The Prospects for a Pan-European Financial Regulator

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Michael Ohle examines the development of financial regulation at a European level. The author outlines the benefits of financial regulation for creating a single market for financial services, and a deep liquid capital market. He concludes that it is not yet clear whether the EU countries will choose a US style federal regulator or opt for the benefits of competition between regulators.

Introduction

Financial regulation exists for three main reasons. It is there to provide a safety net to prevent the collapse of a bank, insurer or investment manager that may cause the collapse of others, It is also there to promote the integrity of the financial system and to protect individual consumers form malpractice and fraud. Finally, it acts as a watchdog for financial markets, policing and prosecuting. This essay examines the issues involved in the regulation of financial markets across Europe. The issue of a Euro Securities and Exchange Commission (SEC) or pan-European supervisor authority is examined as a possible solution to the current regulatory patchwork. Particular emphasis is placed on the bureaucracy in Brussels and the dissimilar legal systems throughout the Union.

We are quite a long way from a single market for financial services. Both the banking and securities industry are pivotal to the financial market yet the extent of their similarity in terms of regulation ends there. Banking enjoys a wide regulatory framework, even if the application of rules varies. The “passport” directive of 1989 set out the principle that once a bank had a licence from its own government it could set up branches in any EU jurisdiction. The directive also put home country supervisors in charge of “prudential oversight” while the bank had to abide by host country’s regulatory rules (Economist, Aug. 19th, 1999).

In contrast, securities regulation and supervision across Europe has no discernible structure. Bureaucratic red tape and high fees still plague retail investors if they want to invest in foreign shares. Countries have different attitudes to shareholder rights and taxes. There are no EU wide rules on accounting, information disclosure and the treatment of minority shareholders. The European authorities recognising this proposed two directives covering stock market listing requirements and prospectuses. Both failed to be adopted fully by national governments.

The Present Environment

Different regulatory structures exist throughout the member states of the European Union. The British system groups the entire financial system under one regulatory body- the Financial Services Authority. The British claim that the system espouses the benefits of economies of scale, streamlined management and greater accountability and transparency of the financial system. The other popular choice is the French "twin heads" approach. Two separate regulatory bodies control the regulation of banks and securities markets. The French claim that there exists a conflict of interest between the two sectors, hence the need for two bodies. The Commission des Operations de Bourse (COB) regulating securities defends the retail investor while the commission of the Bank of France serves banking interests. And besides, claim the French, a single regulatory body, such as the Financial Services Authority (FSA), is too large and cumbersome to operate effectively. The Germans have three separate authorities dealing with banking, insurance, and securities respectively. The present German finance minister would like to see a single regulatory body through the amalgamation of the three separate authorities. This however is meeting stiff opposition from the Bundesbank as well as the state governments, which control Germany's eight bourses. The other twelve member states fall roughly between these three categorisations.

Fragmentation such as this reduces efficiency by reducing the depth and liquidity of the market thereby making the cost of capital higher than in America. Per head of population there is five times as much venture capital in America as there is in Europe (Economist, March 1st, 2001). Entrepreneurs find it difficult to find start up capital in Europe.

National governments still stick to protectionist investment rules for investment and pension funds. Italian government rules require pension funds to invest a considerable portion of the money that they manage in government bonds. In France, a recent tax break for equity investment was restricted to investment in French companies. As a result, the average American investment fund is six times bigger than its European equivalent, and between 1984 and 1998 the average real return on pension funds was 10.5% in America and 6.3% in EU countries that impose restrictions (Economist, March 1st, 2001).

The merger of Deutsche Borse and the London Stock Exchange exposed cracks in the system. Regulatory supervision was split between London and Frankfurt as

neither exchange wanted to be seen as the "junior" partner. Likewise, the proposed three way bank merger in France between Societe Generate, Paribas and Banque Nationale de Paris in 1999. Because such a large-scale merger had never been attempted before, the French authorities often seemed as though they were making things up as they went along (Financial Times, Jan. 23rd, 2002). Adding these cases to the pressure for change form the development of Internet banking, globalisation and the desire for a US style market centric financial system, it is clear that in Europe the financial market place is severally lacking in coherent direction.

Acknowledgement of the difficulties involved is widespread. Achieving consensus on what to do about it is problematic. Fresh impetus was given to the single market in financial services when after the launch of the Euro, Europe's leaders endorsed the Commissions Financial Services Action Plan at the Lisbon summit in March 2000. As a spin-off from the plan the French proposed a committee to be set up under Alexandre Lamfalussy (former chairman of the European Monetary Institute (EMI), the forerunner of the European Central Bank) to investigate the possibility of a pan-European regulator.

The Lamfalussy Report

The committee was primarily concerned with the urgent measures needed to streamline EU securities markets. The Lamfalussy report advocates a single "passport" for stock markets along the lines of the previous banking directives. International accounting standards and a single prospectus for issuers are recommended. Many of the proposals made by Lamfalussy and his team of "wise men" are mere restatements of articles of previous directives that were not fully adopted by EU governments. While Lamfalussy favours the British model of regulation the committee made no definitive response to the question of a pan-European regulator. The report centres on a new streamlined legislative process that would revolve around the creation of a European regulators committee and an EU securities committee. It was hoped that these new bodies would speed up the legislative process and exert more control over the enforcement of directives.

