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Article

The role and development of EU capital markets

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ABSTRACT

The 1992 “Single Market” failed to create a real single market for financial services across Europe. However, the boom in bond issuance (stimulated by EMU) and the coincidental equity issuance boom have both led to dramatic changes in the infrastructure of financial markets. So, the EU is well past the point of no return in the creation of a single financial market. If regulatory reform can be certain, and coincide with the rising pillars of reform in the dealing and settlement systems, then a dramatic revolution of European financial services will have been achieved – within a decade of the start of EMU.

Graham Bishop founded *GrahamBishop.com* in 2000 to provide independent analysis on European financial affairs. His publications provide an informed commentary from the practical perspective of a market participant. In September 2002, Mr. Bishop was nominated by the European Parliament to be one of its two members of the Inter-Institutional Monitoring Group, as foreseen by the Lamfalussy Report. He was appointed by the Committee as rapporteur for the first report, which should be made public in Spring 2003. He is also a member of the European Commission's *Consultative Group on the Impact of the Introduction of the Euro on Capital Markets (Giovannini Group)* and an Adviser to the House of Commons Treasury Committee on its EMU Enquiry.

The role and development of EU capital markets

1. Introduction

The European capital markets were intended to be unified by the “Single Market” programme that was completed in 1992. But perhaps the real disappointment in 1992 (and the years following) was the growing realisation that in spite of all the effort that had been put into getting the single financial market Directives on to the statute book, they were not going to deliver what had been hoped. Too many of the compromises were fudged and ambiguous. With the benefit of hindsight, it was obvious that this would cause problems as the Directives began to be implemented and that indeed was what happened. So the high hopes were gradually dashed on the rocks of reality as it became apparent that there is not yet really a single market in financial services across Europe.

A major reason to have a single financial market is quite simply that it will assist economic growth. A recent report to the European Financial Services Round Table (Heinemann and Jopp 2002) estimated that closer integration would create additional economic growth of at least half a percent annually. That is a worthwhile prize in its own right, but there is another strong reason for pushing on towards that goal: if the EU does not keep moving forward, there is a significant risk that it will actually slip backwards.

It is against this background that this paper examines the role and development of EU capital markets. We begin in Section 2 by highlighting the key forces that are driving the changes in Europe’s financial landscape. Section 3 reviews bond and equity market activities in recent years, in particular since the creation of European Monetary Union. Section 4 follows up on this with an analysis of structural changes in EU capital markets. One focus here will be progress (or lack thereof) in making the clearing and settlement of capital market trades more efficient. Section 5 turns to regulatory reforms, with a focus on proposals to speed up the EU legislative process and to ensure the effective and timely implementation of the regulatory framework. Section 6 concludes.

2. Key drivers of Europe’s changing financial landscape

Powerful driving forces are at work and they will re-shape European finance in the years ahead. Obviously, EMU and efforts to create a single market for financial services stand out. But before considering these in subsequent sections it is useful to highlight two specific, worldwide phenomena that operate irrespective of EMU – namely advancements in information technology and ageing.

The pace of advancements in information technology remains dramatic: a new laptop may cost the same as two years ago – but is 40 times more powerful! The advent of the Internet, and especially broadband, means that geographic boundaries have become irrelevant. For many citizens (and market professionals), the serious boundary is where the mobile phone signal runs out. Overall, technology is revolutionising the financial markets. It reaches all the way down the transaction chain from the moment when an investor decides to make some sort of transaction – whether in money or securities or



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financial products - and finishes in the “plumbing” of clearing and settling the transaction.

Demographic trends will lead to a substantial increase in financial assets in the period ahead.

As to ageing, most people are already aware of the basic factors: at present, life expectancy at birth for a male in the EU is 75 years - by 2050 that will have risen to 80 years. That does not sound too dramatic. But consider retirement savings for an insured life - they have a longer life expectancy: in the UK, for instance, an insured male, retiring at the now-normal age of 60, has an average life expectancy of almost 84 years. It follows that a typical citizen, from the moment he retires, has 20 to 30 years of life left. Retirees will need an income and many of them will save to get it, either through a second pillar pension system or third-pillar individual savings. That means they will be saving up a huge portfolio of assets, which will be invested in financial assets - intermediated via the single financial market. But the saving really gets underway when people are in their early forties, which means that these financial assets have to maintain their real value for perhaps 50 years. The political class has thus the enormous responsibility of arranging a regime of price stability that must last for half a century. If not, the electors will be very upset: inflation at even 2 percent annually multiplies prices nearly three times in 50 years.

Public pension systems are likely to be under great pressure in the decades ahead. Table 1 shows the basic numbers for EU countries. Given the greater role of funded pension systems in some countries, the United Kingdom for instance, the projected burden of population ageing on public expenditure differs widely across countries. But in general these projections underpin the need to start with sound public finance - to create scope

Table 1. Public pension expenditure (in % of GDP)

	2000	2010	2020	2030	2040	2050	Peak change
Austria	14.5	14.9	16.0	18.1	18.3	17.0	4.2
Belgium	10.0	9.9	11.4	13.3	13.7	13.3	3.7
Denmark	10.5	12.5	13.8	14.5	14.0	13.3	4.1
Finland	11.3	11.6	12.9	14.9	16.0	15.9	4.7
France	12.1	13.1	15.0	16.0	15.8	...	4.0
Germany	11.8	11.2	12.6	15.5	16.6	16.9	5.0
Greece	12.6	12.6	15.4	19.6	23.8	24.8	12.2
Ireland	4.6	5.0	6.7	7.6	8.3	9.0	4.4
Italy	13.8	13.9	14.8	15.7	15.7	14.1	2.1
Luxembourg	7.4	7.5	8.2	9.2	9.5	9.3	2.2
Netherlands	7.9	9.1	11.1	13.1	14.1	13.6	6.2
Portugal	9.8	11.8	13.1	13.6	13.8	13.2	4.1
Spain	9.4	8.9	9.9	12.6	16.0	17.3	7.9
Sweden	9.0	9.6	10.7	11.4	11.4	10.7	2.6
United Kingdom	5.5	5.1	4.9	5.2	5.0	4.4	-1.1
EU 15	10.4	10.4	11.5	13.0	13.6	13.3	3.2

Notes: Expenditure include most public replacement income to people aged 55 and above; projections are based on legislation in force in 2000; recent pension reforms in Germany are projected to lower 2050 expenditure by 2 percentage points; for Denmark figures include statutory labour market supplementary pension schemes; for Ireland figures are in percent of GNP.

