The road towards an internal market for financial services

There are considerable welfare gains to be realised for Europe's economies by creating more efficient cross-border markets for financial services. Some years ago the EU therefore launched the Financial Services Action Plan (FSAP). Covering a period of six years, the FSAP aimed to implement some forty measures in the financial field, most in the shape of new legislation. Furthermore a new legislative model – the Lamfalussy process – has been developed to meet the requirements for more flexible regulations with better adaptability to the high pace of change in the financial sector. Today the FSAP has been implemented on many fronts and the Lamfalussy process has begun to be applied in a number of legislation projects in the EU. The new legislative process has a number of merits compared with the previous model, but some shortcomings need to be addressed in order for it to work as intended.

Benefits of increased integration

The European financial markets have long been fragmented; each country has largely developed its own special rules, institutions and practices for financial activities. The existence of national differences in the supply of financial services is natural and reflects in large measure the particular performance and needs of each country. Until recently, this arrangement has worked reasonably well.

As Europe's economies have become more integrated, however, the drawbacks of this financial market fragmentation have become increasingly evident. The differences in regulations, conventions and supervisory approaches have entailed significant obstacles to the efficient provision of cross-border financial services. Accordingly, it also has become obvious that Europe's economies risk missing out on a number of potential efficiency gains that could benefit growth in the region.

A more integrated market for financial services could, for instance, lead to stiffer cross-border competition and better opportunities to exploit economies of scale and synergies. Greater competition in turn should result in a wider range of investment and financing services and more efficient pricing of these services. With that, expanding SMEs, for example, could be expected to gain better access to risk capital and incur lower financing costs, in the same way that a more evolved and integrated market for corporate bonds has led to a lower cost of capital for large companies. Consumers, too, would benefit from lower borrowing costs and access to a broader range of financial services. Moreover, both companies and households would have better opportunities to diversify risk. Better exploitation of scale economies should also mean cheaper and more secure ways to pay for goods and services.

The underfinancing of the public pension systems will be a big challenge for many countries in Europe in the coming decades. An increasingly large proportion of pensions have to be covered via personal saving. For society at large, a more efficient cross-border market for long-term savings products could contribute to more efficient management of these higher personal pension savings, while households could achieve a better return on savings.

All these efficiency gains could be expected to boost economic growth and help to increase employment in Europe. Exactly how large the welfare gains from a more integrated European financial sector would be is difficult to calculate. However, attempts have been made to estimate the effects of increased financial integration on the real economy in some notable studies.

In June 2004, Guiso, Jappelli, Padua and Pagano published a study of the relationship between financial integration and growth. Among other things, the study showed that European manufacturing firms would be able to boost growth by 0.6-0.7 percentage points a year if they had the same access to financing services as their American counterparts.[72]

A study from the end of 2002 by consultancy firm London Economics focused on the efficiency gains of deeper and more liquid securities markets in the EU15 countries. One conclusion was that increased integration could be anticipated to lead to a long-term rise in real GDP of around 1.1 percentage points and to a 0.5 percentage point higher employment rate in the EU15.[73]

Greater integration could also have positive effects on the stability of the financial system. For instance, more integrated financial markets could improve the financial system's capability to absorb shocks. They also could help to enhance the opportunities for financial institutions to manage and diversify risk. On the other hand, increased cross-border activities could make it easier for financial problems to spill over to other countries.

The Financial Services Action Plan

In the light of the potential for considerable welfare gains, financial integration has been a prioritised policy area in the EU since the end of the 1990s. A fundamental problem was that the member states' regulations differed in so many respects that it made cross-border provision of financial services in the EU difficult. In addition, the regulations were out of date in many ways and needed to be modernised to reflect the changes in the financial sector. To speed up the integration process the Financial Services Action Plan (FSAP) was launched in 1999. Covering the period 2000-2005, the FSAP aimed to implement 42 measures, most in the shape of new directives, in order to increase the harmonisation of the regulations.

72 Guiso, Luigi, Tullio Jappelli, Mario Padula and Marco Pagano, "Financial Market Integration and Economic growth in the EU", Centre for Economic Policy Research, *CEPR Discussion Paper Series* No. 4395, June 2004.

