EU FINANCIAL REGULATION AND SUPERVISION BEYOND 2005

CHAIRMAN: ALASTAIR SUTTON
PARTNER, WHITE & CASE

RAPPORTEURS: KAREL LANNOO
CHIEF EXECUTIVE AND HEAD OF THE FINANCIAL MARKETS RESEARCH PROGRAMME, CEPS

JEAN-PIERRE CASEY
RESEARCH FELLOW, CEPS

CEPS TASK FORCE REPORT NO. 54
JANUARY 2005
This report is based on research and discussions in the CEPS Task Force on Financial Regulation and Supervision beyond 2005. The members of the Task Force participated in extensive debates in the course of several meetings and submitted comments on earlier drafts of this report. Its contents convey the general tone and direction of the discussion, but its recommendations do not reflect a unanimous position reached by all the members of the Task Force, nor do they represent the views of all the institutions to which the members belong. The main body of the report was prepared by the rapporteurs, taking into account the many comments they received from the Task Force members. A list of participants and invited guests and speakers appears at the end of this report.

The rapporteurs are Karel Lannoo, CEPS Chief Executive and head of its financial markets research programme, and Jean-Pierre Casey, Research Fellow at CEPS. They would especially like to thank Alastair Sutton for superb chairmanship, Mattias Levin for laying the groundwork of the Task Force and all the members of the Task Force for their detailed comments on earlier drafts. The rapporteurs would also like to recognise the contributions arising from presentations at Bocconi University, Milan on 12 November 2004 and the Financial Services Committee of the EU Council on 21 January 2005, along with the discussions at the Conference on Supervisory Convergence in Europe organised by the Dutch Ministry of Finance in The Hague on 3 November 2004.

ISBN 92-9079-544-1

© Copyright 2005, Centre for European Policy Studies.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means – electronic, mechanical, photocopying, recording or otherwise – without the prior permission of the Centre for European Policy Studies.
## Contents

**Executive Summary** ................................................................................................................................................. i

1. **Financial regulation and supervision in the EU: A brief review** ................................................................. 1

2. **Issues raised by the regulatory and supervisory reform** ........................................................................... 6

3. **What structure is emerging at the EU level?** ......................................................................................... 11

4. **Regulatory competition, coordination and co-operation** .................................................................... 13

   4.1 The normative question .............................................................................................................................. 14

   4.1.1 Advantages and drawbacks of regulatory competition ........................................................................... 14

   4.1.2 A middle way? The difficult equilibrium of co-operation .................................................................... 18

4.2 The positive question: Is there evidence of regulatory arbitrage? .................................................... 19

   4.2.1 The constitutionality and practicality of deference to foreign regulators or supervisors ................. 20

   4.2.2 The market structure question ........................................................................................................... 20

   4.2.3 Is there evidence? .............................................................................................................................. 21

4.3 Section conclusions .......................................................................................................................................... 25

5. **Future challenges** ......................................................................................................................................... 25

   5.1 Establishing a ‘levels test’ .......................................................................................................................... 26

   5.2 A broad-based approach to implementation and enforcement .............................................................. 27

   5.3 Getting the home-host relationship right ............................................................................................... 29

   5.4 Setting the right priorities ....................................................................................................................... 30

   5.5 Incorporating the new member states ..................................................................................................... 32

   5.6 Financial crisis management in the EU ................................................................................................... 38

   5.7 The EU as a global player in financial services ...................................................................................... 43

      5.7.1 Becoming an internationally accepted counterpart ........................................................................... 43

      5.7.2 The global competitiveness of EU financial markets ....................................................................... 45

6. **Conclusions** .................................................................................................................................................. 51

**Bibliography** ......................................................................................................................................................... 52

**List of Task Force Members** ............................................................................................................................. 58

**List of Invited Speakers and Guests** ............................................................................................................... 60
This is not the time to rest on our laurels. After a phase of intense regulatory activity, much remains to be done to make the single financial market work. The agenda of the Financial Services Action Plan (FSAP) is becoming more complex and multifaceted, implying the need for re-enforced coordination between the respective European Commission departments, between the EU and the member states’ authorities and among the member states. Special attention should now be given to the critical elements summarised below:

1. **Implementation and enforcement**. The new regulatory structure should be an important incentive for adequate enforcement, as it stimulates competition and peer pressure. Both elements are central for allowing the single market to work effectively, as the job cannot be done by judges and courts alone. The role of competition policy, which is always controversial, still needs to be developed by the competent authorities.

2. **Supervision**. Important differences persist among EU member states in supervisory competences. Convergence is expected to occur and needs to happen in conjunction with financial stability oversight, but this will demand the full cooperation of member states’ authorities. Political will needs to be marshalled to adapt to evolving market needs and to remove anachronistic elements in supervisory structures.

3. **‘Levels test’**. Excessive detail in level 1, which sets the framework principles, must be avoided by using a ‘levels test’. The most important required change in the Lamfalussy process is that there should be a clear distinction between the policy objectives of the proposal and the means to achieve them. A test would provide a clear and objective definition of what constitutes framework principles.

4. **Regulatory Impact Analysis (RIA)**. A broader use of RIA in the regulatory process should be supported, as it will further enhance the quality of regulation. It will make the decision process even more transparent and may limit the regulatory burden. It should be recognised, however, that the tool is not a panacea.

5. **The absence of users in the policy debate**. The expected shift of the regulatory agenda towards retail finance will emphasise even more the absence to date of users’ voices in the policy debate. Users should take advantage of the new structure to put their views across to prevent providers’ interests from dominating the policy agenda.

6. **Enlargement** creates further challenges on all the issues mentioned. Moreover, in the new member states, the banking sector is largely foreign-owned. The resulting asymmetry in supervisory structures is potentially destabilising, since it gives rise to incentive problems for host-country supervisors that could result in coordination failures. An EU information clearinghouse is needed to cement trust among supervisory authorities.

7. **Crisis management**. While the structure for resolving liquidity crises is largely secured, the same cannot be said for solvency crises with cross-border effects: the EU framework for burden-sharing is thus largely incomplete and needs to be further elaborated. Thus, it is essential that finance ministries be brought in from the cold through greater cooperation with supervisors and central banks, and the extension of memoranda of understanding to finance ministries to formalise a general *modus operandi* for crisis cooperation.
8. **International cooperation.** This should be extended to other countries or regions, along the lines of the fruitful EU-US dialogue. The framework needs to be further developed, however, to take account of the institutional complexities on both sides, and to allow for more transparency. The bilateral agendas should also not lose sight of the challenge for multilateral trade liberalisation in financial services.

9. **Global competitiveness.** On the post-FSAP agenda, the interaction between the regulatory burden and the competitiveness of European financial services firms, coupled with the attractiveness of EU financial centres as places to conduct international business, has emerged as an issue. The ability of financial services firms to innovate and to generate productivity growth – the key to rising living standards – should be a major concern to policy-makers. Effective regulation can help achieve this goal by overcoming market failures, so the quality of regulation is vital. Proper impact analyses should also study how regulation affects the ability of European firms to compete in global markets and of financial centres to continue to attract foreign business. Trade liberalisation is a vital ingredient in the global competitiveness of European firms, since the competitive pressures of global markets force them to innovate and to upgrade existing services. To ensure competition, equivalence in market access should apply globally.

10. **Self-regulation.** The ability of the market to come up with credible forms of self-regulation will determine its future. Besides the questions related to market integrity, of particular concern is the nexus between self-regulation and financial stability. This may be a future avenue for European initiatives, particularly as there is a significant potential for negative externalities to arise from market instability.
During the first half of this decade, the European Union managed to place itself decisively on the map in financial regulation. It launched the Financial Services Action Plan (FSAP) with a target date of 2005, raised awareness of the issues at stake, got the different stakeholders on board, adapted the structure of financial regulation and supervision and achieved the Plan’s adoption in time.

Political success raises the question of ‘what next’? A phase of intensive and successful regulatory activity prompts high expectations: for regulators, that things are now under control (and that they can relax), for providers and users, that the barriers have finally been dealt with and that they will benefit from a more integrated and competitive market.

This report was written in the context of a CEPS Task Force that was launched in January 2004 to discuss the aftermath of the FSAP and the new regulatory procedure. The Task Force met four times in the course of 2004 and discussed successively the challenges of integrating the new member states; financial stability, financial supervision and post-Lamfalussy regulatory structures; and finally the global dimension.

After a brief review of the recent history of financial supervision in the EU, this report discusses the issues raised by the supervisory and regulatory reform, examines what kind of structure is emerging, how regulatory competition and coordination interact, and finally discusses the challenges that lie ahead.

1. Financial regulation and supervision in the EU: A brief review

At the start of economic and monetary union (EMU), a debate on financial supervision in the EU was triggered by questions concerning the mandate of the European Central Bank (ECB) in this area. The ECB was seen to be a ‘narrow’ central bank, with price stability as its main objective, whereas financial stability oversight was left to the national central banks. Moreover, the ECB was given no direct role in prudential supervision, something that could only be changed further to unanimous agreement within the EU Council.

The situation whereby the ECB was given no role in financial stability oversight was seen as dangerous, as local central banks could give liquidity assistance to banks in trouble, which could undermine the monetary policy objectives of the ECB. Moreover, the lack of coordination of liquidity assistance could lead to market distortions, since national central banks could come under intense political pressure to bail out insolvent – as opposed to illiquid – banks. In addition, the potential for coordination failures to arise during systemic crises had to be addressed. A structure was therefore worked out by the ECB in the context of its Banking Supervision Committee (BSC), by which supervisors would inform the Eurosystem as soon as any major problems in the banking system arise. A mechanism for emergency liquidity assistance (ELA obliges the national central banks within the Eurosystem to provide information on the support given in exceptional circumstances and on a case-by-case basis to temporarily illiquid institutions and markets (ECB, 2000, pp. 98–99).
In the meantime, the EU had adopted its Financial Services Action Programme (May 1999), in which it proposed updating EU financial regulation to market integration with some 42 measures. The FSAP contained, among others, proposals to create structures to ensure appropriate regulation and supervision of the single financial market. It was considered that the current structures of supervisory cooperation were inadequate to deal with greater cross-border integration and conglomeration in the financial sector.

About one year later, the French presidency of the EU Council took the initiative to constitute a Committee of Wise Men to discuss the regulation of European securities markets, more precisely to improve the mechanisms to adapt to market changes and to come to a greater convergence in practices. On 17 July 2000, the EU Council of Economics and Finance Ministers (Ecofin) agreed with the mandate and composition of a group chaired by Alexandre Lamfalussy. The group reported a few months later. Among the main recommendations were the need for framework legislation, broad implementing powers for committees, strengthened cooperation between national regulators and stronger enforcement (see Box 1 for a summary of the ‘four levels’). This was endorsed by the Copenhagen European Council (March 2001).

Box 1. The four-level regulatory approach following the Lamfalussy report

1. **Broad framework principles for legislation** (level-1 legislation) are agreed at the EU level. The Commission, after wide consultations, makes a legislative proposal to the Council and the Parliament using co-decision procedures. In order to speed up the adoption process, existing fast-track procedures are used if possible. In order to speed up the legislative procedure, it was proposed that more use should be made of regulations, i.e. a legislative act that is binding in its entirety and directly applicable in all member states, rather than using directives, which can take up to 18 months for national authorities to implement.

2. **The detailed rules** (level-2 legislation) on how to implement the principles are developed at the EU level through the use of so-called ‘comitology’ procedures. Under such procedures, the Council delegates the power to decide on secondary EU legislation to the Commission. Representatives of the member states assist the Commission by participating in comitology committees – which have implementing power for secondary legislation. The European Parliament has little direct influence at this level and acts more like an external monitor.

3. Enhanced and strengthened **cooperation and networking between national regulators** ensures that implementation of Community law at the member state level becomes more consistent (level 3). The level-3 committees are in charge of producing guidelines for national implementation, in order to set best practice, conduct peer reviews, and develop joint interpretative recommendations and standards for matters not covered by EU law. The committees such as the Committee of European Securities Regulators, the Committee of European Banking Supervisors and the Committee of European Insurance and Occupational Pensions Supervisors have no implementing powers, but advise the European Commission on level-2 measures.

4. More attention is devoted to the **enforcement** of Community law. This is essentially the task of the Commission, but member states and their regulators are expected to enhance their cooperation as well (level 4).

The Council of EU finance ministers played a decisive role in the whole EU process, on the macro-prudential matters as well as on the micro-prudential ones. The European Commission functioned in both cases as a motor.

On the **macro-prudential side**, two reports from the ‘Brouwer Committee’ of the Economic and Financial Committee (EFC) – a committee advising the Ecofin Council on financial regulation, supervision and stability, which is composed of central bankers, ministry of finance...
representatives and Commission officials – are key. The first Brouwer report, published in April 2000, emphasised the need for strengthened cooperation between supervisors (across borders and across sectors) and between supervisors and central banks at national and EU levels. It also highlighted the importance of an effective exchange of information among supervisory authorities. It specifically criticised the lack of effective supervision of financial conglomerates in the EU. The role of coordinator for such groups is not formalised at the European level, according to the report, and consolidated supervision is not practised. For predominantly insurance groups, there is no framework to designate a consolidated supervisor, nor does there seem to be much cooperation among insurance supervisors. The report thus proposed that insurance supervisors conclude multilateral memoranda of understanding (MoUs) on how to commonly proceed towards effective supervision of insurance undertakings.

The second Brouwer report, published in July 2001, was even more revealing. It simply said that financial crisis-management procedures were not coordinated in the EU. Cooperation between home- and host-country supervisors is organised in MoUs, but these do not foresee specific procedures for crisis management. Moreover, information is often not exchanged among these authorities, nor is there agreement on what kind of information should be exchanged and who should be involved.

On the micro-prudential side, the work of DG Internal Market of the European Commission was crucial in sticking to the timetable of the FSAP and in facilitating the acceptance of the Lamfalussy approach by European Parliament and its implementation. Although the acceptance of the Lamfalussy approach was held up by Parliament for almost one year (caused by Parliament’s dissatisfaction with its limited role in the approach), the Commission did not wait and started implementing the new approach in its proposals for the Market Abuse and Prospectus Directives (May 2001). National supervisory authorities also acted and created the Committee of European Securities Regulators (CESR) on 11 September 2001 (a level-3 committee). The CESR charter states that it will improve coordination among European securities regulators and advise the European Securities Committee (ESC) on implementing measures, while remaining independent from the Commission.

The creation of the ESC (a level-2 committee) followed as soon as the European Parliament agreed with the new procedure (February 2002). Parliament agreed on condition that it would be fully informed about the decisions taken by the committee and that it would have sufficient time to make its wishes heard by the committee. Parliament’s agreement also depended on and expired with a satisfactory solution being found to the ‘comitology’ issue in the context of the European Convention and the 2003-04 Intergovernmental Conference.1

The important development from an institutional perspective is that the European Commission is in the driver’s seat under the comitology procedure. The Commission drafts the primary legislation, participates in the work of the CESR, drafts level-2 implementing measures and chairs the meetings of the ESC. Nevertheless, member-state authorities have an important, if circumscribed role to play. They maintain control in the CESR, putting forward advice by unanimity. Moreover, they retain their regulatory role by voting (by qualified majority) on the draft implementing measures put forward by the Commission in the ESC (Figure 1).

---

1 The European Parliament’s sunset clause expires four years after the coming into force of a directive, meaning that the Lamfalussy directives will need to be revisited from 2008 onwards if the new EU Constitution is not approved.
Figure 1. The Lamfalussy procedure – Levels 1 and 2

Level 1

Primary legislation

Consultation

Commission proposal

Co-decision

Regulation

Directive

- Consultation paper
- Comment and summary of replies
- Open hearings

- Focus on framework principles
- Consultation with ESC
  “The split between framework principles (level 1) and implementing measures (level 2) should be determined on a case-by-case basis in a clear and transparent way.”
  Conclusions of Stockholm European Council, Annex 1

- Discussion in ECON (EP)
- Draft report by rapporteur
- First reading EP
- Commission Working Party reaction
- Potential agreement by Ecofin Council
- If not agreement, up to two more ‘readings’

Level 2

Implementing measures

Commission

CESR

Commission

ESC

- The Commission, after consulting ESC, requests advice from CESR
- Awaits outcome of first reading before issuing provisional mandate to CESR
- Informs ECON of provisional mandate

- CESR consults on provisional mandate
- Hearing
- Provides provisional technical measures to Commission
- After adopting level 1 legislation, same procedure for final advice

- “The Commission has committed itself... to avoid going against predominant views which might emerge within the Council, as to the appropriateness of such measures. This commitment shall not constitute a precedent”
  Stockholm European Council (March 2001)

- Transmission of draft measure to ESC and ECON (EP), ECON 3 months to react.
- Discussion and vote in ESC (regulatory committee)
- If ESC agrees, draft goes to Council for decision and EP for consultation

European Parliament kept fully informed

Abbreviations:
CESR Committee of European Securities Regulators
ECON Economic and Monetary Committee of the EP
EP European Parliament
ESC European Securities Committee

Sources: Committee of Wise Men (2001) and Inter-Institutional Monitoring Group (2003).
The new procedure, as applicable to securities markets, was rapidly extended to banking and insurance as well. In December 2002, the Ecofin Council accepted the findings of another report by the Economic and Financial Committee (EFC). In particular, the Council “reaffirmed its clear preference for implementing arrangements based upon the Lamfalussy framework to all financial sectors” (EFC, 2002a). The EU structure for financial sector regulation and supervision would henceforth be made up of three separate sectoral committees, plus a fourth committee dealing with matters related to financial conglomerates (Figure 2).

**Figure 2. The new regulatory structure**

![Diagram of the new regulatory structure with abbreviations and sources](source: Ecofin Council Minutes, 3 December 2002, 14368/02 (Presse 361).)

**Abbreviations**

ESC European Securities Committee  
EBC European Banking Committee  
EIC European Insurance Committee  
EFCC European Financial Conglomerates Committee  
CESR Committee of European Securities Regulators  
CEBS Committee of European Banking Supervisors  
CEIOPS Committee of European Insurance and Occupational Pensions Supervisors  
EFC Economic and Financial Committee  
FSPG Financial Services Policy Group  
FSC Financial Services Commission
Furthermore, the Council decided that the EFC would remain the primary source of advice on issues related to economic and financial affairs along with financial stability, whereas a new Financial Services Committee (FSC), replacing the Financial Services Policy Group (FSPG), would advise the Council and the Commission on financial market regulatory issues and coordinate the work of the different Lamfalussy committees. The Commission’s decisions establishing the new committees were taken in November 2003 and the directive conferring the regulatory powers to the level-2 committees was adopted by European Parliament in April and the EU Council in May 2004. In a few years, the whole structure was re-drawn!

In the meantime, the European Commission managed to progress with the legislative measures contained in the Financial Services Action Plan, and by the end of May 2004 – the end of the 5th legislature of the European Parliament – 39 of the 42 measures had been adopted. The most important of the three outstanding measures, the directives implementing Basel II could not be adopted in time because of delays within the Basel Committee. The other two measures concern the harmonisation of company law, the 10th and the 14th Company Law Directives, and can be considered of lesser importance.

### 2. Issues raised by the regulatory and supervisory reform

The Lamfalussy approach has only been in force since February 2002, when it was approved by the European Parliament, and the first legislative measures following the new procedure, the Market Abuse (2003/6/EC) and Prospectus (2003/71/EC) Directives, are just coming into effect. Implementing measures have only been formally adopted for the Market Abuse Directive. It is thus still early to judge its effectiveness and even more so to evaluate other elements of the new process, such as the cooperation between supervisors (level 3) and better enforcement (level 4). Nevertheless, based on the first two years of experience with the new Securities Markets Directives and three years with the CESR, some general observations can be made.

On the positive side, the new approach has significantly increased the cooperation among supervisory authorities (see Table 1). Not only do ministry of finance representatives have to sit together when discussing draft directives, supervisors now also meet to discuss implementing measures. Although supervisors had already been meeting before, this was largely limited to the presidents of the supervisory commissions, in the context of the pre-Lamfalussy regulatory committees. Today, the specialists also meet on a regular basis in ad-hoc committees dealing with specific matters. This development should certainly have a positive effect on the quality of European financial regulation and on levelling the regulatory playing field. It increases the degree of regulatory harmonisation and reduces the possibility for host-country restrictions. At the same time, supervisors are aware that their respective financial centres are in competition with each other and that they need to ensure that regulation is in line with market needs.

