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Who is Going to Supervise Europe's Financial Markets

Mads Andenas

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Financial Markets in Europe: Towards a Single Regulator?

Editors

MADS ANDENAS

and

YANNIS AVGERINOS

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Contents

Foreword ix
Charles A.E. Goodhart

Notes on Contributors xi

Introduction: **Who is Going to Supervise Europe's Financial Markets** xv
Mads Andenas

PART I: REGULATING AND SUPERVISING THE SINGLE FINANCIAL MARKET

1. **The Legal Integration of Financial Markets of the Euro Area** 3
   Antonio Sáinz de Vicuña
2. **Towards a Single European Capital Market and a Workable System of Regulation** 35
   Jan H. Dalhuisen
3. **Fifteen Regulators for a Single Capital Market: The Project of Regulatory Harmonisation in Europe** 75
   Stavros B. Thomadakis
4. **Problems with Home Country Control and Investment Services** . . . 83
   Yannis V. Avgerinos
5. **Private Law Approaches to Enhancing Financial Stability: The Hague Convention on Indirectly Held Securities and European Union Collateral Directive** 121
   Kern Alexander

PART II: CENTRALISATION OF SECURITIES MARKET SUPERVISION: TOWARDS A EUROPEAN SECURITIES REGULATOR?

6. **The Need and the Rationale for a European Securities Regulator** . . . 145
   Yannis V. Avgerinos

7. **After the *Lamfalussy* Report: The First Steps towards a European Securities Commission?** 183
Gilles Thieffry

8. **Regulating European Securities Markets: Beyond the *Lamfalussy* Report** 211
Rosa M. Lastra

9. **Towards a European Securities Commission: A View from the Securities Markets Industry** 223
Gregor Pozniak

10. **The Case for a Single European Securities Regulator** 235
Eric J. Pan

PART III: HORIZONTAL CONSOLIDATION OF FINANCIAL SUPERVISION: THE NATIONAL, EU AND INTERNATIONAL PERSPECTIVES

11. **International Capital Markets and the Future of Economic Policy: A Proposal for the Creation of a World Financial Authority** 263
John Eatwell and Lance Taylor

12. **International Standards and Standards Implementation** 283
George A. Walker

13. **FSA Revisited, and Some Issues for European Securities Markets Regulation** 323
Clive Briault

14. **Issues in Accountability of a Single Financial Services Regulator: The UK's Financial Services Authority (FSA)** 339
Vasiliki An. Galanopoulou

15. **Financial Market Regulation in Germany: The New Institutional Framework** 359
Mads Andenas and Jens-Hinrich Binder

16. **Twin Peaks *à la francaise*: Reforming Financial Services Regulation in France** 381
Duncan Fairgrieve

17. **Financial Market Regulation: The Case of Italy and a Proposal for the Euro Area** 397
Giorgio di Giorgio, Carmine di Noia and Laura Piatti

18. **The Swedish Financial Market in a Legal Perspective – Some Aspects** 421
Lars Gorton

19. A Path-dependent Route towards a Single Financial Regulator: The Experience of Denmark 447
Jesper Lau Hansen

20. Horizontal Consolidation of Financial Supervision: Impact on the Operations of the European Investment Bank 457
Roderick Dunnett

Foreword

Charles A.E. Goodhart

There are three main sources of external funding for borrowers to tap. These are equity markets, bond markets and bank borrowing. Before becoming too depressed about the prospects for an efficient integration of European capital markets, perhaps in part as a result of reading the excellent contents of this book, it would be well to remember that one component of the European capital market, that is, the *Euro-bond* market, has been a dramatic success story in the last few years since the adoption of the Euro. The enhanced efficiency and growth of this market, to the point where it compares well with its US counterpart, has been well documented.

In some part the comparative success of the Euro-bond market has been due to the fact that, as a market dominated by professionals (rather than by retail, small investors), it has been lightly regulated. In turn the comparative failure to move forward to a more unified European equity market, and to lower the transactions costs in the continuing segmented member national equity markets, are due to the regulatory process in the EU itself. This was high-lighted by the Lamfalussy (Wise Men) Reports (initial and final), which formed the back-drop to this book.

There is a splendid American phrase, 'If it ain't broke, don't fix it'. Both the Lamfalussy Report and many of the chapters in this book reveal that the mechanism for operating equity markets in the EU is now 'broke', and in two main respects. First, EU equity markets remain segmented with relatively high (compared to the US) transactions costs. Second, this is, in some large part, due to the fact that the EU regulatory process is slow, and can be (and is) used to protect (inefficient and high cost) national institutions, rather than construct an EU (equity) capital market. As is described in detail in the Lamfalussy Report and in the chapters in this book, the process of agreeing (and transposing) Directives is grindingly slow (often over 5 years); the Directive procedures are inflexible, without any mechanisms for enabling secondary legislation, in a rapidly evolving financial system – where the regulators/supervisors really need to be able to adjust flexibly to such evolution; and sufficient loop-holes remain in the system (via host-country control over conduct of business issues and the 'general good' provision in particular and subsidiarity in general), to allow those who want to do so to slow down any harmonisation towards a centralised European equity market to a snail's pace.