Source: European Commission (2001).

for meeting rising pension claims - and with pension reforms that aim at cutting the generosity of public pension systems and promoting funded pension systems.

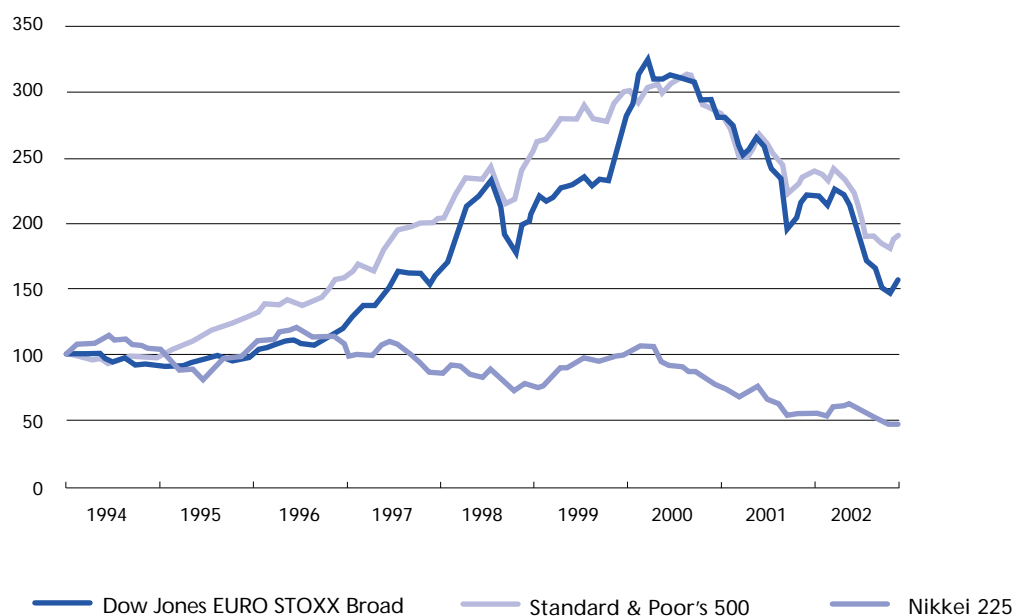
A shift towards funded pension systems inevitably pushes the burden onto individuals to save for their own retirement. The resulting surge in demand for financial assets is likely to coincide with the moment when the financial services industry is digesting the full implications of the completion of the next round of evolution of the single financial market in Europe. The combination with the technological revolution promises (some may say threatens) to change the mechanics of delivering financial services. That may enable the gusher of pension fund money to flow through some rather unexpected conduits, and that is the challenge: how to foster a market that removes the barriers to citizens achieving the full benefit of their savings? Before sketching what needs to be done to complete the internal market for financial services, we briefly review recent trends in bond and equity market activities.

3. A review of recent trends in capital market activities

To begin with equity markets, one should note at the outset that the boom during the early years of EMU could hardly be ascribed to the new currency. Indeed, as Figure 1 shows, EU markets moved closely in line with the US stock market for much of the period. The steps that are underway to improve the regulatory and practical functioning of EU markets - as part of the Financial Services Action Plan (see Section 5) - will play a role in the future volume of issuance, and the subsequent secondary market trading.

Booming EU equity markets in the second half of the 1990s cannot be attributed to the coming of EMU.

Figure 1. Equity market trends in the EU, United States, and Japan, 1994-2002

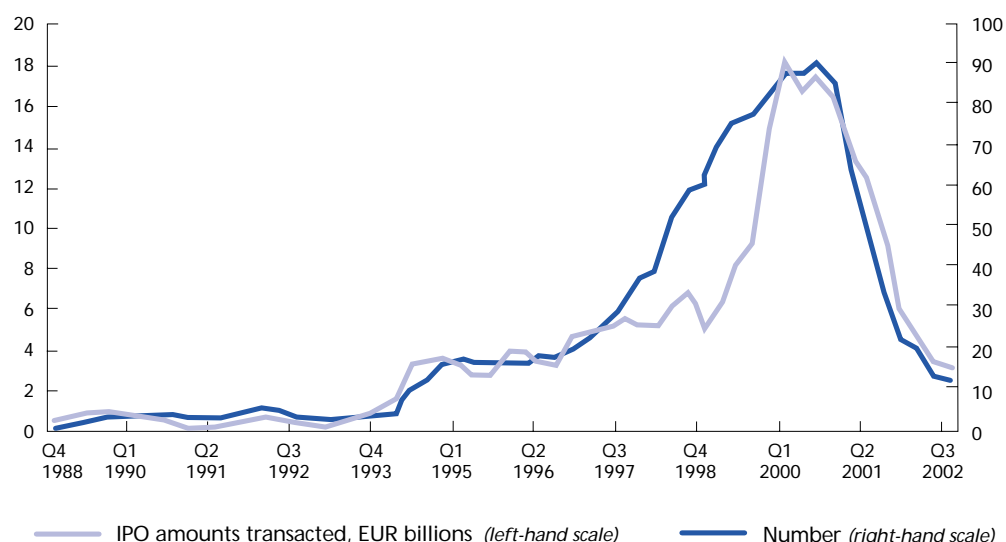


Notes: January 1994 = 100

Source: ECB (Monthly Bulletin, December 2002).

Initial Public Offering (IPO) began to rise sharply after the equity boom had raised investors' appetite for new issues. Figure 2 demonstrates the dramatic uplift - in both value and the number of IPOs. At first, values were running at barely EUR 20 billion annually, but shot up to an annualised EUR 80 billion as the market peaked in early 2000.

