DEVELOPMENTS IN THE EU FRAMEWORK FOR FINANCIAL REGULATION, SUPERVISION AND STABILITY

The completion of the Financial Services Action Plan (FSAP) is expected to provide the realisation of the single market for financial services with a strong impetus. The implementation of the main FSAP measures will contribute to removing the residual legislative and regulatory obstacles to full financial integration, while at the same time promoting financial stability. In addition to the FSAP, other public initiatives with the potential to contribute significantly to the pursuit of the objectives of financial integration and financial stability are being implemented at the EU level. First, the adoption of the ‘Lamfalussy approach’, which was initially devised for the securities field and has now been extended to banking and insurance, represents a unique opportunity to enhance the effectiveness of the regulatory and supervisory processes in the financial sector. Second, the strengthening of specific arrangements for financial stability, which is being promoted under the aegis of the Economic and Financial Committee (EFC), should contribute significantly to enhancing cooperation and information exchange among the relevant authorities both in normal times and in crisis situations. The effective implementation of these initiatives will be a key feature of the ‘post-FSAP’ period.

INTRODUCTION

The adoption of the single currency at the beginning of 1999 provided a powerful stimulus to the integration of European financial markets inter alia by making it easier to take advantage of borrowing and investment opportunities, thus reducing the cost of financing and improving the allocation of financial resources throughout the euro area. In order to reap the full range of potential benefits stemming from the euro and increased financial integration, the construction of the single financial market must be underpinned by an effective public policy framework that aims to remove remaining obstacles to financial integration, while at the same time promoting and maintaining the stability of the financial system. The main elements of this framework are regulation, supervision and specific financial stability arrangements. In all these areas, important developments are under way.

In the field of financial regulation, the FSAP, which was launched by the European Commission in May 1999,1 aimed to complete the necessary legislative regime to enable the effective exercise of market freedoms throughout the EU in financial services. The completion of the FSAP at the end of the term of the European Parliament in mid-2004 was an important achievement. The adoption of 39 of the 42 Community measures that were planned in the context of the FSAP has led to a substantive improvement in EU financial sector regulation. However, it is likely that the impact of the FSAP on financial markets will take some time to fully manifest itself, as a significant number of FSAP measures have only been adopted recently and most still require implementation at the national level, both in regulatory and supervisory terms. This is a crucial period because the extent to which the FSAP will contribute to the effective establishment of a single financial market will hinge on the consistent implementation and enforcement of its measures by Member States.

With regard to financial supervision, an increasing emphasis is being placed on it as a major tool to promote both financial integration and stability. In this respect, the introduction of the Lamfalussy approach2 and its recent extension from the securities to the banking and insurance sectors will enhance the mechanisms for cooperation and enable closer coordination among the responsible authorities.

2 The Lamfalussy approach was set out by the Committee of Wise Men on the Regulation of European Securities Markets, chaired by Baron Alexandre Lamfalussy, in its “Final Report” of 15 February 2001.
Lastly, increasingly integrated financial markets call for enhanced arrangements for monitoring and preserving financial stability. This latter objective is being pursued on the basis of the structures stemming from the Lamfalussy approach and of the recommendations of the Economic and Financial Committee.

This article aims to provide an overview of the most recent developments in the process of setting up an EU framework for financial regulation, supervision and stability, and considers possible future developments in these areas. The first section, on regulation, discusses the main legislative measures adopted under the FSAP, as well as the organisational structure supporting the more flexible regulatory process under the Lamfalussy approach for implementing such measures. The second section, on supervision (i.e. the implementation and enforcement of legislation and regulations), focuses on the enhancement of cooperation among the responsible authorities, notably on the basis of the newly established EU supervisory committees. The third section discusses the strengthening of the arrangements for financial stability, with regard to both the regular monitoring of vulnerabilities and the institutional setting for the management of crises. The article concludes by looking at possible future developments in these policy fields.