What to do? Lamfalussy's response was to try to reform the governance procedures for financial regulation in the EU. While this was accepted in principle at the Stockholm Council meeting in 2001, it is too early yet to tell how this may work in practice. If it should fail to work satisfactorily (and how might

a 'satisfactory' outcome be defined?), Lamfalussy has suggested that the next alternative might be a move towards a European SEC, or possibly more likely a European FSA.

Although I have not done an exact chapter count, my impression is that the majority of contributors to this book would prefer to move directly to the more radical alternative of a European SEC (or FSA). The real question is whether the political will to do so is yet present in a Union comprised of countries with differing legal systems, traditions and structures.

Legal issues are central to this discussion. The editors of this book, (who are also primary contributors), are to be congratulated on having brought together an excellent collection of legal and practitioner experts (and some count as both) to comment on this topic. The chapters provide the best available snapshot of current capital market regulatory conditions both in the main member countries and in the European Union as a whole, and a wide range of arguments about future prospective developments. While most of the contributors are lawyers, it will also be of great interest to practitioners, regulators and all those concerned with the current and future development of European financial markets.

Again, the book is primarily about regulation in European securities (equity) markets. But many, probably most, of the problems that arise in the European context with the regulation of securities will arise with banking regulation also; indeed the advent of the Basel Capital Adequacy proposals (Mark II) makes this imminent. Moreover, the blurring of dividing lines between financial intermediaries operating in capital markets (or insurance) and those operating in commercial banking makes it doubtful whether one can, or should, aim to divorce institutional reform in securities markets from similar reforms in banking. This too is a theme in several of the chapters in this book. Whether supervision should be undertaken in a single body (both at the European or member state level), or in separate bodies, and if a single FSA is adopted, what should be the relation of the Central Bank (ECB or NCB) to it, is a secondary theme in this far-ranging book.

Both themes are 'hot' topics in Europe, and are likely to remain so over the foreseeable future. This book throws much light on them. You will enjoy it.

Notes on Contributors

Editors

Mads Andenas, MA (Oxon), PhD (Cantab) is Director of the British Institute of International & Comparative Law, Supernumerary Fellow at Harris Manchester College, University of Oxford and Senior Fellow at the Institute of European and Comparative Law, University of Oxford.

Yannis V. Avgerinos, LLM (Warwick), PhD cand. (London) is a Research Fellow at the British Institute of International & Comparative Law, and Emile Noël Fellow at the European Union Center, Harvard University.

Contributors

Kern Alexander, MPhil (Oxon), MPhil (Cantab), PhD (London) is the Newton Trust Senior Research Fellow in International Financial Law at the University of Cambridge, Attorney-at Law at the States of Florida, Minnesota and the District of Columbia and Solicitor of the Supreme Court of England and Wales.

Clive Briault, MPhil (Oxon) is Director of the Prudential Standards Division of the Financial Services Authority (FSA), former Director of Central Policy at the FSA, former Head of Capital and Wholesale Markets Division of the Bank of England and former Head of the Monetary Assessment and Strategy of the Bank of England.

Jens-Hinrich Binder is a PhD candidate at the Albert-Ludwigs-University of Freiburg; and holds an LLM at the London School of Economics.

Jan H. Dalhuisen, LLM, Dr. Juris, is Professor of Law at King's College, London, Visiting Professor at UC Berkley, Corresponding Member of the Netherlands Academy of Arts & Sciences, Freehills Visiting Fellow UNSW Sydney 2001, FCIArb., Member of the New York Bar, Member of the SFA Consumer Arbitration Panel, former Secretary General of IPMA and Executive Director of IBJ International Plc.

Giorgio di Giorgio is Associate Professor of Monetary Economics at LUISS University, in Rome. He holds a PhD from Columbia University and has previously taught at the University of Rome La Sapienza. He was a visiting professor at the Universitat Pompeu Fabra in Barcelona and at Columbia University. He has also served as a member of the Technical Secretary of the Economic Policy Evaluation Unit at the Italian Ministry of the Treasury.

Carmine di Noia is Senior Economist at Assonime (the Association of Italian Companies). He was previously an economist in the Research Department and then Head of the Market Information Office at Consob. He received a PhD in Economics at the University of Pennsylvania and a doctorate in Economic Theory and Institutions at the University of Rome.

Roderick Dunnett is Assistant General Counsel at the Legal Affairs Directorate of the European Investment Bank (EIB).

John Eatwell is the President of Queens' College, University of Cambridge.

Duncan Fairgrieve is Laming Junior Fellow, The Queen's College Oxford and Maitre de Conférences invité, L'Université de Paris II Panthéon-Assas.

Vasiliki An. Galanopoulou, LLM (Edinburgh), PhD cand. (London) is a lawyer, Member of the Athens Bar.

Charles A.E. Goodhart is Deputy Director of the Financial Markets Group and Norman Sosnow Professor of Banking and Finance at the London School of Economics.

