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The EU Financial Market Policy: Evolution, Innovation and Research Outlook

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Abstract

This paper reviews the process of regulatory integration in the financial markets of the European Union. It shows that the regulatory framework for the single market in financial services has progressed in stages reflecting the evolution of EU policy-modes; from market opening to attempts at harmonization, to reliance on mutual recognition. The slow progress induced the EU to innovate its decision-making processes by introducing the Lamfalussy procedure in 2001. The new procedure accelerated the adoption of new regulations and is being adapted to ensure consistent enforcement across all EU jurisdictions. The next round of challenges to regulatory integration will stem from weak crisis management mechanisms revealed by the current crisis.

Keywords: *European Union, financial market, regulation, Lamfalussy procedure*

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1. INTRODUCTION

A single market in financial services is one of the basic goals of the European Union[1] embedded in the Treaty of Rome. Developing such a market requires the presence of a regulatory framework to ensure its efficiency and stability. The integration of the regulatory infrastructure for cross-border finance has been on the EU agenda ever since 1957. However, the complexity of the task has so far proved overwhelming and, substantial progress notwithstanding, it still lags behind achievements in markets for goods.

The purpose of this paper is to take stock of recent developments in regulatory integration in the EU financial markets and extend the existing academic literature (Dermine 1996, Hall 1997, Young 2005) to the state of the art prior to the current financial crisis. This review also yields several non-trivial observations that go beyond mere description of the process of regulatory integration.

Firstly, we show that the course of the regulatory integration can be analytically separated into four phases according to the dominant policy-mode of integration. Until 2001 it followed the evolution of integration modes that evolved for the single market in goods. The initial *market opening* was followed by *attempted harmonization* and then a switch to a *mutual recognition* policy-mode. However, by 2001 the EU had accumulated enough experience to conclude that its standard decision-making processes can never keep up with the speed of change in financial markets and are thus a major obstacle to regulatory integration. Therefore, the EU had introduced a Lamfalussy process and related changes in co-decision and comitology procedures to be able to produce better regulation faster. Given that the Lamfalussy procedure represents a rare case of *institutional innovation* within EU, we pay considerable attention to its emergence.

Secondly, we show that different components of the regulatory regime are not equally integrated. Until the introduction of the Lamfalussy procedure, the EU focused almost

[1] This paper abstracts away from making specific legal references to predecessors of the European Union such as European Economic Community (EEC) and European Community (EC). This context is observable from titles of relevant directives.

exclusively on adoption of directives. As a result, integration advanced the furthest when it came to directives that specify the *regulatory rules*. The Lamfalussy procedure extended the systematic reach of the regulatory integration into the second component of the regulatory regime - *supervision*. The Lamfalussy committees not only draft future regulations, but are increasingly engaged in the process of convergence of supervisory practices that would ensure EU regulations are enforced consistently in all the EU Member States. The third component of the regulatory regime - *crisis management and resolution of failed financial firms* - is the least integrated. In fact, there the regulatory integration did not proceed beyond non-binding Memoranda of Understanding between all the EU regulatory agencies, ministries of finance and central banks. Given this state of affairs, it is not very surprising that crisis management mechanisms have failed in the current crisis.

The paper is structured chronologically and follows the suggested phases. As each phase is a reaction to broader developments, we briefly summarize relevant economic policy context and mention the most important directives approved during the given period. We pay special attention to the Lamfalussy procedure in the second last section. Given that the ongoing crisis is bound to dominate the next round of regulatory integration, we outline some of the key challenges that will have to be addressed in the last section. In conclusion, we complete our stock-taking exercise by outlining the future research agenda that could build on observations within this paper.

2. PHASE ONE: DEREGULATING ENTRY

One of the founding objectives of the European Economic Community (EEC) was the integration of the highly segmented and protected markets of its member states into a single common market. However, markets in financial services were not the top priority during the first two decades of European integration. The progress was thus limited to deregulation of entry of banks from other EU countries into domestic markets.

The slow progress of financial integration and exclusive focus on banks till the mid-70s reflected the economic structure and policies of EC members at the time. The founding member states had developed inwardly oriented bank-dominated financial sectors with limited role for securities markets (Hall and Soskice 2001). Governments were heavily involved in finance not only as regulators, but also as owners and explicit guarantors of deposits. Capital flows were restricted even within the EU, and the Bretton-Woods system of fixed exchange rates was still in place. As a result, the EU banks had limited incentives to expand internationally and thus there was little political urgency attached to the integration of financial markets.

Nevertheless, as trade among the EU members intensified, the demand for cross-border banking services grew. The Council responded to these changes in 1973 by adopting a directive that abolished restrictions on entry of EU banks to other EU markets and ensured their equal treatment by domestic regulatory authorities. The directive allowed EU banks to set up local subsidiaries, but these had to be full-fledged local banks complying with all specifics of national regulations (Dermine 1996). This preserved the differences in bank regulation across the Member States and limited opportunities for economies of scale, thus making international banking more expensive and preserving the fragmented structure of EU banking markets. The EC tried to address this problem in the next phase.

3. PHASE TWO: HARMONIZATION

The process of harmonization started in 1977 with the First Banking Directive and continues to this day. Harmonization has proven to be a complex, difficult and protracted path. Nevertheless, the directives adopted between the mid-70s and 80s facilitated some progress towards market integration.

The First Banking Directive established the home country control as a general principle for harmonization of regulations to allow for a gradual shift of supervision responsibilities for cross-border banks from the host country regulators to their home country regulator. This was followed by the series of specific directives harmonizing some aspects of consolidated supervision, the format of bank accounts and the rules of consumer protection, which were adopted by mid-1980s.

As in the first phase, the harmonization efforts remained focused almost exclusively on banks. Although the new legislation laid the foundations for cross-border integration, it did not abolish all measures that kept banking fragmented along national borders. Banks still had to obtain national licenses they were subject to heterogeneous banking regulations and had to have dedicated capital in each country (Hall 1997).

As in other policy domains, a full-fledged harmonization proved too cumbersome. Member states developed many institutions that were highly specific to their national economies, such as explicit state guarantees of some types of banks. These had to be catered for in the EU directives, which resulted in overly complex legislation and numerous exceptions. Even with such side-deals gathering unanimous support required by the EU, the decision-making process was difficult and slow. Clearly, an approach to financial market integration different from harmonization was needed.

4. PHASE THREE: MUTUAL RECOGNITION

The new approach to integration was allowed for by the landmark case of Casis de Dijon in 1979. The ruling effectively introduced mutual recognition as a complementary mode for European integration, which reduced the demands for harmonization only to the most essential core issues (Dermine 1996). Concurrently, in the mid-1980s the process of European integration was relaunched by the "1992 agenda" of creating a single European market. Initially, this agenda was specified in the Commission's White Paper in 1985, which included a section on the single market in financial services and on capital liberalization. The White Paper also went beyond the almost exclusive focus on banks and called for a single market for insurance and securities products as well.

