs

Transparency Directive

58. One element in this Directive in particular has caused concern in London, namely the requirement for companies to make quarterly reports to the market.

“The main issue with quarterly reporting is the need to ensure that companies announce material changes to the market. In the UK, this is a requirement placed upon companies right now in that they have to report immediately any information that is material to the share price. Such a requirement is not present in most European countries” [which have] “a phraseology about reporting to the market in terms such as “as soon as possible”. The real concern, therefore, is that a transparency obligation that will improve reporting in some countries would actually reduce reporting in the UK”⁴⁰.

59. In fact, the obligation to report to the market is present in other European countries but is not practiced and enforced in the same way as it is in the UK. The real issue is a cultural one – the UK is used to reporting price sensitive information speedily whereas continental Europe is not.

60. APCIMS adds:

⁴⁰ Written evidence from APCIMS – Page 174.

“it needs to be noted that such reporting cannot be done without proper auditing as no company could afford to make a financial statement of this sort unless the numbers had been independently checked”⁴¹.

61. We find this proposition questionable. Auditors do some sort of a review which might vary from private reporting to the Board of Directors to a formal review-style opinion which could be published. The point is that public reporting would require companies to prepare information to public reporting standards (with or without auditing) and to spend time communicating the results to the market (shareholders and analysts). There is also the question of liability which we address in paragraph XX below.

62. The Chairman of Euronext argued that when companies got used to it, quarterly reporting was not necessarily as onerous as feared and he did not accept that a requirement on companies to submit quarterly reports would lead to volatility and “short-terminism” or even accounting errors simply because people had to comply [Q. 478–479].

63. For the Commission, Dr Schaub said

“personally I believe that this is not a topic which requires a particular religious conviction. For me, it is typically a topic where we can live with diversity and see how the conviction within this integrated market will develop” [Q. 313].

64. The Committee found this to be a sensible approach. Mandatory quarterly reporting would not increase transparency in those markets where companies directed a regular flow of information to the markets but would increase costs. Quarterly reporting, however, would increase transparency in those markets where reporting was not currently frequent. **The obvious solution should be for a requirement for flexibility so that Member States could choose quarterly reporting or UK-type practice where existing national practice did not already require frequent reporting to the market. The objective of the Directive, after all, is transparency.**

Liability

65. One witness identified a potential problem that could arise from the Transparency Directive as it is currently drafted. Mr Lachlan Burn, a partner at Linklaters, introduced supplementary evidence covering this single point. He argued that:

“the draft Transparency Directive (“the Directive”) significantly extends the established limitation in English case law on the civil liability of directors and auditors arising from the publication of a company’s annual accounts and audit report. As a result, if implemented in its current form, the Directive would mean that directors and auditors would not only be liable to shareholders (as is presently the case) for any errors in the published financial information, but that they would also be liable to the general public. This substantial amendment to the current position on civil liability under English law is contrary to the Commission’s stated intention that the Directive should not have such an effect in Member States”.

66. Mr Burn’s supplementary evidence goes into considerable detail on this point. The Committee were not in a position to take a view but when we spoke to the Director-General of the DG Internal Market, Dr Schaub admitted that it was not a point that had been raised to date [Q. 317]. Dr Schaub asked Baroness Cohen of Pimlico, a Member of our Committee who is also a non-Executive Director of the London Stock Exchange,

“is it your impression that the rules, as they are at present discussed in the Council and Parliament, would increase the degree of liability?”

67. Baroness Cohen answered that, she believed they did [Q. 318]:

“at the moment doctrine and practice are fairly clear in England. We are responsible to shareholders and only incidentally to the wider market, the people who can sue you - which, as a lawyer, is where I always look – are your shareholders. It looks as if the category of people who can sue you is being widened to anybody who might be a potential shareholder – to investors generally”.

68. The Commission have yet to comment on Mr Lachlan Burn’s supplementary evidence. **The Committee considers that it is important that the text of this Directive be clarified so that the degree of potential liability may be accurately identified. We therefore urge the Government to establish with the Commission the extent to which the liability of directors and auditors might be**

⁴¹ Written evidence from APCIMS – Pages 173 and 174.

increased as a result of this Directive. If Mr Burn's interpretation of the effect of this Directive is confirmed, we wish to know how the Government will respond.

Takeover Directive

69. The Community has been struggling to agree a Takeover Directive for over 22 years. The last attempt failed in the European Parliament on 4 July 2001⁴². A further attempt failed in the Competitiveness Council on 19 May 2003. The Committee raised this issue with the Chair of the European Parliament, Economic and Monetary Affairs Committee, Dr Christa Randzio-Plath, who said:

“I am very sorry I cannot give you a guarantee that at the end we will have a Directive but I can give you the impression that there is a positive approach to try to find reasonable compromises”.

70. Asked what the sticking points were, Dr Randzio-Plath said,

“the problems that you have are that you have the different cultures of the shareholders” [Q. 307-308].

71. Part of the European Parliament's difficulty lay in deciding where responsibility resided. Dr Randzio-Plath explained:

“we deal with this Directive in three different Committees the Social Affairs Committee insists on the rights of the employees, there is also support in the Economic Affairs Committee. We do not know what the Legal Affairs Committee is doing” [Q. 304-308].

72. For the Commission, Dr Schaub said:

“we believe that we need a Directive which eliminates at least some of the more unreasonable obstacles to cross-border takeovers” [Q. 313].

73. The two most difficult aspects of the Takeover Directive relate to articles 9 and 11. Article 9 proposes a ban on directors taking frustrating action, such as issuing new shares to a friendly party, when in receipt of a hostile bid. Article 11 would seek to override differential voting rights when an acquirer has more than 75% of the risk bearing capital of the target company. In this context, readers are invited to refer to the Committee's Report⁴³ published in June 2003 in which we examined the extent to which the potential advantages that the draft Directive would make available to UK companies/investors outweighed the potential disadvantages and the risk of increased litigation in the UK. The Government's Response sets out the Government's position in detail⁴⁴.

74. The Committee did not explore the nature of the new Portuguese compromise on the draft Directive nor whether it might succeed in attracting a majority in the European Parliament. Our concern was to determine how the failure to adopt this Directive within the deadline might seriously affect the FSAP. The Treasury witnesses believed that it would not [Q 499].

75. It will be important for the capital markets that a level playing field in the regulation of takeovers emerges. The lack of an agreement on the Takeover Directive by the April 2004 deadline would not in itself seriously affect the ability of the EU to make progress with the other elements of the Financial Services Action Plan but such a failure could weaken the movement towards the efficient and effective operation of a single market in capital including that in existing companies. However, key provisions in the proposed Directive should not be diluted. There is, as we have said before⁴⁵, a clear UK interest in the Directive improving the position in other Member States, and in particular opening up markets for UK companies and making more secure the position of UK investors in Europe.

⁴² The Parliamentary vote split 273-273, but the vote was lost because of 22 abstentions. For a Directive to be passed, it must have a majority over those against and any abstentions – European Information Service (06/07/2001).

⁴³ “If at first you don't succeed Takeover bids again”. 28th Report, Session 2002–03, HL Paper 128, Paragraph 80.

⁴⁴ Government Response.

⁴⁵ “If at first you don't succeed Takeover bids again”. 28th Report, Session 2002–03, HL Paper 128, Paragraph 80.

CHAPTER 4: IMPLEMENTATION AND ENFORCEMENT

76. A key mechanism for implementation is the Lamfalussy process. The structure for this process is sketched in Box 1 but it is worth going back to the original task of the “Committee of Wise Men” chaired by Baron Alexandre Lamfalussy to see what that Committee was asked to do. The Committee was required:

- to assess the current conditions for implementing the regulation of the securities markets in the European Union;
- to assess how mechanisms for regulating the securities markets in the European Union can best respond to the developments underway on the securities markets; and
- in order to eliminate barriers and obstacles, to propose adapting current practices in order to ensure greater convergence and co-operation in day-to-day implementation and to take into account new developments on the markets⁴⁶.

Problems

77. The “Wise Men” identified the following key problems:

- the EU legislative system was too slow and there was no mechanism in place to adopt or update Directives in a timely manner in order to respond to developments in the market;
- too many delays occurred in the transposition and implementation of EU Directives by Member States. Member States faced a low risk of being sued for infringement;
- many of the Directives in the Financial Services field failed to distinguish between core principles and detailed provisions necessary to implement these principles. As a result, EU securities regulation had become inefficient and rigid with negative effects on European competitiveness. Many texts adopted were ambiguous allowing Member States to apply the same provisions in the treatment of business in different ways creating unnecessary cost. It also violated the requirement of the so-called “competitive neutrality” of supervision; and
- the existence of more than 40 public regulatory authorities concerned with regulating EU securities markets was far too many for an efficient system.

The Lamfalussy Solution

78. The response in the form of the Lamfalussy process, which was subsequently ratified and adopted, identified four levels.

Framework Principles and Implementing Measures

79. **Level 1**, the framework principles, consist of legislative acts, Directives or Regulations adopted by the co-decision process (Council of Ministers and European Parliament). **Level 2** would comprise technical implementing measures adopted by the Commission on the basis of powers delegated by Level 1 legislation.

80. The “Wise Men” recommended that Level 2 implementing measures should be used in order to ensure that technical provisions could be kept up-to-date with market and supervisory developments. Such amendments would be enacted according to a rule-making procedure using a “comitology” Committee. The newly established Committee, the European Securities Committee (ESC) would act in both advisory and regulatory capacities in the field of securities markets. A representative of the European Commission would chair the ESC which would be composed of Member State nominees representing the EU Economic and Finance ministries. In its *advisory* capacity, the ESC would advise the Commission on security issues relating to the adoption of proposed Directives or Regulations under the co-decision process. In its *regulatory* capacity, the ESC would vote on implementing measures proposed by the Commission (Level 2), though the ESC does not have a veto as such. In the absence of agreement, the matter would be referred back to the Council for decision (i.e. Level 1).

Committee of European Securities Regulators (CESR)

81. The Commission would also be assisted by a second Committee, the Committee of European Securities Regulators (CESR). CESR would comprise senior representatives of national regulatory

⁴⁶ Hertig/Lee 2003 paper.

agencies designated by Member States. CESR would act as an independent advisory group in the preparation of technical implementing measures (Level 2).

82. **Level 3** was designed to ensure consistent, timely, common and uniform implementation of Level 1 and 2 acts in Member States through enhanced co-operation and networking among EU securities regulators. Level 3 would be the responsibility of the Commission assisted by both the ESC and the CESR.

83. Finally, at **Level 4**, the Commission and the Member States would strengthen the enforcement of Community law.

Progress to Date

84. At Level 2, CESR has begun to develop implementing legislation for the Market Abuse and Prospectus Directives. The process is still in its infancy and, according to the London Stock Exchange, raised concern about the volume of implementing measures and the speed at which it was required to be processed⁴⁷. Although most witnesses welcome the advent of the process, and believed that if properly applied, it would help speed the implementation of regulation, there was already a fear that the original objectives embodied in the four level structure were beginning to be lost. In particular, witnesses feared pressure on Level 2⁴⁸ exacerbated by extremely short timescales⁴⁹.

85. Other witnesses welcomed the fact that the Lamfalussy process firmly embedded consultation with practitioners and transparency into the policy-making process⁵⁰ but called for more clarity with regard to the specific competencies of Level 2 and Level 3⁵¹.

86. One witness suggested that the Lamfalussy process and the creation of CESR should enable the EU to address differences in interpretation and transposition before they became embodied in national legislation or regulation. This would ensure that Directives were applied consistently across the EU⁵².