---

2 The FSPG was created by European Commissioner Mario Monti in early 1999 to give new impetus to ensuring a fully functional single market for financial services.


4 A political agreement was reached in the Competitiveness Council on the 10th Company Law Directive (cross-border mergers) on 26 November 2004.
Table 1. Strengths and weaknesses of the Lamfalussy procedure

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Forces supervisory authorities to cooperate, fostering convergence of supervisory practices</td>
<td>• Lacks a clear rule to differentiate between framework measures and details</td>
</tr>
<tr>
<td>• Fosters ‘co-opetition’ among supervisory authorities: there is a constructive ambiguity between regulatory cooperation and competition</td>
<td>• Raises questions of what is left for level 3 – standardisation?</td>
</tr>
<tr>
<td>• Increases the transparency of the regulatory process</td>
<td>• Tendency towards more centralisation: the European Commission is in the driving seat and the role of national supervisory authorities is limited (to an advisory capacity)</td>
</tr>
<tr>
<td>• Ensures a higher degree of regulatory harmonisation</td>
<td>• Process is laborious, complex, time-consuming and resource-absorbing for the authorities as well as for the private sector</td>
</tr>
<tr>
<td>• Reduces possibilities for host-country restrictions</td>
<td>• Increases the opportunity for regulatory capture</td>
</tr>
</tbody>
</table>

Because of the need for consultation and openness during different stages in the process, the regulatory process has also become more transparent and accessible. This has, however, at the same time increased the inherent complexity. Owing to the requirement to consult at several stages, the process has become very laborious and complicated. It is both very time-consuming and resource-absorbing, for regulators as well as for the private sector, let alone for consumers, to be informed in all the stages. This is especially the case for smaller member states, small firms and less-powerful interest groups. Those who care most about following the process from the beginning, and who have the means to do so, can possibly influence the process the most (although it could be argued that this was not visible in the past).

On the more critical side, two major related points emerge: the relativity of the concept of ‘framework legislation’ and the corollary danger of too much centralisation. The legislative process so far has revealed that framework legislation, although attractive in theory, is difficult to apply in practice, mainly for political reasons. When a certain matter is left to level-2 decision-making, it is largely in the hands of the European Commission, away from the direct political control of the member states and European Parliament. The 2001 European Council in Copenhagen already recognised this difficulty, when it stated that “the split between framework principles (level 1) and implementing measures (level 2) should be determined on a case-by-case basis and in a clear and transparent way” (European Commission, 2002d), thus recognising that there is no theory on this and that its interests have to be taken into account. The European Parliament also insists on having as much say as possible on level-1 matters, since it has no say on those in level-2. In the first legislative measures following the Lamfalussy approach, both institutions have been demanding more detail on level-1 legislation.

The best examples to illustrate the inherent tendency of the political process to bring more details into level 1 are the negotiations surrounding the new Investment Services Directive (ISD). The new ISD, now renamed the Markets in Financial Instruments Directive (MiFID) (2004/39/EC), was one of the centrepieces of the Financial Services Action Plan. It updates the regulation of exchanges and investment firms to market developments and addresses inconsistencies and loopholes in the 1993 ISD (Directive 93/6/EC). It abolishes the concentration provision, by which trading orders have to be executed on an exchange, and forces all the member states to allow the internalisation of trades by investment banks. The draft was published in November 2002, following extensive consultation with interested parties, as is required under the Lamfalussy approach. Just before the formal proposal was published,
however, an article was added to the Directive (Art. 27) requiring ‘internalisers’ to publish quotes for shares they trade on a systematic basis, the so-called ‘pre-trade transparency’ rule. The Commission initially thought to leave this matter to level 2, i.e. to the implementing measures to be decided upon by the supervisors, but at least two member states strongly insisted that the European Commission have it as part of level 1. Nevertheless, our research did not find evidence to mandate pre-trade transparency.5

A simple comparison of the 1993 ISD (or ISD I) with the 2004 MiFID indicates how relative the concept ‘framework’ legislation is (Table 2). The 2002 Commission draft (ISDII) was already 80% longer, based upon a simple word count, than the 1993 ISD. The final text, after it went through the co-decision procedure with the European Parliament and the EU Council, was a further 20% longer than the Commission’s proposal and more than double the size of the 1993 version. The much-debated Art. 27 regarding pre-trade transparency doubled in size in the co-decision process. Moreover, comitology will be applicable to 21 articles of the Directive, which will further increase the wordiness of the legal texts.6

Table 2. ISD I and ISD II (MiFID) in European law

<table>
<thead>
<tr>
<th></th>
<th>Number of articles</th>
<th>Articles open to comitology</th>
<th>Total word count (including recitals)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ISD I (1993)</td>
<td>32</td>
<td>(few and never implemented)</td>
<td>14,381</td>
</tr>
<tr>
<td>ISD II (Commission draft, 2002)</td>
<td>67</td>
<td>21</td>
<td>25,556</td>
</tr>
<tr>
<td>MiFID</td>
<td>73</td>
<td>21</td>
<td>31,451</td>
</tr>
</tbody>
</table>

Source: Rapporteurs’ own data.

A related point of criticism is that there is a danger of too much centralisation, as previously mentioned. One of the reasons for the FSAP and the Lamfalussy approach was to stimulate further market integration. Additional host-country rules in EU financial market regulation were often so restrictive as to prevent the cross-border provision of services and were a hindrance to the single market. The new procedure tries as much as possible to make sure that a single rule will apply in the EU as a whole. Once a measure has been adopted at level 1, it is largely in the hands of the European Commission to make sure that it works. The European Commission is, in the implementing measures, free in principle to accept or reject what the committee of supervisors proposes, and it also chairs the comitology committee that decides on implementing measures. It is furthermore in charge of enforcement. The new Constitutional Treaty of the EU further strengthens the control of the European Commission over implementing measures, as comitology is formally abolished in Art. 36, meaning that the Commission could, in theory, itself decide on secondary legislation, subject to a ‘call back’ of the European Parliament and the Council (see Art. 36 of the Constitutional Treaty of the EU (2004), reproduced in Box 2).

5 Considering the uncertainties regarding i) the harmfulness of the underlying feature (fragmentation, internalisation), ii) the effect on market quality of imposing pre-trade requirements and iii) the current extent of the potentially harmful activity, Levin (2003) argues that imposing pre-trade transparency on investment firms appears premature.

6 Level-2 measures are implemented by the European Commission through EU directives or regulations; see the Market Abuse Directive (2003/6/EC), implementing measures.
Box 2. Art. I-36 of the EU Constitution

Delegated European regulations

1. European laws and framework laws may delegate to the Commission the power to adopt delegated European regulations to supplement or amend certain non-essential elements of the law or framework law.

The objectives, content, scope and duration of the delegation of power shall be explicitly defined in the European laws and framework laws. The essential elements of an area shall be reserved for the European law or framework law and accordingly shall not be the subject of a delegation of power.

2. European laws and framework laws shall explicitly lay down the conditions to which the delegation is subject; these conditions may be as follows:

(a) the European Parliament or the Council may decide to revoke the delegation;

(b) the delegated European regulation may enter into force only if no objection has been expressed by the European Parliament or the Council within a period set by the European law or framework law.

For the purposes of (a) and (b), the European Parliament shall act by a majority of its component members, and the Council by a qualified majority.

Whether centralisation in EU legislation is already too advanced is again probably too early to say. Yet the above example of the ISD certainly illustrates that there is a levelling-up harmonisation occurring in financial market regulation – a tendency towards the ‘one-size-fits-all’ approach. The new ISD renders operating conditions much more demanding than its predecessor. Best-execution and customer-information requirements have become very onerous, to a degree that many may prefer to stay out of the business. While large firms will be able to cope with these requirements, smaller brokers or special business models may not. Not only does it increase the cost of doing business, it may open the way to much more litigation than we have seen so far.

An element of this tendency towards centralisation is the use of maximum harmonisation in some directives. Under this approach, member states cannot introduce additional requirements other than those specified in the directive. It has been used in the Prospectus Directive (2003/71/EC) to ensure that a single format for prospectuses for securities issues is acceptable throughout the EU. The reliance on maximum harmonisation emerged in response to the difficulties that providers have faced with additional host-country restrictions in the cross-border provision of financial services in the EU. Under the minimum harmonisation approach, followed in the EU’s single market programme, minimum standards for the free provision of services are set under EU law and additional national rules are subject to mutual recognition. This approach was seen to be more effective for market integration, as maximum harmonisation was almost impossible to achieve and it leaves scope for market-driven adjustments. In practice, however, mutual recognition was often not working sufficiently.

The reliance on maximum harmonisation raises some fundamental problems, however. First, as the body of EU single market law is based on the principle of minimum harmonisation, the practical application of legislation where member states cannot impose additional rules is a recipe for problems. It will only work in clearly distinct areas with limited or no overlap with

---

7 Maximum harmonisation was also used in two other financial market directives, i.e. the Distance Marketing of Financial Services Directive (Directive 2002/65/EC) and the prospectus-related part of the UCITS 3 Directive (Directive 2001/107/EC) regarding investment funds. The Commission also proposed using it in the draft Consumer Credit Directive (COM(2002) 443 of 11.9.2002), although the European Parliament changed this to minimum harmonisation in the first reading.
other areas of lawmaking. In the area of consumer credit, for example, a directive harmonising the conditions for the cross-border provision of consumer credit using the maximum harmonisation approach directly affects EU or national legislation regarding personal data protection or contract law. Second, it will be much harder to prove on the basis of subsidiarity and proportionality – basic principles of EU law-making – that a maximum harmonisation directive is necessary. Third, it excludes regulatory competition and market-driven adjustments. In the area of disclosure regulation, for example, mandating a maximum level of harmonisation in securities prospectuses seems like a contradiction in terms, as an optimal level of disclosure can never be mandated, and room must therefore be built-in for market-led improvements.8

Maximum harmonisation also opens the way towards a single supervisory authority. If standards are the same all over the EU, it is of little use to continue to apply the home-country control principle, which is a cornerstone of the single financial market. Under maximum harmonisation, member states only compete in supervisory performance, not on regulatory standards. It would thus strengthen the argument in support of unifying financial supervision in a single authority. Yet this would be a fundamental mistake. It would suppress one of the central elements of the Lamfalussy approach, the constructive ambiguity between regulatory cooperation and competition (‘co-opetition’) and the incentives for supervisory authorities to stay alert and responsive. As the corporate scandals in the US have illustrated, oversights under a single-entity supervisory model can have more damaging effects for market confidence than a more decentralised structure. Moreover, a single European supervisory agency would be ill-adapted to the state of European market integration. It would suit the needs of some big players, while creating perverse effects in the markets.

Another factor that indirectly leads to more harmonisation, and thus centralisation, is the cooperation between supervisors in level 3. The Lamfalussy approach foresaw in its level 3 essentially two elements, i.e. advisory work for level-2 implementing measures and standardisation regarding matters not covered by EU law. The practice regarding the second angle of level 3 has shown that it is almost impossible to work through standardisation because of legal reasons. This is a weakness within the Lamfalussy approach, which has surfaced during its implementation. Standards adopted by supervisors at level 3 have no legal force; hence market participants fear that under level-3 standards local operators may be advantaged if problems occur (see the IIMG report, 2004). This was concretely brought to light in the work on the CESR/ECB consultations regarding standards for clearing and settlement bodies, which will now most probably lead to a directive (see below).

A final point of critique is the insufficient attention given to cost/benefit analysis. The FSAP has been pushed through with remarkable speed. This has, however, often been achieved at the expense of a broader impact analysis and a proper appraisal of the merits of certain proposals. A case in point is the Transparency Directive, which deals with ongoing disclosure requirements for issuers on European capital markets.9 The Directive had in its initial draft a requirement for limited quarterly reporting for all equity issuers in the EU, of which debt issuers would be exempt.10 The argument for this requirement in the original Commission proposal was thin and not well-substantiated. It was stated that mandatory quarterly reporting, which is not required to the same degree for debt securities issuers, would enhance stock performance and provide better

---

8 See Lannoo & Khachaturyan (2003) for a detailed discussion of this specific issue.
10 The requirement for quarterly reporting was omitted in the final adopted text and replaced by a requirement for “interim management statements”. Quarterly reporting was left to national governments or exchanges as a listing obligation.
Research, however, shows that the usefulness of mandatory quarterly reporting in the US remains unclear. It is not seen to clearly increase the level of relevance or reliability of the disclosed information, nor does it lead to enhanced stock performance. It rather strengthens investors’ biases without necessarily improving market quality (which does not mean that it cannot be useful to mandate it as a criterion for stock-exchange listing or to use it at the firm level) (Lannoo & Khachaturyan, 2003, p. 33). One cannot avoid the impression that its insertion illustrates an eagerness to merely replicate what is in place in the most-developed capital market in the world. Regarding debt issuers, successive events in European capital markets have made the argument for exemption look pale. A proper cost/benefit analysis could have avoided such embarrassing statements.

3. What structure is emerging at the EU level?

The new structure for financial supervision is based on sectoral committees, under the control of the finance ministers and the European Commission, with a lesser role for the central banks. Two important reasons for keeping the central banks, particularly the ECB, at a distance are accountability and the need for a link with fiscal powers. Several excerpts of discussions in the Ecofin Council make it clear that the Finance ministers took a definitive stance on the emerging structure. The minutes of the meeting on 7 May 2002 (EFC, 2002b, p. 10) explicitly state, as quoted below, that the structure for financial regulation and supervision must be consistent with:

- The allocation of powers and responsibilities as set out in the Treaty;
- Appropriate accountability to EU institutions, in particular political accountability to the Ecofin Council;
- Subsidiarity, since supervisory tasks are best performed as close as possible to supervised entities and since financial crises may have implications for public finances;
- Neutrality with respect to models adopted at the national level.

The 12 July Ecofin meeting of the same year added that the new approach should “take into account synergies between banking supervision and central banking” and that also accountability to the European Parliament was of great importance (EFC, 2002c, p. 7). The same Council also stated that all EU parties with an interest in maintaining financial stability should be brought together in a new forum, and that insurance sector legislation should be dealt with by the Ecofin Council. Insurance matters were previously dealt with by the Internal Market Council (industry ministers).

The final decision on the new structure was taken by the Ecofin Council of 3 December 2002. The Council clearly specifies that financial regulations, and issues to be decided upon in the level-2 committees, are a matter for the (finance) ministries. On the supervisory level, “non-supervisory central banks, including the ECB, should attend meetings of the new banking committee, with the competent supervisory authorities holding the vote” (EFC, 2002a). The Council adds that the representative of the ECB’s Banking Supervision Committee will have observer status, meaning a non-voting seat. It is only on financial stability issues that the responsibility is shared with the central banks, where the Economic and Financial Committee has the task of coordinating and signalling matters to the Ecofin Council.

---

It is no coincidence that the debates at the European level often reflect what is going on at the national level. Among the ministers, the lead in the debates was taken by German Finance Minister Hans Eichel and British Chancellor Gordon Brown. A letter from both, which foreshadowed the 7 May 2002 decisions, was addressed to the President of the Ecofin Council, Minister Rodrigo de Rato y Figaredo. Mr Eichel had been involved in a political fight with the Bundesbank regarding the structure of financial supervision in Germany, which he finally won, whereas Mr Brown had made the reform of financial supervision in the UK a priority as soon as he took office in May 1997.

It is well known that the ECB tried to obtain a bigger role in banking supervision for itself and for the local central banks. In 2001, the ECB issued a paper on the role of central banks in prudential supervision, in which it argued strongly in favour of combining prudential supervision and central banking (ECB, 2001). It even detected a trend in this direction and refuted the arguments against combining both: “Arguments in favour of a separation of prudential supervision and central banking lose more of their force, while those in favour of combining become more prominent” (p. 7). It concluded that “when viewed from a Eurosystem perspective, the attribution of extensive supervisory responsibilities (i.e. both macro- and micro-prudential) is likely to prove beneficial” (p. 9). By issuing this paper in the heat of the German debate on the reform of the local financial supervisory structure, the ECB probably exceeded its competences, something that Mr Eichel will not have forgotten.

The role left to (non-supervisory) central banks and the ECB is mainly on the macro-prudential and crisis-management side, in cooperation with the EFC, which reports to the finance ministers. The ECB responded to the second Brouwer report by adopting an MoU in March 2003 regarding the cooperation between central banks and banking supervisors in crisis-management situations. The MoU covers the authorities responsible, the required flow of information and the practical conditions for sharing information across borders.

Is the new European structure a step towards a European financial services authority (FSA)? More likely not than yes. One of the weaker points of the new structure may be the lack of coordination between the different committees and the possible overlap of competences, something that should not happen in an FSA. For example, the Capital Adequacy Directive implementing Basel II (‘CAD III’) deals with banks and investment firms, meaning that both the banking and securities committees could be in charge of proposing implementing measures. A clear decision will need to be made in such cases as to which supervisory committee will deal with this matter. This gives an important role to the Financial Services Committee to coordinate the work between the different sectoral committees, a task it is committed to undertake. To deal with horizontal matters, the European Commission is also said to have initiated a cross-sector Roundtable of Regulators, where the chairs of the sectoral committees meet.

The new European structure will be closer to sectoral federal supervisory commissions, such as the US Securities and Exchange Commission (SEC), but of a more virtual nature, with a well-developed degree of coordination among them. The level-2 comitology committees have broad decision-making powers and decide by qualified majority. Decisions in the committees could

---

12 The letter from Mr Eichel and Mr Brown to Mr de Rato concerned the structures for European financial stability and supervision of financial institutions, dated 11 April 2002.

13 On the German structure, see Schüler (2004).

14 To overcome the lack of coordination, some have called for a European framework along the objectives of supervision; see Di Giorgio & Di Noia (2003). Others have argued that the Lamfalussy structure will fail since regulators are unwilling to share competences and a European FSA will follow; see Hertig & Lee (2003).
thus go against the interests of certain member states.\textsuperscript{15} The advisory committees have a permanent secretariat with a staff of about 10 persons and continuous interaction with the member states’ supervisory authorities on a wide variety of issues within their domain of competence. The structure of the European committees will, however, remain largely decentralised, and a fully integrated sectoral authority is unrealistic in the current constitutional and financial markets context. The most that could be done is to create a ‘one-stop-shop’ for certain specific aspects of financial regulation, such as a single authorising agency for securities prospectuses. This was proposed at some stage in the discussions on the Prospectus Directive by Minister Eichel.\textsuperscript{16} Yet it could only be effective within a totally unified framework of law and following a clear political decision on the legal basis (see below).

4. Regulatory competition, coordination and co-opetition

The present section delves into the academic debate on regulatory competition. Those who prefer to focus solely on the policy debate may wish to proceed straight to section 5. The decision to introduce this section was motivated by the fact that the tension between the benefits of regulatory competition and those related to creating a level playing field was always present in the background of the Task Force meetings and the wider policy debate. Therefore, this section looks at the merits and drawbacks of regulatory competition for financial services (securities in particular) and arrives at some conclusions in the EU context.

The degree to which regulators interact in today’s environment consists of a balance of competition and coordination, or ‘co-opetition’. In an increasingly globalised economy, the action of regulators is based upon a mixture of reactions to national preferences, regional developments and global tendencies. Which course of action national regulators decide to take for each of their functions will depend on how they balance their response to these various influences, such that social welfare in their respective jurisdictions is maximised.\textsuperscript{17} In some cases, social welfare is improved in a dynamic of competition between regulators, such that they face pressure to maximise the efficiency of government interventions in the economy. In others, negative spillovers from outright regulatory competition could result in a dynamic that is detrimental to welfare globally. Thus, the multi-faceted challenges posed by a globalised economy have undermined the role of ideology in defining regulatory stances: neither a liberal strategy of full-fledged regulatory competition, nor a \textit{dirigiste} one relying on coordination alone is likely to maximise social welfare.

\textsuperscript{15} The Stockholm European Council (March 2001), while endorsing the Lamfalussy report, stated explicitly that: “The European Council notes that within the framework of the comitology decision of 28 June 1999, the Commission has committed itself (…) to avoid going against predominant views which might emerge within the Council” (European Commission, 2001a). The European Parliament on the other hand had to be satisfied with the promise that the Commission would take “utmost account” of its views (ibid).