In the context of the financial market, the principle of mutual recognition requires a shift to home-country control. The responsibility for the regulation and supervision of financial corporations rests with the country of its domicile, while the role of host-country supervisors is reduced to information sharing and cooperation. These principles were embedded into three groups of directives. The Second Banking Directive, adopted in 1989, harmonized banking authorizations and prudential supervision. The Investment Services Directive of 1993 dealt primarily with the cross-border activities of investment firms. The third group consisted of Solvency Ratio (1989) and the Capital Adequacy (1993) Directives, which defined the prudential regulation of banks and investment firms within the EU. Additional supportive directives included the Directive on Liberalization of Capital Flows (1988) and the Directive harmonizing the basics of Deposit Guarantee Schemes (1994). The Maastricht Treaty also addressed some issues of financial integration by assigning some role in oversight of financial stability to the then emerging European Central Bank.

The Second Banking Directive authorized all credit institutions in any EU country to establish branches or supply cross-border financial services without further authorization from host-country supervisors, provided that it had been authorized to provide such services in its home country (the so called 'single passport principle'). This right covers practically all services typically provided by universal banks; from taking deposits to all forms of lending and payment services, to trading and advisory services. The home-country supervision requires that financial information about all these activities whether performed by branches or subsidiaries are consolidated, in order to ensure the overall financial standing of each financial corporation across all the EU markets. The host country authorities retain the right to intervene to ensure the protection of public interest in areas such as liquidity management, monetary policy or advertising aimed at retail customers (Hall 1997).

Although home-country control is the dominant approach, ensuring of trustworthiness and stability of EU-wide financial markets required a degree of harmonization as well. This was addressed by Solvency and Capital Adequacy Directives that defined minimum standards for the initial capital of credit institutions, set risk-weighted capital ratios to 8 percent, set exposure limits, and reporting requirements on participation in non-financial firms. At the same time, these directives aligned the EU rules with emerging international banking standards formulated by the Basel Committee of Banking Supervisors under the auspices of the G10.

The third phase in the evolution of EU financial market regulation coincided with important shifts in economic policies worldwide. There was a general trend towards deregulation of finance, liberalization of international financial flows and reliance on more flexible exchange rates. As financial integration gathered political support, some deep technical barriers, which could not be addressed during previous phases, were reduced.

Despite this momentum, the directives required for the single market in financial services proved one of the most demanding parts of the 1992 project (Young 2005: 109). The necessary measures were extremely difficult to negotiate and threatened to derail the overall schedule. As a result, the EU had to scale back its ambitions and sidestep some of the most difficult issues. Even then, compliance with key directives in banking had to be postponed to 1993, in insurance till mid 1994 and in securities till 1995 (de Visscher et al. 2008:41). Moreover, unanimity proved impossible to achieve in some cases, so the Deposit Guarantee Scheme Directive was only passed in 1993 after the Maastricht Treaty allowed for qualified majority voting[2]. As a result, the Single Market project has achieved less in terms of creating an EU-wide infrastructure for trade in financial services than it did for trade in goods.

Overcoming the political and technocratic complexities of deep financial reforms requires strong political commitment. Sometimes, such commitment can be enhanced by some exogenous shock to the system that shifts the expectations and preferences of at least some stakeholders. Historically, financial crises have often provided such impetus, but the next stage of EU reforms was triggered by a positive exogenous factor – the planned introduction of the Euro.

[2] Germany continued to object to Deposit Guarantee directive, because, unlike in all other member states, it developed a deposit insurance system run by private banks without direct state involvement. This illustrates the difficulty of harmonizing rules across different varieties of financial sectors that evolved in Europe over preceding decades and centuries. Many such institutional arrangements are deeply embedded in a system of complementary institutions so even minor reforms may trigger extensive changes.

5. PHASE FOUR: INSTITUTIONAL INNOVATION

A single financial market is one of the important benefits of the single currency. The single market for the Euro should not only improve financial services for EU citizens, but also the allocation of their savings into investments, thus improving innovation, growth and job prospects within the EU. This was also the reason why the EU counted on financial integration to become one of the important drivers towards the goals of its Lisbon strategy of making the EU economy more competitive.

In order to harness benefits of the single market in finance, the European Parliament endorsed the Financial Services Action Plan (FSAP) in 1999. It was an ambitious agenda covering five areas of financial markets (see Table 1). In a mere 6 years it aimed to remove legislative obstacles, which had proved insurmountable during the previous phases of financial market integration.

Table 1: Initiatives under the Financial Services Action Plan 1999–2005

I. Wholesale — securities and derivatives – markets
• Removing outstanding barriers to raising capital on an EU-wide basis
• Common legal framework for integrated securities and derivatives markets
• Moving towards a single set of financial statements for listed companies
• Providing legal security to underpin cross-border securities trade
• Promoting cross-border restructuring through mergers, takeovers, etc
• Creating conditions for asset managers to optimise the performance of portfolios
II. Retail financial services
• Promoting information for cross-border provision of retail financial services
• Elimination of non-harmonised consumer-business rules
• Promoting the resolution of consumer disputes
• Creating a legal framework for new distribution channels and technologies
III. Prudential rules and supervision
• Adjusting prudential legislation to international standards
• Regulating the prudential supervision of financial conglomerates
• Promoting cross-sectoral and regional co-operation amongst authorities
IV. Wider conditions
• Eliminating tax obstacles to financial market integration

Source: EC (1999)

On the EU level, the legislative blitz of the FSAP was a resounding success. Despite long-standing disagreements and political challenges, the Council, Commission and Parliament were able to agree upon 39 out of 42 planned directives through the co-decision procedure by the mid-2004 deadline. The remaining Capital Adequacy directive and two Company Law Directives were completed soon afterwards.

However, the transposition rates on member state level were much less impressive (Lannoo 2008). By the end of the FSAP period in 2005, the best performing countries achieved some 80% transposition rates (Austria, Denmark, Germany and Ireland), whereas some slow adopters were only at 40% (Greece, Netherlands and most new EU members). Slower transposition after a period of intense legislative activity is not unusual. There was a transposition backlog after the 1992 deadline for the Single Market, but member states caught up in subsequent years. However, in this case transposition and enforcement were compounded by numerous exogenous factors that made financial regulation a fast moving target.

Over the last three decades financial markets in Europe and worldwide have undergone substantial changes, culminating during the FSAP period. The deregulation of finance and capital flows, new information and communication technologies as well as innovations in financial product design have changed the fundamental nature of many regulated entities. Financial corporations are no longer clustered neatly into the three segments of banking, insurance and securities that were traditionally regulated separately. Large conglomerates were active in all three segments and many of their product lines – such as evolution of bank assurance - defied segmented regulation. Moreover, whereas the largest financial groups were truly global, many medium sized groups have expanded across the EU and neighboring states. These developments made some undeniable achievements of FSAP look obsolete, even before their implementation deadlines. By the turn of the century, it was apparent that the EU needed a more flexible rule-making mechanism to keep up with changes in financial markets. The time was ripe for institutional innovation within the EU.