Lars Gorton, LLM (Lund) is Professor of Banking Law at the University of Lund and Professor Adjunct of International Business Law at the Stockholm School of Economics.

Jesper Lau Hansen, LLM (Cantab), Dr.Jur. (Cantab) is Professor at the Department of Legal Science A of the University of Copenhagen Law Faculty.

Rosa Maria Lastra, MA, LLM (Harvard), PhD (Madrid) is Senior Lecturer in International Financial and Monetary Law at the Centre for Commercial Law Studies, Queen Mary & Westfield College, University of London.

Eric J. Pan, J.D. (Harvard), MSc (Edinburgh) is a lawyer at Covington & Burling, Washington DC, and former Lecturer in Law at the University of Warwick.

Laura Piatti is Senior Executive at Reale Mutua Insurance Corp., and Head of the Research and Financial Studies Unit. She also teaches Financial Market Regulation at the Politechnics in Turin. In the past, after spending a period as a visiting scholar at Harvard University, she served as an economist at Consob, the Italian Securities and Exchange Commission and at the Competition Authority.

Gregor Pozniak, MSc (Vienna), PhD (Vienna) is Deputy Secretary General of the Federation of European Securities Markets, former Head of Listings and Membership at Vienna Stock Exchange and former Deputy Head of Investment Research at Creditanstalt Vienna.

Antonio Sàinz de Vicuña is the General Counsel of the European Central Bank (ECB). He has held numerous high level legal positions in the Spanish Government and the European Community and he has been an Adjunct Professor at several Spanish Universities.

Lance Taylor is Director of the Center for Economic Policy Analysis at the New School for Social Research, New York.

Gilles Thieffry is Partner and Head of Capital Markets at Andersen Legal, Solicitor of the Supreme Court of England and Wales, Member of the New York Bar and the Paris Bar.

Stavros B. Thomadakis, BA (Yale), MSc (MIT), PhD (MIT) is Chairman of the Capital Market Commission of Greece. He has been Professor for many years at different U.S. Universities and at the University of Athens, former member of the Monetary Committee of the European Community and of the BOD of the European Investment Bank and the Commercial Bank of Greece, member of the Greek Council of Economic Advisers, Economic Counsellor of the Hellenic Banks Association and Chairman of the Greek Centre of Planning and Economic Research.

George A. Walker, DipLP (Glasgow), DAES (Bruges), LLM (London), PhD (London) is a Fellow and Lecturer in Banking and Finance Law with the International Financial Law Unit at the Centre for Commercial Law Studies, Queen Mary & Westfield, University of London. He is a Legal Consultant with Farrer & Co, and the International Monetary Fund.

Who is Going to Supervise Europe's Financial Markets

Mads Andenas

1 Separating Money and Supervision

Monetary policy and supervision of financial institutions or markets were until recently an unchallenged competence of the nation state; some would regard it as being at the very core of the modern state. All the European Community could offer was a low level of coordination of economic and monetary policy and a severely restricted free movement of financial services with a limited harmonisation of supervisory rules. European Economic and Monetary Union has introduced a geographical separation between money and supervision of financial institutions and markets. In the euro area, with a single currency, it is still the many different national authorities that are regulating or supervising banks and other financial institutions. The European Central Bank defines and implements the single monetary policy as one of its basic tasks. But within a harmonised legislative framework in the directives, national authorities (in some countries there are more than one) remain responsible for banking supervision. The European Central Bank's complementary supervision role in relation to banks and payment systems adds to the complication.[1]

One of the major obstacles to the development of an Internal Financial Market was the economic policies pursued by Member States. The old quantitative regime regulated the supply of credit. It did this through the fixing of interest rates, loan terms and quotas for credit, both on the total lending by different financial institutions and on what sectors of the economy they could lend to. It restricted the access to the bond market. There were numerous other regulatory techniques applied. This kind of credit policy as well as monetary policy was a matter for Member States. And it could not be effective unless capital flows between Member States were kept to a minimum. Responsibility for policies concerning money and banking supervision had to be united in the Member States. This has changed, partly as a consequence of the new economic and monetary policies that have taken over. In the following section, I will look further into this background.

There are a number of issues that need to be resolved when money and supervision is separated. There is first the question of the lender of last resort (LOLR) and the wider handling of banking crises. The central bank acts as the banks' LOLR, providing liquidity when the market does not do so. This will often extend to a more extensive responsibility for the handling of banking crises, and crises of other financial institutions or markets.

This leads to the issues of regulation and supervision of institutions and markets generally. Are there problems in separating the handling of crises and the preventative

[1] See the discussion in M Andenas and C Hadjiemmanuil, 'Banking Supervision, The Internal Market and European Monetary Union' in M Andenas (ed.) *European Economic and Monetary Union: the institutional framework* (Kluwer Law International, London, Doordrecht 1997) 373.

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regulation and supervision? Does separation result in any distortions or perverse incentives on the side of regulators or the regulated?

There are also the questions of efficiency and of transparency and democratic control. It is not clear that the present uncertain and complex situation scores highly on either of these boards.