\textsuperscript{17} This naturally assumes a ‘benevolent dictator’ regulator as opposed to a myopic one driven only by self-interest.
4.1 The normative question

After the initial removal of barriers on a national level as a result of the single market programme, there has been a tendency towards re-regulation in the field of financial services at the EU-level. Evidently, a number of legislative measures were an essential component of completing the internal market for financial services. Yet in the wake of the FSAP, regulatory fatigue seems to have gripped European financial market actors, who have voiced their concern that regulation seems to be a growth industry in the EU. The tendency towards re-regulation, evidenced in the application of the latest ‘new approach’, or maximum harmonisation (as opposed to minimum harmonisation cum mutual recognition), could threaten the very ability of financial services firms to compete for available pools of capital (and service provision) in the global contest to attract foreign financial flows. For this reason, calls for focusing on market-oriented solutions such as self-regulation and market discipline, combined with an emphasis on enforcing current regulations rather than further burdening firms with additional layers of regulation, have recently multiplied. At the same time, there is an ongoing academic debate on the merits of regulatory competition, which has important policy implications for the trajectory of financial market development on both sides of the Atlantic. The debate is framed by both normative and positive concerns: should there be regulatory competition in the field of financial services; and is there any?

4.1.1 Advantages and drawbacks of regulatory competition

In a static setting, such inter-governmental competition is equivalent to a zero-sum game, since limited pools of capital are only available in fixed quantities. But whether regulatory competition is ‘positive-’ or ‘negative-sum’ in a dynamic context is the subject of considerable controversy. On the one hand, the ‘race-to-the-bottom’ school of thought, as expressed by a number of European regulators, argues that competition between governments is driven by the disproportionate leverage of mobile factors of production in determining regulatory outcomes, much to the detriment of social welfare. According to this logic, a society’s welfare may even suffer net losses ex-post, hence the term ‘negative-sum’. The classic counter-argument advanced by proponents of regulatory arbitrage is comprised of two elements: regulators are subject to capture by an influential, albeit exclusive, group of actors; and because the regulator has a monopoly, the level of regulation in a given jurisdiction tends to exceed that which corresponds with the optimisation of social welfare. Both scenarios justify regulatory competition as the best instrument for maximising the quality of regulation for a given regulatory burden, thus ensuring a ‘race to efficiency’ that improves social welfare.

A common starting point for any study on the merits of competition between regulatory authorities is Tiebout’s (1956) “theory of local expenditures” model. In this seminal contribution, Tiebout highlights the welfare-enhancing properties of limited competition between jurisdictions for tax revenues. The fundamental tenet of the model is that citizens behave like consumers and shop for the best ratio of quality of public services to tax burden. If they are dissatisfied with the level of this ratio in their home jurisdictions, citizens can ‘vote with their feet’ by migrating to a neighbouring jurisdiction, thus disciplining their home government.

In theory, this disciplining action can yield benefits: first, it puts pressure on governments to provide public services more efficiently; second, it is conducive to innovation and quality upgrades in the provision of public services. Much as the right of free entry acts as a constraint on the ability of a monopolist firm to squeeze rents out of its customers, the mere threat of a government’s tax base migrating abroad may restrain the spending impulses of the ‘leviathan’. Competition between governments is healthy according to this logic, since the ‘cartelisation’ of
government functions through excessive international cooperation could lead to inefficient outcomes. Regulatory monopoly at the international level can lead to a variety of abuses that replicate the dangers of excessive regulatory discretion at the national level: a regulatory leviathan, an entity subject to capture and (to take the example of securities exchanges) a limitation of both issuer and investor choice that reduces social welfare.\textsuperscript{18} In the case of the latter, not only does this limitation have the ability to reduce welfare by excluding some economic choices that free market competition would have enabled market participants to choose from, but it removes the freedom to choose in the first place, a value from which economic actors may derive some utility.\textsuperscript{19} In addition, excessive regulatory cooperation at the international level outside the contours of a clearly defined legal framework effectively amounts to a lack of democratic legitimacy (international standard-setting and policy coordination, such as in G-10 summits, may be of dubious constitutionality).

Two forces, one public, one private, can explain why cartelisation or excessive regulatory convergence leaves little room for innovation in securities market regulation. To begin with, a common standard or regulatory regime enjoying a monopoly through network externalities need not pay much attention to upstart rivals, so there is little incentive for regulators to improve their regime or to introduce better standards when they cooperate closely at the international level. In addition, there is an inherent risk in “benevolent planners” choosing what they believe to be the most appropriate market structure, because they may impose the wrong market structure and respond inadequately to changes in demand and to the introduction of new technologies, which may warrant a need to radically alter the market structure (Harris, 2003, p. 529; Sunder, 2001).

Now we turn to the private forces. As the incumbent standard is challenged on efficiency grounds, pioneers with low switching costs may migrate to the new standard, undermining the entrenched standard in the process. Firms with high switching costs owing to scale effects will be loathe to part from the old standard. At the same time, policy-makers in favour of the new standard will seek to buttress their arguments with academic cost-benefit analyses that underpin the case for introducing a new system. In such an environment as that described above, analysing the benefits of any rival system must by definition be an exercise in the counterfactual, since there is but one standard to begin with, and incumbents may undermine the credibility of the research by appealing to the concrete benefits of the current system over the benefits the rival system could potentially deliver. Further, incumbents may deliberately stifle innovation to maintain a certain market infrastructure that is advantageous to them. Such behaviour can explain why outdated trading systems such as that employed by the NYSE are still in existence (Harris, 2003).

What are the good reasons against governments competing? The most common argument relates to the classic outcome of negative externalities. Market failures arise in those specific cases where markets are known not to produce efficient outcomes. One such example is the case of a

\textsuperscript{18} A good example of the potentially welfare-reducing restrictions on market activity by the government is provided in Trachtman (1999, p. 5): “If the U.S., for example, regulates securities disclosure by requiring a minimum level of disclosure, that entails an implicit decision to constrain issuers from competing by offering less disclosure but a higher return, or other benefits”. In this case, a whole segment of the market is virtually wiped out by regulation. And, according to the first fundamental theorem of welfare economics, if a market exists, it is precisely because the situation that prevailed prior to the appearance of the market was not Pareto-efficient. By definition, a trade occurs because the two trading parties expect to be better off by executing the trade. Thus, when market participants will have exhausted all possible non-coercive means to increase their welfare through exchange, markets cease to exist and the allocation of resources in this economy will be Pareto-optimal.

\textsuperscript{19} For more on how the freedom to make choices consistent with one’s utility maximisation is itself a value that contributes to an individual’s welfare, see Sen (1999).
‘missing market’. The ‘missing market’ reflects the fact that economic agents do not ‘internalise’ (or bear) all the costs associated with their actions, thereby driving a wedge between the private and the social benefits of an action. As a result, they do not have a sufficient incentive to take stock of the costs their actions impose on others. It is the property of negative externalities that leads to the race-to-the-bottom outcome in regulatory competition.

In the case of securities markets, negative externalities can arise in the competition for foreign listings. When a dynamic of competition is introduced into disclosure regimes, jurisdictions that offer firms an option of less transparency could potentially attract listings away from foreign exchanges where more stringent standards apply. Because they are afraid to lose market share, the foreign exchanges may be forced to match or to one-up the lax regime by softening disclosure standards. This game of tit-for-tat thinning down of regulation harms social welfare, because it will lead to an under-provision of public goods, in this case regulation. As a result, investor protection will lie beneath its socially optimal level.

Other arguments against competition concern litigation rights and investor approval of midstream regime changes (Romano, 2001). Most securities regulators apply territorial jurisdiction, or host-country control, as in the case of the SEC in the US. But host-country control is not consonant with regulatory competition. Where there is genuine competition among regimes, home-country control means that investors buying securities on a foreign exchange is listed can expect to have no more protection than that accorded to investors resident in the home country of the firm. But cross-border litigation rights are difficult to enforce, particularly as the costs are high and there is usually little expertise in foreign securities law. As for midstream regime changes, Romano points to the possibility that once a firm’s capital is raised in a high-disclosure regime, managers may shift the firm’s domicile to a jurisdiction where disclosure standards are lax. If such a move were to be unanticipated by investors, the premium they will have paid for greater disclosure will have been for nought – a clear profit-making opportunity for firm insiders.

More importantly, Trachtman (1999) argues that regulatory competition is inconsistent with private competition – and hence, market efficiency. In a situation where governments compete for foreign capital, for example, by demanding lower disclosure standards to lure firms away from foreign exchanges, considerations other than the pure economic return generated by the investment are entering a firm’s choice of how best to allocate its capital. The costs of the distortions generated by a government that seeks to undercut its competitors by offering laxer regulatory standards are borne by the citizens or other corporate sectors of the domestic economy (or both), which are effectively taxed to provide the subsidy to the sector facing foreign competition, as well as by taxpayers abroad, who must bear the costs of the negative externalities generated by such a dynamic. On the other hand, where regulation is harmonised across borders, firms operate on a level playing field, which means that capital is allocated according to the purest method: the opportunity costs of production. Distortions of market-driven allocative processes will thus be minimised. Economic theory predicts that for efficiency to be maximised, true comparative advantage must be divorced from a competitive advantage that arises from distortionary government policies.

Finally, there is the issue of sovereignty. One of the chief concerns surrounding regulatory competition is the risk that regulatory outcomes are dictated by mobile factors of production, to the detriment of other policy objectives conducive to the general public interest. Because capital is highly fungible, external pressures undermining the domestic regulatory regime cannot be ignored by regulators. This can lead to perverse effects. Allowing home-country control for third countries in a framework of regulatory competition, which would grant access to EU financial markets under terms that differ from standards for EU market participants, poses a certain number of problems, not least because it would undermine the need to regulate in the
first place. Under home-country control for third countries, a foreign firm could benefit from the liquidity and depth of EU financial markets without paying the costs associated with these benefits, the costs being a higher regulatory burden. As Trachtman (1999, p. 5) notes, such competition would “frustrate the public policy goals expressed in these local laws. The need for regulation indicates a need for ‘monopolist’ regulation”. It is one of the main reasons why in the EU mutual recognition cannot be applied bilaterally by one of the member states to a country outside of the EU.

Nevertheless, as Drezner (2001, p. 12) notes, the race-to-the-bottom hypothesis does rely on three strong assumptions: it assumes corporations always prefer lower regulatory standards; that irrespective of labour productivity or cost, regulations impose enough of a cost on firms to affect their choice of location; and that the state cares only about the preferences of mobile factors of production, regardless of the other sectors in the economy.

After this overview on the merits and drawbacks of regulatory competition, we analyse from a financial regulatory perspective two key concerns surrounding the Tiebout conclusions: whether the assumptions in the model are valid for financial markets, such that the model can be successfully extended, and whether a stable equilibrium can be reached, which would prevent a ‘race to the bottom’.

Can the Tiebout model be extended to the regulation of the securities industry? When cross-listing, firms do not truly leave their home jurisdictions as citizens in the Tiebout model would do by ‘voting with their feet’. On the contrary, despite listing on foreign exchanges, these firms continue to trade on exchanges in their home jurisdictions. In fact, it has even been observed that when firms cross-list overseas, most of the trading activity in its stock eventually flows back to the home exchange, the so-called ‘flow-back’ effect. As Coffee (2002, p. 85) notes, because firms only make a “pseudo-flight” away from their home jurisdiction when cross-listing, one cannot compare them to the actors in the Tiebout model – and thus the prediction of the Tiebout model that efficient outcomes will result from this arbitrage cannot be assured.

As for the second key concern, it is unlikely by any measure that regulatory competition would automatically lead to a race to the bottom. Why this is so is related to attempts by firms to correct for investor aversion to asymmetric information. As shown by Akerlof (1971) in the classic ‘lemons’ paper, the information advantage sellers have over buyers leads to an equilibrium where sellers of good-quality products are worse off relative to sellers of ‘lemons’ in markets where the products are sold side-by-side, such as firms’ stocks on securities exchanges. This type of market structure encourages quality sellers to exit the market, a perverse equilibrium, in the absence of ways for these to differentiate their products from the lemons in a credible and cost-effective way.

To extend the model to securities issuance, firms with sound balance sheets and solid projected cash-flows will want to distinguish themselves from Ponzi-type operations that prefer to shy away from disclosure. The incentives of quality firms are driven by the fact that investors are prepared to pay a premium for the securities of firms that reduce the asymmetry of information, thus lowering their costs of capital by raising the share price. As a result, complying with

---

20 In the Tiebout model, regulatory arbitrage denotes physical migration to another jurisdiction in order to exploit a tax arbitrage opportunity high enough to compensate the costs of migration plus a trivially-small positive premium epsilon to tip the balance away from perfect indifference between two tax regimes in favour of one of the regimes. Physical migration would mean, for a citizen, that s/he is no longer subject to the laws of his/her former jurisdiction. This is clearly not the case for securities that are cross-listed on foreign exchanges.
stricter disclosure standards by listing on exchanges with more demanding requirements is an important signalling mechanism to investors in a world of imperfect information. In other words, a more burdensome regulatory regime need not lose firm listings to laxer regimes, much as jurisdictions that seek to attract listings by requiring lower disclosure standards may in fact precipitate the de-listing of firms where good corporate governance prevails. There is ample empirical evidence to support this theory: Pagano, Roell & Zechner (1999), Coffee (2002) and Jackson & Pan (2001).

There is also a corporate governance corollary. The interests of minority shareholders could be better protected in a framework of regulatory competition, leading to an improvement in corporate governance. Managers of firms that are characterised by a high concentration of the shareholder base are unlikely to heed the desires of minority shareholders. Because controlling shareholders enjoy substantial private benefits from the lack of disclosure, they prefer to opt for a minimum of transparency (Coffee, 2002). Once the dynamic of competition is opened among jurisdictions, firms with higher corporate governance standards will self-select into higher disclosure regimes as a signalling mechanism to minority shareholders, whereas firms that opt for laxer disclosure standards will signal to markets that there is substantial ‘insider’ activity. Thus, corporate governance improvements result from the greater disclosure of information that could be a side-effect of greater regulatory competition.

The academic community is divided on the regulatory competition debate. One school of thought (e.g. Trachtman, 1999) advocates the application of the precautionary principle, so that the burden of proof falls on those who advocate regulatory competition to show that the benefits of this approach outweigh the costs. On the other hand, a rival school (e.g. Romano, 2001), which favours competition, believes that the costs of applying the precautionary principle to protect investors ought to be quantified. Nevertheless, as we later show in section 4.2 on the possibilities to engage in regulatory arbitrage — and whether these are exploited in practice— fears of a race to the bottom may be limited by practical and firm-strategy considerations, even in a dynamic of regulatory competition. Either way, focusing solely on the competition between public regulatory jurisdictions, as opposed to the competition between public and private regulatory jurisdictions is to ignore what arguably is the key policy issue concerning securities markets for several years to come.

4.1.2 A middle way? The difficult equilibrium of co-opetition

In view of the unattractive corner solutions that could arise in the absence of a stable equilibrium between the extremes of all-out competition or harmonisation, recent research on securities markets in the field of law and economics have focused on optimal regulatory regimes. According to Geradin & McCahery (2003), the complexity of financial markets and the challenges governments face are such that sophisticated regulatory strategies are necessary to promote the public interest, and quite often these will demand an optimal mix of regulatory competition and cooperation (or co-opetition). Instead of cooperating in all domains of legislation, it is best for policy-makers to decide what policies should be determined through international agreements and what should be left to market forces.

---

21 Further, for a more detailed treatment of how disclosure affects the cost of capital, see Lannoo & Khachateryan (2003).

22 “A decision to regulate is a decision to suppress competition, as (mandatory) regulation, by definition, prevents private parties from competing along a particular dimension” (Trachtman, 1999, p. 5). In other words, regulation should be used sparingly.
But once regulators have opted for co-opetition, it is necessary to check whether the mixed regime can find an equilibrium – that is, whether the system can achieve dynamic stability. Both the race to the top and the race to the bottom denote unstable regulatory regimes. They are constantly in flux, with regulators responding to the strategic moves of their foreign counterparts in a vicious cycle. The fundamental question here is: Do governments have the self-discipline to maintain the right balance of co-opetition without reverting to one of the corner solutions, namely, excessive coordination or all-out competition? In other words, is co-opetition a stable equilibrium?

Generally speaking, there are three principal objectives of financial regulation in advanced economies: market integrity (investor protection), market stability and market efficiency (competition combined with innovation). Although these objectives may overlap to some extent, (for example, one could view market stability as a precondition for market efficiency), neither are they perfect complements (cut-throat competition may lead to excessive risk-taking that is not conducive to market stability). Whereas regulators in different jurisdictions may agree on the objectives of financial regulation, it is likely that in response to differing societal preferences, they will have different opinions as to how to rank those objectives. Ranking objectives implies a value judgment as to how a regulator can best help contribute to the maximisation of social welfare. To the extent that preferences differ across jurisdictions, regulators will have different mandates: Is the policy rule to which they adhere characterised by the maximisation of investor protection subject to the greatest possible financial stability? Or is it to ensure the greatest financial stability as the overarching objective of financial regulation? Is their task one of maximising market efficiency, with integrity and stability reduced to secondary objectives? Even if regulators could agree on a ranking of objectives, the points where the marginal benefit (of promoting one of the objectives over the others) equals the marginal cost may not correspond across jurisdictions.

A corollary to this argument arises out of the need for regulators to respond to unexpected events. In a dynamic framework, policy goals may be assigned different weights in different states of nature. Granted, the interdependence of markets has reached a point where the need to coordinate policy responses is essential, particularly for large economic regions whose regulatory initiatives are susceptible to spillover effects that impact other regions. But within the context of coordination, the degree of convergence of policy responses to various challenges may be constrained by both state- and space-specific considerations.

Since government agencies are constrained to act within the bounds of their mandates, assigned to them by democratically-elected representatives, it is natural that the extent to which governments can compete is limited. In a static context, the different mandates for regulators reflecting heterogeneous societal preferences amount to a limit to which exercises in government-imposed convergence can be successful. As Alexander Schaub said in a recent transatlantic dialogue forum: “Working on the basis of equivalence [as opposed to harmonisation] is not an admission of defeat: it is a healthy admission by both sides that there can be more than one way to achieve a common objective” (NAIC, 2004).

### 4.2 The positive question: Is there evidence of regulatory arbitrage?

Is regulatory arbitrage really a possibility in today’s financial markets? The potential for full-blown regulatory competition is mitigated by large sunk costs, the home bias phenomenon, institutional considerations (such as the securities law regime) and cultural factors. Even if arbitrage opportunities do exist, economic agents may not be able to exploit them. High transaction costs, broadly defined, may render such arbitrage unprofitable, leading to the
locking in of inefficient outcomes. For example, a firm listing on an exchange with a laxer regulatory regime may have to pay a penalty in terms of the reduced liquidity of its shares, which would then trade at a discount – a penalty that may negate the benefits from exploiting a regulatory arbitrage opportunity. Since the scope for regulatory competition is thus reduced, academics and other observers have wondered whether there can really be effective regulatory competition even if there was enough political will on both a national and on a multilateral level to muster support for such a paradigm.

4.2.1 The constitutionality and practicality of deference to foreign regulators or supervisors

Even if there was a general consensus surrounding the economic benefits of regulatory competition, markets do not operate in a political vacuum. The notion of supervisory authorities delegating to foreign counterparts may have merits on economic grounds, but as a political proposition, it runs into great difficulty, even within the European Union. First, there is the legal dilemma. Among other things, the introduction of the lead supervisor in the EU will probably require an overhaul of the legal framework governing banking and finance in EU member states – at least if the lead supervisor is to have any serious responsibilities outside his/her home jurisdiction. Regulatory arbitrage is also a purely internal matter in the EU, since bilateral mutual recognition agreements between EU member states and third countries are prohibited by the EC Treaty clauses on a common commercial policy. Likewise, in the United States legal impediments prevent the emergence of full-scale international regulatory arbitrage. The SEC is vested by Congress to ensure the protection of US investors, bolster confidence in the US financial system and promote the stability of that system. No foreign authority has been legally vested by the US Congress with the responsibilities and powers concomitant with the mandate of the SEC. Thus, the SEC could never justify the outsourcing of some of its responsibilities to foreign counterparts, as this would be most unpalatable to members of Congress. Legal constraints therefore bind the degree of deference the SEC will and can give to foreign ‘home’ supervisors.