I  FINANCIAL REGULATION

A main feature of the Lamfalussy approach is to recognise the distinction between legislative principles and technical rules. On the one hand, basic policy choices should be translated into Community law in the form of framework principles. In terms of procedure, these framework principles should be adopted in accordance with the normal EU legislative procedures, which consist of a Commission proposal submitted to the Council and the European Parliament for adoption by co-decision. This layer of legislation corresponds to Level 1 in the Lamfalussy terminology. On the other hand, there are the more detailed technical measures that are needed to implement the policy objectives of legislation. They should be adopted through a more flexible regulatory procedure. In particular, the Commission, with the support of sectoral committees made up of the competent authorities, is entitled to prepare draft legislation which is subject to voting by regulatory committees comprising representatives of the Member States. This layer of legislation, which draws on “comitology” procedures, corresponds to Level 2.

Many of the FSAP measures adopted more recently have already followed the Lamfalussy approach. They confine themselves to the definition of framework principles and entitle the Commission to adopt implementing measures in accordance with the procedures foreseen under Level 2.

LEVEL 1: THE KEY MEASURES OF THE FSAP

The FSAP measures represent both an overhaul of the existing regulatory regime for many financial services activities and an extension of the harmonisation at the EU level to new areas. They also close certain gaps in the EU framework of financial legislation (see Box 1). Most of the effort has been devoted to the improvement of securities regulation, where

3 The Lamfalussy approach is a four-level process for approving legislation on securities, banking and insurance regulation. Level 1 consists of framework principles, namely in the form of Directives or Regulations, to be decided by normal EU legislative procedures. Level 2 arranges for the implementation of detailed measures following the Level 1 framework principles. Level 3 consists in enhanced cooperation and networking among EU supervisors to ensure consistent and equivalent transposition of Level 1 and Level 2 legislation. Level 4 consists in strengthened enforcement, notably with action by the Commission to enforce Community law, underpinned by enhanced cooperation between Member States, their regulatory bodies and the private sector.

4 The term “comitology” refers to the procedure according to which the Commission is assisted by a committee comprising Member States’ representatives in the adoption of implementing measures for Community legislation. Under Article 202 of the Treaty, it is the Commission’s responsibility to implement legislation at the Community level. Council Decision 1999/468/EC of 28 June 1999 specifies the types of comitology procedures to which the adoption of implementing measures may be subject.
Box 1

KEY MEASURES OF THE FINANCIAL SERVICES ACTION PLAN

Banking supervision

– Amendment of the Directives governing the capital framework for banks and investment firms (to be implemented by 31 December 2006);
– Directive on the reorganisation and winding-up of credit institutions (2001/24/EC of 4 April 2001); and

Insurance and occupational pensions supervision

– Review of the solvency system in insurance (expected in 2005);
– Directive on reinsurance supervision (expected in 2005);
– Directive on insurance mediation (2002/92/EC of 9 December 2002);
– Directive on the reorganisation and winding-up of insurance undertakings (2001/17/EC of 19 March 2001); and

Securities and investment funds

– Directive on transparency obligations for securities (scheduled for autumn 2004);
– Directive on the prospectus to be published when securities are offered to the public or admitted to trading (2003/71/EC of 4 November 2003);
– Directive on the distance marketing of consumer financial services (2002/65/EC of 23 September 2002); and

Cross-sector supervision


Payments, clearing and settlement

– Commission Communication on clearing and settlement (COM(2004) 312 of 28 April 2004);
– Directive on financial collateral arrangements (2002/47/EC of 6 June 2002); and
the Lamfalussy framework was first implemented. In this sector, the regulatory intervention concerned the intermediaries, the trading facilities and other areas.

The new Markets in Financial Instruments Directive (MiFID) is one of the most important measures of the FSAP. It has been adopted after four years of intense negotiation and has replaced the regime set up by the 1993 Investment Services Directive (93/22/EEC). The MiFID concerns both trading infrastructures and intermediaries. It deals with new issues arising from the increased competition among stock exchanges and new order execution platforms, laying down a comprehensive set of rules concerning all trading venues, namely regulated markets, multilateral trading facilities and intermediaries that execute client orders internally. As regards intermediaries, the main implication of the MiFID is that it widens the scope of the investor-oriented activities benefiting from the single passport, while enhancing investor protection. It therefore also reinforces the cooperation among securities regulators, for the purpose of achieving an effective supervisory framework across the