Figure 2. Initial public offerings in the eurozone, 1988-2002



Notes: Four-quarter moving average; quarterly data
Source: ECB (Monthly Bulletin, December 2002)

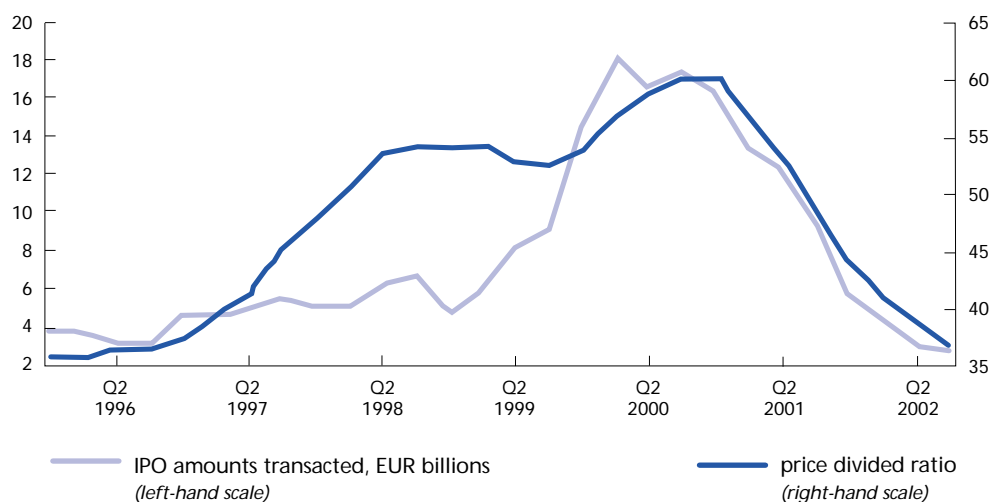
The surge in equity issuance until mid-2000 was driven by a substantial drop in the cost of capital.

The motivation for this issuing boom is easy to understand when we account for the cost of capital. As can be seen from Figure 3, the rising equity market was not accompanied by a surge in dividends and, thus, price dividend ratios increased substantially, implying a sharp fall in the effective cost of capital. Unsurprisingly, many issuers were prepared to raise capital at negligible cost, and the lag before this mechanism sprang into effect was barely a year, but thereafter the response was dramatic - until the market peaked.

However, the surge in equity issuance prompted the authorities to begin a review of prospectus requirements even before the Lamfalussy plan (see Section 5) came into operation. The coordinator of European securities regulators at the time - the Forum of European Securities Commissions (FESCO) - produced its consultation paper on prospectuses in May 2000 - virtually coincident with the equity market peak. While the consultation paper was on prospectuses for equity issuance, it paved the way for the later realisation that bond markets should also be covered when the formal proposal was made for a new Directive.

Turning to bond markets, it is worth noting at the outset that the euro bond market is an undoubted success of the capital markets. Moreover, its scale dwarfs the equity markets, with annual issuing volume running at some EUR 670 billion even before EMU, approximating 50 times equity issuance at the time. As Table 2 shows, the total value of bond issuance doubled in 1999 and it is still running at twice pre-EMU level.

Figure 3. Initial public offerings and price dividend ratio in the eurozone, 1996-2002



Notes: Four-quarter moving average; quarterly data
Source: ECB (Monthly Bulletin, December 2002)

Is the current scale of this market a “euro phenomenon”? The answer is surely “yes” – because the very act of creating a single currency meant that the obligation on all the insurance companies to match their assets and liabilities was suddenly achieved by creating a single currency across most of the EU. One cannot overestimate the resultant pan-European demand for euro-denominated securities. It was anticipated, but it took a while to put in place the portfolio management teams to carry it out. At the stroke of midnight on 1 January 1999 – the beginning of EMU – that legal matching requirement crystallised a pan-European demand for euro-denominated securities, after which the world was different.¹

These developments did not happen by accident – there was an explicit intention to create a single bond market and that is well on the way. There was a political, emotional, and intellectual desire to go from the disjointed and inefficient situation 15 years ago to a clear and simple market. The relative scale of the euro bond market should not be a surprise; it is not a flash in the pan – it is the natural result of the creation of a single currency for Europe, built on the concept of a single financial market.

The phenomenal increase in the euro bond market is the natural result of the creation of a single currency for Europe.

The government debt managers of the eurozone took the lead in the mid-1990s and made great efforts to take advantage of the opportunity presented by EMU. Essentially, they epitomised the outcome of the “emotional and intellectual” desires by their decision to compete head on with the US Treasury and, most importantly, with each other. That required reforming the size of their issues and the types. Now that objective is achieved, attention has moved to the minutiae of clearing and settlement – the plumbing.

¹ Going back to the mid-1980s, this author wrote a series of “bond manuals” on different countries but now they are just museum pieces. The changes in those 10 to 15 years are phenomenal, and are due initially to the single financial market – the 1992 programme, but EMU is now the accelerator.

But as Table 2 shows, the private corporate sector is also making use of this market on a scale that could not have been imagined. To highlight one fact: the new issuance by private corporations and utilities is still up by a factor of 8 from pre-EMU days. In 2002, the level of issuance was still high, even after the various global problems raised a series of questions about corporate governance and accounting standards. This dramatic increase represents a disintermediation of the banking system by European and other companies. Moreover, the massive growth in the private finance category masks the use of financing subsidiaries by industrial companies as a means of bypassing the banking system.

Table 2. Euro bond issuance in billions of euros, 1998-2002

	1998	1999	2000	2001	2002
Sovereign	385	448	429	439	475
Supranational	13	15	8	12	15
Corporates (incl. utilities)					
Private	14	121	104	167	113
Public	10	19	32	41	27
Financial institutions (incl. banks)					
Private	144	437	390	419	375
Public	102	198	153	201	198
Total	668	1,238	1,116	1,279	1,203

Source: Capital DATA Bondware.

To conclude the description of bond market activities since the creation of EMU, we note that one of the key characteristics is the size of issues. Traders would regard a EUR 500 million bond issuance as a reasonably liquid bond – something that is going to be traded by institutions internationally, as well as just bought and held. It is a measure of what is needed to have a global bond market. Table 3 indicates that at the start of EMU, half the non-government bonds were in this category; now some 60 percent of non-government bond issues exceed this threshold – even as issue activity has risen sharply. Splitting the category further, one would see that about 40 percent of the non-government issues are over EUR 1 billion each – roughly twice the proportion in pre-EMU days.

Since the creation of EMU, the size of the eurozone government bond markets has further increased relative to government bond markets elsewhere in the world.

How does the size of eurozone bond markets compare to markets in the rest of the world? We start with a look at government bonds because any currency that lays claim to be a world reserve currency must have at its foundation a large and liquid government bond market. Government bonds are the top credit in any country, so are the foundation for an international role. Significantly, Figure 4 illustrates that, even as EMU was starting, the euro-denominated aggregate of government bonds in the eurozone became substantially bigger as a proportion of the world bond market. Moreover, it enlarged its lead over the US bond market despite the euro depreciation. While this was partially because the US government was running budget surpluses and repaying bonds, the performance of the euro government bond markets was nevertheless impressive from the very beginning, and now there is a huge disparity between the eurozone and the United States. For reference, Figure 4 also shows data for the United Kingdom, which issues the only other major European currency; it is obvious, that the UK government bond market accounts for a relatively small proportion of the world government bond market.