87. UNICE, the Union of European Employers' Organisations expressed concern that,

“all of the easy compromises have been made. We now have difficult ones to deal with.....we feel that in some instances there has been too much regulation at Level 1, in other instances, there has been too little” [Q. 341].

88. Mr Paul Arlman, Secretary General of the Federation of European Securities Exchanges also had problems with the loading of responsibility at Level 2 – he called the process one of “*entassement*” – simply piling different national regulatory rules on top of each other. Nevertheless, he felt there was no going back – the Lamfalussy process had to be made to work [Q 354].

89. The Committee were privileged to have a private conversation with the Secretary-General of the Committee of European Securities Regulators (CESR), Mr Fabrice de Marigny. Mr de Marigny was accompanied by Mr Nigel Phipps who had been seconded to CESR's staff from the FSA. In spite of the difficulties that witnesses had pointed to, there was a sense that CESR was the beginning of an entirely new way of implementing EU legislation across the Union. The process of transparency and consultation with the practitioners in the marketplace had been formalised. This meant that in addition to the Council, Parliament and Commission legislating, the markets themselves were now part of the process of implementation. **The Committee concluded that this could only be to the good and that it was understandable given the complexity and magnitude of the task imposed by the FSAP, that progress should appear to many witnesses to be hesitant.**

90. **The Committee remains uncertain whether or not sufficient resources will be available to ensure smooth and effective implementation of legislation through the different levels of the Lamfalussy process. We have already recorded the Commission's concern on this point (paragraphs 46–48). We were struck by the modest size of the permanent cadre of CESR. We are also concerned that the process of implementation has yet to be costed. Deadlines set by the European Council are important to maintain the impetus towards integrated markets in financial services but there is still a lot to do. There is tension between those who want to keep regulation flexible at Level 2 and 3, primarily politicians, and CESR who want the same rules in each Member**

⁴⁷ Written evidence from the London Stock Exchange – Page 2, paragraph 12.

⁴⁸ Written evidence from LIBA – Page 15, B, paragraph 5c.

⁴⁹ Written evidence from Pricewaterhouse Coopers – Page 209, paragraph 3.

⁵⁰ Written evidence from FSPP – Page 196, paragraph 2.1.

⁵¹ Written evidence from ICAEW – Page 200, paragraphs 24 and 25.

⁵² Written evidence from Fidelity Investments – Page 194.

State. Inevitably, this will affect the way in which legislation is implemented and will pose problems in many Member States.

A European Regulator – EUROSEC?

91. One witness in particular doubted that the Lamfalussy process would succeed, although in oral evidence, Dr Ruben Lee did appear to mitigate this view. Nevertheless, he argued that eventually the system would prove impracticable and that there would be a need for some EU-wide, common regulator – EUROSEC⁵³. This is a question which the Committee put to many of the witnesses⁵⁴. None was inclined to support this proposition. The Committee had expected some support for this concept to have come from the French witnesses given the approach to regulation that has been associated with French administrative practice. However, all French witnesses we put the question to said that it was far too early even to think of such a proposition. **We agree with witnesses: there is no case for a European Regulator for as far forward as we can realistically see.**

Report of the Inter-institutional Monitoring Group (IIMG)

92. The Inter-institutional Monitoring Group (IIMG) for Securities Markets published its first interim public report on the Lamfalussy process in May 2003⁵⁵. The IIMG consists of six experts nominated by the Commission, the Council and European Parliament and is expected to report bi-annually on the implementation of Lamfalussy. The May report stated that initial indications were that legislation was progressing faster than would otherwise be the case, that there had been positive joint working between all participants but that it was very early days and a more authoritative assessment would have to wait until more evidence was available⁵⁶. **The Committee agrees that it is still too early to be able to judge the eventual success of the Lamfalussy process.**

The role of the Commission in monitoring implementation and enforcement

93. The Committee was encouraged by the enthusiasm shown by Director-General Schaub, for directing the Commission's resources into ensuring that implementation and enforcement become the focus of the Commission's activities (Q. 315). Dr Schaub stressed that the financial markets were special because inherent in them was the risk of *systemic* failure. Member States, the Commission and regulators had to be prepared to intervene should such a risk appear on the horizon. At the same time, European consumers and investors had to have confidence in the system.

94. In its recent communication "Internal Market Strategies Priorities 2003-2006" (IP/03/645) the Commission proposed a number of measures intended to increase the speed and consistency of transposition of internal market law including an "internal market compatibility test"⁵⁷ to assess whether specific regulations in specific Member States were compatible with internal market law; a recommendation on "best practices" to speed-up and improve the quality of transposition of internal market law; and a study on the different options for improving enforcement of internal market law⁵⁸. **We welcome these proposals designed to increase the speed and consistency of transposing EU Directives into national law.**

Measuring the effectiveness of implementation and enforcement: the Commission's views

95. In his oral evidence to the Committee, Director General Schaub said:

"first we must make sure the rules are effectively and correctively transposed and that they are applied" [Q. 321].

96. Mr David Wright, Director of Financial Services in the Internal Market Directorate General spoke about the means:

- first, – the Commission needed resources;
- second, – from an economic point of view to look at market behaviour;

⁵³ The analogy is drawn with the US regulator – the SEC – which is a federal agency.

⁵⁴ Q.20, Q.52, Q. 83, Q. 108, Q. 151, Q.178, Q. 207, Q. 269, Q. 293, Q. 309, Q. 315, Q. 393–395, Q. 474, Q. 489, Q. 537.

⁵⁵ First Interim Report—Monitoring the New Process for Securities Markets in Europe (the Lamfalussy Process). <http://europa.eu.int/comm/internalmarket/en/finances/mobil/docs/lamfalussy/2003-05-monitoringen.pdf>

⁵⁶ Written evidence from HM Treasury –Page 158, paragraph 15.

⁵⁷ Written evidence from Prudential – Page 211, paragraph 17.

⁵⁸ Written evidence from Investment Management Association – Pages 202 and 203, paragraph 6.

- third, – to have scoreboards of Member States’ performance in terms of implementing and enforcing Community rules;
- fourth, – for the Commission to publish guidance on how certain provisions of Directive should be implemented: [Q. 315].

97. Mr Wright went on to say that the private sector had been largely absent from helping the Commission to identify where Community Law was not being implemented and enforced properly, possibly through a fear of the commercial consequences of doing so:

“I think that ways have to be found and the private sector has to be more bold and imaginative in bringing such cases to us”. [Q. 315].

98. We agree with this view: the private sector has to be persuaded to identify cases of poor implementation or enforcement and to bring this information to the attention of the Commission.

Measuring the effectiveness of implementation and enforcement: proposals from the London Stock Exchange

99. In supplementary evidence, the London Stock Exchange argued:

“despite the difficulties in measuring outcomes, it is essential for the Commission and policy-makers to set objectives for all legislative proposals and to keep sight of them throughout the process, at Levels 2, 3 and 4 of Lamfalussy, as well as during Level 1.”

100. The London Stock Exchange suggested that one possible measure of success for the Prospectus Directive might be the number of cross-border issues of securities following implementation in 2005⁵⁹ and that the impact of the new Investment Services Directive might be assessed by surveying investment firms to see whether the Directive had affected their ability to operate from a centre elsewhere in Europe⁶⁰.

Measuring the effect of the FSAP: Retail Markets: The Gyllenhammar Report

101. For the retail markets, a recent report for the European Financial Services Roundtable – the Gyllenhammar Report⁶¹ – offered a more sophisticated analysis suggesting that the so-called “Sharpe ratio” measure of diversification – could be significantly increased by a Europe-wide diversification.

102. The Committee was in no position to comment on whether or not these proposals would be effective though we recognise that some form of measurement of success after 2005 would help demonstrate the benefits that are expected to flow from a fully-liberalised market in financial services.

Harmonisation versus Flexibility

103. It was clear to the Committee that while witnesses recognised the key importance of implementation and enforcement, there were inherent contradictions built into the system. Some Directives attempted maximum harmonisation even at the Level 1 Framework stage. Others sought to elaborate core principles and to allow flexibility in implementation though at Level 2, CESR appeared intent on securing maximum uniformity. There is no easy answer to this conundrum; inevitably the FSAP will be a mixture of both maximum harmonisation in some Directives and greater flexibility in others [Q. 521]. This will ensure that the process of implementation remains dynamic and will require all participants, Member States’ Governments, the European Parliament, the Commission, the Regulators and the market practitioners to continue to co-operate in translating regulation across the European Union. **Given the uneven record of Member States in implementing Directives, we urge the Commission to engage at an early stage in the appropriate enforcement processes.**

Coherent Legislation

104. There are elements in the way in which the process is being managed that continue to give cause for concern. There is criticism of the lack of detailed cost-benefit analysis in the consultation stage of drafting Directives and there is no mechanism to measure the relative effect of Directives against the objectives of other Directives. Some witnesses argue that the overall aims of the single market may be

⁵⁹ Supplementary written evidence from LSE – Page 13, paragraph 18.

⁶⁰ Supplementary written evidence from LSE – Page 13, paragraph 24.

⁶¹ Hynaman and Jopp, “The Benefits of a Working European Retail Market for Financial Services 2002”.

served by one Directive and yet another Directive will, in effect, bring about a retrograde step⁶². There is also concern about how long it might take to change regulations to accommodate changes in the market⁶³. One witness [Q. 344] suggested that the legislative process would take three years even if there was common agreement to make such changes, though the Lamfalussy Process is designed to allow changes to be made at Level 2 more quickly than at the level of primary legislation. **The Committee believes that there needs to be some review process and a mechanism to deal with fatal flaws that might emerge when Directives are transposed. We are glad to note that the Commission has set up four groups of market practitioners to assess the internal market for financial services and to help map out the next stage of the integration process following the completion of the Financial Services Action Plan.**

⁶² Written evidence from Lachlan Burn – Page 76.

⁶³ The Times, 7 November 2003, Page 39.

CHAPTER 5: THE FSAP IN A GLOBAL CONTEXT

105. The degree of fragmentation in the European capital market still compares unfavourably with the US. In theory, the FSAP should encourage greater convergence and integration and, in time, competitiveness. But there is a careful balance to strike in regulating financial services. The FSAP may equally undermine the competitiveness of the European market if, for example, legislation hinders the development of some markets or drives them abroad⁶⁴.

106. The FSAP is essentially a European mechanism to bring about the creation of an internal market in financial services across the European Union – but in the nature of the global economy, whatever happens in Europe is bound to have repercussions in the major financial services markets elsewhere, most notably in the United States of America [Q. 520].

107. The three most important equity wholesale sectors are London, New York and Asia-Pacific (Tokyo/Hong Kong/Singapore). The most important debt markets are centred in London, New York and Luxembourg. Europe is also an essential time zone in the global economy. The most important retail financial industries can be found in those countries with high disposable incomes and an appetite for sophisticated products, for example, the United States. Continental Europe has lagged behind the UK in its appetite for equity investment in pension funds which is reflected in the relative sizes of the stock exchanges.

108. Many of the witnesses, particularly the UK witnesses, expressed concerns that there had not been a sufficient awareness of the global aspect among legislators, particularly from those Member States that had not traditionally been exposed to the international capital markets. Clearly, a Member State that has financial services primarily concentrated in the retail sector, will be less concerned with international capital movements than those Member States that participate actively in the global financial services markets.

109. It is important that as Member States implement the measures constituting the FSAP, they should be aware, individually and collectively, of the need to remain competitive when measured against New York or the Asia-Pacific centres.