A more practical reason for restricting such ‘outsourcing’ is that financial market regulators want a certain minimum of information to be derived from their own sources. Regulators must have reliable in-house channels of intelligence about trading and other activities susceptible to investigations, in order to cover potential gaps that can emerge in cross-border information sharing. A related question is that of enforcement. Domestic regulators cannot always be confident that foreign regulators have the same methodology or apply the same degree of rigour in their investigations. In terms of enforcement, the SEC needs to be able to vindicate the violations of US securities law that occur. Naturally, the SEC is interested in ensuring some complementarity of enforcement with foreign regulators. Yet at the same time, the SEC must be able to prosecute offences to the fullest extent of US law if an issuer breaks not only foreign laws but also US law. Likewise, in the EU, the Commission must be capable of prosecuting offences against EU law.

4.2.2 The market structure question

The possibility to exploit arbitrage opportunities in a dynamic of regulatory competition could lead one to believe that such a dynamic implies a certain panacea towards convergence in market regulatory structures. Nevertheless, depending on the scope of regulation in a

---

23 Transaction costs may, however, be losing their relevance, given progress in IT and communications technology.
jurisdiction, the mandates of securities regulators could include the very operation of the markets or the underlying market structure. Without first appreciating why markets fragment to begin with, it is difficult to assess whether arbitrage would result from regulatory competition. If fragmented markets arose out of happenstance or were the inevitable outcome of path-dependent institutional evolutions, then regulatory arbitrage could be seen to make sense.

Yet one of the primary causes of market fragmentation is that traders are not identical everywhere and their trading problems are considerably different (Harris, 2003). In other words, fragmented markets may arise not as an *ex-ante* hurdle for private actors to overcome, but may be the result of market-based processes. According to Coffee (2002), the policy stance taken by regulators is quite often influenced to a great degree by the governance architecture of the firms a regime seeks to attract — thus “different markets will serve different clienteles” (p. 8). It is likely that regimes with laxer disclosure standards are seeking to attract firms characterised by a high concentration of share ownership, such that the concerns of minority shareholders matters little for firm managers. On the other hand, as noted above, where firms are seeking a diffuse ownership of their shares, they will want to signal their transparency to investors. Therefore, if varying regulatory regimes are an endogenous response to different market structures that arise from deliberate actions by market players, then there is little reason to believe that the regulatory frameworks in which these markets operate ought to converge, let alone that they would in a dynamic of open competition between regulatory regimes.

Since mutual recognition, or home-country control, is a precondition for regulatory arbitrage, and since problems of a constitutional order must first be resolved before regulatory jurisdictions are truly in competition with each other, there are clear political constraints that impede the emergence of exploitable regulatory-arbitrage opportunities. In addition, it is unclear to what extent other factors, such as market structure and investor psychology, would limit arbitrage.

### 4.2.3 Is there evidence?

It is evident that where firms decide to list or issue their shares is not a calculation that is divorced from the severity of reporting requirements, the corresponding compliance costs of abiding by those and other requirements, the extent of sanctions against non-complying firms and the degree of enforcement. Two important considerations, which nonetheless prevent a race to the bottom in an equilibrium of regulatory competition, are the degree of integration between pools of capital and the depth and liquidity of the capital market a foreign firm is trying to access. As for the first point, regulatory competition may be difficult to sustain over prolonged periods of time. Empirical evidence suggests that sustained trading activity in a foreign market will only persist if markets are fragmented. Otherwise, the strong gravitational pull of the home market, owing to the order-flow network externalities associated with trading activity, will tend to draw trading away from the foreign exchange and back to the home exchange. In an important contribution, Halling et al. (2004) show that trading activity in stocks that are cross-listed on several exchanges is fundamentally unstable. Their results indicate that it is only a matter of time before the exchange on which the stock’s primary listing was launched captures back most of the market share initially taken away from it by the foreign listing. In other words, localised information produced about the firm along with a captive base of unsophisticated investors make it very difficult for foreign exchanges to durably attract trading volume off the domestic exchange (Halling et al., 2004, pp. 6 and 23), unless the exchange is poorly run.

As for the second point, in a world of imperfect information and incomplete markets, the forces of regulatory arbitrage do not necessarily favour jurisdictions where regulation is more lenient. In the case of the United States, irrespective of the stringency of the SEC’s regulatory regime –
the strictest in the world – there is a marked demand for listing on the NYSE by foreign firms. If anything, there was an explosion in the demand for US listings over the last 20 years, as the number of foreign listings on the NYSE grew from around 55 in 1985 to nearly 470 today.\(^\text{24}\) This phenomenal increase occurred despite burdensome regulation, not least because the severity of a regulatory regime may only be a small price to pay for the benefits associated with listing in a wide and deep capital market.\(^\text{25}\)

Nevertheless, some observers claim there is recent evidence from the US that regulators have gone too far in their zeal to purge the excesses that reigned during the stock market bubble. Several firms have specifically cited the excessive costs of the regulatory burden imposed by the Sarbanes-Oxley Act of 2002 as the reason they were not seeking to list in the American market or the reason they were looking to de-list or de-register from the SEC.\(^\text{26}\)

Despite the departures of some foreign firms, the Act has not led to massive capital flight from the US in the form of de-listings. A possible explanation is that firms simply do not bother to de-list, since they continue to be subjected to the SEC’s expensive disclosure regime until the firm has fewer than 300 American shareholders of record. Although the costs and difficulty of effecting a de-registration from the SEC may be an intimidating ‘lock-in’ factor for foreign firms that has earned the SEC’s regime the dubious sobriquet of ‘roach motel’, this hypothesis cannot explain why there continue to be new foreign listings on the NYSE, since firms mulling public offerings are undoubtedly aware of the associated regulations.\(^\text{27}\) In fact, far from seeing a secular decline in foreign listings on the NYSE, the world’s most-demanding exchange, one can observe an increase of 26 listings between end-2000 and end-2003. As of September 2004, foreign listings were up to 466, compared with 417 in 2000, an increase of 49 (Table 3). In view of these figures, one can hardly say that Sarbanes-Oxley dramatically reduced the attractiveness of the American market. It is also interesting to note that the decline in foreign companies registering and reporting with the SEC (as seen in Table 3 in the last column to the right) were concentrated in the NASDAQ market, suggesting that the popping of the tech bubble had more to do with the lower figure for foreign registrations than the Sarbanes-Oxley Act, particularly as the greatest declines were registered before the Act was even passed.

\(^{24}\) For details, see the NYSE website (http://www.nyse.com).

\(^{25}\) The benefits may also be incidental or time-sensitive. The United States stock market bubble that prevailed throughout the second half of the 1990s may have amounted to a powerful incentive for foreign firms to profit from the low costs of raising capital in the American market. Some would argue, however, that the success of the American model arose not despite, but rather because of, an intense regulatory regime.

\(^{26}\) Porsche decided not to list, citing the Sarbanes-Oxley Act. Likewise, Benfield Group, Ltd. preferred the London market, again citing the Act. Daiwa Securities delayed the listing planned for 2002 and opted for a waiting game to see how the new regime would affect other foreign firms. Both Nippon Telegraph and Telephone considered de-listing. Finally, LVMH actually opted to de-list (Woo, 2004, p. 19). More recently, Air China decided to list on the LSE, citing the costs of complying with the Act, as did South Korea’s Kumho Tire. China Construction Bank is said to be leaning towards a listing on the LSE instead of the NYSE, also citing Sarbanes-Oxley compliance concerns (see “CCB might shun China listing” by Francesca Guerrera in the Financial Times, 25 January 2005).

\(^{27}\) In a recent speech, Chairman of the Securities Exchange Commission William Donaldson announced that the US regulator would seek to address the concerns of foreign firms regarding the impediments to de-registration (see “SEC poised to ease rules for foreign listings”, Dan Roberts, Financial Times, 25 January 2005).
Table 3. Foreign companies registered and reporting with the US Securities and Exchange Commission

<table>
<thead>
<tr>
<th></th>
<th>NYSE</th>
<th>AMEX</th>
<th>NMS</th>
<th>SM CAP</th>
<th>OTC</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 Dec. 2000</td>
<td>417</td>
<td>48</td>
<td>360</td>
<td>64</td>
<td>421</td>
<td>1310</td>
</tr>
<tr>
<td>31 Dec. 2001</td>
<td>445</td>
<td>45</td>
<td>322</td>
<td>57</td>
<td>475</td>
<td>1,344</td>
</tr>
<tr>
<td>31 Dec. 2002</td>
<td>451</td>
<td>46</td>
<td>268</td>
<td>55</td>
<td>499</td>
<td>1,319</td>
</tr>
<tr>
<td>31 Dec. 2003</td>
<td>443</td>
<td>49</td>
<td>247</td>
<td>40</td>
<td>453</td>
<td>1,232</td>
</tr>
<tr>
<td>Sept. 2004</td>
<td>466</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Change 2000-03</td>
<td>26</td>
<td>1</td>
<td>-113</td>
<td>-24</td>
<td>32</td>
<td>-78</td>
</tr>
</tbody>
</table>


Sources: US SEC and rapporteurs.

Another reason to be sceptical of the hypothesis touting the importance of de-registration costs derives from a pure accounting exercise. If indeed the costs of implementing the Sarbanes-Oxley Act were overbearing, it would be logical for a firm – and would create value for shareholders – to bear the one-time costs of de-listing, rather than to succumb to the reportedly high fixed costs of compliance year after year.

Finally, the great variance across listed firms in the cost of complying with the Act suggests that the decisions made by management can have a significant impact on compliance costs, either by amplifying them considerably or by finding the most cost-effective way to do so. While Steelcase ($2.6 billion in annual revenue) and Affiliated Computer Services ($3.8 billion) require some 20,000 staff hours to fulfil the compliance obligations of the Act, a corporation that is ten times larger in terms of revenue, Dell ($35 billion in annual revenue), requires only a quarter of the staff hours, or in relative terms, it has a more efficient compliance system by a factor of 40 (!); likewise, surveys of approximate mid-sized companies show cost estimates ranging from $10,000 to well over $1 million. These data indicate that compliance costs of regulation can, to a relatively large extent, be controlled and determined by the firm. On the other hand, they may also indicate that the legislation was insufficiently clear, leading to considerable uncertainty for market participants.

While it may be true that large multinationals are coping tolerably well with the Sarbanes-Oxley Act, particularly in light of the expected learning curves, there is doubt as to whether small firms can cope with compliance measures that are disproportionately costly for them. The fact that many mid- and small-caps have felt compelled to ‘go dark’ leads to concerns that the Act may have had the counter-productive effect of reducing transparency, precisely in those firms where it is most needed. At the same time, however, small firms are not shunning public markets, as evidenced by the significant increase in US initial public offerings (IPOs) in 2004, up 195% to 233, more than 2002 and 2003 combined. In value terms, the year-on-year increase

---

28 See the article “Sarbanes-Oxley: Dragon or white knight?” by Del Jones in USA Today, 19 October 2003.

29 The concern was sufficient enough to incite the SEC to launch an advisory committee (Securities and Exchange Commission Advisory Committee on Smaller Public Companies) with the specific task of analysing the effects of the Sarbanes-Oxley Act on small firms and the extent to which a less rigid regime could be applied to them. As Table 3 indicates, most small cap de-registrations between 2000 and 2004 occurred after Sarbanes-Oxley was enacted.
nearly quadrupled to $43 billion, up from $16 billion the year before. In fact, 2004 was the most successful IPO year in the past four. If indeed the Act was driving small firms underground into less transparent regimes, then it is difficult to explain how the IPO figures indicate that there is a powerful countervailing force.

In the long run, Sarbanes-Oxley may well prove beneficial to US capital markets by restoring confidence in the system. While numerous commentators and business practitioners argue that small firms in particular are negatively affected by the disproportionate costs of complying with the Act, some facts seem to point the other way, requiring (if nothing more) an appreciation of the nuances of the debate. This is not to say that the legislative measures taken in the Act were perfect. There is reason to believe that had sections of Sarbanes-Oxley been better drafted, firms would have faced fewer uncertainties and could have reduced the costs of complying with its statutes. But pressure on legislators to act rapidly can hardly ever be expected to produce optimal legislation.

In this sense, the Sarbanes-Oxley episode is one from which EU legislators can learn at least three critical lessons: the SEC’s experience with Section 404 of the Act, which has led foreign firms to seek de-listing from American exchanges and driven small firms ‘into the dark’, could provide a useful lesson in the post-FSAP agenda, in that it is important for them to be mindful of the consequences of their actions on the ability of firms to compete. An important corollary is that the advantages of higher levels of regulation (if economically justified) can only be achieved when coupled with quality, interpreted as minimising uncertainties surrounding proposed legislative measures. Whether the benefits of the Act outweigh the costs or not, the American experience also highlights the importance of proper enforcement – an essential lesson for the EU. Much of the additional burden brought about by recent legislation in the US could have been avoided had enforcement been more effective. In short, effective prevention eliminates the need for costly cures. Finally, the absence of any dramatic effect of Sarbanes-Oxley on the attractiveness of the American market indicates that fears of regulatory competition driving business away from more demanding regulatory jurisdictions are exaggerated and must be tempered by considerations other than regulation that affect firms’ decisions to list, invest or engage in commercial activity. Simply put, regulatory arbitrage does not necessarily favour the laxest regimes.

To bring the debate back to a European context, despite the revolution ushered in by the so-called ‘new approach’ as a result of the Single European Act, regulatory competition within the EU regarding financial services has not emerged forthright. One can perhaps attribute this phenomenon to economic causes, i.e. the particularity of services markets. There is, however, another impediment thwarting the emergence of a dynamic of regulatory competition within the EU, namely the absence of a true “mutual recognition culture” (Pelkmans, 2002). It is high time, therefore, that minimum harmonisation married to mutual recognition in the field of financial services stop being construed as paving the road to a ‘race to the bottom’ and that greater trust be fostered between national regulators and supervisors. Often, protectionism is the culprit. At the wholesale level, national protectionism often takes the guise of a prudential precautionary principle, whereas at the retail level, it is buttressed by the myth that investor protection is always better achieved by the home member state. Both forms of protectionism are choking the emergence of a truly integrated financial market. The single financial market is stalling in some

---

30 Certain specificities of services, such as the need for provider-consumer proximity, the higher switching costs and less-perfect substitutability of services as opposed to goods, reputation effects, consumer loyalty schemes and the need to consume a service before making a judgment on quality, impede the ability of non-established firms to earn market share, even if mutual recognition agreements are in place.
areas not because it still lacks a sufficiently harmonised set of rules to create a level playing field (as some would argue), but rather because minimum harmonisation together with mutual recognition simply is not allowed to function properly.

In the global context, an important advantage offered by the nexus of mutual recognition and regulatory competition is that it is sensitised to the merits of efficiency and proportionality in legislation/regulation. Indeed, regulatory reform is imbedded in mutual recognition by default, because its built-in disciplining mechanism forces regulators to focus on the broader objective of overcoming market failures and the most effective way of achieving it, rather than concentrating on detailed specifications (Pelkmans, 2002). When properly implemented, this approach is consonant with speed, the least-intrusive regulation satisfying minimum standards and little susceptibility to regulation being polluted by political negotiations in the Council. As previously mentioned, the marriage of minimum approximation coupled with mutual recognition and the healthy regulatory competition it can induce capitalises on the ‘constructive ambiguity’ that is the fine line between cooperation and competition between regulatory jurisdictions. Although it does place a heavy burden on the EU in terms of effective enforcement, mutual recognition offers the advantage that it supports a regulatory culture attuned to the flexibility needed for EU firms to successfully compete in global markets.

4.3 Section conclusions

As this section illustrates, the classic fear that regulatory competition can trigger a race to the bottom in terms of standards such as investor protection and prudential measures aimed at achieving financial stability are often exaggerated. It is unlikely that regulatory competition in the field of financial services will lead to a race to the bottom, not least because capital markets are imperfect: the presence of information asymmetries means that investors tend to reward firms that self-select into stricter regimes by paying a premium for their securities, and recent disturbances in capital markets worldwide remind regulators that adopting lax prudential measures is not in their self-interest.

Despite its benefits, regulatory competition alone is an insufficient strategy to address the complex challenges arising from a globalised economy, hence the need for a balance of cooperation and competition, or co-opetition. Where both social preferences and market structures are as heterogeneous as in the EU, an equilibrium of co-opetition is more efficient than outright harmonisation. By fostering ‘regulated regulatory competition’, a system of minimum harmonisation coupled with mutual recognition pressures regulators to achieve their objectives in the most efficient manner without compromising their other policy objectives.

It is possible that the closer the EU is to achieving a perfectly integrated market for financial services internally, the more the opportunity cost of the measures required to effect it will rise in terms of foregone external competitiveness. For this reason, EU policy-makers ought to properly address the dangers of pushing for too much harmonisation in their efforts to complete the single financial market.

5. Future challenges

Building upon the issues raised by the new regulatory and supervisory structure, this section discusses proposals to cope with some more problematic elements of the new structure and to deal with future emerging challenges.
5.1 Establishing a ‘levels test’

In order to prevent the arbitrary assignment of public economic functions to different levels of government in a many-levelled public sector, the economic theory of federalism has developed a set of criteria, the so-called ‘subsidiarity test’, as a functional rule to assign economic competences to various levels of the public sector.

The confusion surrounding what constitutes ‘framework principles’ in the Lamfalussy procedure is potentially costly and suggests the need for a similar functional test for the assignment of legislative competences. Framework principles – at least as the Committee of Wise Men saw them – were to establish the core political choices, the essential elements of every legislative proposal. Yet because there is no exact definition of what constitutes ‘essential elements’, the Council of Ministers in particular has proven reluctant to relinquish control to level-2 regulators. This reticence has led to an over-burdening of level-1 legislation, slowing down the legislative process.31 More importantly, compromises to accommodate national interests tend to pollute the quality of legislation and can be very costly in terms of foregone efficiency.

Clear rules need to guide the legislative process. We suggest an initial, albeit crude, test for establishing framework principles (Table 4). Though imperfect, the advantage of such an approach is that it minimises the risk of poor decisions arising as the outcome of political horse-trading and lobbyists’ wrangling. The most important required change is that there is a clear distinction made between the policy objectives of the proposal and the means to achieving them. Objectives ought to be defined in level 1, means in level 2. This distinction would minimise the risk that the very essence of the Lamfalussy process – flexibility, effectiveness and coherence – is prevented from functioning. As previously discussed, the 2004 MiFID was plagued by an excessive level of detail entering level 1.

Table 4. The ‘levels test’

<table>
<thead>
<tr>
<th>Level</th>
<th>Questions to ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-proposal consultation</td>
<td>‘Whether’</td>
</tr>
<tr>
<td>Normative</td>
<td>• Should there be regulation?</td>
</tr>
<tr>
<td></td>
<td>• Can market discipline exercise a more effective</td>
</tr>
<tr>
<td></td>
<td>regulatory role than legislation?</td>
</tr>
<tr>
<td></td>
<td>• Should the measure be taken at the EU level or left</td>
</tr>
<tr>
<td></td>
<td>to the member states? (subsidiarity test)</td>
</tr>
<tr>
<td>Level 1 (co-decision)</td>
<td>‘What’</td>
</tr>
<tr>
<td>Positive</td>
<td>• What are the objectives of the legislation?</td>
</tr>
<tr>
<td></td>
<td>• Which approach: harmonisation or mutual recognition?</td>
</tr>
<tr>
<td></td>
<td>• What are the trade-offs involved?</td>
</tr>
<tr>
<td></td>
<td>• What weights should be assigned to each objective</td>
</tr>
<tr>
<td></td>
<td>if there are multiple objectives?</td>
</tr>
<tr>
<td></td>
<td>• What are the available courses of action?</td>
</tr>
<tr>
<td>Levels 2 and 3 (comitology)</td>
<td>‘How’</td>
</tr>
<tr>
<td>Functional</td>
<td>• How to attain the objective?</td>
</tr>
<tr>
<td></td>
<td>• How to achieve maximum neutrality?</td>
</tr>
<tr>
<td></td>
<td>• How consistent are the various interpretations of</td>
</tr>
<tr>
<td></td>
<td>level-2 rules?</td>
</tr>
</tbody>
</table>

31 The Lamfalussy Report had already complained that “in the Council of Ministers […] there is far too often a tendency to add unnecessary levels of complexity to straightforward Commission proposals” (Committee of Wise Men, 2001, p. 14).
If indeed level 1 were to focus more, perhaps solely, on the objectives of a proposal, the framework principles would act as a lock-in mechanism, a sort of pre-commitment to the outcome, irrespective of the modalities. The advantage of this approach would be that it makes good use of the ‘veil of ignorance’. Garrett (2004, p. 14) argues that the procedural rules established in American framework legislation ensure equality of treatment to a certain extent and “may be vital to ensuring passage of a controversial outcome-oriented framework”. Such a focus on outcomes, rather than procedures, would limit the extent of political interference. As experts, level-2 regulators are in a better position than legislators to define the details of implementing measures.