73 Quantification of the Macro-Economic Impact of Integration of EU Financial Markets: Final Report to The European Commission - Directorate-General for the Internal Market, London Economics, November 2002.

Since then new European Community legal acts in the financial field have been prepared in rapid succession. With 40 of the 42 measures now ticked off, the FSAP today has been more or less completed. Consequently, the EU integration process for the financial services sector is now entering a new phase, with consolidation and national implementation of the common regulatory framework at the top of the agenda. In fact, it is now that much of the real work begins, not least for the financial institutions that have to adapt their practices and systems to the new rules. According to the European Commission's plans, new common legislation projects will be confined to a few priority areas, such as the market for retail financial services and asset management.[74]

THE HARMONISED RULES AND REGULATIONS

As a result of the FSAP, there has been harmonisation of legislation in a number of areas of great significance for the integration of the market for financial services and for the evolution of the financial markets in Europe in general:

1. More open and secure retail markets for financial services through, for example, harmonised rules for remote sales of financial services, cross-border payments, insurance services, insurance broking and e-commerce in financial markets as well as common standards for providing information in connection with the offering of financial services.

2. More secure banks and insurance companies through, for example, new common capital adequacy requirements for banks and solvency requirements for insurance companies (the latter are still being worked out in the EU). Furthermore, agreement has been reached on rules for liquidation and other procedures in the event of insolvency in banks and insurance companies, prudential supervision of financial conglomerates and money laundering, measures that help to improve prudential supervision and reduce the risks in the financial system.

3. More secure pension and fund saving through harmonised rules for pension funds and other arrangements for collective investment.

4. More secure and more integrated securities and derivatives markets through the Market Abuse Directive and the Directive on Markets in Financial Instruments.

5. Lower risks in securities settlement through agreements on the pledging of financial collateral. Harmonised rules for clearing and settlement of financial instruments are also being developed.

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74 *Green Paper on Financial Services Policy (2005 - 2010)*, European Commission, Brussels, May 2005. The green paper is currently being developed into a white paper – *the Financial Services Policy Programme* – which after discussion in the EFC is expected to be adopted by the EU's finance ministers in 2006.

6. More efficient raising of capital through the Prospectus Directive and the Transparency Directive, which give more uniform rules for the provision of information in connection with securities issues, and not least through the new financial reporting standards, IAS, which entail more up-to-date and harmonised reporting rules for listed companies in the EU.

7. Simpler cross-border corporate restructuring through harmonised rules for company acquisitions. Other aspects of company law have also undergone considerable harmonisation, not least through the creation of a joint statute for a European company, "Societas Europaea". Company law in the EU is continuing to evolve and initiatives have also been taken to establish common standards for corporate governance.

The above points indicate that the harmonisation measures have been important. In terms of fostering integration the agreement on a new common financial reporting standard is presumably the single most important measure. The harmonisation of the regulations has not been unproblematic in all respects, however.

PROBLEMS IN THE HARMONISATION PROCESS

Harmonisation necessarily entails compromise. Unfortunately, the EU member states often do their utmost to ensure that the common rules involve as few changes as possible in relation to their existing national legislation and their established routines. Sweden is not much different to other countries in this regard. Not infrequently, member states try to obtain national derogations of different kinds. In some cases there also are tendencies to attempt to protect from competition financial institutions that have obtained the status of national prestige symbols, "national champions".

Therefore, the efforts to compromise result in common directives that often resemble patchwork quilts of rules with different origins and aims. As a consequence, the wording of directives is often unclear and inconsistent. That makes it difficult to interpret and comply with the common legislation. The reasons for some regulations can also be difficult to understand. It also takes time before case law is established through test cases in the Court of Justice of the European Communities.

Another result of the compromising is that the directives often become unnecessarily extensive and detailed. It seems to be politically easier to reach compromises by adding paragraphs rather than to delete some when a final text has to be agreed upon. Accordingly, there is often a tendency to over-regulate, which benefits neither developments in the financial markets nor society at large.