EU/US Dialogue

110. The Commission was aware of the need to manage EU/US relations both at a political level and in the construction of a single market. In his written evidence to the Committee, the Commission's Internal Market Director noted that:

“therefore it is very important in parallel with the construction of a convincing European system to keep a clear eye on the transatlantic angle⁶⁵”.

The Sarbanes-Oxley Act 2002

111. Referring to the American reaction to the Enron scandal – the introduction of the Sarbanes-Oxley Act 2002, Dr Schaub said:

“the lesson to be learned from it is that we have to make sure that we do not ignore the transatlantic/global dimension but keep one eye on our internal process and, in parallel, work on the international prolongation” [Q. 320].

112. The Committee has already sought to monitor the impact of the US Sarbanes/Oxley Act in relation to the issue of reinforcing the statutory audit in the EU⁶⁶ and the need to register EU audit firms in the US. The Minister of State at the Department of Trade and Industry wrote

“our understanding is that a constructive dialogue is taking place but that it is too early to speculate on the outcome with confidence⁶⁷”.

113. In her evidence to the Committee, the Financial Secretary to the Treasury confirmed that the Government had sought to help establish and to promote a dialogue between the EU and the US in order to broaden and deepen discussion and to make it more forward-looking and proactive [Q. 516].

114. The Committee is encouraged that the Government has been actively engaged in current discussions between the EU and the US and strongly supports the Commission's role in

⁶⁴ Written evidence from the Royal Bank of Scotland – Page 217, paragraph C3.

⁶⁵ Written evidence from DG Internal Market – Page 94, paragraph 4.

⁶⁶ Chairman of the Select Committee on the European Union's letter of 18 September 2003 to the Department of Trade and Industry – Doc 10739/03 Communication from the Commission: Reinforcing the statutory audit in the EU.

⁶⁷ Letter from the Rt. Hon Jacqui Smith MP dated 7 October 2003 to Lord Grenfell.

encouraging a transatlantic dialogue. Inevitably, a single European market in financial services could provide a major challenge for New York. The dialogue will have to be handled carefully but the benefits to the global market in financial services are so great that any form of protectionism on either side of the Atlantic should be eschewed.

US Protectionism?

115. The Federation of European Securities Exchanges (FESE) was critical of the unilateral way in which the US had acted in the context of the transatlantic capital markets, in particular, in denying access to the United States of foreign trading screens. The FESE argued that the issue was essentially one of protectionism and a refusal on the part of the Americans to recognise the separate European regulatory authorities. Attempts to engage the United States in dialogue had, according to the FESE, only been partly successful [Q. 373].

The Position of London

116. The Committee also considered the consequences of FSAP legislation on the markets located in the City of London. We found that UK witnesses were mostly nervous fearing that the implementation of the FSAP would be slewed by political negotiation and that this would adversely affect the very large and vibrant capital markets that have emerged in London⁶⁸. Witnesses also felt that the capital markets located in London were regarded by other Member States as a UK asset rather than as a resource that benefited EU industry as a whole and that, as a result, attempts were being made to use the legislative tools of the FSAP to “repatriate” business to other Member States⁶⁹. Other witnesses thought that the FSAP’s attempts to harmonise regulation would prove burdensome and have the effect of driving away non-EU business⁷⁰.

117. Continental witnesses tended to see things differently. Mr Michel Prada, Inspecteur Générale des Finances, Ministry of Economic and Financial Affairs, argued that:

“the City of London is old, strong and rich and open and innovative enough not to worry about the consequences of financial integration in Europe”.

118. This is a view echoed by the Federation of European Securities Exchanges who thought that the removal of barriers to cross-border trades could only benefit those service providers (in the UK and elsewhere), who understood and implemented the play of competition better than others⁷¹ – a view supported by a UK witness, ProShare⁷².

119. We believe there has been increased awareness in other Member States about the importance of the London markets to the EU economy as a whole. Nevertheless, there are still, in part, residual, protectionist inclinations. These come more clearly to the fore in the Council rather than in the Commission or the European Parliament as was evident by the vote in ECOFIN on 7 October 2003.

120. We were heartened by the catalytic effect that CESR has had in the implementation process that has led to an increasing awareness of the different systems that need to be brought into some form of harmony. We gained the distinct impression from our discussions with witnesses in Brussels and Paris that the views expressed by some of the UK witnesses may well have applied in the early stages of the FSAP but that there had been, in the intervening period, a change in attitudes as the complexity of regulating these sophisticated markets was borne in on the national regulators and finance ministers in other Member States.

121. The Committee recognises the fears of the practitioners in the UK market. London is, undoubtedly, successful and this attracts both admiration and envy from less successful markets. A single market in financial services can only be to the benefit of an efficient and competitive dominant market player. Nevertheless, it will be important for the Government and the financial services industry to monitor closely the implementation of Directives as the Lamfalussy process evolves and to be prepared to intervene at an early stage if EU legislative proposals contain elements that might seriously inhibit the ability of the markets in London to continue to attract non-EU issuers and participants.

⁶⁸ CEBR–City’s importance to the EU economy (Jan 2003).

⁶⁹ Written evidence from LSE – Pages 1 and 2, paragraphs 6 and 7; written evidence from Michel Prada – Page 208 and written evidence from Lachlan Burn – Page 77, paragraph 3.3.

⁷⁰ Written evidence from LIBA – Page 16, paragraph 11.

⁷¹ Written evidence from FESE – Page 110.

⁷² Written evidence from ProShare – Page 35, paragraph 16.

CHAPTER 6: ASSESSMENT AND CONCLUSIONS

An internal market for financial services

122. All the witnesses spoke strongly in favour of achieving a single, internal market in financial services. The benefits of such a market were evident. A truly liberal internal market in financial services would reduce the cost of capital and borrowing and increase the range of choice for savers and investors. It would broaden the market base, deepen liquidity and provide wider choice and adequate protection for the investor.

Financial Services Markets are Different

123. As Dr Schaub, Director-General for the Internal Market in the Commission rightly pointed out, financial services are different: there is an inherent risk of *systemic* collapse if the markets are not regulated with care.

The Global Context

124. It is essential for those involved in the process of regulating the financial markets to keep the global context firmly in view at all times. The European Union is not an island and business can and will go elsewhere⁷³. The global context of every financial market reform should be a key criterion against which to judge the necessity for, and the impact of, proposed legislation and its implementation.

EU/US

125. In this context, it is vitally important for the development of globally competitive financial markets in the European Union that a dialogue be maintained with the world's largest capital markets – the United States of America and the Asia-Pacific markets which embrace Japan, Singapore and Hong Kong. We look forward to IFRS, planned for introduction in the EU in 2005 being accepted by markets globally and for other equivalent standards such as US GAAP being accepted in EU capital markets.

The Commission's Financial Services Action Plan (FSAP)

126. The FSAP can play a major part in achieving a single financial market within the European Union and we support the thrust of the Action Plan. However, its scope is large and timescale challenging. It would be foolish to ignore some of the potential problems, notably the balance to be achieved between speed of implementing legislation and the quality of that legislation.

127. The retrogressive vote at the ECOFIN Council meeting on 7 October 2003 on the Investment Services Directive was "justified" in part by the need to meet the administrative deadline set for the jurist/linguists within the political deadline for the Directive to be adopted. Not only was this vote a breach of the convention that agreement in ECOFIN should be sought by consensus but the vote effectively undid progress made in the European Parliament to keep the balance between a light, regulatory touch – particularly for the large, international investors - and retail investor protection measures. We regard this ECOFIN decision as possibly the most important signal to date that mishandling the FSAP could lead to a movement of financial services away from the EU and to a reduction in the availability of low-cost capital for EU industry. We trust that the decision to force a vote will not be repeated when other decisions on the single market in financial services are taken by ECOFIN.

Volume of Legislation

128. The volume of legislation, some of it yet to be agreed in principle, most of it yet to be agreed in detail, imposes substantial demands on businesses, on regulators, and on the Commission. In our view, the European Council and ECOFIN, the Commission and the Committee of European Securities Regulators (CESR) all need to recognise this and to consider a clear strategy to assess how realistic the 2005 implementation date is and to have a clear sense of priorities.

⁷³ It is interesting to compare this possibility with the reaction expressed by Mr Philippe de Buck, Secretary General of the Federation of European Employers Organisation (UNICE) in connection with the Commission's draft Directive on the European Chemical Industry – EU Reporter, Week 42, 13–17 October 2003.

The Role of London

129. The reason why London is currently the dominant wholesale capital market in Europe is in part because of the way in which the regulations have been drawn up and administered. London has welcomed foreign participants and has regulated with a light touch sensitive to the vagaries of the markets. However, there appears to be a widespread view in other Member States that the London-based markets are somehow a United Kingdom asset rather than an EU asset where profits are remitted to a Member State's companies or institutions. The wholly UK element is a very small proportion of this market. For example, the London Investment Banking Association lists 40 institutions which comprise its membership but of these, only 2 could be described as British and the British Bankers' Association has 272 members of which only 71 are UK institutions. A globally-efficient, low-cost financial market in London benefits both the EU industry and EU investors.

Lamfalussy Process

130. Effective consultation is at the heart of developing successful implementation of regulation. We welcome the fact that through this process the financial services industry itself has been formally integrated into the formulation of legislation. This was certainly not the case before in a number of Member States or at the European Commission and the earlier measures that constitute the FSAP were often marked by a lack of professional input.

131. We have also been impressed by the desire to consult, co-operate and to succeed at the heart of the Committee of European Securities Regulators. Witnesses have told us that the extent of consultation by national regulators now far exceeds that previously experienced. However, a much larger volume of work lies ahead, increased by the enlargement of the European Union to 25 Member States. Maintaining market responsiveness while achieving a large degree of harmonisation will be an enormous challenge to the whole process.

Harmonisation and Flexibility

132. A number of witnesses, both in the United Kingdom and France, expressed the hope that detailed legislation at the Lamfalussy process Level 2 and 3, would allow flexibility at Member State level. However, it is clear to us that CESR, in which the FSA plays an important role, is looking for maximum harmonisation and will face a real problem in seeking uniformity across 25 Member States. Some flexibility will undoubtedly be required. On the other hand, it will be important to ensure that the call for flexibility is not an excuse for non or slow implementation.

The Ability to respond to Changes in the Markets

133. It is important that the desire to achieve uniformity and harmonisation across 25 Member States does not result in sclerosis of the financial arteries of Europe. In spite of good intentions, detailed legislation at Level 2 could become inflexible and difficult to change quickly and it is vital that detailed legislation does not stifle financial innovation. By way of example, increased formal legislation is already slowing reaction times at national level. The listing rules on the London Stock Exchange used to be changed yearly. Now, to meet increased consultation through the FSA, it takes 18 months. Clearly, increased demand for consultation within 25 Member States and between 25 Member States will add a further drag on the flexibility of the regulatory system to respond rapidly to changes in the market⁷⁴.

Parliamentary Scrutiny

134. The major innovation in the Lamfalussy process is the introduction of the "comitology" procedure at Level 2. While this can lead to the more rapid implementation of regulations agreed under the Level 1 Framework principles, it also threatens the important principle of parliamentary accountability. We support the "call-back" provision which will require consultation with the European Parliament at Level 2.

Measures other than those proposed in the FSAP: Clearing and Settlement Systems

135. The FSAP alone cannot deliver a true internal market in financial services although it goes a considerable way towards creating a regulatory framework for such a market. There are elements which lie outside the formal corpus of measures which constitute the FSAP. One important example is the matter of cross-border clearing and settlement. This has been described by witnesses as the "plumbing system" of a single market in financial services. An efficient and effective cross-border single financial

⁷⁴ See the Editorial in the Times Business Section, 7 November 2003, Page 39.

market must have efficient and effective clearing and settlement systems. This is a fundamental building block that has to be in place. In this context, we strongly support the work being done by the Giovannini Committee and we urge that an early decision be reached at all political levels whether EU legislation will be needed or whether the market itself realistically, could bring about a pan-European effective and flexible clearing and settlement system.