Table 3. Issue size of non-government euro bonds (in % of total), 1998-2002

	1998	1999	2000	2001	2002
Issue size in millions of euros					
< 100	3	8	9	6	7
100-500	39	43	36	31	30
> 500	58	49	55	63	63
Total	100	100	100	100	100

Source: Capital DATA Bondware

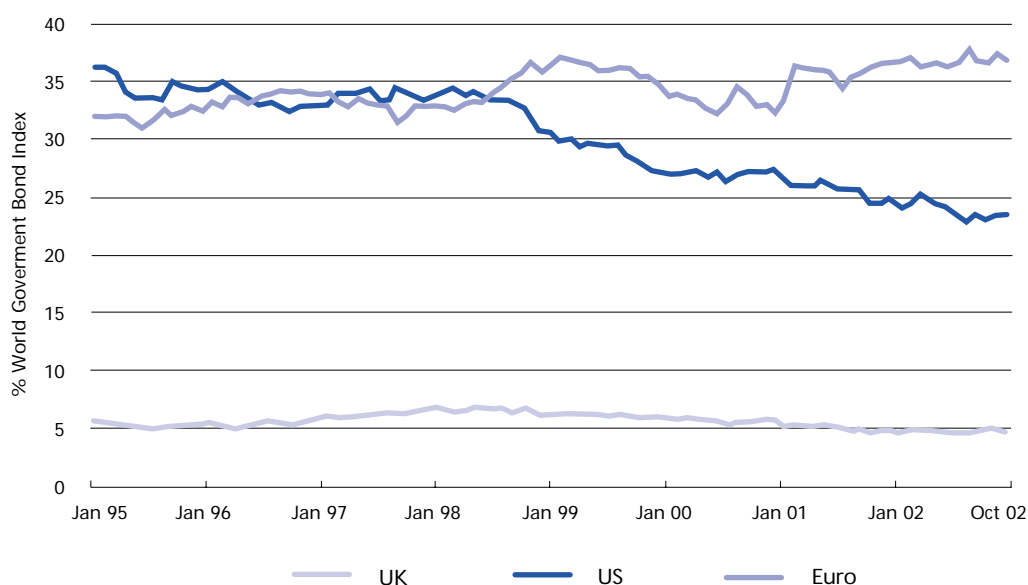
To appreciate the potential for eurozone bond markets it is worth pointing out that only about half of gross general government debt is in the form of bonds that are publicly traded. There is a chance that more could be made tradable (securitising government debt), which could have tremendous implications for both markets and intermediaries who are presently extending loans directly to the governments.

But obviously government bonds are only part of the universe of bonds available. One measure to assess the totality of the bond market rests on the Schroder Salomon Smith Barney Broad Investment Grade Performance Index, which has a minimum size requirement for a bond of EUR 500 million outstanding. On this measure, the US dollar component was EUR 6.7 trillion equivalent at the end of October 2002 and the euro component was EUR 3.9 trillion, implying that the US dollar denominated bond market is about twice the size of the euro bond markets. As the index includes both the domestic market and "offshore" markets, it truly allows an "apples and apples" comparison.

Another measure rests on the European Central Bank's data on bonds eligible for repo money market operations, which effectively takes all euro-denominated bonds. The data

Even when looking at the totality of bond markets one thing is clear: after just four years, the eurozone has bond markets that compare favourably to that of the United States.

Figure 4. Relative size of eurozone, US, and UK government bond markets (in % of total)



Source: Schroder Salmon Smith Barney - World Bond Index

shows EUR 7.6 trillion of bonds outstanding, which is about the same size as the US market, though, of course, the US market would also have that long tail of small issues. But the key point remains: after quite a short period of development – just four years – the eurozone already has bond markets that compare favourably to that of the United States.

4. A review of structural developments in Europe's capital markets

We are now moving beyond issues of size and activity and take a look at key structural changes. Europe's financial markets have been subject to far-reaching structural changes as a result of EMU. For instance, the ECB's forerunner insisted on the creation of a Real Time Gross Payments System (RTGS) – which has become TARGET – to ensure that the single monetary policy would not be impeded by any difficulties in moving money around the eurozone. Settlement standards were also raised – for money and bonds. In this section, we focus on two other key developments that are taking place. One is the transformation of European stock exchanges from being “clubs” to profit-maximising companies. The other change concerns clearing and settlement, i.e. that essential – though less visible, and sensational – activity following once bonds, equities, and other financial instruments have been traded.

The transformation of European stock exchanges is largely driven by market participants' response to technological changes.

To start with the transformation of European stock exchanges, a key feature here is that while politicians have set the scene, market participants within the financial chain are embarking on sweeping changes in the way they embrace technological advances. In assessing how the European stock exchanges will evolve in the coming years, perhaps the biggest difficulty is that virtually all aspects of equity dealing are undergoing change simultaneously. An analysis of the different functions that used to be combined under the single roof of the stock exchange may help shed some light on the way in which these functions can be fulfilled, or may change, in the new world.

An original driver for the creation of stock exchanges was the need for a “club” to create and enforce rules to ensure the solvency of the members so that the credit risk of deferred settlement was minimised. In the world of open-outcry, the physical proximity of a central market place, preferably in a grand and ornate 19th century building, also provided some transparency, as well as liquidity amongst the dealers. Policing issuers and investors was a third function that was sometimes backed by a legal monopoly. As a result, investors and issuers had to abide by the rules of the local stock exchange because they had no alternative mechanisms available.

The club of stock exchange members usually managed the processes carried out within the ornate building. Key functions would normally include:

- overseeing the financial soundness of the members to protect members dealing with each other and the public customers of the members; the latter function would often include some sort of guarantee fund;
- conduct of business rules towards each other and the public customers of the stock exchange's members;
- setting listing rules for companies; the initial prospectus for a listing would be checked and then the issuer would have to agree to make additional disclosures from time to time; in effect, this imposed standards of corporate governance;
- organising linkages into the settlement chain of payments and security delivery;

- information services were a valuable source of income as the stock exchange had the monopoly of price information that investors needed; moreover, information flowing from listing rules would be reported to the stock exchange first, and then re-broadcast to the general public.