A third consequence is that in practice the degree of harmonisation may not become as comprehensive as intended. The endeavour to include special, nationally adapted solutions occurs at all levels and at all stages of the process. Even after a common

directive has been adopted there may be tendencies towards gold plating at national level, i.e. to add a number of national regulations to the common legislation. A problem of the exact opposite nature is the lack of zeal that many member states have demonstrated when it comes to transposing commonly agreed regulations into national legislation. It should be said that Sweden by no means is a model country in this respect. Both gold plating and under-implementation of common rules further work to the effect that the end result is not always the harmonisation intended from the outset. In the worst-case scenario it also can lead to the emergence of new barriers to entry.

That is not to say that total harmonisation always is the optimal solution. Differences in the level of development in the financial sector and other conditions mean that regulatory needs in many respects can differ widely across countries. An overly mechanical and uncritical application of the motto "one size fits all" runs the risk of cementing structures rather than increasing the opportunities for change and adjustment. Which legislation that should be harmonised and how far the harmonisation should be brought is something that generally should be given careful consideration. Increased integration can sometimes be better achieved through other solutions than common legislation. In some cases self-regulation coupled with a tougher application of EU competition policy would be more effective.

MEASURES TO ACHIEVE "BETTER REGULATION"

The above discussion shows that the requirements for, and consequences of, new common rules need to be analysed carefully in advance, but also that the regulations have to be subsequently evaluated, if the aim is to attain both high quality in the legislation and the right balance between harmonisation and national solutions.[75] To date this has not been given enough attention at EU level.

For that reason it is particularly interesting that the quality and focus of the regulation is now being emphasised so strongly under the slogan "better regulation" in the green paper from May 2005 that contains the Commission's proposed new agenda in the financial services field.[76]

To guarantee high quality in regulation the aims include increasing the number of external consultations. In order to receive relevant opinions at an early stage the intention is to engage industry representatives, consumers and various experts in different reference groups, conferences, open hearings, Internet surveys, and so on – all in accordance with the Lamfalussy Committe's wishes to have a more open and transparent legislative process.[77]

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75 Risks associated with introducing extensive legislation without a careful needs assessment and analysis of the costs and benefits for society at large are discussed, for example, in the article "Economic reasons for regulating the financial sector" in *Financial Stability Report* 2005:1.

76 Green Paper on Financial Services Policy (2005 - 2010), European Commission, Brussels, May 2005. The green paper is currently being developed into a white paper, *Financial Services Policy Programme*, which after discussion in the EFC is expected to be adopted by the EU finance ministers in 2006.

77 See "A new model for legislation, regulation and prudential supervision" further on in this article.

The Commission has also undertaken not to propose new legislation in the financial field without first carrying out detailed cost-benefit analyses that confirm the value added for European markets and consumers. With the aid of such evidence-based policymaking the Commission hopes to achieve higher quality in the legislation.

Another explicit ambition is to produce simpler legislation. Many European Community legal acts are, as mentioned, unnecessarily complicated and in numerous respects the legislation is badly arranged and difficult to interpret. To simplify and improve existing rules the Commission has declared a willingness to change and possibly remove rules that are so complex that they cause unnecessary problems for the market or have other undesirable effects. The Commission has given an assurance that it will not have any sacred cows when it comes to proposing such measures. To this end the Commission has initiated an evaluation programme that will be implemented for a number of years ahead. Such evaluations will also require extensive consultations with industry representatives and consumer interest groups, among others. The extent to which the Commission will succeed in phasing out already adopted rules remains to be seen, though.

It is essential that the directives for the financial sector are fairly uniform in terms of their approach, terminology, etc. to avoid conflicting interpretations or undue extra work for the institutions. Today, the directives in the financial field greatly lack such uniformity. In its green paper on financial services the Commission has signified an intention to carry out read-across exercises, i.e. to read and compare connected directives to identify shortcomings in consistency and propose changes to make them more coherent.

As a longer-term aim, the Commission has mentioned attempts to achieve a uniform set of rules for all European companies operating in the same industry – a European Rule Book. However, there is considerable uncertainty and differences of opinion over the exact design of such a rule book. So, for the time being there seems to a fair distance to go before such a project can be realised.