**Accounting rules**


**Company law**

– Proposals for a 10th Company Law Directive on cross-border mergers and a 14th on the cross-border transfer of the registered office of limited companies (to be adopted in 2005);
– Directive on takeover bids (2004/25/EC of 21 April 2004);
– Commission Communication on modernising company law and enhancing corporate governance in the EU (COM(2003) 284 of 21 May 2003);
– European Company Statute (Directive 2001/86/EC and Regulation 2001/2157/EC of 8 October 2001 – entry into force on 8 October 2004); and

**Market integrity**

– Proposal for a Directive on the prevention of the use of the financial system for the purpose of money laundering, including terrorist financing (third Money Laundering Directive); and

**Taxation**

EU. The ECB, in its Opinion given according to Article 105 (4) of the Treaty establishing the European Community (the Treaty), has welcomed and supported the main provisions of the Directive.5

Other important measures have been adopted in the securities regulation field to improve the harmonisation of significant aspects of the securities business and to modernise securities market legislation in Europe. First, the Prospectuses Directive introduced a new single passport for issuers, enabling the approval of a prospectus for the issuance of securities by the relevant authority in one Member State to be accepted by those in all Member States. In order to attain this objective, the Directive introduces the necessary harmonisation of the rules applicable to public offerings and of the information contained in a prospectus, thus ensuring equivalent protection for investors at the Community level.

Second, the Market Abuse Directive has introduced harmonised rules against market abuse, thus strengthening investor confidence in the European financial markets.

The ECB has supported both regulatory initiatives, which should further promote the integrity of European financial markets, strengthen investor confidence and ensure the smooth functioning of the markets.6

Third, regulatory action has been taken to further harmonise disclosure rules applicable to companies with securities listed on European financial markets, in the form of the Transparency Directive, and accounting rules, in the form of the Regulation on the application of international accounting standards. The introduction of harmonised and enhanced disclosure standards will have beneficial effects on the European economy, as it will improve market efficiency, further the integration of European financial markets and contribute to financial stability.

Fourth, the Financial Collateral Directive has improved legal certainty in the cross-border use of collateral in wholesale financial markets. These measures are of special relevance for the Eurosystem since they will support the smooth functioning of the single monetary policy.7

In the area of banking, the major and most recent initiative concerns the amendments proposed by the Commission on 14 July 2004 to the Codified Banking Directive (2000/12/EC) and the Capital Adequacy Directive (93/6/EEC) regarding the new capital requirements framework for banks and investment firms. The objective of this review is to modernise the existing EU framework on the basis of the work by the Basel Committee on Banking Supervision (BCBS). On 26 June 2004, the central bank governors and the heads of the banking supervisory authorities of the G10 countries endorsed the BCBS report entitled “Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework”. The Commission’s proposal for the re-casting of the aforementioned Directives is also broadly in line with the Lamfalussy approach and provides for a flexible procedure to adapt their technical rules, which may be modified through Level 2 procedures.

In the insurance field, a major review of the prudential framework for insurance undertakings is also under way. The “Solvency II” project aims to establish a regulatory regime that better reflects the risk profile of an insurance undertaking. Like the Basel II framework for banks, the Solvency II initiative aims to reform capital requirements for insurers by introducing a three-pillar structure. The Commission’s proposal for a Directive is expected in 2005. The Commission also

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intends to propose the new prudential regime in accordance with the Lamfalussy approach. The related field of occupational pensions, encompassing institutions such as pension funds, also benefited from the improvements in the supervisory framework introduced by the 2003 Occupational Pension Provision Directive.

The FSAP also includes measures aimed at addressing cross-sectoral activities. The 2002 Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, which Member States had to implement by August 2004, sets out prudential requirements targeted at the particular features of large financial groups active in insurance and at least one other financial sector (e.g. banking, securities). This Directive covers solvency requirements, risk concentration rules, suitability of managers, risk management and internal control systems within the conglomerate. It also promotes supervisory cooperation and, in that context, provides for the appointment of a coordinating supervisor from among the authorities involved in supervising financial conglomerates. The Financial Conglomerates Committee, which is a Level 2 committee set up under the Lamfalussy approach, will assist the Commission in the adoption of technical rules and the provision of other guidance for the regulation of financial conglomerates.

