

OBSTACLES PREVENTING INTEGRATION OF EUROPEAN FINANCIAL MARKETS AND SINGLE EUROPEAN REGULATOR AS A POLICY OPTION

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1- Introduction

European countries have been committed to create a single integrated market since the Treaty of Rome. This commitment reemphasized with Single European Act in 1986 and a new road map was determined to accelerate this process. It is clear that one of the main components of European integration and single market idea is capital market integration and more particularly, integration of financial markets which requires free movement of capital without any explicit or implicit restriction in EU zone. In Lisbon Summit, heads of government set the objective of making the EU the most competitive economy in the world by 2010. One crucial dimension of this target is creation a competitive capital market which can be a real rival to the North American capital markets in terms of dept, liquidity and flexibility (Davies, 2004). Even though there is distinctive achievement of integrated European financial markets, it is difficult to say that a competitive single European financial market is achieved fully. It is required to eliminate all significant barriers that hinder further integration. Problems such as fragmentation in supervision, late transposition and asymmetrical implementation EU laws in national jurisdictions are not the only but some of the major problems to hinder further integration. Considerable improvements such as Lamfalussy reform have achieved to eliminate a number of problems in recent years. However, as witnessed in present financial crisis, there are remaining problems persisting and necessitating additional measures in EU regulatory process. Though it is unlikely in the near future, single European regulator is becoming a popular solution option to reach the target of integrated European financial market. My argument is that forming the single European regulatory can be supportive for further integration; nevertheless it cannot solve all problems. There will be remaining problems that hinder further integration of financial markets in addition to regulatory and supervisory obstacles. Moreover, political support, probable treaty amendment, institutional setting, regulatory and supervisory scope and enforcement capability will be the critical and though issues in the design of single European regulatory authority.

In the following sections; firstly evolution of European regulation will be stated; in the second section, obstacles in European financial market will be evaluated and last section will discuss whether single European regulatory agent can be an option for further integration.

2- Development of the European Financial Regulation

The ultimate goal of single integrated market has remained unaltered through the history of European integration since 1957. This aim has achieved in a considerable degree in an evolutionary way. Free movement of capital is one of four basic freedoms that European integration and should be achieved for a fully single market. In this manner, the Commission's White Paper on Completing the Internal Market which is the base for the Single European Act of 1986 is a corner stone for accelerating integration process (Welch, 2006).

Harmonization of minimum prudential rules and mutual recognition became major mediums of integration in financial regulation and supervision in old system before Lamfalussy process to achieve integrated financial markets (Welch, 2006, p. 759). This period was mainly characterized by harmonization only to the extent needed to establish a sufficient level of trust in each other's standards to enable mutual recognition to operate minimum harmonization (Ferran, 2004, p. 111). Financial Services Action Plan (FSAP) was launched in 1998 to achieve single deep and liquid capital market (Welch, 2006, p. 760) 42 separate regulatory measures were targeted to adopt until 2003. It intended an intrusive and costly regulatory regime for EU financial firms. The Lisbon Council (2000) set a new commitment to deliver the commitments in FSAP by 2005. However, old system of EU regulatory process was too slow, too rigid, complex and ill-adapted to the pace of global financial market change. Moreover, existing rules and regulations were implemented differently and that therefore inconsistencies occur in the treatment of the same type of business, which threatens to violate the pre-requisite of the competitive neutrality of supervision (Final Report of the Committee of Wise Men, 2001). So, to achieve FSAP, pragmatic changes in rule making structure were proposed by Lamfalussy team.

The Lamfalussy Report was delivered to the Council in February 2001(Welch, 2006). Problems resulted from EU policy making such as difficulties of securing agreement in a large group with diverse interests, tactical manoeuvring, political compromises, division of

policy making responsibilities between institutions, openness to lobbyists causes slow, less transparent, detailed and at the same time ambiguous regulatory process (Ferran, 2004, Hertig & Lee, 2003). Although it did not aim to solve all problems, Lamfalussy process with 4 levels was rapidly accepted by the EU. Level 1 would be principle base framework directives and level 2 would be detailed implementing directives of ‘comitology’ procedure. Because of political concerns and other EU institutions’ (the European Parliament) reluctance, two levels would split case by case which was a danger to departure the traditional rule making with old problems. Level 3 would ensure consistent, timely and uniform implementation of Level 1 and 2 directives. Lastly, at level 4, better enforcement of compliance with EU legislation would be sustained. Two new committees were established. The Committee of European Securities Regulators (CESR), which is a potential candidate for European regulatory authority in the future, would advice in Level 2 to the Commission and would be the main actor in level 3. In short, new approach was more aggressive and provided limited role for national states. It moved beyond regulation in the strict sense of rule-writing with the establishment of the CESR infrastructure for closer co-operation and coordination between national supervisory bodies and with new focus on ensuring consistency in supervision and enforcement across EU via CESR and the Commission. (Ferran, 2004, Final Report of the Committee of Wise Men, 2001) As a result, Lamfalussy process affected positively legitimacy and accountability of EU regulator process. Large scale and accelerated regulatory change were achieved and the EU emerged as the primary regulator for the European financial markets (Moloney, 2007). However, whether single European financial market and desired transformation have been achieved is a question mark. I will discuss in the next section what hindrances remain and prevent single financial market in the next section.