A new model for legislation, regulation and prudential supervision

The initiation of the FSAP highlighted a problem with the normal legislative process in the EU. The process was considered too slow and rigid to handle the rapid changes in the financial sector. According to the normal process, the European Commission presents a proposal for a directive to the European Council and European Parliament. The Council and Parliament make a decision in accordance with the co-decision procedure, which places them on an equal footing.

In practice, the way the process works is that the Commission's proposed legislation is first revised and negotiated in a working group under the Council. When the national representatives in the Council have finished negotiating and arrived at a proposed text

on which they can agree, this is sent to the Parliament for a first reading. Once the Parliament has given its opinion, the text and any proposed changes or amendments is sent back to the Council, which in turn takes a position on the new draft. Following an additional discussion in the Council and its working groups, the text is sent back to the Parliament for a new reading. Not until the Council and Parliament are in agreement can the new directive be adopted. If they fail to agree, a conciliation committee is appointed, consisting of representatives of both institutions, which has to arrive at a text that is acceptable to both. In the event that an agreement still cannot be reached, the legislative process may be discontinued entirely. Normally, it takes two to three years to go from proposal to agreed directive (sometimes considerably longer). In addition there is the time it takes for national transposition, which seldom is less than one and a half years. Even minor changes of a more technical nature in the regulatory framework would need to go through this entire process. Considering the rapid developments in the financial sector, the authorities would constantly find themselves lagging behind with such a lengthy legislative procedure.

To remedy this, about a year after the FSAP had been adopted a Committee of Wise Men was formed, chaired by the Belgian Alexandre Lamfalussy. The Committee's task was to propose measures to enhance the mechanisms for adapting European legislation to the fast pace of change in the financial sector. The Committee of Wise Men presented a number of recommendations that aimed to make the legislative process more efficient.[78] The recommendations were adopted by the European Council at its meeting in Stockholm in March 2001, and the new model came to be called the Lamfalussy process. In short, the new procedure involves dividing the legislative process into four different levels, where framework principles are adopted at level one in the hierarchy, while rules of a more technical nature and regulations related to the national implementation are prepared and adopted at lower levels (see the box below).

78 Committee of Wise Men, Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, Brussels, 15 February 2001.

The Lamfalussy process

Level 1 involves the adoption of directives and regulations based on framework principles. In this part of the process the Commission – normally following extensive consultation with industry representatives, national authorities and consumer interest groups – presents a regulatory framework to the Council and Parliament. The Council and Parliament in turn adopt the legislative proposal by way of the co-decision procedure or in especially urgent cases through a fast-track approach. To further increase the speed and flexibility of the legislative process, the Committee of Wise Men suggested that a larger proportion of the legislative measures than before be implemented in the form of *regulations* instead of *directives*.

Unlike directives, regulations are directly binding for the member states and in principle must not be followed up by national legislation. Transposition of directives at national level usually takes 18 months or more.

Level 2 entails the development of more detailed rules through a comitology procedure. Under such a procedure the Council and Parliament delegate in a legislative act certain legislative decisions to the Commission. The Commission is assisted in its work by special committees which include representatives of the member states. In these committees the member states' representatives vote on the Commission's proposed decisions, after which the Commission can issue secondary legislation. The committees at level 2 include *the European Banking Committee* (EBC), the *European Securities Committee* (ESC), the *European Insurance and Occupational Pensions Committee* (EIOPC) and the *European Financial Conglomerates Committee* (EFCC).

At **level 3** the transposition of the common legislation is ensured and made as consistent as possible. This is achieved through strengthened cooperation and networking between the financial regulators in the different member states. To this end there are a number of level 3 committees whose task it is to prepare technical guidelines for transposition at national level, specify standards, carry out peer reviews, and draw up interpretative recommendations as well as to set standards in matters that are not covered by the joint EU legislation. The committees at level 3 have no legislative powers, but are advisory bodies in the Commission's level 2 measures.

These level 3 committees include the *Committee of European Banking Supervisors* (CEBS), the *Committee of European Securities Regulators* (CESR) and the *Committee of European Insurance and Occupational Pensions Supervisors* (CEIOPS). The committees can be said to be networks of national financial regulators and central banks in the EU.