Important additional measures stemming from the FSAP are the following. The Commission Communication on clearing and settlement of April 2004 proposes a Directive aimed at increasing competition and efficiency through comprehensive rights of access for clearing and settlement providers throughout the EU. Furthermore, in the area of company law, the establishment of the European Company Statute, which entered into force in October 2004, represents a major breakthrough and the starting-point for a more ambitious project: an Action Plan for modernising company law and enhancing corporate governance. It aims to set out the priorities at the EU level for the regulatory framework in this field. It includes initiatives to strengthen shareholder rights, reinforce protection of employees and creditors, and increase the efficiency and competitiveness of business from a cross-border perspective. Lastly, it is also worth mentioning the recent Commission proposal for a third Directive widening the scope of measures for preventing the use of the financial system for terrorist financing.

Box 2

THE LAMFALUSSY APPROACH: THE NEW ORGANISATIONAL STRUCTURE

<table>
<thead>
<tr>
<th>Regulatory committees</th>
<th>Supervisory committees</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banking</strong></td>
<td>European Banking Committee</td>
</tr>
<tr>
<td><strong>Insurance and pension funds</strong></td>
<td>European Insurance and Occupational Pensions Committee</td>
</tr>
<tr>
<td><strong>Securities and investment funds</strong></td>
<td>European Securities Committee</td>
</tr>
<tr>
<td><strong>Financial conglomerates</strong></td>
<td>European Financial Conglomerates Committee</td>
</tr>
</tbody>
</table>

LEVEL 2 OF THE LAMFALUSSY APPROACH

As noted earlier, many FSAP measures already enable the Commission to issue Level 2 legislation. Following the October 2002 report by the EFC on financial regulation, supervision and stability, the Lamfalussy approach has been extended from the securities sector to the banking, insurance and investment fund sectors. The committee structures necessary to support the Commission in its regulatory role have been established. The process for achieving more efficient and flexible legislative and regulatory processes at the EU level has therefore been set in motion.

The new regulatory committees (see Box 2) will assist the Commission in the adoption of technical measures at Level 2 in accordance with the comitology framework. These committees are composed of high-level representatives from Member States and are chaired by a representative of the Commission. In the banking field, the European Banking Committee (EBC) will replace the Banking Advisory Committee. In the insurance field, the European Insurance and Occupational Pensions Committee (EIOPC) will replace the Insurance Committee. In the securities field, the European Securities Committee (ESC) has been in existence since 2001 but will take over the regulatory responsibilities of the UCITS Contact Committee. The European Financial Conglomerates Committee was established in 2002. The ECB has observer status in these banking, securities and financial conglomerates committees.

The new supervisory committees (see Section 2) have the function, with regard to Level 2 legislation, of providing technical advice to the Commission on the content of the implementing measures.

2 FINANCIAL SUPERVISION

The conduct of financial supervision relates to the day-to-day implementation and enforcement of legislation and regulations. In accordance with the Lamfalussy approach, the transposition of Level 1 and Level 2 legislation into national laws and practices should take place on the basis of a framework for enhanced cooperation among supervisory authorities. This is designated as Level 3, and its objective is to ensure consistent and equivalent transposition among Member States of Level 1 and Level 2 legislation.

The development of Level 3 activities has been entrusted to the recently established supervisory committees (see Box 2). They are composed of high-level representatives from the competent national supervisory authorities. In the banking sector, the Committee of European Banking Supervisors (CEBS) also includes representatives of the central banks not directly involved in the supervision of individual credit institutions, including the ECB. This stems from the recognition of the contribution that central banking tasks can make to the conduct of banking supervision, as also reflected in Article 105 (5) of the Treaty. The banking supervisory authorities hold the voting rights, however. In the securities field, the Committee of European Securities

9 On the basis of the following Decisions by the Commission: Decision 2004/5/EC establishing the Committee of European Banking Supervisors; Decision 2004/6/EC establishing the Committee of European Insurance and Occupational Pensions Supervisors; Decision 2004/9/EC establishing the European Insurance and Occupational Pensions Committee; and Decision 2004/10/EC establishing the European Banking Committee, all of 5 November 2003.
Regulators (CESR) succeeded the Forum of European Securities Commissions (which was established in 1997), while in the insurance sector, the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) builds on the former Conference of European Insurance Supervisors, which was created more than 40 years ago.