The key element in this process was that the club had a certain responsibility for public policy in the financial sector that could be enforced by the effective monopoly of capital-raising opportunities. However, the club was run, ultimately, for the benefit of its members. This is the area where changes have been most dramatic, as stock exchanges have turned themselves from clubs into profit-maximising corporate entities. These entities must develop their own customer base and adapt their systems infrastructure in order to meet customers' needs. Those customers – investors, intermediaries, and issuers – may correspondingly re-examine their own best interests rather than simply accepting *diktats* from the old pattern of national authorities. Responding to the needs of customers is a key challenge for the new model of a stock exchange.

The architecture of European exchanges has changed dramatically in a few years.² Critically, Euronext, Deutsche Börse, and the London Stock Exchange have all become listed companies. Moreover, they have seriously discussed a wide variety of methods of co-operation, including offers to purchase. They have also absorbed players in various other sectors – clearing and settlement, derivatives markets, and central counter-parties.

The new model is still evolving, driven by technological advances and regulatory changes, and the traditional functions of the stock exchange are being questioned. As an example, information services have exploded everywhere and the rationale for making a stock exchange the initial point of contact now seems slender when investors and intermediaries rely on screen-based providers for all other instantaneous information. Even listing rules will be moved away completely from the exchanges by the Prospectus Directive.

One of the major questions facing equity transactions is the future functionality of the stock exchanges' trading platforms. The well-publicised danger is that, as re-invented financial service providers, the exchanges focus their resources towards the liquid end of the stock market. Major stocks are so actively traded that liquidity is rarely an issue for the average investor, but this is often not the case for smaller stocks.

In this context, it is important to have well-regulated financial intermediaries, whatever entity – public or private – performs the regulatory function. Electronic auction systems enable investors from all over the globe to deal at the best price available at that instant. However, that leaves open the question of how liquidity is created to provide the counterparty to that investor's trade. Order-driven platforms combined with a quote-driven infrastructure offer a viable answer to these concerns. But then, when a dealer assumes that risk, adequate compensation must be available.

Finally, as most exchanges become electronic and remote trading becomes possible, it is essential for the continued systemic stability of the equity markets that trading functions continue to be carried out by adequately capitalised and regulated exchanges, clearing

A key feature of the changes in the European exchange landscape is that stock exchanges have turned from clubs into profit-maximising entities.

² Figure A1 in the Annex illustrates the complexity of the European exchange landscape.

houses and financial intermediaries. Permitting unregulated and thinly capitalised software or technology companies to provide key processes in electronic securities transactions creates potential new risks.

Moving on to clearing and settlement, i.e. the plumbing of the financial architecture, we start by recalling that there continues to be considerable scope for making cross-border capital market activity more secure and cost-efficient. Examining what can be done on this front is part of the remit of the Giovannini committee, which was organised by the European Commission to analyse some of the detailed nuts and bolts that need to be solved to approach that Holy Grail – a genuine single capital market.

Making clearing and settlement more effective is crucial for creating an efficient single capital market.

Cutting the costs of trading improves market liquidity, which – in the bond market – can impact the intermediation spread that a bank can make between its deposit rate and its lending rate to, say, triple B companies. If the securities markets can get in the middle of that banking spread by cutting dealing costs as well as the holding costs (which includes all the settlement aspects), then there is a squeeze on the cost of bank intermediation that is to the advantage of both lenders and borrowers. In sum, making clearing and settlement more effective is a necessary (and powerful) effect in improving the efficiency of the capital markets.

The method of working of the Giovannini group is interesting. The group, which commenced working when the financial community was focussed on the changes needed in markets to get EMU running, addressed the key question of how to get 15 systems to evolve very quickly into one single system that would deliver the benefits of the genuine single capital market for the EU.

Participating in such an exercise certainly forces recognition of the complexity, and the historical nature, of the evolution of a financial system. In each member state, there is a different amalgam of primary legislation, secondary legislation, rules of public bodies (some of them formally independent) and finally, market conventions agreed by the dealer community when a particular market comes into existence. Some of these conventions, in fact, finish up as laws.

How to make these have consistent practical results so there is a single market? The group started by taking an inventory of what exists and what is directly relevant. Then what is seen as “best practice” is laid out and usually quite high agreement is achieved – but the real conundrum is how to change from what is today to what is now seen as that new ideal. Primary legislation “from Brussels” is always seen as absolutely the last option because it will take so long. Instead, fostering competition is seen as the most effective way of inducing change: when people realise they are about to be outflanked commercially, entrenched positions evaporate miraculously. This is what seems to have happened in the clearing and settlement area – now two main systems in the EU – and the stock exchanges have already shrunk to three major groups.

In November 2001, the Giovannini group issued its first report (Giovannini 2001), which identified 15 barriers to efficient cross-border clearing and settlement in the EU. These barriers have been grouped under three headings: (i) barriers relating to national differences in technical requirements/market practice, (ii) barriers relating to national

differences in tax procedures, and (iii) barriers relating to issues of legal certainty that may arise between national jurisdictions. To illustrate, the first group of barriers comprise:

- technical requirements versus market practises;
- absence of intra-day finality;
- practical impediments to remote access;
- national restrictions that require multiple systems;
- national differences in IT and interfaces; rules on corporate actions, beneficial ownership, and custody (this is the localisation debate); settlement periods; operating hours and settlement deadlines; securities issuing; restrictions on primary dealers and market makers; and in location of securities.³

The second report of the Giovannini group came out in April 2003 (Giovannini 2003). In this report, the group proposes to replace existing barriers by a set of technical standards, market convention, rules, regulations and laws that are consistent with a barrier-free environment for clearing and settlement. Furthermore, the group suggests a strategy of how to remove existing barriers, based on an appropriate sequencing of actions, a clear allocation of responsibility for those actions and aggressive but realistic deadlines. Obviously, many of these actions will require legislation - either at the Member State level, or possibly by the EU itself. There is a natural tendency to set deadlines that will fall within the timeframe of the Financial Services Action Plan (see Section 5), i.e. the year 2005. However, there is much to be done yet to uncover the exact tasks that are needed, so there may easily be some overshoot before all the key problems are dealt with.

Building on its earlier findings, the Giovannini group has now proposed measures to remove barriers to cross-border clearing and settlement in the EU.