Post-Lamfalussy process was set with the Commission’s 2005 White Paper on financial services. Since EU has become a mature regulator, unlike FSAP, new phase targeted more smooth regulatory agenda (Moloney, 2007). The objectives of the Commission’s financial services policy for 2005-2010 are to consolidate dynamically towards an integrated, open, inclusive, competitive, and economically efficient EU financial market; remove the remaining economically significant barriers, implement, enforce and continuously evaluate the existing legislation and to apply rigorously the better regulation agenda to future initiatives; enhance supervisory cooperation and convergence in the EU, deepen relations with other global financial marketplaces and strengthen European influence globally (White Paper, 2005). Nevertheless, the financial crisis in 2007-2009 has ignited new debates and

possibly causes radical changes not only in EU financial regulation but also global scale within the helm of G20 summits. Larosière Report (2009) gives some clues for the future direction of EU financial regulatory structure. Larosière Report (2009, p. 27) states one more time that the EU regulatory harmonization and coordination among national regulatory and supervisory authorities are crucial to eliminate competitive distortions and regulatory arbitrage, efficient monitoring of cross border groups and the management of crises in cases of cross border issues. Shortly, up to now, similar problems which hinder the full integration of European financial markets have persisted despite different reform initiatives.

3- Obstacles for European Capital Markets for Further Integration

Though not perfect, the Lamfalussy process was an important step in the right direction. It has provided a pragmatic solution to multi-dimensional, difficult problem of EU financial regulation. It aims to overcome the challenge presented by the mismatch between slow-moving legislative process and dynamic financial markets (Ferran, 2004). However, it did not aim to settle all problems of European financial markets. Thus, assuming that single European financial market would be achieved with Lamfalussy process is a naive idea. Actually, Lamfalussy, himself, explicitly indicate that point. On the other hand, there are also strong critics of Lamfalussy process. Hertig & Lee (2003) criticise the Lamfalussy process since it focus on symptoms not root causes of the problem. According to them two major causes are national protectionism and bureaucratic inertia. Since, supervision and enforcement responsibilities remaining firmly rooted in fragmented national systems; there was a scope for member states to go along with the adoption new EU laws while quietly leaving room for themselves to apply them in a ways best suited to meeting perceived national interests (Ferran, 2004, p. 111). Although level 3 and 4 of Lamfalussy process aim some coordination in supervision and uniform enforcement, it is far from required capacity and enforcement power. Moloney (2007) and Davies (2004) point out that FSAP in Lamfalussy process has undertaken costly, complex legal and institutional change but does not deliver positive transformative effects on markets. For instance, from nineteen major banking mergers in five years term, only seven were cross-border within the EU and most of them were relatively smaller deals (Davies, 2004). Especially fragmentation in retail markets remains in practice. Similar problems were also mentioned in Inter Institutional Monitoring Group's final report on Lamfalussy process in 2007.

Recently, Larosière Report one more time indicates the parallel issues and this time propose a radical change in regulatory and supervisory structure of the EU. It states that present regulatory framework in Europe lacks cohesiveness. 2007-2009 financial crisis revealed that inadequate risk management infrastructure in the EU, both in terms of cooperation between national supervisors and public authorities, lack of common framework to respond crisis, especially for the larger financial institutions a quick reaction to avoid bank failures are also problems for regulatory mechanism of not only maybe the EU wide but also globally (Larosière, 2009).

In short, in the environment of a diverse interested group with different domestic political concerns, institutional power struggle either within EU institutions or between supranational and national agencies creating an efficient and well functioning regulatory structure is difficult. However, refining and upgrading Lamfalussy process is required. Establishment of an independent regulatory agency may not guarantee the correction the all known deficiencies; but, can be an option for further integration.