The introduction of Level 3 activities in the EU framework for financial supervision is aimed also at addressing the supervisory challenges stemming from increasingly integrated financial markets. First, the enhanced regulatory framework enabled by Level 1 and Level 2 legislation may only be effective when a consistent application of the common rules at the national level has been achieved. Furthering financial integration within the framework of the FSAP implies that market players operating throughout the single market should face broadly similar enforcement practices and procedures. If this were the case, the compliance costs for cross-border activities, as well as potential competitive distortions, arising from different procedures among Member States would probably be reduced substantially. Regulatory convergence therefore needs to be complemented by supervisory convergence, which would allow the fulfilment of the objectives of the FSAP. Second, enhanced cooperation and exchange of information among authorities would allow more effective supervision of financial institutions with significant cross-border business. This applies in particular to major financial groups which have an EU-wide relevance due to their cross-border activities or to their role in key financial markets or market infrastructures.

LEVEL 3 ACTIVITIES OF THE NEW SUPERVISORY COMMITTEES

In accordance with the proposals of the Lamfalussy Committee and the October 2002 EFC report on financial regulation, supervision and stability, the supervisory committees have the following specific Level 3 tasks. First, they should promote consistent implementation of EU Directives and develop best supervisory practices in this regard. Second, they should set up an effective operational network mechanism for the purpose of supervisory convergence and exchange of information on specific institutions, both in normal times and during periods of stress. In the performance of these tasks, the committees should enjoy institutional and operational independence. As a means of ensuring accountability, the committees should present an annual report to the Commission, which will be sent to the European Parliament and the Council. Their respective chairpersons should report to the European Parliament periodically and/or upon request. An important requirement is that the committees should operate in an open and transparent manner, with appropriate consultation and public disclosure practices.

The supervisory committees may employ a variety of instruments to perform their tasks. For example, they may produce guidelines for the regulations to be adopted at the national level, issue interpretative recommendations and set standards or best practices for matters not covered by either Level 1 or Level 2 legislation. As these acts are not legally binding, their implementation by the members of the committees remains voluntary. In addition, the committees may perform peer reviews of national practices.

The three supervisory committees, despite their recent establishment, have drawn up demanding agendas to fulfil the needs arising from the FSAP measures in particular and those of integrated markets in general.

CESR, located in Paris, was the first supervisory committee to be established as a result of the Lamfalussy recommendations. It has already concentrated much of its activities on the provision of technical advice to the Commission regarding the content of Level 2

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Developments in the EU framework for financial regulation, supervision and stability

rules implementing the Directives in the securities field adopted under the FSAP. This has included advice on the implementing measures for the Market Abuse, Transparency, Prospectuses and MiFID Directives. At Level 3, CESR is working on the development of standards on matters not yet covered by EU legislation, notably coordination among securities regulators with regard to the control of financial information, and on securities clearing and settlement systems. The latter work is being carried out through a joint working group of the European System of Central Banks (ESCB) and CESR. With a view to enhancing its Level 3 role, CESR launched a public consultation on the definition and organisation of work at this level in April 2004. In its consultation paper, CESR sets out some proposals to improve its functioning with regard to regulatory and supervisory convergence. For example, it suggests that more authority could be given to its guidelines, recommendations and standards. In addition, CESR members could increase the scope of joint initiatives, e.g. to include joint supervisory visits, joint training and the development of databases in the areas of regulatory interpretations and judicial cases.

In the banking sector, the recently established CEBS, located in London, is expected to play a major role in ensuring the consistent implementation of Basel II. It has already identified a number of priorities, which include efforts to reduce the scope for national discretion in the forthcoming legislation, the practical enhancement of cross-border banking supervision, the development of common principles for the implementation of the supervisory review process (Pillar 2 of the Basel II framework) and the validation of banks’ internal ratings-based (IRB) approaches for credit risk and advanced measurement approaches for operational risk. The enhancement of cooperation in crisis management situations is another task of this Committee, to be undertaken with the ESCB’s Banking Supervision Committee (BSC). CEBS will also set up an operational network for the exchange of information on specific institutions and, in particular, major EU banking groups.