5.2 A broad-based approach to implementation and enforcement

Consistent implementation and adequate enforcement of Community rules plays a central role in the new structure. Levels 3 and 4 of the Lamfalussy approach are all about it, but the distinction between the levels is not crystal clear. Level 3 is fairly detailed and is the subject of a new CESR interpretative document, but level 4 is scarce in details compared with the other levels. The European Commission has the central role in enforcement, but also the member states, the supervisors and the private sector need to participate. To facilitate implementation and enforcement, the Lamfalussy report proposed relying more on regulations, which are directly applicable in the member states, rather than using directives, which need to be implemented in national law.

Three years on, it is too early to say whether implementation and enforcement works, as the new structure still has to face its test in the coming years, when practice will demonstrate how integrated European markets effectively are and how willing member states are to support this objective. The deadline for transposition into national law of the Market Abuse Directive, the first legislative measure following the new approach, expired in October 2004 and almost none of the member states were on time for implementation – a rather preoccupying fact. Nevertheless, some general points can be made.

The use of more regulations in financial services legislation has so far not been applied. All level-1 measures following the Lamfalussy approach have been directives, and it is only for some implementing measures of the Market Abuse and Prospectus Directives that the Commission has used a regulation. It is only in the domain of accounting, i.e. for the implementation of International Accounting Standards (IAS) for listed issuers on EU capital markets, that a regulation has been used. The structure for IAS implementation is comparable to Lamfalussy, although not formally part of it.

Overall, the use of a regulation requires that the European Union has strong competences in the field concerned. It also assumes that there is an urgent need to follow this particular line of action, since it is generally considered to be less ‘democratic’, i.e. there is no second step of implementation through national legislation at the member state level (regulations thus also

32 See Commission Regulation (EC) 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments; Commission Regulation (EC) 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements. There is not a general rule as to why regulations have been used for certain implementing measures and directives for others. It should be added that the use of International Accounting Standards for listed issuers on EU capital markets was the subject of an EU regulation and that the implementing structure is comparable to Lamfalussy, although it is not part of it.
exclude the scope for lobbying and pressure at the national level). Neither condition is fully satisfied in the case of financial markets. Moreover, the use of regulations seems to be inconsistent with the general objective of framework legislation, as they tend to be more detailed than directives.

Implementation will certainly be much better monitored under the new institutional structure. Through coordination among supervisors during the level-3 advice period, implementation should be better prepared and synchronised. Also supervisory approaches should converge, as a result of common interpretations of the rulemaking powers of the national supervisors, joint standard-setting work under level 3 and cooperation in the execution of supervisory tasks, to which the level-3 committees are committed (CESR, 2004a). This was also acknowledged at the November 2004 Ecofin meeting.

The last two items raise some fundamental problems, however. They relate to the powers of the level-3 committees in their standard-setting and cooperation functions. First, will not everything that is a level-3 standard come back under level 2, and finally level 1, because of the demand for legal certainty, and thus exacerbate the tendency towards regulation and centralisation as previously discussed? Second, supervisors are supposed to cooperate, but to what extent can they delegate? For multi-jurisdictional market players it is not efficient, from the supervisory or business point of view, to have the same reporting work done in every jurisdiction (see CESR, 2004b). The Lamfalussy method may thus require a high level of mutual confidence, for which legal and political systems are not yet adapted. Over time, it should be possible for supervisors to fully delegate certain problems to other authorities, but this may require some central ‘monitor’ and a clear political decision or an EU Treaty change, which is not envisaged in the near future. Third, although the institutional structure of securities markets has converged over recent years, the powers of supervisory authorities in the EU continue to differ in terms of rulemaking, supervisory, investigative and disciplinary means.

Level 4, adequate enforcement, seems evident but also raises concerns. Enforcement is composed of a two-staged process, whereby under Art. 226 of the EU Treaty the Commission sends a reasoned opinion to the member state formally requesting the member state concerned to implement EU law. If a satisfactory answer is not provided within a given period of time, the Commission may refer the case to the Court. Enforcement has not always been the strongest point of the European Commission, however, which is more inclined to draft new rules rather than insist on adequate enforcement. This task has moreover become more complex with the successive enlargements of the EU. In the case of the follow-up of the FSAP, the Commission has recently come out insisting that it intends to take its job seriously, in close partnership with all the partners involved. It will use the regular meetings of the level-2 committees to monitor and discuss progress, to organise ‘transposition workshops’ with the member states and to publish ‘transposition tables’ to increase the transparency of the process. It also calls for a pro-active role of the financial services industry to signal cases and not to stand aside (McGreevy, 2004).

Also the existence of the level-3 committees should be an important incentive for effective enforcement, because of their independent role vis-à-vis the European Commission. If the latter does not perform its job properly, the former will most reasonably be expected to react or vice-versa. Nevertheless, the fact that the CESR has emphasised on several occasions that level 4 is “the exclusive prerogative of the European Commission” (CESR, 2004a, p. 5) raises concerns. The boundary between implementation and enforcement is not crystal clear: if the CESR participates in naming and shaming those who are behind on implementation, this is also enforcement.
For what concerns the member states, the record of transposition of EU directives is bleak, with the founding members of the European Community and Greece being in the bottom league, according to the latest internal market scoreboard of the European Commission (2004a). The enlargement of the EU with 10 new member states in May 2004 may further blur this picture. Although the new member states were found to be performing well on several accounts, it cannot be ruled out that problems will emerge with accession, for example, litigation on the basis of the EU acquis. Furthermore, there are the new agreements, such as the FSAP, which were largely not part of the accession negotiations.

A priority for financial markets is the speed of settlement of legal disputes. If an infraction is noticed and passed on to the judicial authorities, it can take years for a decision to be taken, depending on the legal system. Work will need to be undertaken to come towards a more common system, which can rely on administrative sanctions and be settled more rapidly.

Self-regulatory systems to resolve disputes should in this context be stimulated as cost-effective and speedy ways to deal with problems. Certain groups have proposed the creation of a European ombudsman for financial services to oversee cross-border disputes between businesses and national regulators. This entity should function as an independent intermediary between both parties, but be accountable to the EU institutions (FESE, 2004). More broadly, self-regulation is often insufficiently acknowledged with regard to its importance in the enforcement of laws, certainly in securities markets (see for example Lopez-de-Silanes, 2003). More attention should thus be given to the role of private enforcement in the drafting of laws and by the private sector to credible forms of self-regulation.

5.3 Getting the home-host relationship right

The home-country control principle is a cornerstone of the single market for financial services. Once a firm or financial product is duly licensed in one member state, it can provide its services, through branches or across borders, or products in another member state. Many elements in the FSAP, certainly in the securities markets measures, are designed for getting the home-country control principle right and creating a truly single market. Yet problems remain, which have given rise to proposals from different sides.

In prudential supervision, the home country is in charge of exercising the consolidated supervision EU-wide of the firms it licensed. Financial institutions also operate through subsidiaries, however, which are separately licensed and supervised by the host-country authorities. The host country is also responsible for the stability of its financial system. To give the home country fuller responsibility, proposals have been made recently for a clearly defined lead supervisor. Within the current legal framework, the European Financial Services Roundtable (EFR) proposed a college of supervisors that advises the lead supervisor (see EFR, 2004). But given the current legal framework, the role of host-country supervisors in such a context is non-committal. The other proposals that give the lead supervisor greater responsibility require a clear European mandate, and thus a clear political decision to grant this mandate, following a resolution by the European Council (based upon an article of the Treaty, such as Art. 308) or a Treaty change. Under a European system of financial supervisors, the

33 “If action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community, and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, take the appropriate measures”, Art. 308, EU Treaty (consolidated version). Other articles could also be considered, such as Art. 80, para. 2 and Arts. 37, 95 and 133. These articles were used for the creation of European agencies, such as the European Aviation Safety Agency or the European Food Safety Authority (see Lastra, 2004).
lead supervisor, who has the final responsibility for supervising a bank EU-wide, takes the interests of all depositors into account. Day-to-day supervision is carried out in cooperation between the lead and the national supervisor. A variant of this proposal gives a central body of a European system of financial supervisors full responsibility for EU-wide operations, both branches and subsidiaries (Oosterloo & Schoenmaker, 2004).

Discussions surrounding the draft directive on capital requirements (incorporating Basel II) emphasise the need to start considering legal changes to allow for a European mandate. The draft foresees in its Art. 129 that validation of a banking group’s internal-risk models will be undertaken by a college of supervisors drawn from the main countries in which the group operates. But if they can not agree about a bank group’s validation application after six months, then a lead or consolidating supervisor – usually the home supervisor in the country where the parent bank is located – will be empowered to make the decision. This approach is said to be disliked by some European supervisors, particularly those in countries that are host to many large branches of foreign banks, notably in the new member states in Central and Eastern Europe, who argue that they need to bear the interests of local depositors in mind. The fear is now that banking supervisors will use the powers they have under pillar 2 of the new Basel Accord, supervisory discretion, to maintain control on host-country branches and subsidiaries. A European mandate, whereby the home-country supervisors take the interests of all depositors into account, would deal with this problem.

In the area of securities markets, the way markets are supervised is less integrated than for financial institutions, but the same legal problem emerges. International and EU-level cooperation in supervision is less advanced than it is in banking, and supervisory powers are less aligned. Concepts such as ‘home’ and ‘host’ are less clear-cut, because supervision is mainly oriented towards the conduct of business matters, the lead supervisor model does not exist formally and multi-jurisdictional players have only recently started to emerge. The MiFID addresses the cooperation between supervisory authorities in its Arts. 56-62, but leaves wide powers to host-country supervisory authorities (e.g. Arts. 59.1, 61 and 62). The CESR has addressed these issues in a recent paper and proposed that delegated supervision should be considered, and that the delegated supervisor would have the full authority to take decisions in certain precise areas (CESR, 2004b). The recent Prospectus Directive foresees the possibility of delegated supervision, without much further discussion on the legal implications such as who has the final responsibility.

It is clear from the above discussion that policy-makers will need to be creative and open to adapt the regulatory and supervisory structure to market developments.

5.4 Setting the right priorities

The new regulatory approach stresses at length the central role of consultation. Consultation happens at least four times for a new regulatory proposal. In level 1 decision-making, the European Commission consults before issuing a proposal for a directive. The European Parliament invites comments from interested parties on Commission proposals. At level 2, the Commission requests advice from the competent committee of supervisors on technical implementing measures. The committees of supervisors in turn organise consultations and hearings with interested parties on this matter and submits its proposals to the European

---

Commission. The European Commission publishes the draft implementing measures on its website for comments, as it is submitted to the implementing committee. Moreover, the European Parliament is kept fully informed during the level-2 decision-making process and can adopt a resolution if the proposed measures exceed the implementing powers.\(^{35}\) There is thus ample room for interested parties to put their points across.

Given the central role of consultation, questions thus arise as to whether the Commission manages to address the right priorities and remain non-partisan. There is first the question of how priorities are set, and second, once a regulatory area has been identified, how the Commission takes into account comments from interested parties. In its review of the FSAP, the European Commission set up four independent expert groups to assess the progress achieved. Yet the groups, which reported by the end of April 2004, were overwhelmingly composed of industry representatives, with only one academic and two consumer or small-investor representatives among a total of 90. Only a few were users of financial services, the remaining all providers or their sector representatives.\(^{36}\)

An example of the regulatory capture may be the debate surrounding the regulation of clearing and settlement facilities in the EU, compared with the limited attention for retail financial market matters. A debate has been going on since early 2000 regarding the excessive costs of clearing and settlement in Europe, above all for the cross-border dimension. It is argued that this is a disincentive for investors and thus hampers market integration. Nevertheless, clearing and settlement is only a small fraction of the total trading chain and its cost at a national level is not significantly higher than in the US (Lannoo & Levin, 2001). The issue is mainly one of national monopolies, which need to adapt to changing market circumstances. Consensus seems now to emerge among policy-makers that there is a need for an EU directive to open-up the sector. But there are risks that a directive may become a very sensitive issue, as custodian banks want to limit the services a clearing and settlement depository can offer, and it could lead to a very uncertain outcome depending on rather difficult and unpredictable discussions in the European Parliament and the Council.

On the retail side, on the other hand, there is limited policy attention given to the absence of integration of the markets, the vertical integration of financial service providers and the lack of competition in several of the EU banking markets. More attention to issues hampering the integration of retail financial markets and the effect of national consolidation in EU financial markets would certainly be welcomed by EU citizens. The downside of the sectoral committees at the European level is that horizontal matters, such as consumer finance, are not a specific objective. Retail finance is a matter for the three sectoral committees, but it is unclear whether it is much of an issue for them at all. Moreover, retail finance issues are not necessarily dealt with by financial supervisors, but may be the task of consumer protection or judicial authorities. At the Commission level, it would therefore be useful to extend the Lamfalussy approach to specific consumer finance directives, such as the draft Consumer Credit Directive (COM(2002) 443 of 11.9.2002). This would certainly ease understanding among the respective authorities of each other’s consumer protection systems (Lannoo & de la Mata Muñoz, 2004).

Will more reliance on Regulatory Impact Analysis allow the reduction of regulatory capture? Impact assessment is no panacea for what should be or not be regulated. It can probably only answer how something should be regulated, once it has been identified. The new Commission

\(^{35}\) Under the new Constitutional Treaty, the European Parliament can revoke implementing powers (see discussion above).

\(^{36}\) This was also criticised in the Fin-Use Forum (see European Commission, 2004b); the Commission tried to involve more users, but without much success.
model introduced in 2002 seems to adequately take into account the main lessons drawn from international best practices in RIA. The new procedure takes adequate account of the main lessons drawn from international best practice and is seen to be very complete and effective. It should render the decision process more transparent and improve the quality of lawmaking. The implementation, however, seems more difficult than expected, as the Commission only managed to complete 21 of the 43 impact assessment procedures planned in 2003. The reasons were, among others, the difficulty of including different policy alternatives in an RIA (as they tend to focus on one policy option) and discussion of the application of the principles of subsidiarity and proportionality, in particular the respective merits of different regulatory approaches. Furthermore, exact quantification of the effects of a certain possible measure has been limited and these have placed a heavy burden on EU administrations, increasing the cost of many regulations.

5.5 Incorporating the new member states

The new member states have been involved for quite some time in the EU policy-making process, but not in a full formal capacity until accession on 1 May 2004. Nevertheless, incorporating the new member states fully into the new structure remains an important objective. Problems with the incorporation of the acquis cannot be ruled out, and there will be an enhanced need for cooperation in an EU of 25 or more states and for a transfer of supervisory know-how. As Community procedures have developed and the EU has grown, the Commission will not be able to accord the same lenience as it accorded to Spain and Portugal in 1986.

Financial markets in the Central and Eastern European Countries (CEECs) are still well below the degrees of development of those in the EU. Total assets of the banking sector in the eight CEECs are 2.4% of the consolidated balance sheet of all banks in the euro area (2003 data). Their markets are, in contrast to what is the norm in the EU-15, largely dominated by foreign banks, with a higher degree of concentration than in the eurozone. The share of total bank assets held by foreign-controlled banks exceeds 70% in most of these new member states (with one notable exception being Slovenia). This creates challenges for regulators, which are different from those in the Western European markets.

Risk diversification and the search for efficiency gains are the motors driving international financial integration. Both are often offered as justifications for capital account liberalisation. Despite the positive connotation of these two terms, one must be careful to respect the nuances, i.e. under what conditions they are valid arguments. In an inter-dependent world where uncertainty and imperfect information reign, cross-border risk diversification is itself inherently risky. While the risk of domestic shocks is mitigated, the economy becomes more vulnerable to contagion from overseas. In an equally delicate balancing act, the search for efficiency gains will only represent a net benefit to society to the extent that the aforementioned gains do not come at the expense of stability. When considering the merits of international risk diversification, bank regulators will have to decide whether the benefits of reducing the risk of domestic liquidity shocks can compensate for the greater exposure to foreign shocks. As for the efficiency-stability trade-off, it is primarily a question of preferences, or degree of risk-averseness, as well as one of timing, so regulators may not always see eye-to-eye on this issue. First of all, risk attitudes may diverge from country-to-country. Second, where one regulator

---

38 Based upon Renda (2004).
39 See Bank Austria Creditanstalt (2004, p. 4) for more details.
handling a crisis may have a clear preference for focusing on achieving stability, efficiency considerations may continue to dominate the policy stance of his/her counterpart in a more stable neighbouring economy.

If policy outcomes are a reasonable proxy for the preferences of policy-makers, bank regulators in Eastern Europe have already decided which course of action they want to take with respect to each of these trade-offs. The very high concentration of foreign ownership in the banking sector means that regulators in the CEECs view the threat of domestic liquidity shocks as more likely or potentially more devastating than those emanating in the home countries of the respective bank holding companies (Table 5). The same observation could also lend support to the hypothesis that CEEC bank regulators have opted to maximise efficiency subject to achieving the greatest possible financial stability as a second-order objective, rather than the other way around. Nevertheless, the extent to which there is such a trade-off between stability and efficiency is not independent of institutional arrangements in the public sector and governance structures in the private sector.

Thus, the verdict on high rates of foreign bank penetration is that it has served the new member states well so far. But whether it continues to do so is an entirely different question. A single crisis may be all that is necessary to prove the dynamic inconsistency of, and the inherent danger in, the policy bias towards foreign institutions. Unfortunately, the chances of a crisis occurring are exacerbated by the current supervisory arrangements. As is standard in international supervisory practice, the responsibility for supervision of a subsidiary is placed on both the home- and the host-country supervisors. The joint responsibility is asymmetric in that the home-country supervisor has the responsibility of viewing the subsidiary in the context of the entire institution, while the host supervisor focuses solely on the subsidiary itself. Whereas there are generally frequent contacts between the supervisors, the degree to which the home-country supervisor is obliged to share information about the bank is rather unclear.

The potential for deficiencies in the sharing of information creates scope and incentives for increasing the risk of host-country subsidiaries, or may at least raise suspicions with host-

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of foreign credit institutions (% of total assets)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>n.a.</td>
</tr>
<tr>
<td>Denmark</td>
<td>0</td>
</tr>
<tr>
<td>Germany</td>
<td>4</td>
</tr>
<tr>
<td>Greece</td>
<td>11</td>
</tr>
<tr>
<td>Spain</td>
<td>9</td>
</tr>
<tr>
<td>France</td>
<td>n.a.</td>
</tr>
<tr>
<td>Ireland</td>
<td>n.a.</td>
</tr>
<tr>
<td>Italy</td>
<td>6</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>95</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2</td>
</tr>
<tr>
<td>Austria</td>
<td>n.a.</td>
</tr>
<tr>
<td>Portugal</td>
<td>18</td>
</tr>
<tr>
<td>Finland</td>
<td>6</td>
</tr>
<tr>
<td>Sweden</td>
<td>n.a.</td>
</tr>
<tr>
<td>UK</td>
<td>46</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>90</td>
</tr>
<tr>
<td>Estonia</td>
<td>99</td>
</tr>
<tr>
<td>Hungary</td>
<td>89</td>
</tr>
<tr>
<td>Latvia</td>
<td>65</td>
</tr>
<tr>
<td>Lithuania</td>
<td>78</td>
</tr>
<tr>
<td>Poland</td>
<td>69</td>
</tr>
<tr>
<td>Slovakia</td>
<td>86</td>
</tr>
<tr>
<td>Slovenia</td>
<td>21</td>
</tr>
</tbody>
</table>


40 With a long road to convergence with the standard of living in the EU-15, the new member states have more to gain (and less to lose). As a result, the new member states are, in many respects, risk-loving societies relative to the EU-15. This asymmetry in attitudes towards risk-taking extends to regulatory matters (to the extent that the acquis has not already destroyed relative risk-averseness as a component of comparative advantage). Our hypothesis therefore seems to be consistent with the revealed preferences of Eastern European regulators when faced with similarly difficult trade-offs in other fields, such as environmental policy.
country supervisory authorities. Specifically, if a multinational bank as a whole is facing distress, it might shift risk to the subsidiary where it expects the greatest government support. If the subsidiary goes bankrupt, it is the deposit insurance system in the host country that is responsible for providing support. This implies losses, which are borne by the local taxpayers. A high banking concentration in a host country adds to the likelihood of a bail-out, because the government may not be willing to accept the failure of a subsidiary that constitutes a substantial part of the country’s financial system. It is an odd fact that in countries reporting large current account deficits (in the order of 4 to 7% of GDP), which must be financed by capital inflows from abroad, a greater share of banks’ portfolios is held abroad than domestically according to Riess, Wagenvoort & Zajc (2002). These authors offer various explanations (lack of quality investment opportunities, underdeveloped creditor rights and inter-company loans in the non-financial sector) for their surprising finding. Another explanation could be suggested: bank holding companies in Western Europe may be using their Eastern subsidiaries’ assets to take greater risks than they would otherwise take if these holdings were branches instead, for example, by shifting assets to the holding company, which in turn may invest them in riskier securities from a third country.