The gap between the market and regulatory integration was the largest in the securities markets, where the EU lagged behind developments in other advanced economies such as the US or Japan as well as behind its own Lisbon ambitions. The ECOFIN recognized the problem and in July 2000 asked a committee of wise men chaired by baron Lamfalussy to assess conditions for the implementation of securities regulations and mechanisms for regulating securities markets and suggest practices to ensure timely adjustments, faster convergence and better cooperation in the day to day enforcement of existing rules. In short, the committee was not asked to deal with the content of regulations, but with the process of agreeing on and enforcing them.

The Lamfalussy committee proposed a novel four-level governance mechanism, which – in the EU context – represented a genuine institutional innovation. The Lamfalussy process introduced a distinction between framework legislation and its implementing rules and redistributed responsibility for each of them among existing and new bodies. The new structures created more intensive relationships between the EU and national bodies dealing with financial regulations. The process was initially introduced in 2001 in securities and expanded to banking and insurance four years later. The Lamfalussy process represents the hallmark of the fourth phase of regulatory integration in the EU financial market.

5.1. The Lamfalussy network

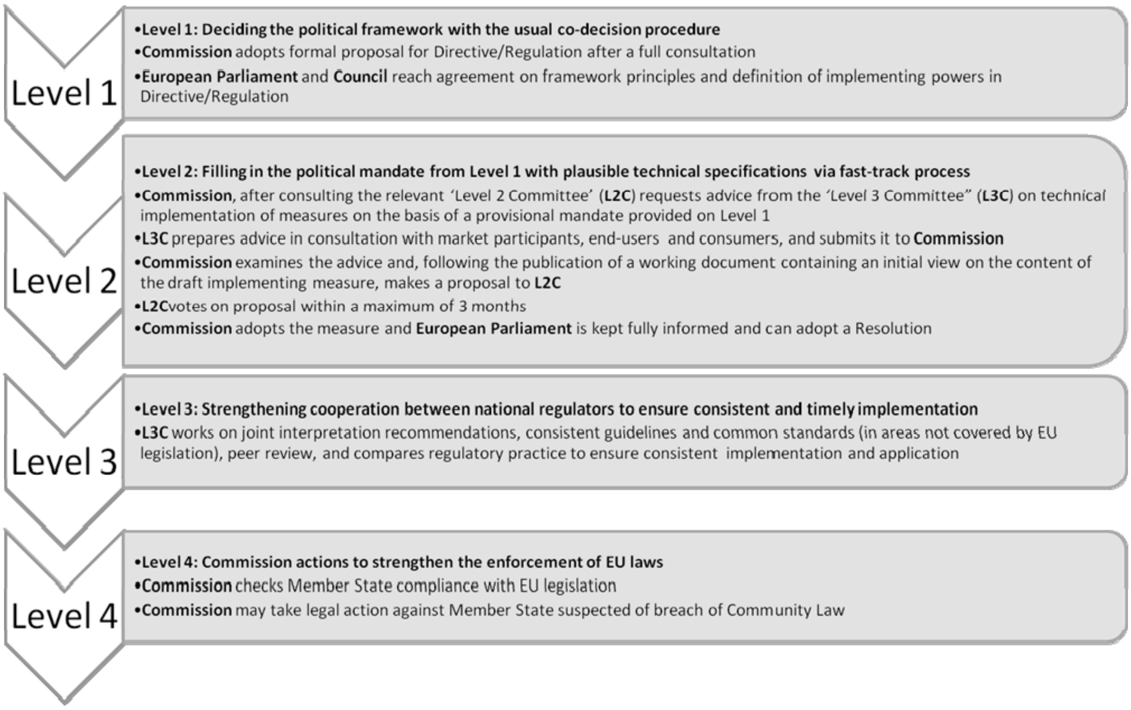
Until the specification of the Lamfalussy procedure decisions regarding regulatory integration in financial markets followed the standard comitology procedure. Decisions were made by the Council and European Parliament on the basis of the Commission's proposal, and the decision-making process was assisted by the host of comitology committees (see Bergström 2005 for overview). These committees enabled the Commission to discuss proposed measures with national administrations before adopting them and were expected to ensure that measures reflected as far as possible the situation in each of the countries concerned.

The Banking Advisory Committee provided its advice to the European Commission from the time the First Banking directive was adopted in 1977. Even more informal was the Groupe de Contact, which served as a forum for exchange of day-to-day information among the EU banking supervisors from 1972. The European Monetary Institute set up a Banking Supervision Committee, later carried over to the ECB, which monitored and provided advice on systemic issues related to banks. Although the network of committees was most developed in banking, similar committees existed also in the insurance and securities sector (DG Markt 2000). However, the informal structure and the low activity of these committees made them poorly suited for supporting the rapid implementation of the FSAP. The Lamfalussy group proposed to replace them with a formalized network of committees staffed by high-level representatives of governments and experts for national supervisory bodies, who would be meeting frequently and regularly.

The structure of the Lamfalussy process is organized on four levels that correspond to the usual policy cycle. The first level constitutes the initiation phase of the legislation making, whereby the Commission proposes framework legislation and the Council and the European Parliament decide by the usual co-decision procedure. The second level committees composed of Member State representatives are then responsible for the adoption of the implementing powers, which specify technical rules implementing the framework legislation approved on Level 1. The third level committees, composed of representatives of Member States' financial supervision agencies, aim at strengthening the consistency of the day-to-day enforcement of securities regulations and are also charged with drafting implementing powers for decisions on Level 2. Finally, monitoring of transposition and enforcement is to be done on the fourth level.

At Level 1, decisions are made by the co-decision procedure. The only difference is that they do not need to specify every provision all the way down to complex technicalities. As in all other the EU policy domains, the Commission has the sole right to initiate legislation. It has to decide, whether legislation is needed, conduct comprehensive consultation with affected parties and issue an official proposal. The Lamfalussy process does not affect this arrangement, although all Lamfalussy committees are also involved in the initial consultative process. In line with the co-decision procedure, the proposal is sent to the European Parliament and the Council that adopt the directive or a regulation containing the framework principles and the definition of the implementing powers to be conferred on the Commission. These powers are then turned into specific technical rules on Level 2.

Figure 1: The Lamfalussy procedure



The formulation of the implementing rules starts with consultations between the Commission and Level 2 Lamfalussy committees. Depending on the financial market segment that the proposed legislation concerns, the Commission consults with the European Securities Committee (ESC) or the European Banking Committee (EBC) or the European Insurance and Occupational Pensions Committee (EIOPC). Members of these committees are high level representatives of national governments – typically deputy ministers of finance – who represent views of member states. Committees are, however, chaired by the Commission representative and may decide by qualified majority vote. Usually, Level 2 committees meet three times a year to vote on the proposals submitted by the Commission. The Commission submits proposals for vote only after they pass through extensive consultations with Level 3 committees.