Level 4 involves the actual enforcement of the Community rules. This is primarily the Commission's task, but the member states and national regulators are expected, on the basis of the Lamfalussy model, to increase their cooperation in this field as well. Enforcement is being taken more and more seriously in the EU. In August 2005, the Commission announced that it had decided to initiate infringement procedures against a number of member states for failure to implement certain rules on time at national level. The first step in this process is that the Commission sends a formal request to the concerned country to implement the rules in question as soon as possible. If the member state fails to do so within two months or does not provide a satisfactory explanation for the delay, the matter can be referred to the Court of Justice of the European Communities.

The legal basis of the Lamfalussy model today rests on a temporary agreement between the EU Commission, the EU Council and the EU Parliament. This agreement includes sunset clauses, which give the

Commission the right to issue level 2 measures for a limited period, after which the Commission cannot continue to issue such measures without first acquiring renewed delegation from the Parliament and Council. The clauses also give the Parliament the right to revoke level 2 legislation within the sunset period. The purpose of these sunset clauses is to give the Parliament and Council control possibilities for that part of the legislation that has been delegated to the Commission in accordance with a comitology procedure.

The Lamfalussy process was originally intended for the regulation of the securities markets, but through an agreement between the Commission, the Council and the Parliament has been widened to include banking, insurance and mutual fund operations. The first European Community directives to be drawn up with the aid of the Lamfalussy process include the Prospectus Directive, the Market Abuse Directive and the Directive on Markets in Financial Instruments.

APPLICATION OF THE LAMFALUSSY PROCESS

The new regulatory process entails increased cooperation and coordination among national supervisors and a pressure for greater convergence of supervisory methods and detailed rules. This higher cooperation between supervisors in Europe is necessary for effective prudential supervision and is also sure to contribute to many synergies in that field. In the level 3 committees much has already been accomplished to strengthen cooperation. CEBS, i.e. the level 3 committee for banking supervision, has drawn up a common standard for how supervisors in the EU should provide information about laws, rules and supervisory methods. The committee has also agreed on a programme to build a more consistent supervisory culture, among other things with the aid of common training and staff exchange. A concrete example of successful cooperation is the creation of a single format for capital adequacy reports in the EU, which should both reduce banks' reporting costs and facilitate consolidated prudential supervision.

Even though the Lamfalussy process has proved to be a success in many respects, the application of the new legislative model has revealed a number of deficiencies – or teething problems – that need to be addressed if the model is to work fully as intended.

As mentioned earlier, one of the basic ideas behind the Lamfalussy process is that the rules at level 1 are to take the form of framework principles. In spite of that, the directives drawn up with the aid of the new model so far have had a marked tendency to become highly comprehensive and detailed. In the Prospectus Directive, the Market Abuse Directive and the Directive on Markets in Financial Instruments the degree of detail has been far too high. That the Lamfalussy process has not, as planned, resulted in less extensive and less detailed directives is a problem.

At the same time as the level 1 rules have been overly detailed there has sometimes been a tendency to delegate politically controversial matters to level 2, or in practice to officials at level 3. Thus, matters that in reality require higher-level agreement have been passed on to levels at which the mandate, the forms for enforcing accountability and other prospects for resolving them are inadequate. Not least in the Directive on Markets in Financial Instruments a large number of tough issues – for example, the extent to which investment companies are to be affected by the controversial rules for pre-trade transparency – have been temporarily swept under the carpet by referring the solutions to level 2 and the level 3 committee for securities regulation, CESR.[79]

The introduction of level 3 in the legislative process means that the expertise of national supervisors and central banks can be better utilised. That should guarantee higher quality in the legislation. In

79 This applies to article 27 of the Directive on Markets in Financial Instruments and investment firms that systematically and frequently execute customers' orders against their own account should have to make a fixed bid in advance.

addition, it seems to mean that urgent measures will also actually be realised. In some cases, though, shortcomings have arisen in the decision-making arrangements because the boundary between the legislator and the object of the legislation has not been kept distinct. For instance, as regards the design of supervisory regulations and solvency requirements for insurance companies, CEIOPS, i.e. the level 3 committee for insurance supervisors, has in practice formulated the Commission's legislative proposals. While utilising the expertise that exists in a certain field to attain high quality in legislation is important, there is a danger when a group that is clearly an interested party in certain legislation also obtains an overly dominant influence over its design. In such a case there is an obvious risk that the legislation will become too focused on specific supervisory objectives and lack the overall view that is needed if it is to benefit the situation in the financial sector as a whole.