What is then the optimal institutional outcome? What should remain at a national level, and how would the tasks at a European level best be organised? One major problem here is that financial market regulation has rarely come about as a consequence of rational deliberation. Historically, regulatory reform has taken the form of panic stricken short-term responses to the crisis that has just passed.

One also has the situation that authorities in this field are generally not too concerned with acquiring any formal responsibility. Although increasingly formalised through detailed rulemaking, the regulatory competences remain broad and widely discretionary. Sanctions and enforcement remain uncertain. Certain central bank or regulatory functions, such as the LOLR, are traditionally left open ended in order not to affect market behaviour. It is assumed that clear rules could lead to distortions and perverse incentives. A situation where responsibility is not clearly allocated can have its further advantages for a regulator. Financial market crises will continue to occur and not having the formal responsibility (the European Central Bank) or not having the tools (national regulators) for handling them, may disperse the institutional repercussions of flawed supervision.

2 Keeping Money and Supervision Together – The Old Model under the Quantitative Regime

The relationship between financial market regulation and economic policy is a complex one. Major changes in the established policies and the abolition of capital controls have been necessary for the development of the Internal Financial Market. The Euro will bring it further and will also entail further challenges.

Let us go back to the Commission's 1985 White Paper *Completing the Internal Market*.[2] The White Paper set out the legislative programme for the creation of a single market by the end of 1992. Free movement of capital and financial services stood out as an area where little had been achieved and as to which the Commission proposed many ambitious measures. One reason for the slow progress of the internal market in financial services was that it depended on capital liberalisation, that is, on the abolition of restrictions and administrative controls on cross-border financial transactions. Capital liberalisation would, in fact, inevitably have two consequences. First, deregulation of financial markets, and, second, the abolition or easing of rules with respect to the participation in domestic financial markets of foreign institutions.

Capital restrictions were a necessary precondition for the effectiveness of the direct instruments of monetary and credit control. Credit control imposed limitations

[2] COM (85) 310 final.

on the growth of clearing banks' assets (in some cases also their liabilities). It usually extended to other financial institutions' assets and to markets such as those in corporate bonds. With the help of such instruments, monetary objectives could be achieved at a lower interest rate than would otherwise be possible.

Capital restrictions made it possible to pursue relatively autonomous monetary and credit policies. Such policies depended on the possibility of maintaining an interest rate different from that of neighbouring countries. Capital restrictions were instruments to limit capital inflows and outflows. Their importance would depend on the trends in other financial markets. Restrictions on capital outflows – so that savers and investors could not go abroad – allowed, in the short term, the preservation of low interest rates. It impeded downward pressures on the currency's exchange rate. In the long term, they protected domestic savings and domestic capital markets. Particularly strict restrictions on pension funds and life-assurance companies, affecting their ability to diversify their investments by investing abroad, could have both such short- and long-term effects.

Restrictions on capital inflows – for instance, so that lenders could not go to banks or securities markets abroad to raise capital – preserved, in the short term, price stability and avoided upward pressure on the exchange rate. In the long term, restrictions on foreign investors contributed to the protection of the domestic control of key industries, which in several countries was considered to be an important matter of national sovereignty. The national interest in domestic control of business enterprises was thought to be particularly strong in the area of financial institutions, such as banks, pension funds and insurance companies. Strong partnerships would be established between the authorities in charge of banking supervision and the quantitative restrictions, providing an effective shield against foreign establishment or direct competition. Similar intensity partnerships were established in the other financial industry sectors.

Capital controls have been applied by all countries, in different ways and to different degrees. There is a tidal quality to capital controls, which rise and subside with some regularity. In the late eighties and early nineties they had subsided to a lower ebb than ever before in modern history. Economic policy in the 1980s became increasingly based on a doctrine of greater market orientation. Indirect instruments, seeking to influence credit expansion through price mechanisms, gradually replaced the direct instruments of monetary control. This is what is usually described as liberalisation in domestic economic policy and in domestic financial markets.

The final conversion to liberalisation came after the experiences of the late 1970s and early 1980s. Skeptics had to accept that the existing controls were characterised by a low degree of effectiveness and high costs. There were costs of an administrative nature. More importantly there was a macroeconomic cost in that distortions in asset prices and interest rates could lead to a sub optimal allocation of capital resources. Financial markets became less effective. There were also problems following from shielding financial markets from foreign competition. Temporary advantages could be outweighed by the cost of postponing the economic policy and private sector adaptation to changes in international economic circumstances.

The direct instruments of monetary and credit control had created a close relationship between the major players. They were the financial institutions, in particular

large clearing banks, and the monetary authorities, ministries of finance and central banks. Banking supervision became subordinated to this relationship, and played a limited role. Prudential rules – for instance, liquidity requirements – were turned into instruments of monetary policy, with a view to influencing interest rates. Competition polices were not developed, or at least not enforced with any rigour. In many countries the banking supervisory authorities managed to keep their sector out of the remit of the general competition authorities. All the parties to those close relationships had a strong interest in retaining them.