Level 3 committees, together with the Commission, shoulder most of the consensus seeking burden. They are charged with drafting concrete proposals of implementing rules and conducting consultations with all affected parties. Their proposals are then considered by the Commission and submitted to the relevant Level 2 committee for vote. Providing a favorable vote by Level 2, the Commission issues the final draft of the directive, which is submitted to approval by the Council. The European Parliament is continuously informed in line with the comitology rules related to 'regulatory committees with scrutiny' (see next section). The Parliament may reject the draft, if it concludes that the proposed measures exceed the scope of implementing powers that have been approved on Level 1.

At Level 3 there is also a separate committee for each segment of the financial market. Specifically, the Committee of European Banking Supervisors (CEBS) for banking, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPC) for insurance and the Committee of European Securities Regulators (CESR) for securities markets. Each Level 3 committee is composed of representatives of relevant national regulatory authorities and supported by the secretariat provided by the Commission services.

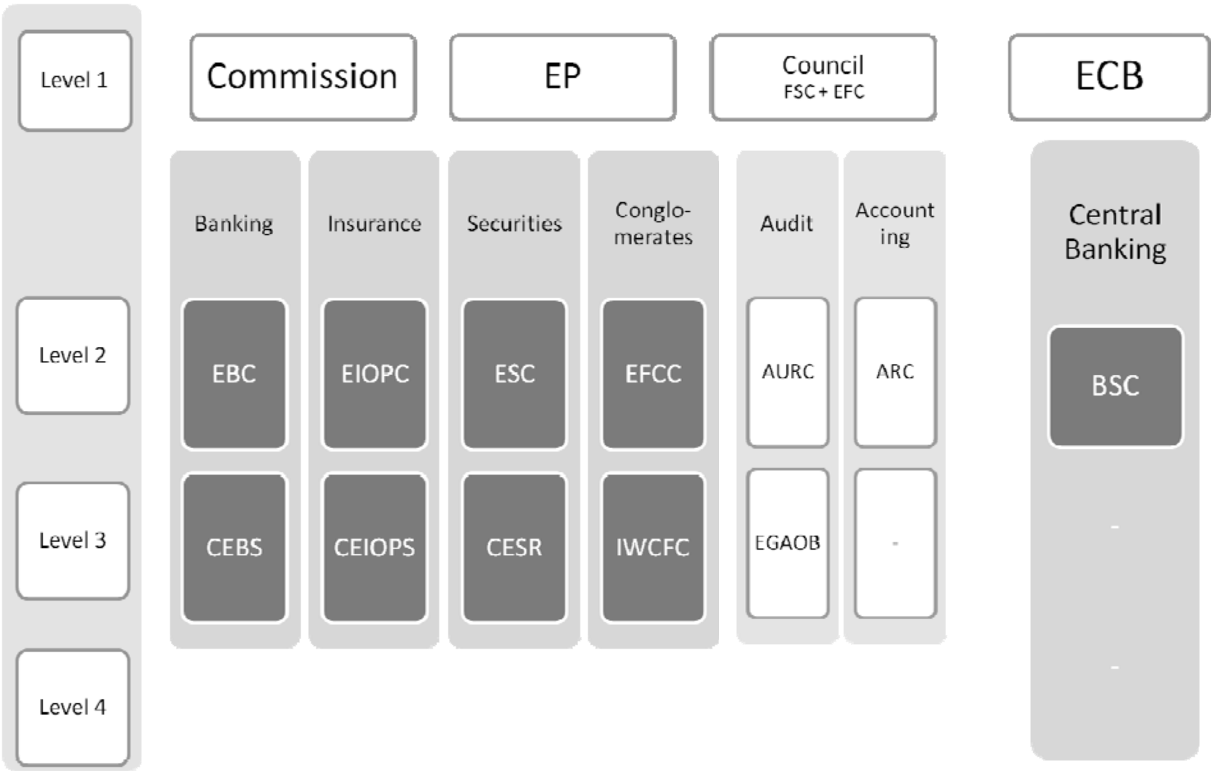
Apart from drafting and consulting provided in support of the rule-making process on Level 1 and 2, the agenda of Level 3 committees consists of formulating joint recommendations on the interpretation of EU financial rules, drafting joint standards for issues not covered by EU legislation and preparing peer reviews that compare supervisory practices. Level 3 committees often establish temporary expert committees which prepare various technical proposals. The underlying goal for the Level 3 committees is to achieve convergence in day-to-day financial supervision across all EU states.

At the fourth level the Commission monitors consistent transposition and application of measures adopted at Level 1 and 2. The Commission plays its role of the guardian of the Treaty by monitoring compliance of member states with EU legislation. In case of non-compliance it may start proceedings for failure to fulfill respective obligations and subsequently refer the case to the European Court of Justice. The Lamfalussy procedure did not introduce anything new to the compliance monitoring procedure. Level 4 has been included largely to stress the need for strong political commitment to transpose and enforce rules of the single market in financial services.

The four level Lamfalussy network is complemented by standard comitology committees that provide their opinion to the Commission on adopting or endorsement of new standards in cross-cutting areas of the EU financial market agenda. These include the Accounting

Regulatory Committee dealing with international accounting and financial reporting standards, the Audit Regulatory Committee reviewing international standards of auditing or the European Group of Audit Oversight Bodies that coordinates public oversight systems of statutory auditors and audit firms within the EU.

Figure 2: The network of Lamfalussy committees



Note: EBC – European Banking Committee, EIOPC – European Insurance and Occupational Pensions Committee, ESC – European Securities Committee, CEBC - Committee of European Banking Supervisors, CEIOPS - the Committee of European Insurance and Occupational Pensions Committee, CESR - Committee of European Securities Regulators, ARC – Accounting Regulatory Committee, AURC – Audit Regulatory Committee, EGAOB – European Group of Audit Oversight Bodies, BSC – Banking Supervision Committee of ECB.

The Lamfalussy process has affected the institutional balance among EU bodies, member state governments and regulatory bodies within the domain of financial market regulations (Christiansen and Vaccari 2006). The power to make decisions about rules that affect the wellbeing of European economies and citizens has been partially shifted to technocrats in Level 2 and 3 committees and away from the Council and the European Parliament that have a stronger claim on political legitimacy. The shift was justified by the need for faster policy making, which was widely accepted. Nevertheless, the Council and Parliament sought more checks and balances to ensure that the delegation of powers to the Commission and the Lamfalussy committees does not go too far. This was the subject of several rounds of negotiations between 2001 and 2006.

The Council, reflecting concerns of some of the member states, has sought to ensure that the Commission and Level 2 committees do not push implementing powers too far towards one model of financial regulation. This has been safeguarded by the so-called Prodi declaration of 2002, which commits the Commission not to go against a “pre-dominant view” of the Council when adopting Level 2 rules. There is no definition of what constitutes “pre-dominant” (IIMG 2003: 14) so the clause merely introduces an element of uncertainty into decision-making. The arrangement is named an “aerosol clause”.