International Accountancy Standards

136. We have already referred to the importance of international accountancy standards and mutual recognition with other accountancy standards such as the United States GAAP. Together with a clearing and settlement system, accounting standards constitute the basic tools for operating a true single market in financial services.

Redress

137. Many market players believe that there is a fundamental problem at the stage when regulation is implemented. How will the Commission obtain the detailed information and evidence required to take timely and effective enforcement action against a Member State before the European Court of Justice? [Q. 315]. Many believe that professionals and businesses will be reluctant to report their national regulator to the Commission for failing to enforce the FSAP. One witness suggested an informal method of resolving the difficulties – resort to an arbitrator or an ombudsman for professionals. This is a problem that needs to be addressed before 2005.

A Single European Regulator

138. Some observers have cast doubt on whether the Lamfalussy process will be able to cope with the enormous regulatory burden which is looming. We agree that there will be difficulties and we are not yet convinced of the commitment of all Member States to speed-up implementation. But in our view, the Lamfalussy process has to be given every opportunity to develop its role. We agree with the overwhelming majority of the witnesses that a single European Regulator is neither necessary nor desirable for as far ahead as we can realistically see.

CHAPTER 7: RECOMMENDATIONS

139. We list the various recommendations that we have made in the course of this Report.

- **Clearing and Settlement:** The Committee did not examine these issues in detail in the course of this inquiry but consider that an efficient and effective cross-border clearing and settlement system is a fundamental building block that has to be in place. We strongly support the work being done by the Giovannini Committee and we urge that an early decision be reached on whether EU legislation will be needed or whether the market alone could bring about a pan-European clearing and settlement system (paragraph 28).
 - **International Accounting Standards:** We urge all parties to consider the importance of common accounting standards, not only in the interests of achieving an internal market in financial services in the European Union, but also in order to bring about compatibility of standards with the American and Asia-Pacific markets (paragraph 33).
 - **Wholesale Retail:** There is a problem, too, in that it is difficult to define what is meant by wholesale and retail in the context of financial services. More effort should go into seeking to clarify this distinction (paragraph 40).
 - **Deadlines:** We were, therefore, pleased to hear the Financial Secretary to the Treasury argue robustly for quality of legislation, “we are very aware that it is much more important to get it right than to meet a deadline [Q. 494]”. However, success remains a hostage to political fortunes as we have seen in the matter of the Investment Services Directive (paragraph 44).
 - **Resources: Commission:** The Commission’s Directorate General for the Internal Market will have an important role to play in monitoring implementation and enforcement and should be properly resourced to do the job effectively (paragraph 48).
 - **Burden on Companies:** We endorse the Minister’s sentiments that the Directives should be sensitively implemented and that quality of regulation was more important than deadlines in the creation of a single market (paragraph 50).
 - **The Investment Services Directive:** The Committee regrets that an issue of some importance was decided in ECOFIN by Qualified Majority Vote (QMV) in the face of opposition from important financial centres and urges the Government to make every effort to ensure that an acceptable outcome be reached. (paragraph 55).
 - **Transparency Directive: Quarterly Reporting:** The obvious solution should be for a requirement for flexibility so that Member States could choose quarterly reporting or UK-type practice where existing national practice did not already require frequent reporting to the market. The objective of the Directive, after all, is transparency (paragraph 64).
- Liability:** The Committee considers that it is important that the text of this Directive be clarified so that the degree of potential liability may be accurately identified. We therefore urge the Government to establish with the Commission the extent to which the liability of a director or auditor might be increased as a result of this Directive. If Mr Burn’s interpretation of the effect of this Directive is confirmed, we wish to know how the Government will respond (paragraph 68).
- **Takeover Directive:** It will be important for the capital markets that a level playing field in the regulation of takeovers emerges. The lack of an agreement on the Takeover Directive by the April 2004 deadline would not in itself seriously affect the ability of the EU to make progress with the other elements of the Financial Services Action Plan but such a failure could weaken the movement towards the efficient and effective operation of a single market in capital including that in existing companies. However, key provisions in the proposed Directive should not be diluted. There is, as we have said before⁷⁵, a clear UK interest in the Directive improving the position in other Member States, and in particular opening up markets for UK companies and making more secure the position of UK investors in Europe (paragraph 75).
 - **Lamfalussy Process: Consultation with Market Practitioners:** The Committee concluded that this could only be to the good and that it was understandable given the complexity and magnitude of the task imposed by the FSAP, that progress should appear to many witnesses to be hesitant (paragraph 89).

⁷⁵ “If at first you don’t succeed Takeover bids again”. 28th Report, Session 2002–03, HL Paper 128, Paragraph 80.

Resources: **The Committee remains uncertain whether or not sufficient resources will be available to ensure smooth and effective implementation of legislation through the different levels of the Lamfalussy process. We have already recorded the Commission's concern on this point (paragraph 48). We were struck by the modest size of the permanent cadre of CESR. We are also concerned that the process of implementation has yet to be costed. Deadlines set by the European Council are important to maintain the impetus towards integrated markets in financial services but there is still a lot to do. There is tension between those who want to keep regulation flexible at Level 2 and 3, primarily politicians, and CESR who want the same rules in each Member State. Inevitably, this will affect the way in which legislation is implemented and will pose problems in many Member States (paragraph 90).**

- **A European Regulator?: We agree with witnesses: there is no case for a European Regulator for as far forward as we can realistically see. (paragraph 91).**
- **Success of the Lamfalussy Process: The Committee agrees that it is still too early to be able to judge the eventual success of the Lamfalussy process. (paragraph 92).**
- **Commission's "Internal Market Strategies 2003–2006": We welcome these proposals designed to increase the speed and consistency of transposing EU Directives into national law (paragraph 94).**
- **The Private Sector and Enforcement: We agree with this view: the private sector has to be persuaded to identify cases of poor implementation or enforcement and to bring this information to the attention of the Commission (paragraph 98)**
- **Measuring the effectiveness of the FSAP proposals: The Committee was in no position to comment on whether or not these proposals would be effective though we recognise that some form of measurement of success after 2005 would help demonstrate the benefits that are expected to flow from a fully-liberalised market in financial services. (paragraph 102).**
- **Enforcement: Given the uneven record of Member States in implementing Directives, we urge the Commission to engage at an early stage in the appropriate enforcement processes (paragraph 103).**
- **Review Process: The Committee believes that there needs to be some review process and a mechanism to deal with fatal flaws that might emerge when Directives are transposed. We are glad to note⁷⁶ that the Commission has set up four groups of market practitioners to assess the internal market for financial services and to help map out the next stage of the integration process following the completion of the Financial Services Action Plan (paragraph 104).**
- **Global Context: It is important that as Member States implement the measures constituting the FSAP, they should be aware, individually and collectively, of the need to remain competitive when measured against New York or the Asia-Pacific centres (paragraph 109).**
- **EU/US Dialogue: The Committee is encouraged that the Government has been actively engaged in the current discussions between the EU and the US and strongly supports the Commission's role in encouraging a transatlantic dialogue. Inevitably, a single European market in financial services will provide a major challenge for New York. The dialogue will have to be handled carefully but the benefits to the global market in financial services are so great that any form of protectionism on either side of the Atlantic should be eschewed (paragraph 114).**
- **Position of London: The Committee recognises the fears of the practitioners in the UK market. London is, undoubtedly, successful and this attracts both admiration and envy from less successful markets. A single market in financial services can only be to the benefit of an efficient and competitive dominant market player. Nevertheless, it will be important for the Government and the financial services industry to monitor closely the implementation of Directives as the Lamfalussy process evolves and to be prepared to intervene at an early stage if EU legislative proposals contain elements that might seriously inhibit the ability of the markets in London to continue to attract non-EU issuers and participants (paragraph 121).**

140. The Committee considers that the European Commission's Financial Services Action Plan raises important questions to which the attention of the House should be drawn and makes this Report to the House for debate.

⁷⁶ European Report 2815 – 28 October 2003, Page 11.2.

APPENDIX 1

Membership of Sub-Committee B

The Members of Sub-Committee B who conducted this inquiry were:

Lord Cavendish of Furness

Lord Chadlington

Baroness Cohen of Pimlico

Lord Faulkner of Worcester

Lord Fearn

Lord Howie of Troon

Lord Shutt of Greetland

Lord Skelmersdale

Lord Walpole

Lord Woolmer of Leeds (Chairman)

Declaration of Interests

Lord Cavendish of Furness	Director, Holker Holdings Ltd Director, Park Healthcare Ltd (Private Nursing Home) Director, United Kingdom Nirex Ltd Director, Burlington Slate Ltd
Lord Chadlington	Chairman, International Public Relations Director, Huntsworth Plc/Chadlington Consultancy/Oxford Resources Ltd Chief Executive, Quiller Consultants
Baroness Cohen of Pimlico	Non Executive Chairman, BPP Holdings Plc Non Executive Director, London Stock Exchange Non Executive Director, Management Consulting Group Plc Non Executive Director, Defence Logistics Org
Lord Faulkner of Worcester	Incepta Group Plc
Lord Fearn	Councillor, Sefton M.B.C
Lord Howie of Troon	Consultant, George S. Hall Ltd
Lord Shutt of Greetland	Self-employed Consultant (non-practising Chartered Accountant) Director, The Joseph Rowntree Reform Trust Ltd and subsidiary companies Trustee, The JRSST Charitable Trust Trustee, The Joseph Rowntree Charitable Trust
Lord Skelmersdale	Director, Broadleigh Nurseries Ltd
Lord Walpole	Landowner, retired Farmer, Gardener Active in countryside conservation since 1982 Vice-President, Council for National Parks Director, Peter Beales Roses Member, Country Land and Business Association, National Trust
Lord Woolmer of Leeds (Chairman)	Partner, Halton Gill Associates Partner, Anderson McGraw Non Executive Director, Thornfield Properties Plc Non Executive Director, CourtCom Ltd Chairman, Energy Forum, Yorkshire and Humber Regional Development Agency (Yorkshire Forward) Member, Council of the Foundation for Management Education

APPENDIX 2

Call for Evidence

Sub-Committee B (Energy, Industry & Transport) of the House of Lords Select Committee on the European Union is undertaking an inquiry into the European Commission's *Financial Services Action Plan*.

On 11 May 1999, the Commission adopted an Action Plan which outlined a series of policy objectives and specific measures to improve the single market for Financial Services. The Financial Services Action Plan is to be implemented by 2005.

The Financial Services Action Plan outlined four strategic objectives:

- a genuine single market for wholesale financial services;
- open and secure retail markets;
- clear, efficient, prudential rules and supervision of financial services; and
- wider conditions for an optimal, single financial market

Evidence is invited on the following issues:

THE FINANCIAL SERVICES ACTION PLAN

- What progress has been made to date? Has this been beneficial or deleterious to UK interests? Has sufficient weight been given to the position and experience of UK financial services industry?
- What are the main outstanding matters that remain to be dealt with under the FSAP and what key issues will need to be resolved?

IMPLEMENTATION AND ENFORCEMENT

The success of setting up a single market in financial services will depend to a considerable degree on the way in which the regulatory Framework is implemented and enforced.