For the Lamfalussy process to work as intended it is necessary to seek out ways to achieve a clearer dividing line between the framework principles and the detailed rules.

Another problem is the silo structure according to which the committees at levels 2 and 3 have been organised. These committees have been divided into highly demarcated sectors – banks, securities and insurance – and there is no group with cross-sector responsibility. Integration not only occurs over geographical boundaries, however, but also across industries and sectors. This happens both when companies in different industries are merged to form a conglomerate and through different kinds of cooperation agreement (for example, a bank can conclude an agreement with an insurance company to sell insurance products to its bank customers). The sectoral integration has been met by increased consolidation of supervisory activities at national level, a development that is not reflected in the EU's committee structure.[80] The silo structure in the EU committees risks counteracting the objectives of consolidated prudential supervision and convergence of supervisory methods across industry boundaries. It also could result in the development of separate regulatory and supervisory approaches for different activities, also in cases where the risks in the activities are fundamentally the same. Moreover, there is a danger that innovation and the generation of synergies in supervision will suffer. There have been some attempts to remedy this problem through increased chairman cooperation in the level 3 committees. To date, though, the resources required to develop this cooperation have been lacking. It should be said that this sector division not only exists at the lower levels in the process. Similar tendencies appear already when working groups are put together to draw up directive proposals.

Another problem concerning the lack of an overall view is that issues risk being overlooked or being brought up in inappropriate

80 Austria, Belgium, Denmark, Germany, Ireland, Sweden and the UK are examples of countries that have concentrated the responsibility for their financial supervision in one authority. Finland, Luxembourg and the Netherlands also have achieved a high degree of integration in their supervision, even though they have not come as far as to gather all supervision under one roof.

fora. For example, questions relating to deposit guarantees are raised in committees in which deposit guarantee authorities are not represented. In addition, crisis management matters are dealt with as a separate issue and are not brought up when discussing other parts of the financial sector safety net. In most cases it would be desirable to deal with these questions as a package covering prudential supervision, deposit protection, emergency liquidity assistance and management of insolvent institutions, which normally involves several national authorities.

Also, there is no uniform model for cooperation between supervisory authorities. For instance, in the Directive on Markets in Financial Instruments it is compulsory in some cases to establish cooperation arrangements between the home country's and host country's supervisors. In the Financial Conglomerates Directive the member states must appoint an authority with chief responsibility for coordinating the various supervisors (a co-ordinator). In the Capital Requirements Directive the starting point instead is collegiate discussion, whereby the home country supervisor first tries to reach agreement with the host country counterpart, and second, in the absence of agreement, home country supervision applies. The Market Abuse Directive prescribes the use of a special mediator to resolve conflicts between supervisors. The Prospective Directive provides the opportunity to delegate some responsibility from one supervisor to another. So there are many, different forms of cooperation, a result of the fact that the silo structure already comes into play at directive level. A more uniform structure for cooperation seems desirable, partly to prevent important issues from falling through the cracks and partly so that the concerned institutions meet uniform supervision for the sectors in which they operate.

The new regulatory model means that a large number of supervisors from different countries have to agree on several detailed rules and supervisory methods. This results in pressure – at level 3 as well – to add more regulations to an already detailed and comprehensive directive in order to achieve necessary compromise. It is important to heed the risk of over-regulation and to ensure that the new model is not implemented in a way that simply entails an additional layer of bureaucracy in the European legislative process.

The intention in the EU is to draw up a "roadmap for supervision" until spring 2006, partly to review the possibilities to remedy the lack of an overall view and overall solutions in supervisor cooperation. A number of member states have put forward the idea of a single EU supervisor, while others so far have remained sceptical about the idea.[81] What is important, though, is that the regulatory process and supervisory structure in the EU be regularly evaluated and developed so as to create the best possible conditions for an efficient internal market for financial services.