In any event, the priority should be to achieve legal clarity within the same timeframe as the technological changes flowing through in the trading and settlement systems. The more the owners of those systems see it as likely that they will get a commercial benefit from their investment - due to adequate regulatory reform - the more likely they are to make the investment. In short, a virtuous circle may be at hand. That circle may be accelerated if market participants also believe that the "front office" will be able to trade securities freely across borders - as well as settle the resulting trades.

5. Regulatory reforms aimed at integrating EU capital markets

To set the stage for the discussion in this section, it is probably worth recalling that the creation of a single market for financial services in the EU has been on the agenda for a long time. In fact, as for goods and non-financial services, the 1992 Single Market programme envisioned a single market for financial services to be in place by end-1992. What was largely achieved with respect to goods and non-financial services remains a worthy but yet to be accomplished goal in the area of financial services.

The problem was not that the necessary directives, which allow financial institutions to offer their services across borders without the need to establish subsidiaries, were not put in place on time. Rather, the process of establishing the Single Market for financial services

³ With respect to the latter, the impact of the Robert Maxwell scandal nearly a decade ago is worth mentioning. This caused such a loss of mutual trust amongst regulators that there was a sudden proliferation of requirements to locate institutional assets in the home state - the exact opposite of a single market.

The Lamfalussy committee made innovative proposals to make the EU decision-making process more suitable and effective for the regulation of financial markets.

has suffered from delays in (fully) implementing the relevant directives. About five years ago, the European Commission realised that the coming of the euro, together with enlargement and technological change, meant that the original 1992 programme was looking a bit long in the tooth. What was to be done about it? A committee was formed and came up with a wish list, which has turned into the Financial Services Action Plan (FSAP) - consisting of 42 measures to streamline the regulation of retail and wholesale financial markets - to be implemented by end-2005. This plan was endorsed at the Lisbon summit in March 2000, when the EU set itself a new strategic goal, namely to become the most competitive and dynamic knowledge-based economy in the world by 2010.⁴ It was rightly recognised that to achieve this objective, it was essential to have efficient and transparent financial markets that foster growth and employment by better allocating capital and reducing its cost.

Following the adoption of the FSAP, a small committee was set up to study the possibility of ensuring that the timetable was met. In its report of February 2001, this committee of "wise men", chaired by Alexandre Lamfalussy, came up with ambitious proposals to reform the legislative process required to bring into existence the long-promised single EU capital market (Lamfalussy 2001). The report put forward a variety of reform measures - with innovative proposals to make the EU decision-making process more suitable, and effective, for the regulation of financial services. The remainder of this section elaborates on these proposals, in particular their political and constitutional implications.

Achieving the practical reality of an open, competitive financial market on a European scale requires thoughtful regulation to mould 15 sets of national rules into one secure system. But there may be an inherent tension between the desirable goal of subsidiarity and a uniform, harmonised, single financial market. This raises important political questions.

Market participants may well gnash their teeth about the problems thrown up by the implementation of the FSAP because it has pitch-forked them into the middle of a significant constitutional argument precisely because the Lamfalussy Report focused on the issue of "governance" rather than "what should be done". The latter has been commonly accepted for several years - engendering a rising tide of frustration at the apparent inability of the EU's political system to deliver the necessary reform. That common ground on what needed to be done was the basis of the FSAP, and explained why it was put together so easily and quickly. Yet, the fudges left over from 1992 were precisely the difficult elements that impinged on what some Member States regard as key items.

Many in the markets feel that the triangular power structure of the EU - to adapt the description of the US Constitution: Commission "proposes" and Council (the national Finance Ministers) co-decide with Parliament to "dispose" - risks creating a legal framework for financial services that may not offer consumers the full benefits of the single currency and single market. In practice, criticisms are levelled at the Council for conducting secret negotiations that, historically, have fallen victim to nationalistic pressures. In essence, the key demand from the market is that the Council shares power in an open, reasoned manner - transparency is the watchword.

⁴ Table A1 in the Annex summarises the progress made in implementing the FSAP.

Financial markets will probably be in a permanent state of evolution, as technology and ageing have their impact. In these circumstances, the regulatory framework has to be adapted timely to ensure the efficiency and stability of an increasingly integrated EU capital market. This gives rise to constitutional concerns, highlighted by the Lamfalussy Committee. It proposed the setting-up of a speedy mechanism to amend secondary legislation because it is inevitable that much of the legislation of the FSAP will have to be up-dated over the years. Either it will have been done in a rush and be found to be wrong, or it will be outmoded by technological developments, which are moving at a rate that cannot be foreseen. The EU thus needs a mechanism for rapid and effective clarification/amendment of these measures. But this is a constitutional innovation because there must be a delegation of authority to amend this legislation from the national governments to "somewhere" at a European level.

Who should have that authority? Is it the European Parliament; or is it the Council, i.e. EU governments? Historically, the governments actually created many of the problems by ineffective primary legislation, and the FSAP is meant to correct these. In light of this, will market participants trust governments again to create a real single market? The answer may be "no". The best bet may be to enhance the influence of the European Parliament and, crucially, maintain that authority down the chain of implementing rules. But giving Parliament that role may be a major constitutional shift.

It is a mark of the immaturity at the EU-level that the mechanisms of keeping secondary legislation up-to-date have not yet developed – a basic problem of the EU legislative system, but one that is particularly ill suited in the rapidly changing sphere of finance. The EU cannot go back to the Parliament and the nation states repeatedly to ask for changes on very technical matters. But it is clear that competitive disadvantages are bound to emerge when operating on out-dated laws after, say, technology has moved forward.

It is a mark of immaturity at the EU-level that the mechanisms for keeping secondary legislation up-to-date have not yet developed.

But the need to bring citizens the full benefits of the single currency is forcing the necessary constitutional innovation. That is exactly why the three institutions – Commission, Council, and Parliament – are determined to set precedents now that will preserve their institutional prerogatives. They are petrified of setting precedents in the field of financial services that could be applied elsewhere. This issue is now a topic for the Convention on the Future of Europe that is scheduled to present a draft Constitutional Treaty to the Heads of Government in June 2003.