- How successful do you expect the Lamfalussy process to be? Are any changes needed?
- Who will be responsible for ensuring effective implementation and enforcement of the single market, after the regulatory Framework is in place? How successful do you expect this process to be? What will be the role of competition regulators at EU and Member State level?
- What issues will arise as the single market framework is implemented and enforced?
- What non-regulatory barriers might impede the effective functioning of a single market for financial services?

THE FUTURE

- How do witnesses see the future development of a single market in financial services following implementation of the FSAP? Are additional measures needed?
- Will the changes resulting from the FSAP proposals have an impact on the competitive position of London and EU markets as a whole in the global environment?

APPENDIX 3

List of Witnesses

The following witnesses gave evidence. Those marked * gave oral evidence.

- * Mr Paul Arlman, (Federation of European Securities Exchanges)
 - Association of British Insurers
 - Association of Private Client Investment Managers and Stockbrokers (APCIMS)
 - Bank of England
- * Barclays Bank Plc
- * British Bankers Association
- * Mr Lachlan Burn (Partner, Linklaters)
 - Corporation of London
 - CrestCo Ltd
- * Mr Richard Desmond (UNICE)
 - Euronext
 - European Investment Bank
 - Fidelity Investments
- * Financial Services
 - Financial Services Practitioner Panel
- * Mr Pehr Gyllenhammar (European Financial Services Round Table)
- * Mr Hervé Hannoun (Banque de France)
- * Mr Chris Huhne MEP
 - Institute of Chartered Accountants in England and Wales
 - Investment Management Association (IMA)
- * Ms Ruth Kelly MP (HM Treasury)
- * Mr Ruben Lee (Oxford Finance Group)
- * Mr Jean-François Lepetit (Commission des Opérations de Bourse) [Evidence not printed at the witness's request]
 - Lloyds TSB Group
- * London Investment Banking Association
- * London Stock Exchange
- * Mr Philippe Marini (French Senate)
 - Mr Michel Prada (European Commission)
 - Pricewaterhouse Coopers
- * ProShare
 - Prudential Plc
 - Quoted Companies Alliance (QCA)
- * Ms Christa Randzio-Plath (Economic and Monetary Affairs Committee, European Parliament)
 - Mr Stephen Revell (Freshfields Bruckhaus Deringer)
 - Royal Bank of Scotland
- * Dr Alexander Schaub, (DG Internal Market, European Commission)
- * Mr Peter Skinner MEP
 - Mr Luigi Spaventa
- * Mr Jean- François Théodore (Euronext)
- * Unilever

APPENDIX 4

List of FSAP Measures**Measures proposed but not yet adopted**

(Legislative proposals in bold)

1. **Directive on transparency obligations for securities issuers. Commission proposal 26 March 2003.**
2. **Directive on investment services and regulated markets (upgrade Investment Services Directive). Commission proposal 19 November 2002 (COM (2002)625).**
3. **Directive on Takeover Bids. New Commission proposal adopted 2 October 2002 (COM(2002)534).**

Measures not yet proposed

4. Legal Framework for payments
5. **10th and 14th Company Law Directives**
6. **Risk-based Capital Directive**
7. **Third Money-Laundering Directive**

Measures adopted but not yet implemented

8. Directive on Insider Dealing and Market Manipulation (Market Abuse). Directive 2003/6/EC of 28 January 2003.
9. Amendments to the 4th and 7th Company Law Directives to allow fair value accounting: Directive 2001/65/EC adopted on 31 May 2001.
10. Regulation (EC)1606/2002 of the European Parliament and of the Council on the application of international accounting standards adopted on 19 July 2002.
11. Modernisation of the accounting provisions of the 4th and 7th Company Law Directives adopted 6 May 2003 (PE-CONS 3611/03, amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC, and 91/647/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings.
12. Directive on financial collateral arrangements. Directive 2002/47/EC adopted on 6 June 2002.
13. Political agreement on the European Company Statute. Directive 2001/86/EC and Regulation (EC)2157/2001 adopted on 8 October 2001.
14. Two Directives on UCITS. Directives 2001/107/EC and 2001/108/EC adopted on 21 January 2002.
15. Directive on the Prudential Supervision of Pension Funds adopted on 13 May 2003 (P5_TA (2003) 0086)
16. Directive on the Distance marketing of Financial Services. Directive 2002/65/EC adopted on 23 September 2002.
17. Directive on Insurance Mediation. Directive 2002/92/EC of 9 December 2002.
18. Adoption of the proposed Directive on the Reorganisation and Winding-up of Insurance undertakings. Directive 2001/17/EC adopted on 19 March 2001.
19. Adoption of the proposed Directive on the Winding-up and Liquidation of Banks. Directive 2001/24/EC adopted on 4 April 2001.
20. Adoption of the proposal for an Electronic Money directive. Directive 2000/46/EC adopted on 18 September 2000.
21. Amendments to the solvency margin requirements in the Insurance Directives. Directives 2002/12/EC and 2002/13/EC adopted on 5 March 2002.
22. Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. Directive 2002/87/EC of 16 December 2002.
23. Directive on Prospectuses. Decision on 3 July 2003. Directive (COM(2002)460).

Completed FSAP Measures

24. Amendment to the Money Laundering Directive. Directive 2001/97/EC adopted on 4 December 2001.
25. Commission Communication on the Application of Conduct of Business Rules Under Article 11 of the Investment Services Directive (ISD) (distinction between professional and retail investors). Issued on 14 November 2000, COM(2000)722.
26. Commission Communication on upgrading the ISD. Issued on 15 November 2000, COM(2000)729.
27. Commission Communication updating the EU accounting strategy. Issued on 13 June 2000, COM(2000) 359.

28. Commission Recommendation 2001/256 of 15 November 2000 on quality assurance of the statutory audit (C(2000) 3304).
29. Commission Recommendation 2001/6942 of 16 May 2002 on Statutory auditor's independence in the EU: A set of fundamental principles (C(2002)1873).
30. Implementation of the Settlement Finality Directive 98/26/EC of 19 May 1998. In the coming months the Commission will publish a report to modify the Settlement Finality Directive and the Directive stated under (11) to integrate the The Hague Convention in EU Law.
31. Review of EU corporate governance practices The final report of the Comparative Study was published on 27 March 2002 (available on DG Markt's website : http://europa.eu.int/comm/internal_market/en/company/company/news/index.htm).
32. Commission Communication on Funded pension Schemes. Issued on 11 May 1999 (Com (1999)134). This includes the Review of taxation of financial service products. This action has been taken care of in the context of the initiative on taxation of cross-border occupational pensions.
33. Commission Communication on clear and comprehensible information for purchasers. The work on the communication has been integrated in the context of the Commission Communication on an e-commerce policy for financial services (COM(2001)66 – 07/02/2001).
34. Commission Recommendation 2001/193 of 1 March 2001 to support best practice in respect of information provision (mortgage credit) (C(2001)477).
35. Commission report on substantive differences between national arrangements relating to consumer-business transactions. Discussions with industry ('Forum Group') and consumers are concluded. Information gathered is used for further Commission initiatives in the field of retail financial services.
36. Interpretative Communication on the freedom to provide services and the general good in insurance. Issued on 2 February 2000, C(1999)5046.
37. Commission Communication on a single market for payments. Issued on 31 January 2000, COM(2000)36.
38. Commission Action Plan to prevent fraud and counterfeiting in payment systems. Issued on 9 February 2001, COM(2001)11.
39. Commission Communication on an e-commerce policy for financial services. Issued on 7 February 2001, COM(2001) 66.
40. Commission Recommendation 2000/408 of 23 June 2000 on disclosure of financial instruments (C(2000) 1372).
41. Amendment of the Insurance Directives and the Investment Services Directive to permit information exchange with third countries. Directive 2000/64/EC adopted 7 November 2000.
42. Creation of two Securities Committees. Decision of 6 June 2001 setting up the European Securities Committee - ESC (C(2001)1493) and Decision of 6 June 2001 setting up the Committee of European Securities Regulators - CESR (C(2001)1501).

Based on European Commission *FSAP Eighth Progress Report* (3 June 2003) and Bank of England *EU Financial Services Action Plan: A Guide*, 31 July 2003.

APPENDIX 5

Glossary of Terms

Basel Committee	Basel Committee on Banking Supervision. This Committee is part of the Bank for International Settlements
Bond	A debt instrument issued by a borrower and promised a specified stream of payments to the purchaser, usually regular interest payments plus a final repayment of principal. Bonds are exchanged on open markets including, in the absence of capital controls, internationally, providing a mechanism for international capital mobility.
Capital Adequacy Directive	Directive that designates the amount of capital that a firm has to hold to be allowed to operate
CESR	Committee of European Securities Regulators comprising of senior representatives of national regulatory agencies designated by Member States
Clearance system	An arrangement among financial institutions for carrying out the transactions among them, including cancelling out offsetting <u>credits</u> and <u>debits</u> on the same account
Comitology	Secondary EU legislation
Debt Securities	IOUs created through loan-type <u>transactions-commercial paper</u> , bank <u>CDs</u> , bills, <u>bonds</u> , and other <u>instruments</u>
Derivatives	Contracts such as <u>options</u> and <u>futures</u> whose price is derived from the price of an <u>underlying financial asset</u>
DG Internal Market	European Commission department responsible for EU internal market in financial services
Equity	Ownership interest in a firm. Also, the <u>residual value</u> of a <u>futures</u> trading account, assuming its <u>liquidation</u> is at the going trade price. In a brokerage <u>account</u> , <u>equity</u> equals the value of the <u>account's securities</u> minus any debit balance in a <u>margin account</u>
European Securities Committee	Committee in charge of adopting technical implementation of FSAP framework principles. The Committee comprises of a representative from the Commission as chair and Member State nominees from Economic and Finance ministries
Eurosec	Term often used to describe the possible future single European financial regulator
FESE	Federation of European Securities Exchanges
FSAP	Commission Communication of May 1999 listing 42 measures for a single market in financial services
GAAP	Generally Accepted Accounting Principles
Giovannini Group	Committee set up in 1996 to advise the Commission on how to harmonise euro denominated financial markets
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IIMG	Inter-institutional Monitoring Group responsible for reporting bi-annually on the implementation of the Lamfalussy process. The group consists of six experts from the Commission, the Council and the European Parliament.
ISD	Investment Services Directive

Lamfalussy Process	Tiered decision-making process for EU legislation on financial services
Liability	A financial obligation, or the <u>cash</u> outlay that must be made at a specific time to satisfy the <u>contractual</u> terms of such an obligation
Liquidity	A high level of <u>trading</u> activity, allowing buying and selling with minimum price disturbance. Also, a market characterized by the ability to <u>buy</u> and sell with relative ease. Antithesis of illiquidity.
Retail market	Market the deals with financial services for individual and institutional customers as opposed to <u>dealers</u> and <u>brokers</u> .
Risk	Often defined as the <u>standard deviation</u> of the <u>return</u> on total investment. Degree of uncertainty of return on an <u>asset</u> .
Risk-based capital ratio	Bank requirement that there be a minimum ratio of estimated total <u>capital</u> to estimated <u>risk-weighted asset</u>
Sarbanes-Oxley Act	US Act of law on corporate governance passed in reaction to the Enron scandal
Securities and commodities exchanges	<u>Exchanges</u> on which <u>securities</u> , <u>options</u> , and <u>futures contracts</u> are <u>traded</u> by members for their own accounts and for the accounts of customers.
Settlement	When payment is made for a <u>trade</u>
UNICE	Union of European Employers' Organisations
Wholesale market	Market the deals with financial services for <u>dealers</u> and <u>brokers</u> .