CEIOPS, located in Frankfurt, is the forum for cooperation and information exchange among insurance and occupational pension supervisors. CEIOPS has the main task of furthering supervisory convergence in the insurance sector, in order to ensure more efficient supervision of insurance companies, insurance groups and financial conglomerates. In August 2004 it launched a consultation on the guidelines for coordination committees in the context of supplementary supervision as defined by the Insurance Groups Directive (98/78/EC). The purpose was to ensure consistency in the supplementary supervision of insurance groups, as well as to increase the efficiency and effectiveness of the work of the coordination committees established for each group. In addition to complementing the existing legislation, CEIOPS will also devote efforts towards revising and updating the EU solvency regime for insurance companies (Solvency II). This regime is expected to deliver a more harmonised framework for both capital requirements and supervisory action.

3 ARRANGEMENTS FOR FINANCIAL STABILITY

The arrangements for financial stability encompass both the framework for the analysis of vulnerabilities in the financial sector and the institutional setting for the management of financial crises. With the introduction of the single currency, cross-border risks to financial stability have grown in importance. While the greater degree of financial integration strengthens the ability of the EU financial system to withstand shocks by increasing the depth and liquidity of financial markets, it may also give rise to new sources of potential vulnerabilities. Notably, owing to closer cross-

14 IRB approaches and advanced approaches are to be used by banks in the context of Basel II and the EU regulatory framework for capital requirements.
border linkages between both financial markets and institutions, domestic financial systems may be more frequently exposed to common shocks, and the risk of financial contagion may be increased. The concentration of financial risk, which is associated with the increasing prominence of systemically relevant, large and highly complex financial institutions operating in several jurisdictions, may present an additional challenge to financial stability which needs to be addressed on a cross-border basis.

As financial integration reduces the likelihood of financial disorders remaining confined to one Member State, the pursuit and maintenance of financial stability also assumes a European dimension. A smooth interplay among national authorities is required to identify possible risks to financial stability and to prevent systemic disturbances or manage them effectively.

THE EFC RECOMMENDATIONS

The arrangements for financial stability and crisis management in the EU have been strengthened considerably as a result of the implementation of the recommendations of the EFC in this field. On the basis of the work by high-level groups chaired by Henk Brouwer, Vice-Governor of De Nederlandsche Bank, the EFC adopted a first report on financial stability (April 2000) and a second one on financial crisis management (April 2001), which were subsequently endorsed by the ECOFIN Council. While considering that the current institutional arrangements are adequate, the reports recommended a number of enhancements aimed at improving their practical functioning. In particular, three areas for improvement were identified. First, the exchange of information among supervisory authorities and between supervisory authorities and central banks should be enhanced significantly. This would be necessary not only on a cross-border, but also on a cross-sectoral basis, owing to the greater degree of integration of financial products, markets and intermediaries across the traditional boundaries of the banking, securities and insurance sectors. Second, the convergence of supervisory practices at the EU level should be increased in order to enhance the efficiency of authorities involved in monitoring cross-border financial institutions. Third, crisis management arrangements could also be enhanced, particularly in terms of coordination among the different authorities.

More specifically, the recommendations in the area of financial stability monitoring concern an enhanced exchange of information on major financial groups and market developments, which would enable the competent authorities to arrive at a better understanding of the ability of financial markets, intermediaries and infrastructures to withstand shocks. Central banks are expected to be involved in this dialogue irrespective of their role in financial supervision at the national level, given their special expertise and interest in the area of financial stability stemming from the conduct of their basic tasks. A more intensive exchange of information between supervisory authorities and central banks would also serve to close possible gaps between micro- and macro-prudential monitoring. Another priority for fostering financial stability would be to strengthen supervisory convergence and cooperation, especially with respect to the supervision of large and complex financial institutions operating across jurisdictions.

In the area of crisis management, the EFC highlighted that the first line of defence should remain within financial institutions themselves. Supervisory authorities should take measures to ensure that large financial groups are able to produce accurate financial information at short notice, have adequate contingency procedures in place and perform stress-testing exercises on a regular basis. To ensure effective cooperation in crisis situations, Member States should ensure that no legal or practical obstacles could prevent the timely exchange of necessary information among supervisors, central banks, overseers of payment systems and bodies administering
deposit guarantee schemes. Moreover, clear ex ante agreements for the sharing of information and the assignment of responsibilities among authorities in the event of a crisis should be developed, especially for the major financial groups, and preferably on a multilateral basis.