At present, the Commission makes a legislative proposal to the Council of Ministers and the European Parliament. They then engage in a time-consuming co-decision making process, which takes on average more than two years. The Lamfalussy plan calls for a four-stage decision making process. At the first level, the Council of Ministers, the European Commission and the European Parliament would design the "framework" of legislation to be passed to the next level.

At this second level the "securities committee" made up of representatives from the Commission and the member states would agree within three months on the technicalities of the new legislation, through consultation with market participants and consumers. Levels three and four would involve the co-operative implementation of legislation between national regulators and the new "regulators committee" (Economist, March 1st, 2001).

Predictably, the Commission and the Parliament have been at logger heads over parliaments claim to review legislation proposed by the two powerful committees set up under the Lamfalussy plan. Parliament claims that with the advent of these new decision making bodies, democratic accountability would be removed from the decision making process (Financial Times, Jan. 23rd, 2002). Indeed that may be so, but if Parliament were given the legally binding right of review of legislation passed by the Lamfalussy method then legislation would be further delayed. The committee flatly rejects the right of "call back" on new legislation.

The committee opted instead for safeguard measures similar to those conferred on the Council of Ministers by the Commission. These would include providing the Parliament with all available information during the framing of new legislation and the option to review legislation four years after its implementation (Financial Times, Jan. 23rd, 2002). By proposing these two new committees Lamfalussy aims to inject a sense of urgency into proceedings that for all the elected representatives talk about democratic accountability is what is really needed. Paradoxically, these proposals have delayed even the most basic measures to streamline the financial market by over a year due to the legal wrangling in Brussels. Understandably many commentators voice the desire to leave the Commission and Parliament completely outside of the reform process. The layers of bureaucratic red tape in Brussels are causing as much trouble as the failed adoption of EU financial directives.

A Pan-European Regulator

Does the creation of a European securities committee herald the birth of an EU-wide SEC? The Securities and Exchange Commission was set up in 1934 with the legal remit of supervising and policing not just stock exchanges but all public capital markets. It plays a central role in America's oft-fragmented regulatory structure. Indeed it has been credited with creating deep, liquid, efficient markets with a strong investment culture. Naturally this is to where the EU would look for guidance on the regulatory conundrum.

Most professionals fear that it would add a fresh layer of regulation on top of national ones. So long as legal systems and enforcement remain national and not supra national, the regulatory structure seems likely to remain national two. The lack of a common legal jurisdiction is a major problem. The existing variation in financial intermediation across European countries is a consequence of their dissimilar legal structures (La Porta *et al*, 1997). The structure of finance in a country depends on the legal rights of shareholders and creditors as well as on the degree to which the relevant laws are enforced (Cecchetti, 1999). Legal systems can be grouped into four main categories: English common law, French civil law, Scandinavian civil law and German civil law. Evidence suggests that those countries with a common law system such as the UK and the US support the most developed equity markets with the greatest investor protection. The French civil law system is next, followed by the German and Scandinavian systems. If this view is correct, that the legal system determines the financial structure, this will have serious implications for the reform of the European financial markets.

Most EU member states now consider a single supervisor for all financial services the best solution at a national level. They recognise that the traditional boundaries between banking, securities and insurance markets are rapidly blurring. Likewise there is support for a pan-European regulator to end the mish-mash of regulatory regimes. The French are all for it, the British are opposed, with the Germans stuck in the middle.

There are those who espouse the benefits of competition between regulators across national borders (Economist, March 1st, 2001). Far from generating a race to the bottom (lax regulation), competition nurtures efficiency. To compete effectively markets need to be efficient and consequently well regulated. Competition between national regulators realises effective regulation. These virtues have been recognised by the EU in its "single passport" policy. National stock exchanges have merged forming alliances in the pursuit of greater efficiency. Perhaps the popularity of the single regulatory model may be dampened if the benefits of regulatory competition were voiced more vociferously. Undoubtedly globalisation of both the capital markets and the equity investor throws the difference in regulatory structure into much sharper light.

Conclusion

Change is in the air. It is clear to all involved that the present regulatory patchwork

cannot continue if the goal of a single market in financial services is to be achieved by 2005. The Lamfalussy proposals are a step in the right direction. The births of the two committees under the Lamfalussy plan leave open the possibility for the creation of a Euro-SEC. The EU authorities should concentrate their energies on producing directives that will plug existing loopholes in legislation. The broader issues of reform of the bureaucratic decision making process as well as the legal system are equally important as the choice between a national or pan-European regulatory body. Bureaucratic red tape and legal wrangling between the EU's institutions severely delays the implementation of legislation. Lack of a single legal jurisdiction compounds the problem with enforcement of directives. A pan-European authority is undesirable, if not impractical. It is extremely tricky for a national authority to balance often-conflicting objectives, let alone a supra-national authority. How can a single regulator strive to protect investors, police financial institutions and watch markets in 15 different jurisdictions? If it were desirable, some form of common jurisdiction would be essential.

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