APPENDIX 6

Cost/benefit analysis of the European Commission's Financial Services Action Plan (FSAP)*Executive Summary*

One of the major criticisms of the Financial Services Action has been that insufficient cost-benefit analysis has been carried out on the directives. For example, HM Treasury, the Financial Services Authority and the Bank of England wrote in ““The EU Financial Services Action Plan: A Guide”, July 2003:

“Many market experts consider that the Commission should analyse in more detail the cost-effectiveness of proposed new FSAP measures, and the interaction between them. Their impact needs to be considered, not just on market behaviour and the efficiency of financial markets within the EU, but also on the EU 's global competitiveness, and in particular in relation to the US.”

- The Commission's “impact assessments” for each measure are inadequately detailed, especially in financial terms.
- However, some detailed estimates have been made of the overall benefits of European financial integration. These add up to an annual benefit to the EU economy after 10 years of at least €189bn.
- To outweigh this public benefit, the annual private cost of each of the 40 measures would have to be nearly €5bn.

The consultancy OC&C estimates the cost to the EU of the currently proposed **Investment Services Directive** to be up to €450m per annum.

The Commission analyses make no attempt to estimate the costs involved in securing the assumed benefits.

Graham Bishop, Specialist Advisor

October 2003

The Benefits

The Lamfalussy report concluded the following benefits to EU financial integration:

Expected Benefits from an Integrated European Financial Services and Capital Market

I. Improving the allocation of capital in the European economy:

- More efficient, deeper, and broader securities markets enabling savings to flow more efficiently to investment.
- Reduced transaction costs and increased market liquidity.
- More diversified and innovative financial system.
- More opportunities to pool risk.

II. More efficient intermediation of European savings to investment:

- Intensified competition between financial markets and intermediaries.
- Economies of scale, scope and a reduction in inefficiency.
 - More economic cohesion.

III. A strengthening of the EU economy, resulting in it becoming a more attractive location for inward investment

On the issue of the size of these benefits, the report concluded, "It is not simple to quantify the net sum of these benefits, but potentially they are large". However, recently two reports have attempted such quantification.

London Economics produced a "Quantification of the Macro-Economic Impact of Integration of EU Financial Markets" for the European Commission. Specifically, they investigated "the extent to which the merging of the presently still regionally-fragmented liquidity into a single liquidity pool would reduce the cost of equity and bond finance for businesses in Europe, help stimulate investment and expand productive capacity." So their focus was exclusively on integration of wholesale markets. Their conclusion was

"The level of EU-wide real GDP is raised by 1.1%, or €130 billion in 2002 prices, in the long-run. The press release states that "the long-run" is "defined as over a decade or so".

ZEW/IEP produced a report for the European Financial Services Round Table entitled "The Benefits of a Working European Retail Market for Financial Services". Their focus was exclusively on the retail side. Their conclusion was "World-wide cross-country samples show that differences in financial integration between countries amounting to one standard deviation of the relevant integration indicators can explain annual growth differences of 0.5 - 0.7 per cent. Although these results do not cover all present EU member states they indicate roughly the potential for growth through financial integration: in terms of the EU GDP of the year 2000 the lower per cent figure of 0.5 would mean an additional growth effect of 43 billion euro annually."

The benefits set out in the two reports are additive because the first report looks exclusively at the integration of bond and equity markets, while the second looks at retail markets. **The wholesale benefit is €130 billion after 10 years. The retail benefit (if we also express in 2002 prices) is €59-83 billion annually - with no timeframe given. But if we assume the same timetable, after 10 years the annual benefit is at least €189bn/ £134bn.**

Commission “impact assessments”

THE TEMPLATE

For each new proposal for a directive, the Commission is required to produce an assessment of the “impact on business with special reference to small and medium-sized enterprises”. This involves providing answers to the following template of questions:

TITLE OF PROPOSAL**DOCUMENT REFERENCE NUMBER****THE PROPOSAL**

1. Taking account of the principle of subsidiarity, why is Community legislation necessary in this area and what are its main aims?

THE IMPACT ON BUSINESS

2. Who will be affected by the proposal?

- Which sectors of business?
- Which sizes of business (What is the concentration of small and medium-sized firms)?
- Are there particular geographical areas of the Community where these businesses are found?

3. What will business have to do to comply with the proposal?

4. What economic effects is the proposal likely to have?

- On employment?
- On investment and the creation of new businesses?
- On the competitiveness of businesses?

5. Does the proposal contain measures to take account of the specific situation of small and medium-sized firms (reduced or different requirements etc)?

CONSULTATION

6. List the organisations which have been consulted about the proposal and outline their main views:

Sample of Commission Impact Assessments

Though the impact assessments conducted by the Commission are fairly short, they are too long to all be included in their entirety. Possibly the most important question in the Commission's Impact Assessment template is "4c", "What economic effects is the proposal likely to have on the competitiveness of business?" The following table sets out the answer for the 15 directives for which this analysis has been done. A spreadsheet is available from those who wish to read all the impact assessments.

PROPOSAL	What economic effects is the proposal likely to have on the competitiveness of businesses?
Market Abuse Directive	Prohibition and enforcement against insider trading reinforce the level playing field between market participants in access to issuer information, and so increase the fair competitiveness between these participants. Similarly, prohibition and enforcement against market manipulation reinforce the level playing field between market participants through transparency in market participant behaviours, thus contributing to the fair competitiveness between the participants.
Prospectus Directive	Positive impact can be expected due to the lower cost of raising capital and the existence of harmonised and comparable conditions, for all competitors, within the Union.
Investment Services Directive	<p><u>On the industry.</u> The proposal will increase of the confidence of investors in the fair functioning of the market due to the application of the market efficiency and investor protection oriented rules. This could well soar the European savings rate. In addition, it enhances the competitiveness of the financial industry as a whole. It creates a playing field which can adapt to the future evolution of the financial markets. It encourages innovation whilst taking due account of the interest that are to be protected. This openness will reinforce the European financial industry making it stronger and more adapted to the needs of its customers.</p> <p>Competitiveness, innovation and development will not only result in more employment in the financial sector but also in better shaped strategies towards investors. These will be able to get better risk-adapted financial products which should enhance the medium and long term returns of their savings.</p>
Transparency Directive	Positive impact can be expected due to the lower cost of raising capital throughout the European Union and new robust Community disclosure requirements to which host Member States may not add further disclosure requirements. This does not prejudice other requirements for admission of securities to trading on a regulated market.
Collateral Directive	A sound and efficient legal regime for limiting credit risk will improve the stability of the European financial market. The increased possibilities for conducting cross-border business will create a more competitive market, which in macroeconomic terms are believed to enhance the potential for stronger growth in the gross domestic product and therefore also in job creation.
International Accounting Standards Regulation	Adoption of uniform, high quality financial reporting rules in EU capital markets will greatly enhance the comparability and transparency of financial information, thereby increasing the efficiency of the markets and reducing the cost of capital for companies.
Takeover Bids Directive	Although the proposal does not promote takeover bids as such, the harmonisation of the rules which govern takeover bids will contribute to improving the competitive position of companies in Europe. At the moment there are legal, economic and structural differences between the Member States with respect to defensive measures that can be put into operation in order to fight hostile takeover bids, so that companies in some Member States are more protected than companies in other Member States. The proposal will reduce these differences in several ways, without compromising the competitiveness of EU companies in relation to companies of third countries.

UCITS Directives	The fact that a wider range of investment funds would be covered by the Directive 85/611/EEC and that the units of such funds could be freely marketed throughout the EU, could increase the competition among management companies, thus improving the price/quality relation of these investment products.
Distance Marketing Directive	The text establishes Community rules which will facilitate the use of new technologies in distance selling. This may lead to these techniques being used more often by consumers in the internal market and consequently may have the effect of increasing employment and investment in these activities. The cross-border possibilities may lead to an intensified competitiveness in retail business.
Pension Funds Directive	<p>Positive effects can be expected. In the absence of any coordination at Community level, IORPs are the only major financial institutions unable to offer their services in a Member State other than their own. It has been calculated that, for a pan-European company, the cost of setting up separate occupational systems in each Member State is about EUR 40 million per year.</p> <p>Allowing IORPs to manage schemes for companies established in another Member State would result in economies of scale of several types: more efficient investment policies as a result of asset pooling, simplification of administration and compliance with the prudential and reporting rules of a single supervisory authority. Furthermore, labour mobility would become easier: workers could more easily take up a job in another Member State if they could remain members of the same IORP; multinationals would come up against fewer obstacles to moving their employees from one Member State to another.</p>
E-Money Directive	<p>The proposal, by establishing a legal framework for electronic money issuance, is likely to encourage further development and innovation in this field. This should have positive effects not only on the issuing institutions themselves but also on related enterprises associated with technological hardware and software development.</p> <p>Moreover, the proposal removes any legal uncertainty that may have been associated with cross-border issuance. It should, therefore, increase competition in the business of electronic money specifically and payment instruments generally. Electronic money also has the potential to reduce the costs of cash handling for enterprises generally.</p>
Electronic Commerce Directive	The proposal again has a strong positive effect. By stimulating competition through facilitating entry in the market by small innovative firms, European electronic commerce suppliers will be internationally competitive in what is a truly global market.
Financial Conglomerates Directive	A single financial market will promote the competitiveness of the European economy and financial stability, and therefore will have a positive effect on investments and the creation of new business. The same goes for the competitiveness of business.

Taxation of Savings Income Directive	<p>The present scope for non-taxation of cross-border interest payments results in a loss of tax revenue for Member States and may even force some Member States to reduce their tax rates on domestic interest payments in order to avoid the risk of a further outflow of savings. By ensuring effective taxation of cross-border interest payments, the Directive can contribute to Member States' efforts to restore the balance between the burden of taxation on the different factors of production and thereby to achieve a reduction in the taxation on income from employment. This would be certain to have a positive effect on job creation and the fight against unemployment.</p> <p>The Directive should also have a favourable impact on the European financial area, because savers' decisions will no longer be determined by the possibility of avoiding tax but will instead be based on the intrinsic merits of the investments. This should help financial institutions, investment funds and other market operators to compete on equal terms.</p> <p>Since the scope of the Directive includes all cross-border interest payments, irrespective of the place of establishment of the issuer of the debt-claim giving rise to the interest, debtors established in the EU are not placed at a competitive disadvantage in relation to issuers outside the Community.</p> <p>Moreover, the scope of the Directive also includes income from investment funds established outside the Community when such income is paid in a Member State. The Directive should therefore not involve any particular risk of relocation of debt-issuing or investment fund activities to countries outside the Community. The risk of relocation of paying agent activities is reduced by the efforts that have been made to keep additional administrative costs to a minimum and by the continuing efforts to promote the adoption of equivalent measures at a wider international level.</p>
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Impact Assessments – A Private Sector Example

Ian McKenzie and Andy Sparks of OC&C Strategy Consultants published a study on “The Potential Impact of ISD2 Article 25” in August 2003. Its objectives were:

1. To identify and, to the extent possible, quantify the impact of the Article 25:
 - (i) As originally drafted (Note that this is the major thrust of this paper);
 - (ii) As per the compromise amendments that are emerging (as at mid-July)
2. To investigate the extent to which “off-exchange” trading is a likely to be detrimental to the effectiveness and efficiency of equity markets. We have addressed this by:
 - (i) Estimating the actual extent to which ‘true’ off-exchange trading currently occurs
 - (ii) Investigating the extent to which such principal trading can provide economic benefit to investors (as opposed to passing orders through to a central market on an agency basis)

Their main conclusions are:

- Overall, the model whereby Firms “smooth out” large institutional orders at one end of the order size spectrum and “aggregate” small, retail orders at the other end of the size spectrum is economically sound. Most of this apparently off-exchange trading activity does in fact end up in the central market as the potential for off-exchange crossing is actually quite limited.
- While the intentions seem honourable, many of the ISD2 proposals appear to be misguided in that they may well cause a withdrawal of liquidity from these principal trading roles which will increase costs and hurt investors through reduced liquidity, increased volatility and spreads, and worse prices.