**IMPLEMENTATION OF THE EFC RECOMMENDATIONS**

The main addressees of the EFC recommendations are the EU supervisory authorities and central banks (see Box 3). In particular, both the supervisory committee structures established as a result of the Lamfalussy approach and the BSC report regularly on the progress made in the implementation of these recommendations. The ongoing progress in implementation is being monitored by the Financial Services Committee (FSC) on behalf of the EFC.

As a result of the EFC recommendations, in the area of financial stability monitoring, the exchange of information among supervisory authorities and between them and central banks has been stepped up significantly. The BSC has developed a comprehensive framework for the regular analysis of structural developments and potential vulnerabilities in the EU banking sector. In collaboration with the ECB, this framework has been extended to the entire financial system, encompassing also non-bank financial intermediaries, financial markets and market infrastructures. The new supervisory committees also provide the institutional setting for enhanced information-sharing, including micro-prudential information on specific institutions. A number of arrangements and agreements, such as Memoranda of Understanding, are in place to support such processes.

In the area of crisis management, the Memorandum of Understanding (MoU) on cooperation between the EU banking supervisors and central banks in crisis situations, signed under the auspices of the BSC in March 2003, is one of the main achievements. The authorities of the new Member States which joined the EU on 1 May 2004 signed the MoU in June 2004. The MoU sets out specific principles and procedures for the identification of the authorities responsible for crisis management in the EU, the required flows of information between banking supervisors and central banks, and the practical conditions for sharing information at the cross-border level. It could also serve as a building-block for further cooperative arrangements.

<table>
<thead>
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<th>Box 3</th>
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<tr>
<td><strong>EU COMMITTEE ARCHITECTURE FOR FINANCIAL STABILITY</strong></td>
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<table>
<thead>
<tr>
<th>Committee</th>
<th>Mission</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic and Financial Committee (EFC) – composed of Ministries of Finance; Commission; national central banks; ECB.</td>
<td>High-level assessment of developments in financial markets and services &lt;br&gt; Provides advice to the ECOFIN Council and to the Commission</td>
</tr>
<tr>
<td>Financial Services Committee (FSC) – composed of Ministries of Finance; Commission.</td>
<td>Strategic discussion and guidance on financial services policy issues, mainly from a cross-sectoral perspective &lt;br&gt; Bridging function between political and technical bodies &lt;br&gt; Assists the EFC in preparing advice to the ECOFIN Council</td>
</tr>
<tr>
<td>ESCB Banking Supervision Committee (BSC) composed of national central banks; banking supervisory authorities; ECB.</td>
<td>Macro-prudential and structural monitoring of the EU financial system &lt;br&gt; Cooperation and exchange of information between banking supervisors and central banks on issues of common interest &lt;br&gt; Analysis of the impact of regulatory and supervisory requirements on financial stability</td>
</tr>
<tr>
<td>Supervisory committees (CEBS, CESR and CEIOPS)</td>
<td>Exchange of information on developments in the banking, securities and insurance sectors</td>
</tr>
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This has been the case in the Nordic region, where central banks and supervisory authorities have established a specific MoU on crisis management complementing the wider MoU agreed at the EU level. Work on crisis management arrangements will continue to be developed jointly by the BSC and CEBS.

Cross-sectoral coordination is also being reinforced. To ensure enhanced dialogue and coordination on a cross-sectoral basis, the supervisory committees have established regular ties. In addition, it should be noted that the FSC, which replaced the Financial Services Policy Group in 2003, has the mandate to provide strategic guidance on financial sector policies, especially from a cross-sectoral perspective. It acts as a bridge between high-level policy fora, such as the ECOFIN Council and the EFC, and technical bodies, such as the new supervisory committees.