The second mechanism that compensates the shift of decision-making powers to Level 2 is a “sunset clause”. It requires all Level 1 directives to specify the period of time (generally four years), within which the Commission and Lamfalussy committees may exercise the powers delegated to them. At the end of that period the Council and the Parliament have to decide again on the scope of the delegated powers, but may also decide not to renew the mandate. The “sunset clause” was to be superseded by the Treaty establishing a Constitution for Europe that proposed a call-back right for the European Parliament. However, since the Treaty was rejected in French and Dutch referenda, the Parliament was left without such an option and thus in sub-par position vis-à-vis its partners within the codecision procedure.

In reaction, the Parliament initiated discussions on the reform of comitology in September 2005. The outcome was an agreement on a new type of comitology committee - Regulatory committees with scrutiny – which, unlike the other three types[3], must allow the Council and the European Parliament "to carry out a check prior to the adoption of measures of general scope designed to amend non-essential elements of a basic instrument adopted by co-decision". In the event of opposition on the part of the Council or Parliament, the Commission may not adopt the proposed measure. This process guarantees the Parliament three months to react to any draft implementing measures and one month to review the final draft in order to ensure that all regulatory rules stay within the limits of implementing powers delegated to the Commission on the Level 1 of the Lamfalussy procedure[4].

The amendment of the comitology procedures has concluded the process of rebalancing the decision-making powers triggered by the Lamfalussy procedure. The new mode of governance represented by the Regulatory committees with scrutiny is now firmly embedded in EU decision processes and the institutional innovation that it represented is fully internalized and available for use in other policy domains.

5.2. Experience with Lamfalussy innovations

The Lamfalussy reports (2000 and 2001) stressed the need for regular monitoring of the procedure to ensure that it meets its objectives. These evaluations were prepared by the Inter-Institutional Monitoring Group (IIMG) of six experts, two of whom were nominated by the Commission, the Council and the Parliament respectively. The IIMG conducted annual consultations with all relevant stakeholders and prepared regular reports until 2007, when the Lamfalussy procedure was fully accepted as successful innovation.

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[3] Advisory committees just give their opinions to the Commission, which must try to take account of them; management committees operate on the premise that if the measures adopted by the Commission are not in accordance with the committee's opinion, the Commission must refer them to the Council, which, within a period laid down by the basic act, may adopt a different decision by a qualified majority; and regulatory committees [without scrutiny], which if the measures envisaged by the Commission are not in accordance with the committee's opinion, must be referred to the Council and, for information, to the European Parliament; the Council may give its agreement or introduce an amendment within a period which may not exceed three months and, if the Council does not take a decision, the Commission draws up implementing measures, unless the Council opposes this.

[4] In urgent cases the periods for review of the Level 2 drafts of implementation powers can be shortened.

The Lamfalussy committee identified the EU decision-making procedures as the main shortcoming of the EU regulatory system in financial markets. It argued that the process was too slow, lacked a rapid mechanism to update directives and ensure their consistent enforcement across the EU. It also identified problems with the quality of existing regulations that failed to cover some important issues or covered them in a highly ambiguous manner. Moreover, the transposition of existing legislation lagged behind the deadlines, and enforcement was uneven and uncoordinated (Lamfalussy et al. 2000: 18-19). Given these concerns, the speed, quality and transposition represent natural criteria for the evaluation of the early experience concerning the effectiveness of Lamfalussy process.

The IIMG reports as well as other evaluations (de Visscher et al 2008, ECB 2007, EC 2004) indicate that the procedure had delivered the expected results in terms of speed. The four major directives have been delivered via the Lamfalussy process to date - Transparency (2004/109/EC), Prospectus (2003/71/EC), Market Abuse (2003/6/EC) and Markets in Financial Instruments (MIFID; 2004/39/EC) – took about 20 months to adopt despite the need for considerable consensus building (EC 2004). This compares well with average time of 36 months for similar directives (Lamfalussy et al. 2000) and with the 30 to 100 months it took to adopt the previous generation of directives in the field of securities (EC 2004:6). The Lamfalussy procedure thus proved instrumental to the timely adoption of the Financial Sector Action Plan by 2005 (IIMG 2007: 8). Faster rule-making process was one of the key arguments for the extension of the Lamfalussy process to banking and insurance. There the process proved useful for the implementation of the pre-Lamfalussy Capital Requirements Directive (2006/48/EC and 2006/49/EC) on Level 3 and in the still ongoing preparations of the massive Solvency II insurance directive.

At the same time, the apparent success of the procedure has resulted in a tendency to shift the burden of negotiations to Level 3 committees. However, these committees have neither the sufficient formal status nor the resources for sustaining the growing agenda. Thus they increasingly run against the fixed deadlines of the Lamfalussy process. The more recent debate on further reform of the Lamfalussy process has thus focused on the role of Level 3 committees in order to ensure the sustainability of fast rule-making in future (de Laroisiere et al. 2009, IIMG 2007, ECB 2007, MEFI 2008).

Although it is difficult to evaluate the quality of new regulations due to inherent differences in the preferences of interested parties, it is undeniable that the Lamfalussy procedure improved the input legitimacy of new rules. Indeed, de Visscher and Varone (2006:4) report that opinions on the quality of the new Lamfalussy directives vary among stakeholders. However, they also point out that the four level process and strict adherence to transparent Internet consultations made it more likely that ambiguous provisions would be resolved early on. At the very least, his has improved the interaction, information sharing and cooperation among all stakeholders and Level 3 committees that are responsible for drafting technical rules.

The Lamfalussy process has been only partially successful in addressing the problems of consistent transposition and enforcement. The final review of IIMG in 2007 concluded that delayed and imperfect transposition is a major bottleneck in the development of the Single Market and proposed three measures to address the problem. Firstly, the directives need to spell out clearly the desired level of harmonization. Secondly, the Member States ought to provide information on transposition in a standardized format, including clear explanation of national specifics and add-ons on the “comply or explain” basis. Thirdly, more transparency is needed with regard to incorrect transposition and implementation so that peer pressure could be applied to support compliance. The IIMG suggestions amount to an admission that Level 3 does not work as intended with regard to enforcement of agreed upon rules. This again boils down to the question of status and resources of L3 committees, which are central, both for the consultation and implementation process.

The Level 4 of the Lamfalussy procedure remains untested. It is the responsibility of the Commission to act as the guardian of the Treaty and initiate proceedings in case of non-compliance. So far the Commission has not acted to force compliance. However, this is largely a consequence of the recent introduction of Lamfalussy directives rather than a lack of initiative. It is yet to be seen whether member states fall behind with transposition of

'Lamfalussy' directives and whether Level 4 makes any contribution towards timely transposition and enforcement of new rules.