81 See also the infrastructure chapter in this Report.

Remaining obstacles to integration

INDIRECT OBSTACLES

That there still exists a large number of implicit and informal obstacles to integration was highlighted at the informal ECOFIN meeting in Scheveningen in September 2004. Among other things, market practices can show considerable differences that hamper integration. These can include the margins that are acceptable for certain financial products, separate fee structures for unit-linked insurance policies, and so on. Differences in language, culture and communication also unavoidably contribute to slower integration in some areas. However, among the more serious problems is national supervisors' use of stricter rules for foreign companies than for domestic ones. Unfortunately, there is no shortage of current, concrete examples of how national authorities have raised obstacles to obstruct foreign establishment.[82] An important task is to remove this kind of hurdle so that cross-border investment and competition genuinely gather momentum in practice.

DIFFERENCES IN LEGAL SYSTEMS

Even with a far-reaching harmonisation of financial regulations and convergence of prudential supervision, many obstacles remain in the way of a truly functioning internal market. One factor that at times appears to be more crucial for integration than dissimilarities in specific rules is differences in legal systems and legal application in general. The circumstances can differ widely depending on whether the potential investor or the company looking to carry on financial activities meets a legal system based on the Anglo-Saxon legal tradition or on various traditions in mainland Europe, of which French, German and Scandinavian law are particular varieties.[83]

For those contemplating providing or using a financial service in a different member state, the differences in legal systems can be such a great source of uncertainty that they do not dare take the step over national boundaries. Identifying such sources of uncertainty and strengthening the legal security regarding how laws and rules will be applied is important if cross-border activities are to grow.

DIFFERENCES IN TAX SYSTEMS

One of the biggest obstacles to financial integration is the considerable differences in taxation that exist across different EU countries. The dissimilarities are found in both levels and systems, where differences in tax levels are probably of less significance than differences in the design of tax systems, for example as regards the bases used to calculate tax.

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82 For example, Italy's central bank governor, Antonio Fazio, recently intervened to stop Dutch attempts to take over an Italian bank.

83 For an overview see, for example, La Porta, Lopez-de-Silanes, Shleifer and Vishny, "Law and Finance", *Journal of Political Economy*, 1998, vol. 106, no. 6. See also Michael Bogdan, Komparativ rättskunskap, *Nordstedts Juridik*, 1993.

Differences in tax systems can be a serious stumbling block for the production of financial services when it comes to, for example, the opportunities to take effective advantage of economies of scale; among other things because the differences contribute to major costs for cross-border mergers. Nor do the big differences between countries in terms of the possibilities to set off losses against profits, taxation of capital gains and yield, etc. facilitate cross-border consolidation. Transferring funds between companies in the same group can involve extensive formalities and sometimes also double taxation. For example, VAT that has been paid in one country is not always tax deductible in another.

Differences in taxation essentially create opportunities for tax arbitrage. Even though for most companies this may undoubtedly be both difficult and costly in practice, tax differences may make it profitable for firms to invest considerable resources in finding the most favourable tax location for their activities. From a European perspective, though, this would hardly be an efficient use of resources. On top of this, there are significant costs for companies associated with having to familiarise themselves with several different tax systems and with developing internal routines for taking account of changing taxation bases and tax rates.

For distribution, too, tax differences constitute major obstacles to an efficient cross-border supply of financial products in retail markets. For instance, differences in taxation on capital income and on returns on securities have a big effect in this regard. The development of financial products in the retail market is not infrequently driven by tax factors. Tax differences make it difficult to offer a uniform range of products over national boundaries. The fact that certain select products sometimes are given favourable tax treatment in some countries also is a factor that hampers effective integration.

COOPERATION BETWEEN THE EU AND OTHER COUNTRIES

In the EU, harmonisation is part of the implementation of the internal market. However, financial activities are very much a global phenomenon, and cross-border financial business is carried on to a great extent between the EU and other countries. Consequently, discussions are being held between the EU and the US and between the EU and some of the Asian countries regarding regulation of the financial markets. Of these dialogues, the one with the US has been going on the longest and some strides have been made, among other things regarding cooperation models for financial conglomerates and the adoption of the Sarbanes-Oxley Act.[84] Negotiations are also ongoing concerning mutual recognition of the financial reporting standards US GAAP and IAS. An evaluation is planned to take place during the period 2007-2009. A dialogue between the EU and the US

84 The Sarbanes-Oxley Act was adopted in the United States in 2002 to strengthen corporate governance and restore investor confidence following a number of publicised corporate scandals.

is also being conducted regarding the coordination of the European Capital Requirements Directive (CRD) and the Basel II agreement, i.e. the G10 countries' capital accord. Other present examples concern the possibility to deregister securities from US securities exchanges, cooperation models for insurance supervision, and accounting supervision.