Eventually, the gradual deregulation in domestic credit and monetary policy, with the abolition of direct controls, spurred a strengthening of prudential requirements and supervision and of competition policies.

Some degree of internationalisation of financial markets and institutions took place under the capital controls in spite of the restrictions of national monetary and credit policies. This clearly undermined the effectiveness of these quantitative policies. There was no immediate link between, on the one hand, domestic deregulation and, on the other hand, the opening-up of domestic markets for financial institutions from other Member States or the development of an internal financial market in other ways. The financial services industry continued to enjoy a close relationship to the authorities. In some countries, the state would even directly own the major clearing banks. For most Member States, retaining domestic control over the financial services industry was considered to be of vital importance; financial institutions and markets should remain in the hands of their own nationals. The prospect of clearing banks, pension-fund managers or life-assurance companies being bought up by nationals of other countries appeared distant. Any other direct access to markets for foreign institutions was seriously curtailed.

Gradually, however, deregulation in domestic monetary and credit policy did lead to the implementation of free movement of capital from 1990, on the basis of the Capital Liberalisation Directive,[3] which was adopted in 1988. This was the first time that all Member States agreed that the escape clause in Art. 67 of the Treaty (abolishing capital-movement restrictions 'necessary to ensure the proper functioning of the common market') implied a full liberalisation.

With the lifting of capital controls, an internal financial market was now possible – and even necessary for ensuring that financial business would not drift to the Member State that would offer the least intensive regulatory environment and the best financial and tax incentives. The economic policies of Member States did not any longer depend on domestic markets. Most of the other obstacles just mentioned were still in place. The attempt to resolve them, guaranteeing unrestricted market access, was made in a series of financial market directives, the most important of which has been the Second Banking Directive of 1989.[4] Abolishing capital controls was an easy step in terms of execution, when the economic polices allowed it. It was

[3] Council Directive 88/361/EEC of 24.6.88 for the implementation of Art. 67 of the Treaty.

[4] Second Council Directive 89/646/EEC of 15.12.89 on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC.

mainly a question of abolishing some rather simple regulation. Making free movement work was much more complicated.

Before the 1992 deadline of the Commission's 1985 White Paper, the major directives in this area of financial services and financial institutions were either adopted or going through the late stages of the legislative process, with a common position having been reached, guaranteeing their adoption.[5] The 1992 deadline was extremely tight in an area where so little had been achieved, placing considerable pressure on both the Member States and on the Commission. This was bound to have some impact of the form of the solutions that were found, and certain issues could not be explicitly resolved in the directives.

Making free movement work required more than abolishing capital controls and the supervision of financial institutions and the regulation of financial services. A large number of further issues have had to be addressed. The cost of cross-border payments have become a concern. The euro contributes to making the right to free movement of capital more effective; it could even be seen as the ultimate harmonisation measure! The introduction of the euro harmonises the currency or capital itself and takes care of mutual recognition in a way one could not in practical terms have done if the different national currencies were to be maintained.

3 CAPITAL, SERVICES AND ESTABLISHMENT IN THE EC TREATY

The original provisions of the free movement of capital in the Treaty of Rome (Arts 67–73) were more conditional than those concerning the other Treaty freedoms, such as those on the right to provide services and the right of establishment which have provided the basis for review of national financial market regulation. The obligation to progressively abolish restrictions on capital applied only to the extent necessary to ensure the proper functioning of the common market.

One consequence of this was that the European Court held that the Treaty freedom was not directly effective. With the revisions of the Maastricht Treaty the free movement of capital was formulated in a broader and less conditional way than any other Treaty freedom. But even before those amendments entered into force, the European Court held in *Sanz de Lera* [1995] ECR I-4821 that the Treaty freedom was directly

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[5] In addition to the Second Banking Directive, one must refer here to the following instruments: First Council Directive 77/780/EEC of 12.12.77 on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (the 'First Banking Directive'); Council Directive 89/299/EEC of 17.4.89 on the own funds of credit institutions (the 'Own Funds Directive'); Council Directive 89/647/EEC of 18.12.89 on a solvency ratio for credit institutions (the 'Solvency Ratio Directive'); Council Directive 92/30/EEC of 6.4.92 on the supervision of credit institutions on a consolidated basis (the 'Second Consolidated Supervision Directive'); Council Directive 92/121/EEC of 21.12.92 on the monitoring and control of large exposures of credit institutions (the 'Large Exposures Directive'); Council Directive 93/6/EEC of 15.3.93 on the capital adequacy of investment firms and credit institutions (the 'Capital Adequacy Directive'); and Directive 94/19/EC of the European Parliament and of the Council of 30.5.94 on deposit-guarantee schemes (the 'Deposit-Guarantee Directive').

effective. The Court argued that the Treaty provisions had to be read in the context of secondary Community legislation giving effect to the freedom, in particular the Directive abolishing the Member States' right to restrict capital movements.