4- Single European Regulator and Further Integration of Financial Markets

The goal to create a single regulatory authority requires important institutional, legislative and operational changes. Member states will be willing to support EU regulatory intervention where the advantages of collective action are judged to outweigh and disadvantages involved in pooling sovereignty (Ferran, 2004). But, they have different perceptions of potential advantages which will make difficult to establishment of single European regulator. For example, general aim is better competition against US, Japan and China but what will be the centre of EU financial market, London or Frankfurt? Again, which national regulatory model will be chosen for central body, FSA or any other? Moreover, institutional battle for power, such as the Commission's reluctance to share power is another impediment. CESR is the potential candidate for the role of regulatory authority of the EU, however, it is also unwilling to undertake more authoritative role and lack necessary resources (Ferran, 2004). In addition, requirement a new treaty change is another big worry when the painfully Lisbon Treaty amendment process is memorized.

Assuming that all these problems are surmounted and single European regulatory agency is feasible, what will be the costs and benefits of new agency is another debated issue.

Arguments for central regulatory agency are production of better laws more quickly, more uniform implementation of rules on a pan-European basis, exploitation of scale economies, a one-stop shop for investor complaints and concerns, diminished risk of regulatory capture, potential for improved transparency and accountability (Ferran, 2004, p. 119). On the other hand, there are counter arguments. Firstly, it is known that some sensitive issues have taken more time in Lamfalussy process even it aimed faster legislative process, however, there is no reason that member countries will delegate about these sensitive issues such as take over to the new authority. On the other hand new regulatory agency required working with many national supervisory agencies; so, it is not self evident that central regulator will sustain uniform implementation easily. Moreover, national supervisory bodies may perceive new body as a threat for their existence and this may diminish the effectiveness of new body. So, uniform implementation can also be achieved at level 3 to some extent (Ferran, 2004). And also, there is no automatic mechanism that new agency will increase transparency and legitimacy. Lastly, remoteness to local markets may result less market sensitive regulatory structure. Where national rules reflect local market conditions, uniform European wide rules may easily overlook local peculiarities and detriment their positions. This can be a big problem especially in retail banking, which is highly fragmented and there are big local differences.

Current financial crisis situation points out that reform in regulatory structures are inevitable to accomplish sound and well functioning financial markets. Necessity for strong coordination between national regulators and supervisors, sufficient supervisory powers in all member states and equipped with strong, equivalent and deterrent sanctions, EU wide supervising of some cross-border activities such as credit rating agencies and investment funds actually indicate a single European regulatory and supervisory bodies. In line with these, Larosière Report (2009) is offering a new body called European Systemic Risk Council (ESRC) to be chaired by ECB and composing different bodies and focus on macro prudential supervision. Larosière Report (2009) proposes a two stage process for micro prudential supervision. In first stage quality of national supervisory authority will be strengthened and level 3 committees will be prepared to transform into three regulatory authorities. In the second stage, the European System of Financial Supervision will be established. It will have legally binding mediation role between national supervisory agencies, adopt binding supervisory standards, oversight and coordinate college of

supervisors and cooperate with the ESRC, prospected EU regulatory authority. National supervisory agency will pursue day to day operations (ibid.).

In summary, establishing strong single European regulatory and supervisory authorities are difficult; however, it is the only option at this stage to settle some key obstacles. On the other hand, it is not costless; there are some costs and risks. So, single regulatory authorities can be achieved in an evolutionary rather than dramatic way. As the Hertic and Lee (2003) predicted, at first less sensitive issues such as corporate disclosure issues can be handled by CESR (assuming that it will be the European regulatory body) with a relatively soft but not weak enforcement power. On the other hand, financial crisis display that member states required to do more to prevent further fails. Thus, as proposed in Larosière Report, new agency or agencies can have a broader scope and more enforcement power. Hence, Larosière's proposed regulatory structure can also be on the table.

5- Conclusion

Financial regulation aims to eliminate market inefficiencies and it is a medium to internalize the externalities in financial markets. However, as the last financial crisis has proved, nationwide regulatory structures are insufficient to sustain this aim in a highly interdependent, innovative global financial arena. Moreover, when the ultimate objective is establishment of single financial market like in the EU, high level of cooperation and coordination among member states' regulatory and supervisory structure becomes inevitable to reach more efficient markets. However, as Ferran (2004, p. 122) states; *“...devising a regulatory system that is simultaneously efficient in substance, efficient in process, legitimate and properly accountable raises major challenges whatever the legal environment.”*

Despite the heavy effort in regulatory structure, the EU has not achieved full integrated financial markets yet. Though not perfect, the Lamfalussy process is a step in the right direction. Refining and upgrading Lamfalussy process should be the next step. Establishment of an independent regulatory agency can be an option for further integration of the EU financial markets. Larosière Report (2009) gives some clues in this direction. However, single European regulatory and/or supervisory bodies would not guarantee the correction the known deficiencies. In short, creating an efficient and well functioning regulatory structure which will ultimately sustain full financial market integration is difficult objective in a

complex environment of EU with a diverse interests, political concerns, institutional power struggles and heavy bureaucracy.

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