In the EU, the harmonisation work will of course continue since it is part of achieving an internal market. The discussions with other countries, which do not have the same agenda, must not be allowed to obstruct this. The EU having a common view on these matters also facilitates success in negotiations with other countries.

Conclusions

There are large potential gains to be realised for Europe's economies, companies and citizens from increased integration of the markets for financial services. The financial sector facilitates integration in other areas as well and therefore is essential for growth and welfare in the region. The current efforts to create a well-functioning internal market for financial services are thus important.

The Lamfalussy process has been developed to achieve a more efficient legislative process in the financial field, and it is important to safeguard this new model. That does not mean that there is no room for improvement, however. This article has highlighted a number of shortcomings that need to be rectified if the new process is to work as intended. Not least, there is reason to further clarify the boundaries between the different levels in the process.

Cooperation between supervisors is currently being developed at a fast pace and with concrete results as regards norms and supervisory practices, for example. This is encouraging. At the same time, it is important to widen the overall view in this cooperation, partly to avoid the development of dissimilar approaches for different parts of the financial sector where the risks are fundamentally the same, and partly because integration is fostered by more uniform supervision for institutions. From the Riksbank's perspective, it is important that the cooperation in the field of prudential supervision extends over both day-to-day supervision and cross-border crisis management. The increased integration suggests that the cooperation might need to be supplemented with some kind of common European supervision. The establishment of such supervision raises a number of difficult questions, though, including how decision-making powers and the ability to demand accountability should be transferred. Consequently, this is probably an issue that can only be resolved in the longer term.

Harmonisation requires many, often difficult sacrifices at national level. To achieve all the common positive effects that a more integrated financial services sector can give rise to, a high level of willingness and readiness will be necessary from nations, authorities and individual decision-makers to give up their own cherished ways.

Thus, it is necessary to be disciplined as regards gold plating and national derogations. Without that, the goal of a well-functioning internal market for financial services will not be achieved. Here, the Commission's monitoring of national implementation also plays a significant role.

The EU's common legislation is highly detailed and comprehensive. In addition, large parts of it are complex and difficult to interpret. All the member states and participants in the negotiation process are to blame for these flaws and are now paying the price for them. It is essential that new legislation projects are subjected to well-founded cost-benefit analyses and that all measures for simplifying, clarifying and checking the concordance between the existing regulations really are implemented. The European Commission's explicit objective of better regulation shows that it is aware of the problems, and marks – as it seems – a turnaround in the EU's regulation culture. However, it remains for the Commission to prove that it can turn its intentions into action. If the ambitions for better regulation are to be realised it also is necessary that the European Parliament and the member states themselves give their active support.

The new Constitutional Treaty would have given the Lamfalussy process a firmer legal foundation on which to stand. Without ratification of the constitution the ground will be less stable. It would be unfortunate if the important strides that have been made were to be jeopardised owing to disagreement over the Parliament's role. It also could have adverse consequences for the financial integration process. Therefore, if the Lamfalussy process is to survive in the long run, new ways must be sought to give the Parliament adequate assurances of reasonable influence.

Even with a far-reaching harmonisation of financial regulations and convergence of prudential supervision, many obstacles remain in the way of an efficiently functioning internal market. One of the biggest stumbling blocks for integration is differences in tax systems. Here, it is likely that the structural differences between the systems are more critical than differences in tax levels. Convergence of the tax systems in the EU would foster integration, which in all likelihood also would boost growth and welfare in the region. Tax issues are among the politically most sensitive and most controversial in the EU cooperation and therefore are seldom popular to bring up on the European agenda. In order to attain an internal market that really functions, it is nonetheless inevitable that these issues will need to be discussed in earnest.