The free movement of capital has been further strengthened by the unconditional and wide formulation in the Treaty. One issue which has been discussed in the legal literature is that of horizontal direct effect. In *Sanz de Lera* the action was against the state and the Court only had to address vertical direct effect. Horizontal direct effect, where a private party invokes the Treaty freedom against another private party, has not yet been addressed by the Court. Treaty provisions are normally capable of both horizontal and vertical direct effect. *Sanz de Lera* does not in any way indicate the contrary in relation to Art. 56. Art. 56 itself does not depend on implementing measures and is widely formulated. Argument to the contrary may be derived from Art. 28 (ex Art. 30) on the free movement of goods which is limited to actions against the State, and there are certain parallels between the provisions.

The Treaty freedoms do provide a powerful tool for review of national regulation. Most of the field is now also based on EC directives, and harmonisation should reduce the restrictive nature of traditional financial market regulation.

But there remain several issues in relation to the institutional solutions, in particular concerning the level of regulation at European Union and national level, and beyond harmonisation which is based on national legislation and actual supervision. The most pressing is to what extent a European supervisor has to be established, and what should be the relationship with the supervisory functions that remain at the Member State level.

4 'Regulation' and 'Financial Markets' – What do we Mean?

Much of the discussion about financial markets and institutions would focus on one kind of institution or market. Traditionally regulation and supervision has developed in very different ways. Banking supervision has focused on banks and their solidity or their supporting role in the traditional credit policies described above. Life insurance and pension fund regulation has had its focus on securing the interests of the insured, and the contractual terms have been regulated often in great detail. Securities markets have been regulated with investor protection as the focus, and fraud legislation an integral part of the regulatory model. The regulators have been based in different ministries and they have championed 'their' industry against the others. Not only the content or character regulation but also the intensity of regulation have varied between these three main sectors.

Similar products are now offered by institutions that are primarily based in any of these three main sectors. Cross ownership requires new consolidated supervision. And there is an increasing interdependency between financial markets going beyond what can be explained by these features of the development. If sectoral supervision is to be maintained it must be heavily coordinated. In many countries new models of a universal regulator have been developed. In the Scandinavian countries this took place in the 1980s, in the United Kingdom in the late 1990s.

Banking supervision is increasingly influential as the emerging paradigm of financial market regulation. The basic regulation relates to capital adequacy and in matching the financial exposures. Risk is priced correctly and the systemic risks of a meltdown of a financial sector or the whole financial market is reduced.

5 Financial Market Regulation Remain National Law

Basically, banking supervision was created to provide solutions for domestic markets. That remains as a limitation even in its modern form. If anything this applies with even greater force to other sectors of financial market regulation. To some extent regulation and the actual supervisory functions undertaken have developed to restrict capital flows from other countries or protect against competition from foreign institutions or markets. Globalisation creates a new role for financial market regulation which has had to become increasingly European and international.

The process of internationalisation of domestic financial market regulation has created problems both for national authorities and for institutions and markets that have an international dimension in their activities.

Other important surrounding areas of law with important impact in this field, such as contract law and company law, remain even more traditionally national. This leads to problems that are becoming increasingly more pressing. Banks and other financial institutions are authorised in one jurisdiction and it remains very difficult to move that authorisation to another Member State. In practice one can establish a branch in the other country which will remain supervised primarily by the authorities of the first country of authorisation. Establishment through a subsidiary is not covered by the authorisation by the home country supervisor. Moving to another jurisdiction is also still impossible as a matter of company law. One cannot move a company from one jurisdiction to another: it remains a foreign company in the new jurisdiction. There are of course techniques that alleviate this. Establishing a subsidiary in the new jurisdiction, and then transferring assets and activities. But a full recognition of a foreign company, so that it can reincorporate or register in the new jurisdiction (acquire a new nationality or citizenship so to speak) is still not possible in the national company laws of Europe. The *Centros* decision[6] of the European Court of Justice has limited, as a matter of EU company law, the possibility to withhold the recognition of foreign companies or their branches. For the purposes of financial market regulation, financial institutions had already achieved this. Authorities cannot discriminate on the grounds that the authorisation has been granted in another Member State. But the company law restrictions remained as for all other companies. The European Commission has drafted a proposal for a new directive on the ultimate free movement issue: how can a company register (or re-register) in a new jurisdiction. But this proposal still has a long way to go.

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[6] Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459.

6 THE INTERNAL MARKET ISSUES

The separation of money and financial market supervision provides an opportunity to revisit the obstacles to the development of the Internal Financial Market. The old model under the quantitative regime did more than keeping money and supervision together. It created regulatory systems which had, as one of their primary aims, to limit capital flows. The present level of harmonisation through the directives in the sector has not done away with this.

Even a very high degree of harmonisation will still lead to the double burden of having to follow more than one set of national rules. The proposed mechanism to limit double regulation in the directives – home country control – is not sufficiently effective. Its extent is not clear enough, there are too many and too wide exceptions, and the reporting even when it applies has proven too burdensome.