The question is whether the current form of supervisory cooperation in the EU can cope with these kinds of problems. Although the new committee structure significantly enhances the possibility for information exchange, the question remains as to whether it will be sufficiently symmetric and multilateral. The ECB’s Memorandum of Understanding (2003a) for cooperation between banking supervisors mentions the existence of a ‘logistical infrastructure’ to allow for the required flow of information between all the authorities involved at the cross-border level, but it does not provide more details and only applies to crisis situations. A hub or clearing house for the exchange of supervisory information should exist on a permanent basis. It should be hosted by a neutral party, which would allow all supervisory authorities to have access to the same information.

Problems can also be expected to surface in the context of the implementation of the new Basel Capital Accord (2004), which the EU will transpose in full. The Basel Accord creates extra demands not only on banks, but also on supervisory authorities, which should be capable of assessing banks’ capital requirements under three different approaches and adopting individualised reviews under pillar 2. In an EU context, a bank should be capable of following a single approach EU-wide, under the final control of the home country. Yet this requires that the host countries can also assess the local capital requirement for a subsidiary under the three different approaches. This will create additional burdens for supervisory authorities in less-developed markets. The Polish banking supervisor at some stage indicated that they will only allow the use of the standardised approach, because of a lack of resources.

The critique of the ‘one-size-fits-all’ approach in the context of the implementation of the Lamfalussy procedure so far is certainly of relevance to the new member states. If a levelling-up process is ongoing, to the standard of the more-developed financial markets, it could have devastating effects on the financial markets of the CEECs. For their degree of development, market regulation will beyond doubt be too developed. At some stage in the accession negotiations, proposals were made for a more asymmetric adoption of laws, whereby lower demands would be applicable to less-developed financial markets. But this seemed difficult to reconcile with the Copenhagen criteria, and it is only for a limited number of areas that longer

41 See the statement by the European Shadow Financial Regulatory Committee (ESFRC, 2004).
42 If this hypothesis were true, it would be a serious cause for concern. The degree to which bank holding companies take greater risks with subsidiaries as opposed to branches is one that would certainly merit further scrutiny by academics and regulators alike.
transition periods were provided (for a more detailed exposition of the transition periods granted in the field of financial services, see Table 6). This was for example the case for the level of depositor protection in the new member states, where CEECs have been given seven years to meet the EU minimum level of €20,000. Nevertheless, there are reasons to believe that this figure is still unreasonably high, given the significant gap in the standard of living between ‘old’ and ‘new’ Europe. The sum of €20,000 is a multiple of the GDP per capita of most of the new member states. Moreover, it will be virtually impossible for most new member states to reduce to seven years a convergence process that is expected to last thirty. The literature is rife with warnings about the moral-hazard dangers posed by excessively high deposit insurance: by giving insufficient incentives to depositors to engage in the proper monitoring of their credit institutions, such a scheme can only act as a perverse incentive for banks, which face a profit curve characterised by limited losses on the downside but virtually unlimited gains if their gambles pay off (see Box 3).

Table 6. Transitional arrangements for deposit insurance

<table>
<thead>
<tr>
<th>Country</th>
<th>Transitional arrangements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>€25,000; no transitional changes</td>
</tr>
<tr>
<td>Estonia</td>
<td>€6,391 until 31 December 2005; €12,782 from 1 January 2006 to 31 December 2007; €20,000 thereafter</td>
</tr>
<tr>
<td>Hungary</td>
<td>€3,783 until 31 December 2004; €7,565 from 1 January 2005 to 31 December 2007; €20,000 thereafter</td>
</tr>
<tr>
<td>Latvia</td>
<td>€10,000 until 31 December 2005; €15,000 from 1 January 2006 to 31 December 2007; €20,000 thereafter</td>
</tr>
<tr>
<td>Lithuania</td>
<td>€14,481 until 31 December 2006; €17,377 from 1 January 2007 to 31 December 2007; €20,000 thereafter (for deposit guarantee); for investor compensation the levels are €5,792 until 31 December 2005; €11,585 from 1 January 2006 until 31 December 2007; €20,000 thereafter</td>
</tr>
<tr>
<td>Poland</td>
<td>€7,000 until 31 December 2004; €11,000 from 1 January 2005 to 31 December 2005; €15,000 from 1 January 2006 to 31 December 2006; €19,000 from 1 January 2007 to 31 December 2007; €20,000 thereafter</td>
</tr>
<tr>
<td>Slovakia</td>
<td>€13,000 from 1 January 2005 to 31 December 2005; €16,000 from 1 January 2006-31 December 2006</td>
</tr>
<tr>
<td>Slovenia</td>
<td>€20,000 from 1 January 2005; until 31 December 2005 neither the level nor the scope of cover provided in Slovenia by an investment firm from another member state may exceed compensation provided by the Slovenian scheme</td>
</tr>
</tbody>
</table>


Box 3. Macro-threats to financial stability in the new member states

From a systemic-stability standpoint, the particularities of the financial systems in the new member states mean that regulators and supervisors will have to stay attuned to, and cope with, challenges different from those faced by their Western counterparts. The vulnerabilities associated with transition dynamics – while declining over time – will continue to cast a shadow on the stability of the financial sector. In particular, given a very weighty foreign bank presence, bank supervisors will have to keep an eye toward exogenous external shocks that could negatively impact financial stability.
There is evidence that global investors are beginning to define sovereign debt issues by the new member states as a separate asset class, distinct from other emerging market securities such as government bonds in Latin America or East Asia. Several facts support such a theory. First, spreads have fallen significantly and rapidly since the conclusion of the accession negotiations (see Figure B.3). Second, most CEECs remained largely unscathed by the Asian crisis, the Russian default and the Argentine default. Primarily, this development is a result of the credible commitments made in favour of reforms – credible because the convergence process is well underway, as any examination of macroeconomic variables in the region will reveal. Yet one cannot be sure that these indicators will continue to score as well in the future. Dynamic consistency is imperative. If policy-makers reign in public deficits, work towards straightening out the current account and manage to control inflation, international investors will continue to reward these governments with ever-more favourable lending terms. Nevertheless, the uncertainties surrounding the convergence process means that fiscal profligacy and poor macroeconomic governance in general could be disciplined by rapid changes of sentiment – and equally rapid withdrawals of capital – by foreign investors. A rapid reversal of market sentiment means that these countries would fall back into the wider category of emerging market bonds in a short span of time – and lose any financing advantages offered by lower yields.

Figure B.3. Yield spreads in 10-year sovereign debt instruments of selected new member states (over 10-year D-Bunds) (hundreds of basis points)

Source: www.sarasin.ch.

Despite becoming EU members and falling into a special category of investment, the former accession countries will still continue to be considered ‘emerging’ markets (with the attendant risks) by international investors, because their capital markets are underdeveloped. This vulnerability is evidenced in Figure B.3, where a noticeable jump in spreads (10-year sovereign debt instruments over 10-year D-Bunds) has recently been observed. In a volatile world, investors are eager to pay liquidity premiums, and with little liquidity along the yield curve, accession countries’ government paper can still be considered residual investments. Foreign investors’ appetite for risk is tempered by jitters shaking the confidence of international markets and developments in G-7 government bond markets.
also act as a constraint on the hunt for yield in emerging markets. Therefore, as yields rise in the US or in the eurozone countries, investors may adopt a more cautious approach to emerging market bonds. Higher yields on US government paper are usually associated with a more than proportional increase in yields on emerging-market sovereign debt, increasing the cost of capital as well as the costs of debt financing, thereby increasing the risks that corporate borrowers may default on bank loans.*

The link between yields on sovereign debt and the health of the domestic banking sector may not be immediately obvious, particularly in countries where the lion’s share of government debt is held by overseas investors. Two factors can, however, act as communicating channels: since sovereign debt is often the benchmark for calculating the riskiness of a given security, increasing yields on government bonds are likely to be reflected in the higher costs of financing for domestic firms; in addition, there is a high correlation between sovereign debt crises and currency and banking crises.

Although the CEECs have attracted very large flows of foreign direct investment in the past decade, these flows are beginning to recede, since the privatisation of large parastatal companies is by and large completed. At the same time, portfolio flows have been increasing, primarily owing to speculation on exchange rate appreciation and on interest rate convergence. Portfolio flows, as opposed to foreign direct investment, are highly volatile. They can be accompanied by rapid and unsustainable credit expansion, as banks (encouraged by the rising value of loan collateral) become less risk-averse in their lending. In the case of speculative inflows, these may lead to over-investment in certain sectors and outright resource misallocation.

Additionally, large capital inflows will put upward pressure on the exchange rate, which will already be appreciating owing to the process of real convergence. It would be unreasonable to expect that all new member states successfully navigate the new exchange rate mechanism (ERM II) to adopt the euro without having to experience any of the ‘growing pains’ associated with the forced marriage of nominal and real convergence. Most of these countries are experiencing real exchange-rate appreciation – a by-product of the Balassa-Samuelson effect – which results from the process of real convergence. A rapidly appreciating exchange rate will handicap the competitiveness of exporting firms in the new member states and falling corporate profits often contribute to the deterioration of banks’ balance sheets.

Finally, a rapid reversal of capital inflows (or of funds channelled from parent firms to their subsidiaries in the region) would mean that banks’ worsening access to foreign capital in these emerging markets will intensify adverse selection problems. As interest rates rise, it is likely that the quality of credit risks in a bank’s lending portfolio decreases – good credit risks will prefer to stay out of the market, whereas poor credit risks are likely to ‘gamble for resurrection’. Such a situation is likely to lead to a credit crunch, as banks cut back on lending. Unless they have large pools of retained earnings from which to finance their expansion, companies will have to cut back their operations, a move that has the potential to further weaken banks’ balance sheets. A second concern arising from the prospect of eventual capital flight is the front-loaded nature of government financing, i.e. the overwhelming dominance of short-term debt. In Poland, 90% of government debt has a maturity of five years or less, a phenomenon that is not uncommon among transition countries, whose capital markets are all still in their infancy.** Such a dependence on short-term debt is risky. A rapid reversal of investor sentiment could pose a serious threat to public finances in the new member states, as debt issues reach maturity and governments have no choice but to roll them over or emit new issues under unfavourable financing conditions.

* For more on how the large public deficits in the US will affect the global economy, see the recent IMF report by Mülheisen & Towe (eds) (2004).

** See the ECB’s report on the financial sector in EU accession countries (ECB, 2002) for a more complete exposition.
5.6 Financial crisis management in the EU

The challenge facing all stakeholders in financial stability in the EU today, whether market participants, supervisors, central banks or finance ministries, is two-fold: buttressed by the FSAP, the euro is driving the emergence of a single financial market, such that EU-wide systemic risks are undoubtedly greater than they were a decade ago; at the same time, financial institutions are becoming increasingly complex, while financial products that facilitate risk-transfer are making it ever more difficult for a supervisor acting alone to pinpoint risk. These crucial new developments, which amount to a radical change in the nature of the risk borne by banks, insurance companies and other financial institutions, require an altogether different approach to financial supervision. They warrant a need for ever-greater cross-sectoral supervision, coupled with greater coordination among supervisors, so that authorities may properly discern at any given time the nature of macro-prudential risks threatening financial stability. Whereas in the past, stability in financial institutions individually was nearly considered a sufficient condition for financial stability, this clearly is no longer the case today when one considers the extent to which risks co-vary. As the functional differences between banks, non-bank financial institutions and other firms are diminishing (Spencer, 2000), functional supervision has now become a relic of the past, which explains the mushrooming of FSA-type regulators/supervisors. Since the nature of risk has changed, policy responses have had to adapt. This is true not only for supervisory authorities but for crisis-management frameworks, to which we now turn.

Since the introduction of the euro, debates are still ongoing as to who should assume the role of lender of last resort in the EU, how to enhance a still largely incomplete supervisory structure, how to manage the insolvency proceedings of financial institutions with cross-border operations and how to manage a financial crisis with systemic implications for the EU.

Recently, however, numerous initiatives have been undertaken in an attempt to patch these holes in the architecture upholding financial stability in the EU. On the crisis-prevention front, the network of contact points that has emerged among supervisors, such as the Groupe de Contact, and between supervisors and central banks (the BSC and the Committee of European Banking Supervisors or CEBS) were established, according to Nieto (2004, p. 5), “under the implicit assumption that, over the longer term, they may enhance consensus on what legal changes could improve financial stability”, but they also play an important role in the shorter term to help identify EU-wide macro-prudential risks. The first Brouwer report from the EFC on financial stability also outlined important preventive measures (European Commission, 2000). A number of MoUs (including the 2003 agreements between the European System of Central Banks (ESCB) and national supervisors) emerged from the recommendations of the second Brouwer report, which highlighted the importance of dismantling any remaining legal barriers to information exchange (European Commission, 2001). Informal contacts were reinforced by the establishment of mandatory communication channels between various public authorities. More concretely, ‘war games’ to test crisis-response effectiveness in an international setting have become the latest addition to the crisis-management landscape in the EU. They are modelled after the exercises run by the Scandinavian central banks in the aftermath of the Nordic banking crisis of the early 1990s. With a first exercise of the joint ESCB-national supervisory authorities have taken place in 2003 to test the effectiveness of the MoUs in crisis situations, these simulations have now taken on a European dimension.45 The advantages of

43 For a brief overview see Knight (2004).
44 Yet France, Spain, Portugal, Greece and Italy still organise financial institution supervision along functional lines as in the past – see Nieto (2004).
45 See the ECB’s Annual Report of 2003 (ECB, 2004).
such exercises are several, as they can help identify weaknesses in information exchange, inter-agency cooperation, cross-border policy coordination and legal barriers to effective crisis management (Lind, 2003). Thus, it would be unfair to say that these significant and welcome measures do not represent positive developments and one can only express satisfaction that significant strides have been made since 1999. Nevertheless, the achievements of recent years do not obviate the need to remain vigilant and to press ahead with the few (but essential) elements of the crisis-management architecture that are still not in place.

Certain holes remain. The chief problem can be characterised as the ‘fiscal challenge’. In the EMU, the difficulties surrounding cross-border crisis management are compounded by the absence of a central fiscal authority to match the supranational character of monetary policy (Goodhart, 2004). The fiscal problem is, however, less one of an asymmetric economic federalism than it is one of incentives.

The presence of cross-border externalities, coupled with differing policy objectives, amounts to an insufficient incentive structure for finance ministries to coordinate solvency crisis-management responses, particularly with regard to the pivotal question of burden-sharing.46 By giving rise to coordination failures, externalities will delay and impair the effectiveness of any multilateral policy initiatives, leading to additional (but largely avoidable) social costs in the wake of a crisis. Table 7 gives a good overview of the situations in which coordination failures tend to arise, namely in quadrants II and III.

Table 7. Home- and host-countries’ views on support in the event of a financial crisis in a cross-border bank

<table>
<thead>
<tr>
<th>The subsidiary bank is</th>
<th>The subsidiary bank is small</th>
</tr>
</thead>
<tbody>
<tr>
<td>large in the host country</td>
<td>in the host country</td>
</tr>
<tr>
<td>The parent bank is large in the home country</td>
<td>Both are interested in support</td>
</tr>
<tr>
<td>The parent bank is small in the home country</td>
<td>Differing views on support (B supports; A does not)</td>
</tr>
</tbody>
</table>

Notes: A = home country; B = host country.
Source: Borchgrevink & Moe (2004), modified by the rapporteurs.

And yet the existing crisis-management framework in the EU seems to have been largely built around the eventuality of a liquidity crisis. There is little question that the framework for liquidity crisis resolution in the EU is adequate. Naturally, liquidity crises must be addressed, since prolonged illiquidity can undermine the solvency of a financial institution. Yet this need not mean that the crisis-management framework is designed around the eventuality of a liquidity crisis. Liquidity crises differ from solvency crises in that the former results from a temporary shortage of cash, which can be provided by the central bank at a penalty rate, whereas the latter entails a situation where the discounted present value of liabilities exceeds

46 As Charles Goodhart puts it: “Whether on purpose, or not, in a globalised financial system, losses occurring in a bank in one country could be effectively passed through to the depositors or to the fiscal authorities in another country. There is no mechanism in place to devise a generally acceptable sharing of burdens from international (banking) crises; perhaps the position of the foreign banks in Argentina could be taken as a case in point. Can we rely on voluntary co-operation and co-ordination between the countries involved under such crisis circumstances?” (Goodhart, 2004, p. 7).
that of assets, thereby requiring re-structuring, capital infusions or a combination of both. It is becoming increasingly evident that insufficient political capital has been spent on filling this important gap.

Solvency crises with a cross-border dimension represent a far more daunting prospect for coordination. There is increased awareness among academics and practitioners that the way new perceptions of risk are transforming financial institutions requires an integrated approach to supervision, which would rely not only on national and ‘European’ supervisors from the level-3 committees, but also central banks and finance ministries, the former because it holds the key to liquidity support and the latter because they are responsible for potential capital injections (see Schoenmaker & Oosterloo, 2004). A deeper involvement of finance ministries in the supervisory process, even if as no more than an observer or as privy to regular flows of information would therefore be a first step.

There is a need to act quickly. Financial crises in an era of global capital markets are characterised primarily by their unexpectedness and the swiftness with which they gain momentum. In circumstances such as these, there is no substitute for preparedness on the part of authorities. They will have to make decisions affecting many firms and citizens in stressful situations in a minimal span of time and possibly hampered by both imperfect information and uncertainty about outcomes. At the same time, policy-makers will have to maximise the effectiveness of their response. This challenge is already difficult enough to meet at the national level, but the cross-border dimension only compounds the possibilities for miscalculations to occur. In a crisis situation, the single most important task of the relevant authorities is to restore confidence in the system. This task cannot be divorced from the fiscal question, since it is often the case that confidence-boosting measures require blanket guarantees from the government (finance ministry) to buttress liquidity-provisioning by the central bank (Fischer, 2001).

Yet fiscal measures aimed at stabilisation always involve a certain degree of risk, to the extent they can breed moral hazard. In order to minimise the risk of moral hazard, a central bank (and the finance ministry, should the use of public funds become necessary) should not reveal in what circumstances or to what extent it would be prepared to exercise a lender-of-last-resort function, a phenomenon known as ‘constructive ambiguity’. Nevertheless, there should be no ambiguity about which authority would secure what role in the case of a systemic solvency crisis in the eurozone. It is not difficult to ascertain that there is little constructiveness in the ambiguity of ‘improvised cooperation’, the ad-hoc coordination mechanism that would emerge between finance ministries today if a serious crisis did appear. Without suggesting a homogeneous response to various forms of imbalances in financial markets, there are concrete measures than can be taken in the meantime that do not amount to a blueprint for solvency crisis management.