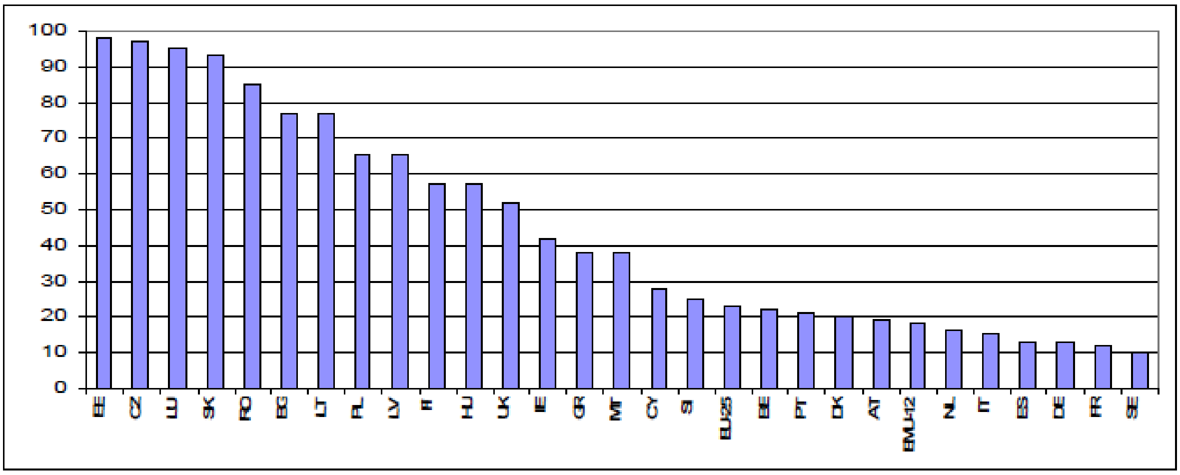
5.3. At the dawn of the fifth phase

The regulatory integration in the EU financial markets progressed in a sequence. It started with opening previously closed markets of all Member States, passed through a period of harmonization effort, jumped on the bandwagon of mutual recognition, and finally, when none of the previous modes worked well enough, resulted in institutional innovation of decision-making processes. Is this a complete cycle so that existing institutions will eventually deliver an integrated regulatory framework for single market in financial services? Or is there going to be a distinct fifth phase that would introduce yet another integration policy-mode or reinvigorate one of the older approaches that proved insufficient on their own? Such forward looking questions were made a lot more complicated by the ongoing financial and economic crisis.

Had there been no crisis, the Lamfalussy procedure might gradually deliver what it was designed to do - convergence to a single set of regulations and consistent supervision across all EU jurisdictions. However, the largest financial crisis in the history of the EU has uncovered the soft underbelly of the prevailing regulatory regime, which was considered much less salient during the previous decades. This weakness stems from the fact that there is no regulatory integration with regard to cross-border crisis management.

The EU countries have experienced many failures of large cross-border financial firms in the past half a century (Gup 1998). In such cases the financial supervisors, in cooperation with central banks and governments of affected countries typically orchestrated ad hoc resolutions. Nevertheless, these cases were few and far between so the ad hoc intergovernmental solutions seemed to provide an adequate framework. EU involvement in such cases was limited to ensuring that the resolution complied with competition rules, especially if state aid was provided. Only in recent years has the ad hoc approach to crisis management and resolution of troubled financial firms become inadequate. The new member states, which joined the EU in 2004 and 2007, have financial sectors almost completely dominated by foreign-owned banks (see Figure 3). This was a new development in the EU context, which increased the importance of the cross-border crisis management rules that, among other issues, define principles for sharing fiscal costs of such crises.

Figure 3: Market share of foreign-owned banks (% of total assets)



Source: de Laroisere et al. (2009: 71)

The solutions to systemic banking crises do not come cheap[5]. The average fiscal costs of 40 recent banking crises were equivalent to 13 percent of the annual GDP of countries affected (Honohan and Klingebiel 2003). Unsurprisingly, there is little enthusiasm for such expenditures on the national level and even less on the cross-border level. The cross-border fiscal burden sharing will inevitably be questioned, because they may constitute net fiscal transfer among two or more countries. Moreover, given the multiyear nature and long term uncertainty about the final costs of public intervention, there is a risk of cross-border disputes regarding the optimal ways of troubled asset disposal and other parameters influencing the final costs.[6] These characteristics make any fiscal burden sharing mechanism a highly sensitive political issue on the national as well as the community level.

[5] The systemic crisis refers to a situation when several or all important banks are threatened by instability. This contrasts with case when only one or few banks are threatened.

[6] It is inherent to financial assets that their price cannot be established immediately, especially in situations when large segments of financial markets are destabilized. Therefore, estimates of net fiscal costs of financial

Until 2008 the approach to cross-border crisis management was essentially bilateral. The supervisory agencies in home- and host-countries where a financial firm was active signed Memoranda of Understanding, committing them to information exchange and elementary cooperation in good times as well as in bad times. They also made commitments to create communication protocols and run occasional simulations of crisis situations. In practical terms, the bilateral memoranda clarified at best 'whom to call' in a crisis, but left everything else open to ad hoc solutions. Moreover, experience shows that when crisis hits a systemically important bank, there can be no solution without the direct involvement of the central bank and the government (Buiter 2009). However, these memoranda were concluded only among supervisory agencies.

The Council had addressed the inadequacy of prevailing memoranda when it endorsed principles for the new, EU-wide Memorandum of Understanding in October 2007. The new Memorandum was signed in June 2008; this time not only by supervisory agencies, but also by central banks and relevant ministries. It commits all its 114 signatories to open, full, constructive and timely cooperation in search and preparation of jointly acceptable solution in the event of cross-border financial instability.[7] It calls for all parties to work together in good times to prepare for bad ones by (i) setting up an appropriate framework for cooperation to manage the detrimental effects of a crisis; (ii) exchanging information relevant for the preparation, management and resolution of a cross-border systemic financial crisis, (iii) coordinating public communication, and by (iv) establishing contingency plans, including stress testing and simulation exercises.

The Memorandum tried to address the issue of fiscal burden sharing. It called for relevant parties to agree upon burden sharing rules in normal times and stick to them in times of crisis

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interventions are notoriously unreliable. In a few happy cases, sales of the assets overtaken or guaranteed by the state may at the end turn net profit. However, typically they result in heavy losses the full extent of which is unclear for years. For this reason, the burden sharing needs to be set by an ex ante formula.