4 FUTURE DEVELOPMENTS

With the completion of the FSAP, the extension of the Lamfalussy approach to all financial sectors and the ongoing implementation of the EFC recommendations on financial stability and crisis management, the EU framework to foster further the single financial market is largely in place. A future challenge for the parties involved in financial integration will be to take advantage of the opportunities offered by the enhanced processes for financial regulation, supervision and stability. Although financial integration has advanced significantly since the introduction of the euro, particularly with regard to wholesale markets, numerous market segments remain insufficiently integrated. The ECB, for its part, has a keen interest in a fully integrated European financial system and it intends to actively contribute in accordance with its capabilities and competencies. The potential gains from Monetary Union will only be fully realised if the remaining barriers to the integration of EU financial markets are effectively removed.

The definition and implementation of the post-FSAP strategy will involve both public authorities and market participants. The public policy framework should be conducive to further integration by removing existing obstacles while preserving financial stability. Ultimately, however, the financial integration process is driven by market forces. In particular, the definition of the concrete boundaries of market-places and of new products remains the initiative of market participants.

With regard to public action, the Commission started the post-FSAP process with a wide-ranging stocktaking exercise in order to obtain the views of all interested parties, notably market participants. In October 2003, the Commission established four expert groups comprising representatives of market participants in the fields of banking, insurance, securities and asset management. The expert groups’ reports were released in May 2004 and provide a first analysis of the possible priorities for the post-FSAP period. They provide a comprehensive assessment of the extent to which different aspects of financial business can be undertaken on a pan-European basis, outline the main expectations and concerns regarding the implementation and enforcement of FSAP legislation, and identify specific areas for enhancing the combination of self-regulation and supervisory cooperation. These reports were opened to public consultation in order to assess the extent to which the views expressed met the overall consensus of market participants. Following this consultation and debates among public authorities, the Commission is expected to issue a Communication setting out the priorities for the post-FSAP period in the first quarter of 2005.

15 This was a result of the recommendations of the EFC report on financial regulation, supervision and stability.
16 See the article entitled “The integration of Europe’s financial markets” in the October 2003 issue of the ECB’s Monthly Bulletin.
Developments in the EU framework for financial regulation, supervision and stability

Although this wide-ranging policy debate is ongoing, a number of priorities already stem from the objectives underlying the FSAP, the Lamfalussy approach and the EFC recommendations on financial stability and crisis management. First, the effective and consistent implementation of both Level 1 and Level 2 legislation in national laws and regulations is crucial for the effective implementation of the FSAP measures. Effective supervisory convergence will be instrumental in pursuing this objective. All this should ultimately lead to genuinely common financial legislation and regulations for market players, enforced coherently across Member States, while respecting the principle of subsidiarity enshrined in the Treaty. Second, a robust supervisory and financial stability framework for integrated financial markets should continue to be promoted. As integration proceeds, financial institutions will increasingly engage in cross-border business, leading to changes in the transmission channels for systemic risk. Consequently, it is important that the relevant authorities – namely supervisors and central banks – continue to enhance cooperation and information exchange in order to monitor such developments and take coordinated action if required.

In addition to these specific objectives, there is a shared understanding that the effects of the FSAP framework should be allowed to materialise before the launch of another wide-ranging legislative programme is contemplated. Future initiatives should undergo a careful ex ante analysis and non-legislative alternatives to regulation as well as market-based solutions should be taken into due consideration. Legislative action in the coming period is expected only in the areas already planned, such as clearing and settlement, company law and corporate governance, and money laundering and terrorist financing, or in a few other areas where a specific need may arise.

One of the key elements for the successful completion of the FSAP was the setting of specific deadlines for initiatives and the implementation of a rigorous monitoring framework. This allowed a clear overview of the progress being made and of the bottlenecks arising in time for them to be adequately tackled. Therefore, as for the FSAP itself, the pursuance of a post-FSAP strategy would require a monitoring and review process ensuring that progress keeps up with the agreed schedule. Certain components of this process are already in place. The Inter-Institutional Monitoring Group, established in 2003 and comprising a group of independent experts, is mandated to assess progress in implementing the Lamfalussy approach in the securities field. The FSC also monitors the implementation of the recommendations on financial stability and crisis management on behalf of the EFC. An independent monitoring structure should therefore be put in place to take account of and regularly review the progress made on the various fronts, while ensuring the full accountability and transparency of the process. This would ensure that the post-FSAP strategy proceeds in the right direction and at the right speed.