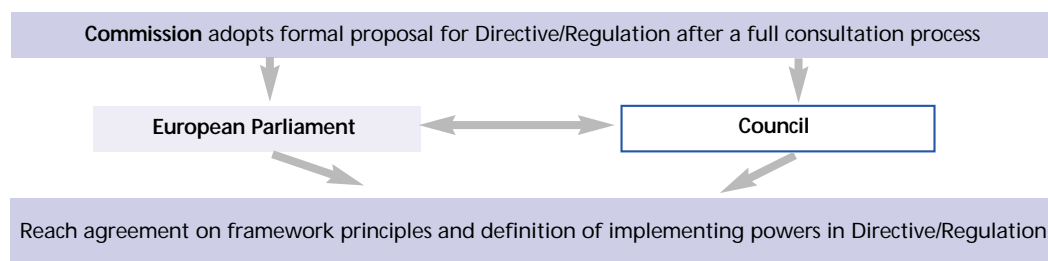
Let us now take a closer look at the process that the Lamfalussy committee has proposed for decision-making and the implementation of financial market regulations. As Figure 5 illustrates, the process, as currently designed, comprises four levels. Level 1 concerns framework principles (primary legislation), Level 2 deals with detailed technical measures (secondary legislation), and levels 3 and 4 are essentially about implementing and enforcing the regulatory framework.

The whole process is, roughly speaking, on schedule for the primary legislation but it may be difficult to complete all the detailed national measures and finalise every single detail. But what are the main strengths and weaknesses of the Lamfalussy process?

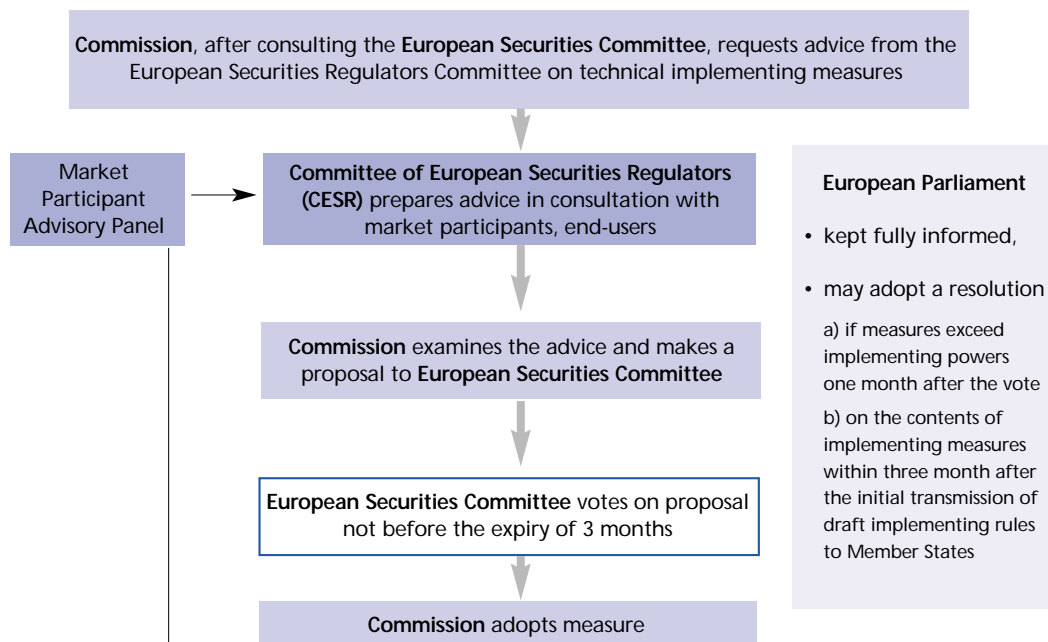
The hallmark of this process is open and transparent discussion with all market users – and at every level. The approach to consultation is welcome as it is clearly making a major effort to be open to market participants and to consult them. Beyond the formal system, perhaps one of the key aspects of the new regulatory system is the informal effect of these

Figure 5. The 4-level Lamfalussy process

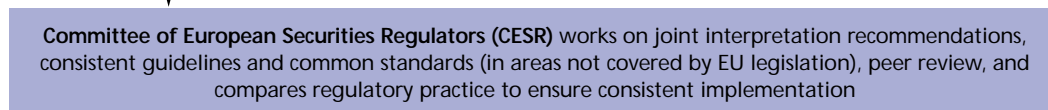
LEVEL 1 (primary regulation)



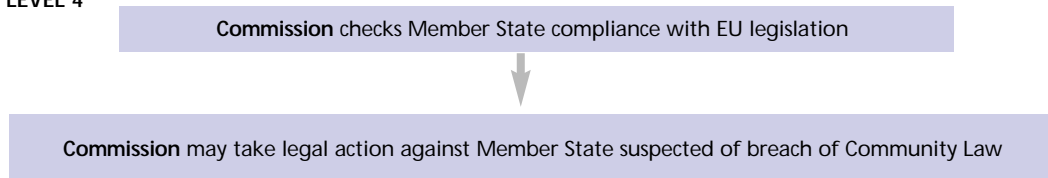
LEVEL 2 (subject to the sunset clause of four years laid down at Level 1)



LEVEL 3



LEVEL 4



officials getting to know each other personally and building up mutual trust about cross-border enforcement. The experience of consultation with the UK's Financial Services Authority (FSA) is instructive – and should stimulate some thought about the mechanics of “consultation” generally. The FSA is setting an excellent example for other European regulators in terms of openness. Nonetheless, there is a real risk of the process falling short of achieving its goals due to the sheer scale. The total of discussion papers stood at 107 about a year ago. Today, the total is over 160. Can this really be done effectively – on both sides? Are the Commission and the Committee of European Securities Regulators (CESR) sufficiently staffed to deal with this scale of activity? And what about the burden on the private sector trying to respond?

Notwithstanding the considerable progress that the Lamfalussy process involves, there are shortcomings. At level 2, Parliament is restricted to considering whether implementation is consistent with the powers agreed – in co-decision – in the Directive. What appears to be missing is the power to review a decision that is thought to be wrong, rather than merely *ultra vires*. Parliament gets the details of meetings, the agendas and the minutes. That means they will be effectively public so there will be an additional level of the interested public – including market practitioners – able to scrutinise progress, but only after the event.

The hallmark of the Lamfalussy process is open and transparent discussions with all market users, but despite the progress that this implies, shortcomings remain.

In practice, once the discussion goes into conclave between the Commission and Council – as represented by the admittedly “high-level” European Securities Committee (ESC) – the outside scrutiny disappears. That is the vital moment when the Commission becomes aware through informal discussions that it may have to trim its proposals to achieve agreement by qualified majority voting. At that critical moment, the tried, tested and failed mechanism of a secretive Council Working Party takes over and may again produce decisions of the type that has led us to the current position of too much poor quality legislation.