[7] The signatories include 58 financial regulatory authorities, which reflects the variety of organizational models in the EU (see Masciandaro, Nieto and Quintyn 2009 for review), as well as 28 central banks (member states and ECB) and 28 ministries (Denmark is represented by the ministries of finance and economy). The sheer number of signatories is telling with regard to the complexity of the task that can hardly be managed through an informal network.

resolution. The Memorandum suggested that such agreements should be based on principles of equity and accountability, whereby the former would define the contribution of the relevant Member State based on the economic impact of crisis and the latter on the basis of allocation of home/host supervisory powers. The Memorandum did not provide any clear and verifiable rules and simply presumed that authorities of Member States concerned would work out the details. However, authorities not only had little time to prepare any plans, but more importantly, quickly ran into the inevitable political constraints surrounding any large fiscal outlays.

The multilateral Memorandum has been in effect only for a few weeks, when the crisis forced a number of the EU governments to intervene in leading European banks with cross-border operations. This was a major test of the new system and anecdotal evidence so far suggests that it was not a success. Even the founding EU members with a long history of policy coordination failed to sustain the cross-border cooperation while managing the current crisis. For example, the Belgian, Dutch and Luxembourg authorities tried to save the Fortis Group, by orchestrating a joint guarantee. However, the attempt at cooperation, as envisaged by the Memorandum, lasted for only two weeks. Then each authority switched to national solutions by guaranteeing all Fortis assets within their jurisdiction (Buiter 2009, Lannoo 2008). Similarly, communication and coordination failures occurred in cases of interventions into cross-border financial firms domiciled in Ireland, Germany, Denmark and the UK (Eijffinger 2008).

Facing the onslaught of the financial crisis and uncooperative reactions of member states, the EU opted for proven response. In November 2008 the Commission President Barroso asked a committee of wise men chaired by former head of International Monetary Fund Jacques de Larosière to make recommendations on “strengthening European supervisory arrangements covering all financial sectors, with the objective of establishing a more efficient, integrated and sustainable European system of supervision and also of reinforcing cooperation between European supervisors and their international counterparts”. The committee published its report making over 20 recommendations on the content of EU and global financial regulations. It also suggested two structural changes to the EU regulatory architecture in finance.

The first suggestion was the creation of the European Systemic Risk Council (ESRC) under the auspices of ECB and chaired by ECB President. Its role would be to gather information on all macroprudential risks in the EU and issue risk warnings. These warnings would require mandatory follow-up and monitoring by either national supervisors or, in serious cases, directly by the Commission. The ESRC would also work closely with the International Monetary Fund and other global bodies with a stake in financial stability.

The second structural recommendation is transforming Level 3 committees into a European System of Financial Supervision (ESFS). This recommendation is a direct follow up on the experience with the Lamfalussy procedure. It would turn Level 3 committees into European Authorities giving them formal status, more resources and new competences including binding mediation between national supervisors, the right to adopt binding standards and technical decisions, maintenance of transnational supervisory colleges overseeing the largest financial firms and a coordinating role in crisis management[8].

The de Larosiere report also reflected on the dismal experience with the cross-border fiscal burden sharing. However, it did not suggest any new answer. It called for the amendment of the Memorandum, which would introduce additional criteria to the fiscal burden sharing formula. The report still presumed that Member States would conclude voluntary agreements during normal times, and made no recommendations towards strengthening the cooperation during the crisis. Developing robust crisis management and burden sharing rules thus remains the key challenge for the next phase of regulatory integration. It will not be an easy one to meet.

[8] The ESFS recommendation reintroduces into a policy debate measures that have been proposed but not accepted during the 2007 review of the Lamfalussy process. As two years ago, it is likely to face opposition especially from Germany that are UK reluctant to shift supervision of their financial firms to the EU level (FT Deutschland, May 28, 2009). The proposal has also been criticized by the ECB, which would prefer full control over the financial stability issues (EurActiv, March 3, 2009). The Commission plans to file the legislative proposals embodying de Larosiere recommendations in autumn 2009.

The weakness of the crisis management arrangements has causes that run deep into the basic legal foundations of the European Union, specifically to the rules that keep fiscal powers strictly under the control of Member States. However, any workable regulatory regime, including the EU one, needs to be backed by substantial fiscal capacity[9]. This introduces a deep structural misfit that needs to be resolved. In the long term, the EU cannot have an integrated financial market and integrated financial regulation, without an integrated crisis management regime. At the same time, integrated crisis management requires substantial fiscal resources to draw upon when no other solution is available. So far there have been no policy proposals going beyond the 2008 Memorandum, although there is a number of proposals ranging from strengthened fiscal burden sharing rules to the creation of a special guarantee fund that had been proposed in the academic literature (see Goodhart and Schoenmaker 2009 for review).

The weakness of the crisis management regime is not only a challenge to the future. It also makes questionable some of the existing achievements of the regulatory integration derived from mutual recognition. The most important of them are the principles of single passport for financial firms and home-country supervision. The single passport policy allows banks to provide cross-border banking services through branches, which only need to be announced to the host-country supervisor, but do not require any license or separate capital base. Such branches are supervised almost exclusively by their home-country supervisor. In principle, this regime allows for situations when a minor bank in a big EU country, operates a systematically important bank in a small EU country as its branch. In case of failure of such a bank, the big EU country has little reason to intervene, because the bank is not systemically important. On the other hand, the small country may have every reason to save the bank, but cannot intervene directly, because assets, managers, information systems and all other key

[9] The string of failures of large cross-border banks has reminded policy-makers that management of financial crisis requires substantial fiscal capacity for stabilizing interventions. In a modern economy, systemically important financial firms are part of the basic infrastructure as much as utility companies so it is hardly acceptable to let them fail. The growing list of massive bailouts as well as the case of US financial firm Lehman Brothers that were allowed to fail with massive adverse repercussions for global financial markets, only underlines the fact that many financial firms are too-big-to-fail. Their systemic functions need to be preserved even if astronomic amounts of public resources have to be put at risk.

banking functions are not within its jurisdiction. Managing such a crisis under the current EU regime, which is neither fully supranational nor fully national, is surrounded by deep uncertainty.

The above example is largely hypothetical, because major foreign owned banks tend to operate as subsidiaries rather than single passport branches. This means that they are separate legal entities, with their own capital and under the supervision of host-country supervisor. Such circumstances allow governments of Member States to intervene either on cross-border basis, or, if this fails, on the national basis, as it happened in the case of Fortis Group.

However, the current crisis has also shown that the problems arising from the single passport regime without clear fiscal burden sharing rules are not only hypothetical. The Icelandic banks had successful retail branches in the UK, Ireland and Germany, which attracted a lot of deposits from retail customers, municipalities and other public institutions, by offering higher interest rates on their savings.[10] When the Icelandic banks collapsed, the authorities in Iceland suggested that they may not be able to repay the uninsured deposits of their foreign branches. In response, the UK invoked a clause of its antiterrorist laws and threatened to freeze Icelandic assets within its jurisdiction (House of Commons 2009). Invoking such a raw threat against a fellow member of European Economic Area illustrates the disruptive potential of weak crisis management arrangements within the current regulatory regime. It is likely that during the post-crisis period, the Member States will be less inclined to rely on mutual recognition, at least until a satisfactory solution to the cross-border crisis management coordination is found.