The recent proposals from the European Commission are still based on the home country control principle.[7] The otherwise very timely proposals deal with the programme of developing and modernising the harmonised regulatory rules. The new model for the adoption of these rules comes from the proposals from the Lamfalussy Committee. The Lamfalussy proposals included the adoption of a new legislative procedure and the use of regulations instead of directives. This has a huge potential when it comes to making the regulatory procedures more rapid and the adopted rules more effective.

It does however not resolve the basic problem of double burden that remains if there are all these different national regulators that remain in charge of the actual supervision. The intensity and extent of regulation of financial institutions is such that this burden is higher than in most other sectors.

7 THE MARKET REGULATORY ISSUES

The Lamfalussy proposals included as mentioned the adoption of a new legislative procedure and the use of regulations instead of directives. This is now adopted for both investment services and (from 2002) for banking. The regulatory procedures become quicker and the adopted rules more effective. But can national regulators deliver a sufficient level of efficiency? They may not only provide restrictions on the free movement which is necessary to get the internal market to function. It is questionable whether they provide the level of effective regulation that is required for the market to function. The European Commission has continued its adherence to home country control. The remedy is seen to be in an elaborate structure of bodies to promote cooperation and coordination between the national regulators.

There is no doubt that coordination is necessary and that much can be achieved this way. But it is very uncertain if it can achieve the sufficient level of efficiency. Where there are different national interests of some strength, one would expect the

[7] Financial Services: Implementing the framework for financial markets: Action Plan. Communication of the Commission. COM (1999) 232, 11.05.99.

agreement to be less lasting. It may not take that much of divergence for cooperation to break down.

8 The Systemic Stability Issues

The aim of systemic stability is now at the core of modern financial market regulation. Financial stability cannot be achieved at a national level with the present level of market integration, not even when it is supported by an extensive body of harmonised EU legalisation in directives and regulations. Here, there will often be strongly diverging national views, and the different fora for cooperation and coordination cannot mediate effectively between these interests.

9 Handling of Crises

The handling of financial crises is one area where the lack of a European institutional solution seems particularly critical. The lender of last resort (LOLR) function depends on arrangements at member state level.

The existing LOLR arrangements are not adequate to deal with liquidity issues in the context of a European banking system. This is the case for both systemic and individual liquidity crises. In case of a systemic problem, the ECB lacks the supervisory information needed to judge on the systemic effect of liquidity problems and decide quickly on the collateral issues. In case of liquidity problems at individual financial institutions, the national central banks along with the national supervisory authorities will act and take on the LOLR costs only when the liquidity crisis poses systemic risks for their own banking system. Even if they are concerned with the implications for the European market, they might lack both the necessary resources and the ability to assess the severity of the liquidity problems. Neither is it clear whether authorization by the ECB is also required.[8] Finally, cooperation on the basis of Memoranda of Understanding (MOU) does not secure the necessary real-time information sharing and action, and the availability of resources is questionable.

A centralized LOLR competence at the ECB level will deal more effectively with most of the inadequacies of the current decentralized framework. The ECB will be able to intervene effectively and timely when the emerging pan-European financial institutions face liquidity problems. It will avoid coordination problems – present in a decentralized system involving discussions between the interested central banks and consultations at the ECB level – and it will be able to decide quickly. It will have the capital resources required and will ensure a proper allocation of the LOLR costs across the Community. It will also reduce the anti-competitive effect of national central bank policies and decisions on eligible collateral, and of interventions in support of insolvent institutions.[9] Still, the precondition for a successful LOLR role by

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[8] The ECB may prohibit or restrict LOLR functions by the national central banks. ESCB Statute Art. 14(4).

[9] It should be mentioned that the ECB can already affect these policies as under 14(4) it may restrict national policies that interfere with the ECB's objectives and tasks.

the ECB will be the establishment of information-sharing arrangements. Such information-sharing arrangements are needed to provide the real-time information necessary for an accurate assessment of the systemic effect of liquidity problems, a decision on the adequate collateral, and a real-time intervention.

Two major arguments can be added in favour of the ECB's handling the LOLR situations. First is that national authorities may act counter to the requirements of monetary policy. It may be to prefer that the balancing of financial stability and monetary policy is undertaken by one institution. This runs counter to some of the arguments brought up by others on this point that seems to build on an ordo liberal division of functions to secure the uncorrupted exercise of monetary policy powers.

Second is that national authorities would easily act against the rules on state aid. ECB could not be restricted under these rules. Time pressures and other factors in this kind of financial crisis will make it less realistic that a solution may be achieved at the national level.

10 REGULATORS SHOULD FOLLOW MARKETS

At this stage it may be useful to sum up some points relating to regulatory jurisdiction. Regulators should follow markets. This seems as an obvious starting point when one deals with regulation aiming at increasing market efficiency or counteracting market failure. Regulators do not follow markets. They follow national jurisdictions and state organisation that less and less often coincide with markets. New economic policies and market conditions should have removed obstacles so that regulators now could follow markets. The way they presently divide them up apply also within domestic markets and not only in relation to foreign markets and institutions.