As the relationship with finance ministries continues to be informal (Schoenmaker & Oosterloo, 2004), there is a need to extend the existing crisis-management MoUs to finance ministries, in order to formalise a general modus operandi for crisis cooperation between the guardians of the public purse. Even so, the extension of MoUs to include finance ministries cannot be considered a cure-all: the private sector will tend to be sceptical of the viability of ad-hoc emergency measures, delaying the restoration of confidence at critical times. Also, the fact that the contents of the MoUs are not publicly available does little in the way of reassuring the private sector, not least because they are not even legally binding. Here, the EU has much to learn from the cooperation between Scandinavian central banks, supervisory authorities and finance ministries (Box 4). In the context of financial crisis management in the EU, the key question for the future is how to resolve the incentive problem that arises in a situation resembling that in quadrant III of Table 7.
Box 4. Key points of the Scandinavian central banks’ MoU *

Motivation

- The increasing prevalence of cross-border banks entails the risks of a financial crisis in a Nordic banking group having repercussions for financial stability in more than one of these countries.
- The provision of emergency liquidity assistance (ELA) inevitably benefits the entire group. Consequently, decisions by one or more central banks to provide or not to provide ELA to a cross-border bank have implications for other central banks.

Principles for an MoU

- A structure has been established for crisis management and dissemination of relevant information to ensure quick and efficient cooperation between central banks.
- A legally non-binding instrument (MoU) is preferable in order to maximise flexibility.

Conditions regarding liquidity and solvency

- Responsibility for managing a financial crisis in a bank rests primarily with the owners/management. Problems in parts of a conglomerate are expected to be solved by leveraging the collective financial strength of the whole banking group.
- Is the insolvency group-wide or subsidiary-specific? If it is the latter problem, the subsidiary is to be recapitalised with internal funds; if the group is insolvent, then the assets are to be sold off to help finance the costs of restructuring.
- The bank must be solvent to obtain ELA. If the bank is insolvent, central banks refer the case to the finance ministries.

Establishment of a crisis-management group

- A contact group will be established, which consists of one high-level representative from each of the concerned central banks plus an alternate.
- In a crisis, the contact group becomes the crisis-management group. The aim is to share all the information, discuss all possible measures and closely coordinate responses.
- Representatives are to communicate directly with their central bank’s executive board.
- The first central bank to identify a potential crisis activates the crisis-management group.
- Thereafter, the central bank of the country where the management of the banking group is domiciled is in practice responsible for coordinating the crisis-management group.

Tasks of a crisis-management group

- The first task of the crisis-management group is to ascertain the bank’s liquidity and solvency through direct communication with the management of the banking group and contact with the supervisory authorities.
- The crisis-management group responsible for producing background material is to facilitate the potential decisions of the central banks’ executive boards with regard to ELA. The material should present information on systemic importance and solvency, and clarify differences of opinion between the affected central banks.

Information management

- The content of internal information shared between central banks and external information provided to the media is to be coordinated through the crisis-management group.
- Communication with the relevant bank’s supervisory group is to be handled by the crisis-management group. Individual central banks are to handle communication with the respective country’s supervisory authority and ministry of finance.
If Nordic central banks draft a separate MoU for a specific financial group, one central bank is responsible for ensuring that the fact book containing the relevant public information about the group is updated regularly.

The purpose of the fact book is to give central banks a common body of knowledge about the structure of the group’s business activities and balance sheet.

* The MoU signed between the central banks of Denmark, Finland, Iceland, Norway and Sweden is significant in that it involves more detailed provisions than the one signed between the ESCB and national supervisors. This may be because of the greater trust Scandinavian authorities place in each other’s competences following coordination during, and rapprochement subsequent to, the banking crisis in the early 1990s.

The legal dimension cannot afford to be ignored either. Attempts to harmonise bankruptcy laws in the EU remain highly contentious and are almost as old as the Community itself. Orderly winding-up proceedings in the case of a large EU financial institution becoming insolvent are a key ingredient of the EU’s financial stability. As Fischer (2001, p. 5) notes:

One of the most important things to have at all times is an effective foreclosure and insolvency process as well as a framework for debt restructuring. The legal and institutional framework should allow the authorities to quickly resolve a bank once it is deemed to be insolvent. As part of the resolution process, the government also needs to have the ability to take over assets from the insolvent institution.

Recently, the Commission and the Council have sought to pave the way forward (the Council regulation on insolvency proceedings (No. 1346/2000) and the Credit Institutions Reorganisation and Winding-up Directive of April 2001), but several important questions remain unanswered. To take an example, the Directive on the Reorganisation and Winding-up of Credit Institutions (2001/24/EC) is vague on how to carry out bank reorganisation/winding-up when the risk of cross-border spillovers is present. On the one hand, home-country control prevails for the adjudication of proceedings (provision 6): “The administrative or judicial authorities of the home Member State must have sole power to decide upon and to implement the reorganization measures provided for in the law and practices in force in that Member State”. Yet at the same time, “those effects may conflict with the rules normally applicable in the context of the economic and financial activity in other Member States” (provision 23), in which case “reference to the law of another Member State represents an unavoidable qualification of the principle that the law of the home Member State is to apply” (provision 23). While the recognition of the authority appointed by the home country to organise and supervise the restructuring/liquidation of the credit institution is “an essential factor in the implementation of decisions taken in the home Member State…the limits within which he may exercise his powers when he acts outside the home Member State should be specified” (provision 27) (emphasis added).

So which provision has primacy? Is it the one supporting home-country control or the one qualifying that principle in order to ensure that doing so will not be to the prejudice of systemic stability in other member states? The fact that the criteria establishing these limits are not identified, either in the Directive or elsewhere, suggests that there is scope for great confusion and political interference in the event of bank insolvencies with cross-border spillovers. As far as the banking system is concerned, these lacunae pose problems for resolving financial crises.

In conclusion, we would stress that the crisis-management architecture in the EU is still incomplete and many lessons can be drawn from the Scandinavian experience. We identify three issues as particularly urgent. First, there is a need to lay the groundwork for an agreement on solvency crisis management by formalising the role of the finance ministries. Second, it is clear that there is a need for a multilateral clearing facility to coordinate the regular exchange of
information pertaining to financial stability. Finally, some clarification is needed on the Directive on the winding-up of credit institutions. Further harmonisation of bankruptcy laws would help to promote orderly crisis resolution.

5.7 The EU as a global player in financial services

5.7.1 Becoming an internationally accepted counterpart

European developments – including the moves towards single supervisory authorities (FSAs) at the national level as well as those towards regulatory integration and supervisory cooperation at the EU level – have been noticed outside the EU, to the extent of becoming a model for reform.47 At the same time, the European Commission and the CESR are increasingly accepted as international counterparts in regulatory and supervisory discussions. The same can be expected to occur for the CEBS and the CEIOPS. This development has several implications.

Between the EU and the US, a Financial Markets Regulatory Dialogue was started in March 2002. It involves the European Commission and the US Treasury, SEC and Federal Reserve Board, with the aim of improving understanding and resolution of complex financial and regulatory issues on both sides of the Atlantic. From an ad-hoc dialogue, concentrated initially on the impact of the Conglomerates Directive (Directive 2002/87/EC) on US firms and of the Sarbanes Oxley Act on EU listed companies, it has become a more permanent feature focusing on a broader set of financial markets issues. Both sides have demonstrated willingness to resolve issues, concerning, for example, the equivalence of rules for auditor oversight.48 Nevertheless, some difficult issues lay ahead, such as the harmonious implementation of the Basel Accord on both sides of the Atlantic, the equivalence of accounting standards for disclosure under the EU’s Prospectus and Transparency Directives and the direct access of EU stock exchanges to the US market.

On the supervisory side, the CESR and the US SEC announced a cooperation agreement on 4 June 2004 covering increased communication regarding regulatory risks in each other’s securities markets and the promotion of regulatory convergence for future securities market regulation. This was followed on 21 October 2004 by a cooperation initiative with the US Commodities and Futures Trading Commission (CFTC). These bilateral dialogues should be pursued with other jurisdictions as well, such as Australia-New Zealand, Japan and other South Asian financial centres.

The increasing role of the European Commission in financial regulation at the international level implies the full cooperation of the member states in accepting and cooperating with this role. This is not always to be taken for granted, as member states may often look for bilateral deals with a non-EU counterpart rather than following the EU route or they may not live up to the thrust of an European Union agreement. The agreement between the European Commission and the US Public Company Accounting Oversight Board (PCAOB) requires the EU member states to create auditor oversight authorities, which is not yet the case in all member states, and

47 In a recent report, the US Government Accountability Office, a think tank of the US Congress, emphasised the capacity of the EU and its member states to reform regulatory structures in view of changes in the financial services industry – see US GAO (2004).
48 This declaration of intention was made public by European Commissioner Frits Bolkestein and US PCAOB Chairman William McDonough in Brussels on 25 March 2004.
to agree on the European Union’s draft 8th Company Law Directive on the statutory audit, as a pre-condition for having equivalence of rules with the United States in place.49

Another implication of the European Commission’s increased role in financial regulation is that it should be given a greater role in international financial bodies. The most obvious body is the Basel Committee, where EU member states today account for nine out of the thirteen members of the Committee. Proposing a reform of its representation would allow a more-balanced representation of countries, which would enhance the credibility and effectiveness of the Basel Committee. Other candidates for an EU representation are the International Organisation of Securities Commissions (IOSC) or the International Association of Insurance Supervisors (IAIS). This could in each case be the chairman or secretary-general of the level-3 committee.

International agreements to open up domestic markets to competition from foreign financial firms certainly merit at least brief attention in a report on the future of EU financial services regulation.50 The last Commission in particular was very keen on opening up financial markets in the context of multilateral fora. Yet history shows that multilateral trade negotiating-rounds aimed at market liberalisation can be painfully slow. Indeed, in the Uruguay Round (1986–94), financial services negotiations in the General Agreement on Trade in Services (GATS) were extended well beyond the formal conclusion of the round, with final agreement not reached until December 1997. Moreover, the amount of ‘new’ liberalisation in GATS financial services commitments has, in general, been relatively limited. A major exception involved China’s WTO accession agreement in 2001, which represented a great leap forward for international trade liberalisation and included commitments to open the banking sector to full foreign competition by December 2006. The GATS/WTO framework has important benefits, however, even when countries make GATS commitments only for current levels of liberalisation (i.e. to ‘bind’ the status quo). These benefits result from the binding nature of GATS commitments, which are permanent in the sense that they cannot be withdrawn without the compensation of trading partners, the enforcement mechanism that gives these commitments their credibility (the WTO dispute-settlement mechanism), and the broad reach of the most-favoured-nation (MFN) obligation of the GATS, which extends to all services covered by the agreement, not just those for which a country has made specific commitments to liberalisation.

With regard to a bilateral as opposed to multilateral approach for trade agreements, the success enjoyed by the US in its strategy of opening markets through bilateral free trade agreements could be emulated by the EU in the field of financial services. Bilateral agreements should, however, be brokered with a view to eventually liberalising both further and multilaterally – and not with a view to promoting the emergence of trade-restricting regional blocs.51


50 The material in the following four paragraphs is based on a presentation made by Dr Sydney Key (International Finance Division of the Board of Governors of the Federal Reserve System) at CEPS on 6 October 2004, entitled “Financial services in the WTO: The contribution and limits of the multilateral agenda”. We also gratefully acknowledge her help through extensive suggestions in these paragraphs and for clarifying the text by adding much precise input. Mr Winfrid Blaschke (European Commission, DG Trade) must also be thanked for his comments, which rendered the same section more rigorous in terms of the facts.

51 If bilateral or regional agreements meet the stringent standards set by the GATS to qualify as ‘economic integration agreements’, they are not bound by the MFN requirement of the GATS, that is, parties to such an agreement are not required to extend the benefits to all WTO members.
In both multilateral and bilateral trade negotiations on financial services, special provisions are made to deal with the highly sensitive area of prudential measures designed to maintain financial stability. When the Uruguay Round agenda was being negotiated in the mid-1980s, financial regulators were loath to include financial services in a multilateral trade agreement without a specific safety valve that would ensure that the agreement did not interfere with carrying out their responsibilities for prudential regulation and supervision. As a result, the ‘prudential carve-out’ allows countries to take measures to ensure the integrity and stability of the financial system and for the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owed without regard to whether they are consistent with any other provisions of the GATS. To guard against abuse of the prudential carve-out, the GATS provides that prudential measures may not be used as a means of avoiding a country’s obligations or commitments in the agreement. In addition to the prudential carve-out, the GATS also contains a provision dealing with unilateral or mutual recognition of prudential measures. This provision allows a WTO member to recognise the prudential measures of selected other countries without being subject to the MFN obligation of the GATS. The GATS requires, however, that similar recognition must be accorded to any WTO member that meets the same standards.

For the EU, the prudential carve-out is a double-edged sword. On the one hand, the carve-out ensures that the GATS obligations and commitments of the EU, as well as other WTO members (including those undertaking capital-account liberalisation), will not prevent their financial regulators from carrying out their regulatory and supervisory responsibilities. On the other hand, some WTO members might attempt to use the prudential carve-out to cover measures that serve primarily to deny ‘effective market access’ and cannot in fact be justified on prudential grounds. With regard to such measures, it seems likely that the EU and a country’s other trading partners would rely on moral suasion to convince the country to change its rules rather than resorting to the WTO dispute-settlement mechanism.

5.7.2 The global competitiveness of EU financial markets

Much attention has been focused recently on the notion of global competitiveness in the debate on the future of financial regulation after the FSAP. This focus is not surprising, given that the FSAP was designed with the goals of the Lisbon Agenda in mind. The increasing attention on competitiveness arises from a combination of factors: the fear that the FSAP may have favoured speed over the quality of legislation; regulatory fatigue setting in among market participants, particularly as to the perceived micro-management of certain financial products; the imposition of compliance costs on EU financial services firms, which may detract from their ability to invest in the development of innovative products and processes; the concern that the regulatory approach taken by the EU institutions in the FSAP has been far too introspective, thereby hindering the ability of EU firms to compete in global markets; and the rapid strides made by regulators in East Asia, coupled with that region’s impressive growth prospects. That EU legislators and regulators should increasingly turn their attention to the impact of regulatory measures on the competitiveness of the EU financial services firms would be a welcome prospect indeed, provided that a precise economic definition of the term be arrived at and

52 One indication of the sensitivity of the financial services sector is the scope of the prudential carve-out in comparison with other domestic policy exceptions in the GATS. In order to protect the areas of health and safety, for example, countries may adopt and enforce measures that are inconsistent with the agreement only if they are ‘necessary’. By contrast, all prudential measures are exceptions, without being subject to any ‘necessity’ or ‘least-trade restrictive’ test. Nevertheless, the issues of whether a measure is in fact prudential and whether it is being used to avoid a country’s obligations and commitments under the GATS are subject to WTO dispute-settlement procedures – see Key (2003, p. 25).
understood. We argue for a cautious approach to the notion of competitiveness by highlighting the importance of a proper definition in order to avoid common pitfalls that can lead to misguided policy. Once these hurdles are overcome, concerns about competitiveness will be more credible. Before arriving at a positive definition of the term and how policy-makers ought to respond to the challenge of global markets, we first seek to clarify misconceptions by outlining what competitiveness is *not*.

Competitiveness remains an elusive concept. What exactly is meant by ‘competitiveness’? A first step is to clarify two points: who is in competition with whom, and how to measure it. First, as argued by Krugman (1994 and 1996) the idea that nations or groups of nations compete with each other in world markets undermines one of the sacrosanct tenets of trade theory: trade is not a zero-sum game. If it were, only those actors who have the expectation to gain from trade would come to the market, but they would have nobody with whom to trade, since the potential losers, better off without trading, would shun the market. Trade by definition implies the voluntary cooperation of two parties, so by its very existence, it suggests the welfare of all improves from transactions in the market. Just as it makes little sense to talk about the competitiveness of a country, it is problematic – or at best risky – to make references to the competitiveness of an entire industry, such as financial services. One could easily envisage a scenario (take the EU Prospectus Directive) where regulations intended to improve the attractiveness of one subset of that industry (imagine equity markets) to foreign investors may have negative repercussions on the competitiveness of another subset (international bond markets). Since it makes little sense to apply it on a national level and little more sense at the industry level, competitiveness is therefore best defined at the level of the firm.

If competitiveness is best defined at the level of the firm, one must then find a proper meaning for the term. Is it defined as the market share captured by EU players in a segment of the global financial services industry or the growth rate of this share? Thus, in the hypothetical case that EU investment banks would generate more turnover than their foreign counterparts, or that securities exchanges in the EU capture a larger share of trading volume than do foreign ones, could one describe the EU financial services industry as more ‘competitive’? In the case of the securities exchange example, this interpretation begs the question of: What is a market? Is it the sum of the trading volume captured by EU securities exchanges or the total trading activity of one exchange (compared with a leading foreign competitor), or the total trading in bonds, or the total trading in covered bonds?

These definitions are all problematic in some way or other. Interpreted as the antithesis of losing market share to foreign competitors, ‘competitiveness’ is derived from the misconception that global trade is a zero-sum game, leading to a politicisation of the management of the country’s external balance. Suppose a scenario such as an EU financial services firm is bought out by a foreign competitor, because its share price is very low owing to low productivity and poor management. Poor financial results have led the firm to remove a good number of workers from its payroll. Subsequent to the takeover, reforms introduced by the new management and the efficiency gains that result from the takeover lead to increased activity in the EU subsidiary of this foreign bank holding company and greater profitability of the EU subsidiary. As a result, there is a sudden surge in new hires in the EU office. The foreign firm is more efficient and can lend to its EU clients at more favourable rates, while offering a higher return on deposits. Can one say that this scenario has reduced welfare in the EU, even though EU firms have lost market share? If competitiveness is defined as market share, large conglomerates could merge to form a behemoth so large that production would surpass the point where long-term average costs would be minimised, such that value destruction would result. This makes little sense, if we are to believe that competitiveness is a positive concept conducive to welfare gains.
Defining competitiveness as the growth rate of market shares could guide a country’s attempts to obtain an artificial cost advantage for an industry through a host of unsustainable and distortionary policies that can only hurt the economy in the long run, including protectionism, exchange rate manipulation, tax breaks, subsidies and other forms of trade-distorting industrial policies. In addition to distorting efficiency-enhancing global trade flows, such policies aimed at enhancing the competitiveness of an industry can potentially also be bought at the expense of other domestic sectors, which then bear the costs of an implicit tax on their activities arising from the subsidy to the sector facing global competition.

Industry-level definitions of competitiveness, for their part, give too prominent a role to government regulation as an overriding factor in deciding the growth prospects or market shares of firms, as if both macro- and micro-scale factors had little or less of an impact on an industry’s global success than regulation. Macro factors affecting competitiveness include exchange rate movements, labour productivity, wage rates, technological advances, a stable macroeconomic environment and agglomeration effects. Other and perhaps more important factors relate to micro-strategic variables: how a firm chooses to finance its operations, which markets it decides to enter, which suppliers to use, whom to partner with, which style of governance to adopt, which business model to execute, etc.

If competitiveness were so critical a factor on the competitiveness of the industry as a whole, one must then wonder why firms that are subjected to identical regulatory regimes vary so greatly in their performance. Also, the variability of the performance of financial firms across the EU at a given point in time, as well as the variability of the performance of a single firm over time, is far too great to be explained by regulation, which is a very slow process compared to the speed of market developments.

Finally, unless competitiveness can be precisely defined, there is little sense in comparing indicators of competitiveness across countries. Three arguments support this claim. The first is that there are good reasons why benchmarking internationally makes less sense than benchmarking against domestic objectives and potential growth, not least because it implies relative performance, whereas the ultimate measure of the success of an industry or an economy depends on absolute performance. Thus, if world output growth in the financial services sector is stagnant at 0.2% and that of EU financial services firms is marginally better but still a measly 0.3%, can the EU sector be said to be competitive? The second, noted by Lall (2001, p. 24), is that “the validity of [quantitative indicators of national- or industry-level competitiveness like the World Economic Forum Competitiveness Index] is debatable”, since:

the framework suffers from vagueness and imprecision, in particular in the way it mixes corporate strategy with economic variables. The causal relations between the independent and dependent variables are very unclear, and many non-linear or controversial relationships are excluded or left unexplored. The plethora of explanatory variables, many apparently repetitive or irrelevant, does not add to the real explanatory power of the index.