[10] Iceland is a member of the European Economic Area and thus eligible to operate under the principle of mutual recognition.

6. CONCLUSION AND FUTURE RESEARCH OUTLOOK

Regulatory integration, which is necessary for the development of the single market in financial services, has proved difficult ever since this ambition was spelled out in the Treaty of Rome in 1957. This difficulty is a function of both economic and political obstacles. Financial markets are much more 'institution-intensive' than markets for goods due to greater information asymmetries between buyers and sellers and due to the elusive nature of traded products. Finance also connect all parts of national economies, and a relatively minor change in regulations may have unexpected impacts throughout the real economy, that are difficult to ascertain ex ante. Such considerations raise political stakes for all stakeholders and compound economic complexities by political ones. Seen in this context, it is no surprise that progress has been slower than in markets for goods.

The regulatory integration in finance advanced in four stages. In 1950s and 1960s, the focus was on opening domestic banking markets to banks from other EU countries. During the 1970s limited progress was achieved in the harmonization of regulations. In the 1980s and 1990s, the EU tried to achieve regulatory integration on the basis of mutual recognition placing the EU financial firms under the supervision of home-country regulators and allowing them to operate in other EU countries on the basis of a single passport. However, explosive changes within financial markets led the EU to conclude that its regulation would never catch up, unless it introduced more flexible rule-making mechanisms. The first decade of this century thus focused on the development of the Lamfalussy process as well as a number of important directives foreseen by the Financial Services Action Plan.

The EU thus entered the period of the current financial crisis equipped with a new rule-making process, but also with glaring discrepancies between the highly integrated financial markets and the still predominantly nationally based regulatory regime, especially in the area of crisis management. The financial crisis has not been kind to this status quo. As it started to threaten the stability of large EU banks by autumn 2008, the cooperative arrangements unfolded and Member States opted for unilateral solutions. Prevention of the collapse of cross-border cooperation is the most important task for the future regulatory integration of EU financial markets.

The regulatory integration in financial markets in general and the Lamfalussy process in particular provide analysts of multi-level governance and regulatory policies with a number of research questions that ought to receive attention in the future. The most obvious one is whether and how the Lamfalussy procedure, which was developed to produce better legislation faster, delivers on these expectations. For example, Christiansen and Vaccari (2006) hypothesized that the increased role of the European Parliament in the comitology process that underlies the Lamfalussy procedure will result in greater delays. The early evidence summarized in previous sections of this paper suggests otherwise, but the regulatory overhaul reacting to the current crisis will provide the earnest test for this question.

The research on the outcome of the Lamfalussy procedure may also provide new insights into the much discussed tradeoff between efficiency of decision-making and its legitimacy (see Scharpf 1999 or Scheuerman 2004 for example). Proponents of the process argued that it can deliver both more efficient decision-making by shifting the technical burden to technocratic committees and greater legitimacy by increasing transparency and scrutiny by the European Parliament. If this is supported by evidence then it would be a rare policy mechanism that improved both the input and the output legitimacy at the same time (Mörth 2009 or de Visscher 2008 are early studies in this direction).

The greater involvement of the European Parliament has also strengthened its role as a potential veto player, thus making it a more attractive venue for lobbying. The wave of new regulations, combined with the considerable resources of the financial industry devoted to lobbying and the greater transparency of the process will provide researchers with unprecedented access to information. This may be an especially fruitful area for comparative research on the political economy of financial reforms, which is a well advanced research program especially in the US (e.g. Kroszner, Strahan 1999).

Analysts of multi-level governance will be interested in effects of the Lamfalussy procedure on the balance between various players. The procedure is based on the traditional distribution of powers between intergovernmental and supranational actors, but it also shifts more power to less traditional players. Apart from the European Parliament, these also include the representatives of national supervisory agencies who staff the Level 3 committees. Financial regulators enjoy a high degree of autonomy within the domestic political process (in many Member State regulation is performed by the independent Central Bank) so they cannot be automatically regarded as government representatives. They also tend to share the commitment to international financial standards formulated by G20 and other global bodies, which makes them less likely to support narrower national interests when these are not aligned with evolving global standards. In short, technocrats from supervisory agencies are neither traditional intergovernmental nor supranational actors, thus it will be interesting to observe how their increased role influences the inner workings and outcomes of the EU rule-making in finance (see Moravcsik 2002).

The ability to balance conflicting interests over the post-crisis regulatory reforms will also influence the EU standing in the global debates about the new financial architecture. The credibility of the US and UK approach to financial regulation has been severely damaged by the crisis and there is a clear demand for regulatory mechanisms that are more skeptical about the efficient and self-correcting nature of financial markets. However, there is also a risk of over-regulation so the EU compromise solutions acceptable for France on one hand and for the UK on the other may have a lot of credibility as an input into a global financial reform. This presents the EU with an opportunity to increase its role in international financial affairs, providing that it can find balanced solutions quickly. Consequently, EU success or failure on the global stage will be of interest for researchers as well.

In the final section of the paper we have also shown some of the key challenges for the future course of the EU financial reforms. Their solution will be important for the evolution of EU integration policy-modes. The weak crisis management rules cast serious doubt on both minimal harmonization and mutual recognition as the preferred policy-modes of integration. It seems that the regulation, supervision and crisis management procedures of the certain segments of financial markets - especially the systemically important cross-border banks -

need to be harmonized much more than minimally. In the context of EU regulatory integration this would amount to a reversion to full harmonization, which had been tried in past, but was abandoned by mid-80s as too cumbersome. Whether the reversion to the full harmonization is a necessary precondition for the completion of regulatory integration in finance is another research agenda.

The regulatory integration of financial markets is bound to stay a source of policy innovations. The Lamfalussy proposal resulted in the creation of the Regulatory committee with scrutiny, which is new and innovative comitology procedure that can now be utilized in other policy domains as well. Policies that address ex-ante fiscal burden sharing rules or collective supervision of largest cross-border banks by colleges of supervisors, may, if introduced successfully, generate additional institutional innovations scalable to other the EU policy domains such as utilities regulation.

Finally, further research on EU regulatory integration in finance may take advantage of recent developments in the EU that are not strictly related to financial markets. For example, recent EU enlargements brought in 10 new Member States whose economies are typically classified as emerging markets. The increased diversity makes the EU a useful laboratory for comparisons of effects of global processes on various groups of countries. For example, there is a debate whether and how the international regulatory standards and best practices need to be adapted to local circumstances of emerging markets (Acemoglu et al. 2009, World Bank 2002). Typically, emerging markets are pressured by the International Monetary Fund and World Bank to comply with these standards. However, in the EU the global standards are first included in the relevant directives, before being implemented. Thus the EU serves as a kind of filter, allowing countries to adapt these rules beyond the minimum requirements. This makes it an interesting case for comparison of adaptations to local circumstances not only for advanced economies, but for the emerging markets as well.

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