National jurisdictions divide markets up. National regulation tends to obstruct market integration. It also makes regulation less effective. Any form of cooperation between regulators will provide less than optimal efficiency, both in terms of costs to business (in the European Union, one still has to submit to 12 different regulatory regimes) and in achieving the primary goals of financial market regulation (increased financial stability, effective competition, market surveillance and sanctions against transgressors).

In the financial markets regulators have traditionally divided markets up, making borders between countries effective barriers, such as protecting their 'own' financial institutions against competition and also making economic policies effective. Today the European Union and also broader forms of international cooperation, WTO/GATS, limit the power of regulators to achieve this. Most will be critical to this at a wholesale level: there are good reasons also to challenge it in relation to consumer or investor protection.

A discussion of national regulation as a barrier leads to the following question. How can so many obstacles remain which are that much against the interests of the financial services industry that wishes to establish itself or sell its products in other Member States. Partly the answer must be that there are other interests that are served by most of the regulatory regimes. There are client relationships where the regulators protect 'their industry' against foreign competition. The other is the inertia that

is displayed by many of the main players. It is not so that the interests are carefully balanced and the best solutions automatically chosen. The story of the Merger Regulation and the 'one stop shop' is indicative. Only when the EU regulation was a fact that could not be avoided did business involve itself, in spite of the obvious benefits of EU level regulation. Business did not move to make merger control an EU competence. Only when this had come about did business take steps to avoid having authorities at both the European Union and the national level dealing with the individual cases at the same time.

11 The Independent Regulator

Conversely, for the international financial institution, the independence of the regulator can be of importance. There is a problem with the lack of independence in a national context. Regulators are too closely involved with the political process. National business interests form too close relationships with the regulator (regulatory caption).

These problems are still there at EU level but there is less scope for caption than in the more limited national political and business environment. There is a case for saying that financial market regulation and supervision cannot be effectively developed and exercised at a national level: it is too vulnerable to pressure and the formation of too many and too close client relationships. National lobbying at EU level is also a problem, but not as great a problem as at the national level.

12 Regulatory Change

What can lead to regulatory change in Europe? The needs of the Internal Financial Market, spurred on by the introduction of the euro, seem to be a realistic platform. However, reform of financial market regulation has rarely come about as a consequence of rational deliberation. Historically regulatory reform has taken the form of panic stricken short-term responses to the crisis that has just passed. Furthermore, authorities in this field are generally not too concerned with extending their formal responsibility. The consequences at a national and a European level are these: formal competences remain at national level where there is little actual competence to deal with the next systemic crisis.

There is a European trend towards a universal regulator. Are there any lessons to be learnt from the last decade? One may discern an emerging European model: a *domestic* universal financial market regulator in a rather tight European framework responding quickly to international developments. The most recent developments include the establishment of the British Financial Services Authority, and the German reforms. Their consequences for Europe are still not clear.

There is also a global financial policy challenge. The major issue here is that there is no viable political structure to support an international regulator, universal or sectoral. International financial liberalisation results in a major increase in risk in both national and international real economy. An effective policy towards financial markets must be international in character. Recent financial instabilities, such as the

Asian crisis, as well as collapses of financial institutions such as BCCI and Barings call for more efficient regulation and for an effective LOLR. Demand for international financial regulation cannot be coped with by traditional forms of international cooperation between regulators. We need a tighter organisation; an IMF for financial market supervision, not only one that deals with such questions as a sideline to currency issues. The IMF, OECD and World Bank have been concerned with financial systems in the developing countries. There are legitimacy concerns with the present international standard setting. They cannot be remedied by civil society participation through consultation. The need is for a political institutionalisation – but that seems to be unrealistic in the medium term perspective.

13 The Financial Regulatory Policy Challenge in Europe

Here we return to the question of whether home country control does achieve the primary internal market aims? The answer must be that very limited financial integration has been achieved. This limitation does, on the other hand, not exclude the increased interdependence and systemic risk.

The introduction of the euro has changed the situation. Here are two perspectives. It shows the costs and inefficiencies of existing market divisions. It also leads to increased integration which in turn increases systemic risk.

Even in more integrated financial markets, such as that of the European Union, cooperation between national authorities is not enough to handle crises. Although certain steps have been made in the field of capital adequacy, arrangements for regulation and monitoring is inadequate in today's markets.

Consolidation of financial services calls for consolidation of supervision at EU level. It is not easy today to distinguish between market risk and the risk of financial institutions. A single supervisor could better function as coordinator of national regulatory authorities and LOLR.

A single regulator with LOLR responsibilities could also respond better to a financial crisis, which would need immediate and resolute action. Negotiations and compromise between national regulators may not provide the optimal process. A constant challenge of other EU policies, for example, on state aid will remain.

The role of the European Central Bank in this: is it the most realistic prospect that it will gradually be filling the void? Its present role is limited but is increasing.

There is a need for analysis and further sorting out of the issues to provide basis for rational policy discourse. The ECB must be discussed as a model in relation to the sectoral regulators or the European super regulator. In itself the ECB and the European System of central Banks (ESCB) may provide an organisational model for the development of a European super regulator.