What is the court of appeal under the Lamfalussy proposal and who has the standing to make the appeal? This is the weak point of the proposal: if the ESC agrees to a proposal, it becomes law. The only appeal may be from the Parliament, but solely on the technical grounds that the decision was *ultra vires*; but this is rather different in significance to the blunt question: is that proposal wrong, despite all the consultation that has gone on?

Overall, the EU needs time to see how this system settles down in practice. Not a single Directive has yet been put through the complete process – all the way to enforcement by the Commission (Level 4 of the Lamfalussy process). But a very promising start has been made and there is a tremendous impetus to complete the FSAP⁵ and to finish up with a single capital market, which will be more single than the United States' internal market.

6. Conclusion

Powerful forces are re-shaping Europe's financial landscape and the EU needs to be sure that these changes are channelled into beneficial paths so that its citizens gain full advantage from the advent of the single currency.

In the 1990s, progress in creating the Single Market for financial services has been disappointing. Nevertheless, EU Member States had been well past the point-of-no-return on the journey to a single capital market, and new, promising efforts are now under way

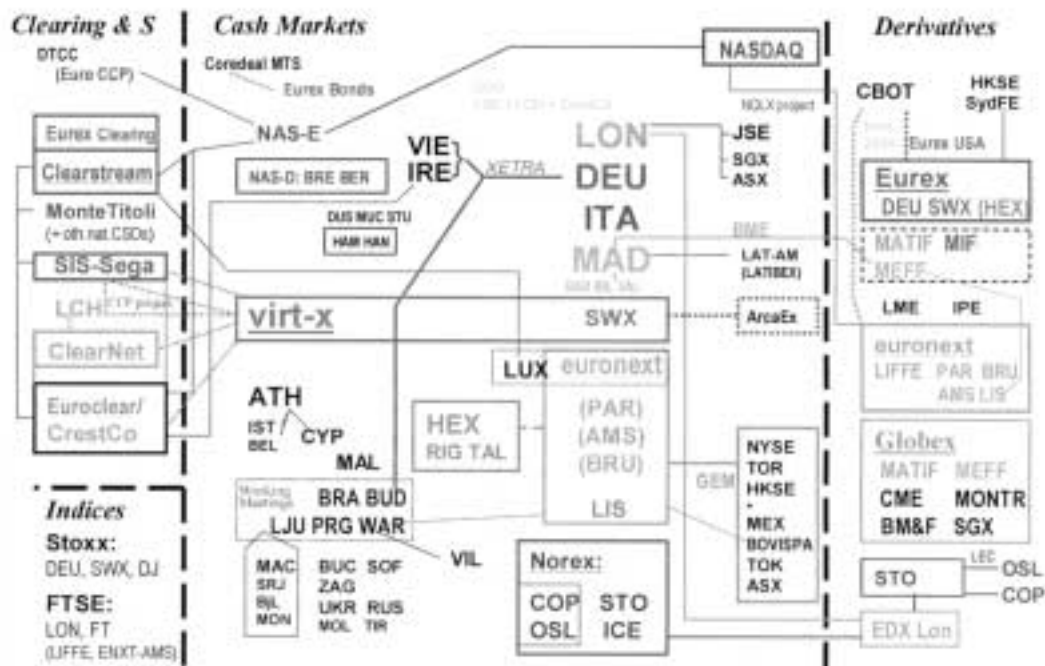
⁵ The FSAP Timelines provided by *GrahamBishop.com* make it easy to follow progress.

to achieve that goal, notably in the context of the FSAP, the Lamfalussy process, and the Giovannini group.

The final steps will not look like the crowning glory. Rather they will be a seemingly interminable march through the undergrowth of the financial system. As technical matters such as clearing, settlement and payments move to a pan-European basis, constant attention is required to make sure that speed, and an admirable goal, do not open the door to the law of unintended consequences! This is not glamorous work - but must be done diligently and patiently if Europe is to reap the rewards: significant extra growth in the shorter term and much higher pensions in the longer run. The hope is that this can be done in good time for the 10th anniversary of the introduction of the single currency - meeting the goals laid down in Lisbon as the millennium began.

Annex

Figure A1. European exchanges at end-2002



Notes: The purpose of this figure is simply to illustrate the complexity of the links and alliances existing in Europe's stock exchange landscape. The most recent version of this figure and an explanatory legend can be found on www.fese.org.

Sources: Federation of European Securities Exchanges (FESE) and Gregor Pozniak (pozniak@fese.be).

Table A1. Progress in implementing the Financial Services Action Plan (FSAP)

Measure	Initial time frame	Adoption expected	Key concerns	State of play
Prospectus	April 2002	June 2003	<ul style="list-style-type: none"> • annual updating provisions • choice of regulator for the issue of bonds • competent regulatory authority • single European regulatory agency 	<ul style="list-style-type: none"> • first reading Parliament finalised • political agreement in Council • awaiting first reading Council
Market Abuse	2003	End 2002	<ul style="list-style-type: none"> • financing of competent authority • frontrunning • transparency and disclosure of financial interests of responsible persons • save harbours • journalists 	<ul style="list-style-type: none"> • awaiting second reading Council
Investment Services Directive	2003	2003		<ul style="list-style-type: none"> • proposal published in November • awaiting first reading Parliament
Takeover Bids	2000	2003	<ul style="list-style-type: none"> • multiple voting shares • golden shares • reciprocity US legislation • protection of employees' rights 	<ul style="list-style-type: none"> • proposal published October • awaiting first reading Parliament December
International Accounting Standards	2002	Early 2003		<ul style="list-style-type: none"> • proposal published end May • awaiting first reading Parliament
Pension Funds	January 2002	December 2002	<ul style="list-style-type: none"> • prudent man 'plus' • investment rules • social issues • cross-border pensions 	<ul style="list-style-type: none"> • political agreement reached in Council • awaiting Council Common Position
Taxation of Savings Income	2000	December 2002	<ul style="list-style-type: none"> • negotiations with Switzerland 	<ul style="list-style-type: none"> • consultation process finalised • awaiting signature

Notes: Based on published proposals (autumn 2002). The FSAP Timelines provided by *GrahamBishop.com* make it easy to follow progress.

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