In terms of quantifying the cost of the compromise proposals, OC&C conclude:

“While the narrowing of scope to the most active/systematic providers of principal execution appears a welcome step, the shift to normal/standard market size would move the impact of Article 25 directly onto the (core) institutional market. Without the ability to choose counterparties or the ability to price improve, those Firms who are caught by this provision will probably find it unattractive to continue to provide principal liquidity, This loss of liquidity would cause deterioration of prices for institutional clients (which might be worth **€375- 450m (around £300m) per annum**) and loss of price immediacy.”

This last figure was cited by the Chief Secretary to the UK Treasury, Paul Boateng, in his argument against the political agreement reached by the European Council on the ISD on October 7th 2003.

APPENDICES

1. SUMMARY OF LONDON ECONOMICS REPORT

“Quantification of the Macro-Economic Impact of Integration of EU Financial Markets”, November 2002

Financial services: integration of EU markets will boost growth, jobs and prosperity says new research

The integration of EU financial markets will bring significant benefits to businesses, investors and consumers. New research predicts that EU-wide real GDP will increase by 1.1% - or €130 billion in 2002 prices over a decade or so. Total employment will increase by 0.5%. Businesses will be able to get cheaper finance: integration of EU equity markets will reduce the cost of equity capital by 0.5% and a 0.4% decrease in the cost of corporate bond finance is expected to follow. Investors will benefit from higher risk-adjusted returns on savings. These are the main findings of new research conducted for the European Commission.

Internal Market Commissioner Frits Bolkestein said: "This economic evidence confirms what we have always said - that an integrated capital market in the EU will strengthen our economy. These results confirm the enormous prize that is up for grabs if we can finish off what we have started and drive through the remaining elements of the Financial Services Action Plan. I will do my utmost to achieve that and call upon the European Parliament and the Council to do likewise by taking the remaining difficult decisions that are necessary as quickly as possible. We must not miss this chance to put money in the pocket of every European. Furthermore these are the minimum gains they do not cover other major benefits such as wider choice, more innovation and easier finance for small companies. There could not be a better wake-up call to accelerate action.

The study is the first substantive piece of empirical research on the impact of financial integration on the cost of raising finance in Europe. The work began in late 2001. The consultants were invited to evaluate any impact of integrating EU equity and corporate bond markets on trading costs and the cost of capital. To the extent that a cost of capital impact could be discerned, they were asked to quantify any consequent impact on investment, GDP and employment.

This research highlights the powerful role that efficient and liquid financial markets can play in complementing bank-based finance to support growth and employment in Europe. It illustrates the need to complete the implementation of the EU's Financial Services Action Plan on schedule by 2005. The swift adoption of legislative proposals on Prospectuses, Market Abuse and Pension Funds, which are currently under negotiation in the Parliament and the Council, would be a decisive step in this direction.

The one measure which will do most to unleash these benefits will be the forthcoming Directive on investment services and regulated markets, due to be proposed shortly.

The estimates measure only the static effect of financial market integration on trading spreads (implicit trading costs). The research does not consider possible reductions in explicit trading costs (brokerage commissions or exchange fees) that can be expected to accompany increased competition between intermediaries and exchanges and lead to further economic benefits for EU citizens and business.

Furthermore, it does not measure the full dynamic benefits of financial integration. Related research including a further study to be published shortly by the Commission suggests that the deepening of financial markets resulting from integration can permanently boost output growth in manufacturing industry.

SUMMARY OF THE MAIN PROVISIONAL CONCLUSIONS OF THE STUDY

The cost of equity capital would fall, on average across Europe, by about 40 basis points, as a result of integration of EU financial markets.

There would be a further reduction of 10 basis points arising from reduced clearance and settlement costs, implying a total reduction in the cost of capital of, on average, 50 basis points across Member States.

The simulations performed as part of the study show that the combined reduction in the cost of equity, bond and bank finance, together with the increase in the share of bond finance in total debt finance should improve the equilibrium level of GDP and potentially also GDP growth:

- EU-wide real GDP is forecast to rise by 1.1%, or €130 billion in 2002 prices, in the long-run, defined as over a decade or so
- GDP per capita in current prices is forecast to be €600 higher in the EU and GDP per capita at 2002 prices €350 higher
- total business investment is forecast to be almost 6.0% higher and private consumption up by 0.8%
- total employment is forecast to be 0.5% higher.

These benefits will be shared by all Member States. There are no losers. Across the EU, the estimated increase in the level of real GDP stemming from integration of financial markets ranges from 0.3% to 2.0%. However, the majority of Member States show an increase in the range of 0.9% to 1.2%.

A breakdown of the contribution of the various changes in the user cost of capital shows that:

- the reduction in the cost of equity finance is the most important impact, accounting for 0.5 percentage points (or 45%) of the 1.1 percentage point increase in the EU-wide level of GDP in constant prices

the impact of the reduction of 40 basis points in the cost of bond finance alone is marginal, explaining a further 0.1 percentage point of the 1.1 percentage point increase in the EU-wide level of GDP in constant prices

The combination of the reduction in the cost of bond finance together with the increase in the share of bond finance in total debt finance, however, results in a more substantial boost to output. Together these two changes account for 0.3 percentage point of the 1.1 percentage point increase forecast in the EU-wide level of GDP in constant prices

Finally, the assumed reduction in the cost of bank finance of 20 basis points also explains 0.3 percentage point of the 1.1 percentage point increase forecast in EU-wide real GDP.

The results of the study do not take account of any dynamic effects that could raise output and productivity growth on a permanent basis. Thus, they can be said to be relatively conservative estimates of the likely impact of reductions in the user cost of capital brought about by deeper European financial market integration.

Moreover, European financial market integration will affect the EU economies through a number of additional channels (better portfolio allocations, greater access to finance, more innovation etc). Thus, the overall impact of European financial market integration is likely to be larger than reported in the research, which has focused on only one dimension of this integration process. A further study, to be published shortly by the Commission, supports this view by indicating the potential for permanently higher output growth in the manufacturing sector if all EU firms were to have access to more integrated and developed financial markets.

The full results are available on the Europa website:

http://europa.eu.int/comm/internal_market/en/finances/mobil/overview.htm

2. EXECUTIVE SUMMARY OF ZEW/IEP REPORT

“Benefits of a Working EU Market for Financial Services”, November 2002

1. Introduction

In spite of considerable progress toward European capital market integration following the completion of the Single Market and the introduction of the Euro, national borders still constitute a considerable de facto barrier for retail financial markets. Direct cross-border business between financial service suppliers and end consumers is still the exception. Against this background this report addresses the following questions:

How powerful is the integrating effect of ongoing market trends like internet and cross-border mergers and acquisitions?

Which benefits could be realised if a higher level of integration could be achieved?

Which obstacles are mainly responsible for incomplete integration?

2. Deficits of retail market integration

Although stringent legal impediments to cross-border activities in banking and insurance no longer exist different indicators show a relatively low openness of national markets. The market shares of foreign banks in individual EU countries are relatively small compared to other wealthy industrial countries.

Entry into national banking markets is largely occurring through mergers and acquisitions (M&A). Case studies on multinational banks reveal that factors like high fixed costs of market entry make greenfield investment less attractive than M&A based access strategies.

The picture is not very different for the insurance sector where direct cross-border sales without physical presence in the target market play only a marginal role. Again, cross-border M&As are the predominant entry strategy. In addition, integration indicators show a markedly lower integration level for the life than for the non-life insurance market.

European fund market data on the number of registered foreign funds seems to indicate a larger degree of integration. However, since many of these “foreign” funds are of the Luxembourg or Dublin “round-trip” type, this indicator is misleading. Market shares of true foreign funds only reach significant levels in big markets like Germany while some small markets are effectively completely dominated by domestic fund suppliers.

The impact of the internet on the integration of retail markets for financial services does not meet optimistic expectations even in the case of the most developed e-finance market, the market for online brokerage. The analysis of price differences and direct cross-border activities dispels illusions: although the internet is increasingly becoming an alternative distribution channel it does not by itself overcome fragmentation of retail financial markets in the EU.

3. POTENTIAL INTEGRATION BENEFITS

The report advances the following arguments and quantified estimates on the beneficial consequences of further integration of financial services markets for consumers and the economy in the EU as a whole:

–*Product choice would increase*, in particular for consumers in small countries who today suffer most from incomplete retail market integration. In these countries, the supply of available funds for example could be augmented by a factor between 10 and 20.

–*There is considerable scope for falling prices* resulting from a higher integration level in financial retail markets. Economies of scale could be realised. Calculations for the fund industry indicate a large cost savings potential: on the assumption that integration would lead to an average fund size in Europe similar to that of the US, there would be a *cost saving potential of about 5 billion Euro annually* given the present size of the EU fund industry.

These cost savings would be particularly helpful in the ongoing European reforms of pension systems since fund products will play an important role for funded old-age pensions.

- Private borrowers could benefit substantially through *lower interest rates*. A simulation for the period of falling interest rates in the second half of the nineties shows: if competitive pressure in a more closely integrated financial market forced banks to adjust mortgage interest rates more quickly to falling market rates private borrowers would benefit. In terms of a 100,000 Euro mortgage loan these integration savings in interest payments would have amounted in the period 1995–1999 to annually 2,550 Euro in Italy, 1,690 Euro in Spain, 1,580 Euro in Portugal and 790 Euro in Ireland.
- Retail market integration would probably also reduce the well-known home bias in private investors' portfolios. Performance calculations for national, European and world portfolios show that investors could significantly increase the Sharpe ratios of portfolios. Often the Europe-wide diversification is already sufficient to harvest all the *benefits of international diversification*.
- Furthermore, a larger degree of financial integration would be associated with *higher economic growth*. Theoretical considerations and insights from the relevant empirical literature back the assumption of a significant link between financial integration and growth. World-wide cross-country samples show that differences in financial integration between countries amounting to one standard deviation of the relevant integration indicators can explain annual growth differences of 0.5 – 0.7 per cent. Although these results do not cover all present EU member states they indicate roughly the potential for growth through financial integration: in terms of the EU GDP of the year 2000 the lower per cent figure of 0.5 would mean an additional growth effect of 43 billion Euro annually. A quantification of potential employment effects associated with more financial integration is difficult to make. They crucially depend on the flexibility of labour markets and the progress in labour market reforms.
- Finally, more financial integration is rewarded by a growing *international role of the Euro* because the efficiency of a currency's financial markets is among the determinants of its global acceptance. A greater acceptance of the Euro could in turn lead to additional benefits due to higher seigniorage, falling liquidity premiums and transaction costs.

4. OBSTACLES

A number of obstacles impedes the development of unified financial retail markets in Europe. There are policy-induced obstacles like different taxation, consumer protection or supervision arrangements that are capable of alteration, and there are natural obstacles like differences in language and culture that can not realistically be addressed by national or European policymakers.

The impact of the different types of obstacles varies according to product type.