A third argument is that international benchmarking ignores the non-economic objectives of financial services regulation. In consumer theory, one is warned against inter-personal comparisons of utility, since the utility functions of individuals are not comparable. Because social preferences (and therefore policy objectives) vary from country to country, there is a limit to the usefulness of exercises aimed at cross-national comparisons of ‘competitiveness’ based on regulatory regimes. One can extend the analogy to international comparisons of regulatory regimes, since a society’s preferences are imbedded in that country’s regulatory structure.
Now that we have spelled out the common misconceptions on competitiveness, we proceed to a positive definition and to the policy implications of this debate in the post-FSAP agenda. At the firm level, a good definition of competitiveness is the following by Buckley et al. (1988):

A firm is competitive if it can produce products and services of superior quality and lower costs than its domestic and international competitors. Competitiveness is synonymous with a firm’s long-run profit performance and its ability to compensate its employees and provide superior returns to its owners.

Competitiveness is therefore not a static concept but a dynamic process. It is a firm’s consistent ability to generate profit – creating a sustainable platform for increases in shareholder value over extended horizons – that will assure the survival of the firm in the long term. These clarifications having been made, i.e. that it is really productivity growth (producing higher quality services at lower costs) coupled with the ability to innovate that we care about, the issue of how firm competitiveness interacts with European Union regulations cannot afford to be ignored.

Today, some 67 million Europeans are employed in services, by far the largest sector in the European economy, comprising roughly 66% of GDP. Financial services accounts for 6% of EU GDP and nearly 3% of employment according to the Commission. The financial services industry in the City of London alone employs one million people, with wages above the UK average, and the financial services sector accounts for roughly one-third of the Treasury’s corporate tax receipts (Buxton, 2001). As strong emerging markets begin to move up the production value-chain, there will be increasing pressure on the financial services sector to create jobs in Europe as well as to stay ahead of the potential pressures to go offshore. Here, powerful agglomeration effects will provide a temporary buffer zone protecting the EU financial services industry, but that is no excuse for regulators to produce a regulation that does not fit the ‘need-to-act’ test. The need-to-act test is motivated by the realisation that regulation should not be pre-emptive, but rather, must only respond to clear cases of market failure with an additional assurance (through Regulatory Impact Analysis) that the potential costs of government failure do not exceed those of the market failure it sought to suppress. In the case of EU regulation, it is very important to establish to what extent the market failure transcends borders and is of a sufficient scale as to warrant EU action.

EU legislators and regulators must also satisfy a subsidiarity test. In other words, they must heed the noticeable differences that still exist in market structures. As always, according to an internal market logic, it is less the structure of markets that matters than the integration of those markets, whether through harmonisation or mutual recognition (the latter being preferable, of course, in a heterogeneous regulatory system – but the ultimate goal is harmonisation, the difference simply being the process by which it is arrived at: market-driven versus policy-driven). Nevertheless, in the context of global markets those regulatory differences could be crucial to firms’ ability to compete internationally. Clearly, there is an underlying tension between the internal versus the external objectives of completing the single market for financial services. Internally, measures to promote pan-European market integration aimed at internal efficiency may come at the cost of some foregone external competitiveness: the opportunity cost

---

53 For further details, see the website of the DG Internal Market (http://www.europa.eu.int/comm/internal_market/).

54 The need-to-act test is an essential component of Regulatory Impact Analysis that examines whether there are normative grounds for policy intervention. It is based on three steps: the detection of a market failure; the attempt to make it disappear through market solutions, i.e. incentive schemes; if that fails, the third step is to resort to regulation, but only if it can be demonstrated that the market failure would be overcome by the proposed regulation (see Pelkmans, 2001).
of pushing through a single market programme for financial services becomes ever greater as the sacrifices that are required to achieve internal efficiency become more demanding the closer the EU comes to creating a fully integrated market.

How does regulation and government intervention in general fit into the firm-level definition of competitiveness? Government intervention would be limited to creating an environment conducive to investment and entrepreneurial creativity – ultimately to growth, while promoting other, non-economic objectives such as the elimination of fraud and other abuses. In accordance with the subsidiarity test, regulation should be the last resort after market solutions have failed, as well as attempts to coordinate the actions of market players through incentive schemes, and must only be used if it can be shown beyond a reasonable doubt that government intervention would successfully overcome the market failure. This is not an anti-regulatory approach. On the contrary, as discussed in section 4, higher levels of regulation can increase competitiveness (for example by reducing information asymmetries in securities markets – a clear market failure). The accent must be placed on effective regulation. Poorly crafted regulation will lead to a tangled web of misinterpretations, facilitating asymmetric implementation at the member state level and further skewing the playing field.

In an environment characterised by an oppressive regulatory burden, it is likely that firms would seek to pass on the increasing compliance costs of burdensome regulation to consumers, driving up the cost of their products and thereby reducing consumer welfare. Adding an intertemporal dimension to this problem, heavy compliance costs come at the expense of more investment. To give an example, investment in IT is key to introducing innovative products and processes. It secures the competitiveness of EU financial services firms in the long run by improving the quality and efficiency of existing products, while introducing new products that expand consumer choice. At the same time, the productivity gains deriving from these investments can then be shared with consumers by lowering the cost of providing these services. The UK Confederation of British Industry (CBI) estimates in a recent report that financial services firms in the UK are now spending 15% of their total IT budgets on compliance measures (CBI, 2004). The fact that 15% of IT budgets are spent on compliance is far from insignificant. Properly understood, the notion of competitiveness can only encourage legislators to devise more efficient laws – and to use legislation as a last resort.

Compliance regulation based on rules is incessantly trying to keep pace with market developments, meaning that it is constantly adopting new rules or modifying old ones to adapt. But outdated rules are rarely removed. This is clearly an area where regulation could hamper the competitiveness of EU financial services firms. The Commission must be lauded for having adopted in 2002 a better regulation action plan,55 the pillars of which are: simplifying/modernising existing legislation; removing unused/outdated legislation; removing any unnecessary complexity from legislation; and extending to eight weeks the consultation period with stakeholders (HM Treasury et al., 2004). More recently, in January 2004, the Joint Initiative on Regulatory Reform launched by the presidencies of Ireland, Holland, Luxembourg and the UK (still to come) and now extended to include the subsequent presidencies of Austria and Finland, intends to ‘competitiveness-proof’ all proposals and to ensure that the decision-making process accurately reflects the conclusions of the impact assessment.56

Although competitiveness is primarily a firm-level concept, in a world where factors of production are mobile, there is scope for regulatory competition between jurisdictions, if their policy objectives are equivalent. Where regulators have different objectives corresponding to varying social preferences, regulatory competition cannot truly emerge since regimes are not directly comparable. In such a scenario, the measure of economic success is not limited to the ability to attract foreign business, since policy must also respond to other, non-comparable objectives. Yet it seems to be the case that the gradual convergence of regulatory objectives in large financial centres such as London, New York or Hong Kong means that measures to enhance the attractiveness of these centres to foreign business are valid. The regulatory regimes in which these financial centres operate certainly play a role in their ability to attract foreign business, and moving towards the maximum effectiveness of regulation is desirable, but one must not either overplay the importance of regulation: other factors related to the costs of establishing a business, such as labour costs and office rents, also play an important role in the ability of financial centres to compete for foreign business.

An interesting policy initiative from which the EU could draw useful lessons is the Swiss creation of a Strategic Advisory Group on the Swiss Financial Centre. The Group was created through an initiative by the Federal Department of Finance to establish an overarching framework for the regulation of the financial sector, with a roadmap of sorts on how to promote the various objectives of financial regulation even-handedly, while keeping an eye on the global competitiveness of the Swiss financial centre. The road map is to be referred to in all future regulation of the sector. While recognising that the government cannot assume responsibility for either entrepreneurship or the innovative capacities of firms, the guidelines do recognise the importance of the government in setting the proper institutional framework upon which the Swiss financial centre will emerge as a strong global competitor. At the same time, one must recognise that in the wake of technological improvements, much of the future competition will not come from physical financial centres as such, but from electronic financial centres.

Finally, an important corollary of the whole competitiveness debate must be the question of market access. Trade liberalisation is a vital ingredient in the global competitiveness of EU firms, since the relentlessly competitive environment of global markets represents the testing grounds for new products, the spawning pools of new ideas and ultimately the battlefields on which firms fight for global domination. As previously discussed in section 5.7.1, multilateral instances for the liberalisation of trade in services are handicapped, despite the GATS, because of technical barriers such as the ‘prudential carve-out’ and because developing countries feel that they have made too many concessions to industrialised countries’ demands in terms of the agenda in previous GATT/WTO ministerial rounds. There will be little scope in the near future, then, for much progress in the GATS, pointing to the importance of bilateral treaties for the European Union.

To conclude, the Lisbon Agenda can be seen as a contract between EU policy-makers, national politicians, corporate representatives and EU citizens: a contract based on the realisation of policy objectives related to the performance of an industry given societal preferences. Therefore, to the extent that there may be a trade-off between certain non-economic policy objectives, such as investor protection, and economic objectives such as global competitiveness, policy-makers should balance the costs, benefits and risks of favouring the one over the other. By applying impact assessments on the external effects of financial regulation – not with the objective of ‘benchmarking’ against the US, but in order to better appreciate the costs of favouring one policy objective over the other (where the two involve a trade-off), policy will become both more transparent and more effective in delivering its objectives. Depending on the way competitiveness is defined, it can exert very different influences on policy design, leading to decisions that may or may not be beneficial for an industry, a country or groups of countries.
Thus, although the debate on competitiveness may seem to be a question of semantics, the powerful vested interests on the sides of both regulators and markets make the precision of vocabulary vital in order to avoid misguided and trade-distorting policies.

6. Conclusions

The EU managed to reform the structure of financial regulation and supervision in a consensual and rapid way, which has surprised many observers. Perhaps the most remarkable element of the reform was the manner of its advent: as opposed to being catalysed by a crisis (as one would have expected), the reform arose endogenously as a response to market developments. As such, the reaction of EU policy-makers can stand as a model for other federal jurisdictions and free trade zones, such as Canada, the US and Australia-New Zealand. Yet it is precisely because the current structure was put into place at a time of relative tranquillity that many observers have noted the mettle of the system will only be tested when the first post-EMU financial crisis strikes Europe. For this reason, the impressive accomplishments of the past five years should not give way to complacency. Much can still be done in the way of refining the regulatory, supervisory and crisis-management frameworks of the EU.

Questions thus arise as to what is left and what will need to be adapted. A primary issue of concern will be adequate implementation and enforcement. With the publicity given to the whole changeover, but also because of the characteristics of the structure, it would be surprising if enforcement were to lag behind. Nevertheless, the discrepancy between rhetoric and practice can often be high, and thought will need to be given as to how to strengthen enforcement in the Lamfalussy framework.

The complexity of the structure, and its eventual impact on efficiency, is a second issue of concern. The EU regulatory and supervisory issues pose a heavy burden on regulators, supervisors and financial institutions. It is not impossible to imagine that the whole process may veer out of control and stifle the markets, certainly the less-developed ones. On the other hand, the current committee structure does not give sufficient attention to matters that cut across sectors, such as retail finance, where progress is desperately needed, albeit only to convince consumers that Europe effectively exists.

A final point is the tendency towards regulatory overkill and centralisation. With Basel II on the verge of implementation, the point of saturation for the financial sector has probably come. Yet the new structure may have an inherent tendency to regulate and legislate, and to have more done at the centre. To the extent that there is a clear hierarchy of rules, with EU rules taking precedence over national rules, it should work. If member states continue to be zealous in applying their own rules, however, it could become counterproductive.


Bank Austria Creditanstalt (2004), Banking in CEE, April (retrieved from http://economicresearch-e.ba-ca.com).


Central Banks of Denmark, Finland, Iceland, Sweden and Norway (2003), Memorandum of Understanding on the Management of a Financial Crisis in Banks with Cross-Border Establishments, signed at Stykkishólmur, Iceland, 11 June.


Committee of European Securities Regulators (CESR) (2004a), The role of CESR at ‘Level 3’ under the Lamfalussy Process, CESR/04-527, CESR, Paris, 28 October.


European Commission (2002c), Economic and Financial Committee, Report on financial regulation, supervision and stability, revised to reflect the discussion at the 8 October meeting of the Ecofin Council, Brussels, 9 October.


European Commission (2004b), Financial Services, Consumers and Small Businesses – A user perspective on the reports on Banking Asset Management, Securities and Insurance of the Post FSAP Stocktaking Groups, DG Internal Market (IP/04/1207), Brussels, 12 October.


List of Task Force Members

The recommendations of this report generally reflect the common position reached by the Task Force, yet neither the recommendations nor the report necessarily represent a fully unanimous position of the members of the Task Force. Accordingly, each member of the Task Force does not necessarily subscribe to every assessment contained in this report, nor does the report reflect the views of the respective institutions to which they belong.

<table>
<thead>
<tr>
<th>Chairman:</th>
<th>Alastair Sutton</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Partner</td>
</tr>
<tr>
<td></td>
<td>White &amp; Case</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rapporteurs:</th>
<th>Karel Lannoo</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Chief Executive</td>
</tr>
<tr>
<td></td>
<td>CEPS</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Jean-Pierre Casey</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Research Fellow</td>
</tr>
<tr>
<td></td>
<td>CEPS</td>
</tr>
</tbody>
</table>

- Ludovic Aigrot
  - Head of the European Affairs Department
  - Euronext Brussels

- Javier Arias
  - Head Representative to the EU
  - BBVA

- Paul Arlman
  - Secretary-General
  - Federation of European Securities Exchanges (FESE)

- Rym Ayadi
  - Research Fellow
  - CEPS

- Luca Battaglini
  - Economist
  - Centro d'Informazione
  - San Paolo – IMI SpA

- Richard Britton
  - ISMA – International Securities Market Association

- Brigitte Bundgaard
  - National Bank of Denmark

- Nick Collier
  - Director
  - European Government & Regulatory Affairs
  - Instinet Global Services

- Gerben de Noord
  - European Affairs Representative
  - Standard & Poor’s

- Gerben Everts
  - DG Internal Market
  - European Commission

- Soren Gade
  - Head of Department
  - Danish Bankers Association (Finansradet)

- Rich Gaffin
  - Financial and Monetary Affairs Officer
  - Mission of the United States to the EU

- Sophie Gautié
  - EU Representative
  - General Secretariat
  - BNP Paribas Securities Services

- David Green
  - Former Head of Policy Coordination
  - EU Affairs
  - Financial Services Authority (FSA)

- Ole Bus Henriksen
  - Former Director-General
  - European Commission

- Charles Ilako
  - Lead Partner
  - Pan European Regulatory Advisory Service
  - PriceWaterhouseCoopers

- Staffan Jerneck
  - Deputy Director &
  - Director of Corporate Relations
  - CEPS

- Arman Khachaturyan
  - Visiting Research Fellow
  - CEPS
Magdalena Kakol
PA to the Head of Section
Budget & Finance Section
Permanent Representation of the Republic of Poland to the EU
Adam Kinsley
Head of Regulatory Strategy
London Stock Exchange
Niall Lenihan
Senior Legal Counsel
European Central Bank
Mattias Levin
Group of Policy Advisors
European Commission
Helmut Martin
Senior Vice-President
Commerzbank EU-Liaison Office Brussels
Wolfgang Maschek
Policy Advisor
National Bank of Austria
Ranald T. I. Munro
Vice-President, General Counsel for Europe Legal Dept.
Chubb Insurance Company of Europe
José Navarro de Pablo
Economist
Group Policy & Research
UBS AG
Salim Nehmé
Senior Adviser
Fédération Bancaire Française
Erwin Nierop
Deputy General Counsel/
Head of the Financial Law Division
European Central Bank
Maria Nieto
Adjunta a la Dirección General de Regulación
Banco de España

Francesca Passamonti
Representative for Benelux and EU
Brussels Representative Office
Banca Intesa
Gregor Pozniak
Deputy Secretary-General
Federation of European Securities Exchanges (FESE)
Wendy Reed
Senior Manager
PERAS
Dirk Schlochtermeyer
Head of Market Policy
Deutsche Börse AG
Bernhard Speyer
Senior Economist
Deutsche Bank AG
Marta Spinella
Expert
European Commission
Panagiotis Strouzas
Expert
European Central Bank
Jonathan Taylor
Head of Public Policy, International
UBS AG
David Wheeldon
Head of Public Affairs
London Stock Exchange
Thomas Wulf
Executive Assistant
Commerzbank EU-Liaison Office Brussels
Winfrid Blaschke  
Trade Analysis Unit  
DG TRADE  
European Commission  

Nathalie de Balsaldua  
Head of Unit  
DG Market  
European Commission  

Fabrice Demarigny  
Secretary-General &  
Head of International Relations  
CESR  

Jacek Dominik  
Counsellor  
Permanent Representation of Poland to the EU  

Mauro Grande  
Director  
Financial Stability & Supervision  
European Central Bank  

Steffen Kern  
Senior Economist & Advisor to the CEO  
Deutsche Bank AG  

Sydney Key  
Division of International Finance  
Federal Reserve Board  

Matthew King  
DG Internal Market  
European Commission  

Katalin Koos-Hutas  
Permanent Representation of Hungary to the EU  

Ruben Lee  
Managing Director  
Oxford Finance Group  

Lelo Liive  
Financial Attaché  
Permanent Representation of Estonia to the EU  

Dirk Mampaey  
General Coordinator  
Central & Eastern Europe KBC  

Axel Nawrath  
Managing Director  
Policy, Communication & Legal  
Deutsche Börse AG  

Sander Oosterloo  
Financial Markets Policy Department  
Ministry of Finance, The Netherlands  

Radek Pilar  
Financial Attaché  
Permanent Representation of the Czech Republic to the EU  

Anders Sahlén  
Council Chairman  
Hansabank Group  

Dirk Schoenmaker  
Deputy Director  
Ministry of Finance, The Netherlands  

Jean-Claude Thebault  
Director,  
DG Internal Market  
European Commission  

Erik Van der Plaats  
Administrator  
European Commission  

James G. Wallar  
Representative for European Affairs  
US Treasury
ABOUT CEPS

Founded in 1983, the Centre for European Policy Studies is an independent policy research institute dedicated to producing sound policy research leading to constructive solutions to the challenges facing Europe today. Funding is obtained from membership fees, contributions from official institutions (European Commission, other international and multilateral institutions, and national bodies), foundation grants, project research, conferences fees and publication sales.

GOALS

• To achieve high standards of academic excellence and maintain unqualified independence.
• To provide a forum for discussion among all stakeholders in the European policy process.
• To build collaborative networks of researchers, policy-makers and business across the whole of Europe.
• To disseminate our findings and views through a regular flow of publications and public events.

ASSETS AND ACHIEVEMENTS

• Complete independence to set its own priorities and freedom from any outside influence.
• Authoritative research by an international staff with a demonstrated capability to analyse policy questions and anticipate trends well before they become topics of general public discussion.
• Formation of seven different research networks, comprising some 140 research institutes from throughout Europe and beyond, to complement and consolidate our research expertise and to greatly extend our reach in a wide range of areas from agricultural and security policy to climate change, JHA and economic analysis.
• An extensive network of external collaborators, including some 35 senior associates with extensive working experience in EU affairs.

PROGRAMME STRUCTURE

CEPS is a place where creative and authoritative specialists reflect and comment on the problems and opportunities facing Europe today. This is evidenced by the depth and originality of its publications and the talent and prescience of its expanding research staff. The CEPS research programme is organised under two major headings:

**Economic Policy**
- Macroeconomic Policy
- European Network of Economic Policy
  - Research Institutes (ENEPRI)
- Financial Markets, Company Law & Taxation
- European Credit Research Institute (ECRI)
- Trade Developments & Policy
- Energy, Environment & Climate Change
- Agricultural Policy

**Politics, Institutions and Security**
- The Future of Europe
- Justice and Home Affairs
- The Wider Europe
- South East Europe
- Caucasus & Black Sea
- EU-Russian/Ukraine Relations
- Mediterranean & Middle East
- CEPS-IISS European Security Forum

In addition to these two sets of research programmes, the Centre organises a variety of activities within the CEPS Policy Forum. These include CEPS task forces, lunchtime membership meetings, network meetings abroad, board-level briefings for CEPS corporate members, conferences, training seminars, major annual events (e.g. the CEPS International Advisory Council) and internet and media relations.