- For *insurance* products, a lack of confidence in the long-run reliability of unknown foreign suppliers is a particularly relevant obstacle. Furthermore, discriminatory tax practices and national differences in consumer protection due to different national policies and interpretations of the “general good” are important obstacles in the insurance business.
- The *internet-based* financial retail business is confronted with the following obstacles in cross-border activities: the need to design a variety of national marketing strategies, market peculiarities related to regulatory differences in consumer protection and supervision, the high costs of cross-border payments, the problems of cross-border identification of new customers, the heterogeneity of technical systems of stock exchanges and the consumer preference for “handshake”, the physical meeting with the agent of a new supplier.
- Since successful management of asymmetric information problems is crucial for successful *credit business*, limited cross-border access to public credit registers and private credit bureaux is a particular integration obstacle for the credit market.
- For *funds* the outdated definition of UCITS in the directives limits cross-border marketing of innovative fund products. In addition, the burden of registration in a target market raises the costs for entering a national market. Furthermore, host country responsibility for supervision of advertising and marketing together with tax discriminations hamper the emergence of a unified fund market. The problems are aggravated by distribution channels that are still biased in favour of domestic fund companies.
- There is the danger that new obstacles are created as a consequence of national pension reforms. The German example shows that very specific national requirements on new *pension products* can constitute additional barriers to entry for foreign suppliers.

5. SOME POLICY CONCLUSIONS

A strategy based on an attitude of “wait and see” is not justified because on-going market trends indicate that integration is unlikely to be completed without adjustments to the regulatory framework. The substantial potential benefits for consumers and economic growth clearly show that it is worthwhile to push hard for more integration of retail financial markets. Any integration strategy should aim to simplify direct cross-border contact between suppliers and consumers.

This contact would speed up convergence of prices and promote a wider product choice everywhere in the EU. The need for political action also comes from the delicate fact that the “costs of non-Europe” are higher in smaller and poorer member countries than in the bigger and richer ones. While the Financial Services Action Plan and other legal initiatives properly address a number of integration obstacles, more needs to be done. Proposals for reforms are listed below. This is not an exhaustive list of recommendations. It briefly addresses the most burning issues; a detailed specification of the reform options would certainly need further analysis.

It is important to devote more effort to ending *discriminatory tax practices* that currently shelter some national retail financial markets from foreign competition, and which do not conform with the EU Treaty. Examples concern the markets for life insurance and investment funds.

Differences in *consumer protection* rules among the 15 EU countries render a pan-European marketing strategy and standardised products impossible. This issue is a critical policy-induced obstacle and could best be addressed by the creation of a consistent uniform level of protection with harmonization on that basis. Three specific recommendations are:

- The debate on derogation from the principle of home country control in the e-commerce directive should be reopened.
- Furthermore, the interpretation of the “general good” provision should be harmonised and/or restricted.
- There is a need to arrive at a unified definition of pension products in order to improve the conditions for developing a pan-European market for this high potential market segment.

With FIN-NET the Commission has initiated an important infrastructure for creating *consumer confidence* in the legal safety of cross-border financial services. However, the existence of FIN-NET so far is not common knowledge.

An information campaign is necessary to make this network of European ombudsmen better known and better understood, at least to the financial media and the staff of banks and insurers.

With regard to *supervision*, there are short-, medium- and long-term options:

- In the short-run it would be helpful if the supervisory committees devoted more effort to the consistency of rule-books, the standardization of reporting requirements and the harmonisation of supervisory practice.
- In the medium-term a serious reform debate should be initiated, reflecting the possible advantages of a two tier supervisory system where multinational companies could opt for supervision on a European level.
- With a long-term perspective, more thought could be given to the possibility of establishing a single European supervisory authority, especially if effective cooperation among 25 to 30 national agencies after enlargement proves to become too difficult.

There is a huge gap between the *vision* of the EU as the most dynamic economy in the world and the *reality* of still fragmented EU-markets. In order to reduce this gap, the whole process of European regulation of financial services needs to be speeded up and member-states have to over-come their national policies of preserving market barriers or even re-establishing new ones. Otherwise it will be impossible to achieve the strategic objective of the Lisbon-process of a more deeply integrated European Union which will be able to match the challenges of globalization and to secure full employment by 2010.

Finally, while the study has shed light on important aspects of the enduring “cost of non-Europe” further analysis is required. Two issues deserve to be looked at more closely given their enormous complexity: First, the implication of national pension reforms for integration and second, the adjustment of consumer protection regulation to the changing needs of the internal financial retail market.

3. Summary of key findings of OC&C Report

“The Potential Impacts of ISD2 Article 25”, August 2003.

Impact of Article 25 as Originally Drafted

1. Given that most Firms provide principal liquidity to their institutional clients across a broad range of equities, Article 25 would require them to publish continuous, firm, two-way prices in retail size for those equities – and to deal at these prices.

2. Article 25 would also appear to require Firms to deal via these retail-size prices with most “eligible counterparties” (which are defined by Member States). This implies that Firms would need to deal with a broader range of counterparties than they do today, with potential consequent increase to counterparty risk.

3. In broad terms Firms have four options in responding to this requirement:

- (1) Offer competitive retail prices and seek retail business
- (2) Offer uncompetitive prices so as to avoid having to execute retail business (though they may be restricted in their ability to do this on account of the requirement in article 25.3 for prices to reflect ‘prevailing market conditions’)
- (3) Refrain from offering these retail-size prices and therefore have to withdraw from providing principal liquidity (in those stocks) to institutional customers
- (4) Relocate trading operations outside the EU

Leaving aside the somewhat draconian option 4, and assuming that option 2 is possible, firms would be expected to make their decisions based on:

- (i) the costs involved in options (1) and (2) (including increased counterparty risk)
- (ii) the revenue likely to be generated under option (1)
- (iii) the impact of pulling out of principal, institutional trading under option (3).

(5) Assessing the likely revenue from option (1) – and the likely detriment from option (3) – is difficult. However, it is fairly clear that:

Firms with existing principal retail execution infrastructure (used at present largely for UK equities) would probably expand into the principal execution of retail order flow in Continental European equities with high traded turnover so as to be able to continue to offer principal execution to institutional clients. There would thus be an increase in principal trading activity at the retail level

Firms with or without existing principal retail execution would be likely to withdraw from principal trading in some less liquid (i.e., lower turnover) equities at the institutional level because principal trading at the retail level would be economically unattractive

(6) This withdrawal of liquidity at the institutional level is likely to cause spreads to widen on the affected stocks (from 5bp to 50bp depending on underlying liquidity). We estimate that this widening might cost European institutional investors around **£200m per annum** (about **EUR300m**) in worse prices, or simply discourage trading per se. The widening of spreads would be most notable at the smaller exchanges that might dent their ability to compete. The magnitude of this impact is very much determined by the scope of the stocks affected by the regulations.

(7) Total withdrawal of principal liquidity by Firms in the lowest traded stocks would expose institutional investors to increased market impact that might cause a further detriment of c **£50m** (about **EUR 75m**) **per annum**. Neither this, nor the effect set out in para -6 above, is a desirable outcome.

(8) Retail investors would also get worse prices under these new arrangements in that Firms would be reluctant to publish prices which included “price improvement” (as is currently the practice) for fear of being exposed to uncontrollable volumes and unwanted counterparties. This effect would cost retail investors an average 10% worsening of spreads.

Impact of Recent Compromise Proposals

(9) Recent (mid-July) compromise proposals seem to embody three major changes: (1) limiting the scope of Article 25's pre-trade price transparency requirements to Firms who "internalize on a systematic, regular and continuous basis", (2) expanding the scope of securities covered to "all listed securities" and (3) moving the published price requirement to "normal/standard market size". At the same time there is still debate around (i) whether to allow Firms to be more selective in their choice of counterparty and (ii) whether to allow Firms the ability to "price improve" their quotes on a client-by-client basis.

(10) While the narrowing of scope to the most active/systematic providers of principal execution appears a welcome step, the shift to normal/standard market size would move the impact of Article 25 directly onto the (core) institutional market. Without the ability to choose counterparties or the ability to price improve, those Firms who are caught by this provision will probably find it unattractive to continue to provide principal liquidity. This loss of liquidity would cause deterioration of prices for institutional clients (which might be worth **EUR 375- 450m (around £300m) per annum** and loss of price immediacy.

(11) Of all the provisions, the ability to price improve is probably the most important one as it provides the safety valve that would allow the other requirements to be workable.

The True Extent of Off-Exchange Trading

(12) The ISD2 legislation appears predicated on the assumption that off-exchange trading (internalisation) is both significant and detrimental. Our findings suggest that there is much confusion surrounding the definition of terms and that, in reality, 'true' off-exchange activity is neither overly large nor damaging.

(13) We have developed a framework for identifying the various different routes for the execution of client orders in the context of order-book equities and classifying them as on- versus off- exchange.

Based on indicative data from Firms, the key findings for order-driven stocks across Europe are:

- Pure agency trading is little used (4% of total traded value); instead major use is made of back-to-back risk-less principal trading (47%) which achieves the same end result and should be treated as on-exchange trading
- Extensive use is made of "worked risk-less principal trades" (23%) whereby the Firm smoothes the order into the market over time. Again we consider these to be on-exchange trades
- The remaining 26% of client trades is handled by Firms as "true principal trades" i.e., where the Firm provides liquidity and price immediacy for its clients. However around half of the resulting positions are actually still worked-off in central markets. Hence the only truly off-exchange trading is the circa 10% which the Firm 'crosses' between clients and the circa 4% which the Firm executes directly with other Firms (inter-investment firm market)

(14) We therefore conclude that off-exchange trading is rather less than some other data would lead one to believe. Consequently, the extent to which principal trading of equities by Firms 'fragments' liquidity is probably less than generally imagined.

The Economic Rationale for Firms to Undertake Principal Trading at both Institutional and Retail Levels

(15) Although still a widely debated issue, OC&C's view is that the 'fragmentation' of liquidity between different trading venues does not necessarily mean that overall market liquidity is diminished provided that there are some (investor) firms who can access across the different pools of liquidity. Rather, we would argue that principal trading by Firms is economically advantageous for certain kinds of orders (essentially very small orders and very large orders) with the result that overall liquidity is enhanced.

(16) Principal trading by Firms for large institutional orders offers advantages in that it can (i) mitigate "market impact" by "smoothing out" demand on the central market which helps avoid unnecessary price volatility (worth potentially 30-50bp), (ii) reduce transaction costs (given the lower cost involved in crossed trades) and (iii) provide price immediacy (which stimulates trading).

Given active competition between Firms, these benefits will largely accrue to investors.

(17) Principal trading at the level of retail order flow is also economically advantageous in that principal execution is inherently cheaper on account of (i) reduction in exchange fees and market-side clearing and settlement costs as the Firm only needs to go to the market (to flatten the net position) on a periodic basis; (ii) ability for Firm to capture spread through crossing of trades which allows the Firm to reduce/eliminate commission; (iii) potentially reduced clearing and settlement costs on the client-side as and when custody is shared.

(18) Finally, it is hard to argue that principal trading by Firms causes detriment to investors through lack of price transparency as (i) institutional investors are sophisticated and (ii) retail investors (trading via retail-facing intermediaries) are generally protected by best execution rules.

Conclusions

(19) Overall, the model whereby Firms “smooth out” large institutional orders at one end of the order size spectrum and “aggregate” small, retail orders at the other end of the size spectrum is economically sound. Most of this apparently off-exchange trading activity does in fact end up in the central market as the potential for off-exchange crossing is actually quite limited.

(20) While the intentions seem honourable, many of the ISD2 proposals appear to be misguided in that they may well cause a withdrawal of liquidity from these principal trading roles which will increase costs and hurt investors through reduced liquidity, increased volatility and spreads, and worse prices.