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An assessment of 10 years Financial Services Action Plan (FSAP)

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ECONOMIC AND MONETARY AFFAIRS

An assessment of 10 years Financial Services Action Plan (FSAP)

Study

Abstract

This is a study consisting of a general assessment of the main achievements and limitations of the FSAP in terms of integration of the European market, harmonisation of rules, efficiency and consumer protection.

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EXECUTIVE SUMMARY

The Financial Services Action Plan (FSAP) was an ambitious legislative programme adopted in May 1999 whose main objective was to increase financial integration in Europe. The completion of the FSAP is considered as the principal achievement of the ECON Committee of the European Parliament over the past term. All segments of the financial industry – banking, insurance, pension funds, asset management and securities markets – have been impacted by FSAP-related legislation. Most directives have now been transposed in national legislation and implemented. This study consists of three sections:

- A general assessment of the main achievements and limitations of the FSAP in terms of integration of the European market, harmonisation of rules, efficiency and consumer protection.
- A review of the key shortcomings in EU financial regulation and supervision in the light of the financial crisis that erupted in the summer of 2007.
- Recommendations for legislative initiatives of the European Parliament in the coming years.

The FSAP's achievements and limitations: main findings

- Banking and insurance: the main achievement of the FSAP was the adoption of risk-based prudential regulation, namely the Capital Requirements Directive and the Solvency II Directive respectively. A consensus still needs to be found for the prudential regulation of pension funds.
- Economic cycles: there is a need to introduce regulatory provision to counterbalance the pro-cyclical effects of the Capital Requirement Directive and of the Solvency II Directive.
- Defined benefit pension funds: a specific prudential legislation is needed but pillar 1 and pillar 3 would have to be specifically tailored. This might lead to reopen Solvency II to insure a common level playing field when insurance companies provide the same services as pension funds.
- The European Parliament might want to consider a legislative initiative with the objective of promoting defined contribution pension funds, able to meet the needs of the ageing European population. Such European pension funds could be successfully exported to third countries.
- Payments: while costs of cross-border payments fell sharply, most payments are still executed within the borders of EU Member States. The Single Euro Payment Area (SEPA) project needs a new impetus.
- Asset Management: the adoption of a legislative framework for UCITS has been the major force in the integration of the asset management industry. However, this achievement did not translate into lower costs for retail investors investing in cross-border funds.
- Retail / Savings: although the adoption of the Savings Tax Directive contributed diminishing tax evasion on interest rate products, lack of harmonisation of tax rates is one of the main obstacles to the integration of the retail market. The European Parliament might want to consider launching an in-depth reflection in order to define what would be an adequate savings policy in the EU. Taxation should give the right incentives to European savers.

- Securities: general trends in the functioning of securities markets contributed more to the integration of primary markets than EU legislation. In the EU, equity markets are significantly less integrated than debt markets.
- Country Bias in Investment: the creation of the Euro contributed more to portfolio diversification than the FSAP.
- Transparency: the Prospectus Directive, the Transparency Directive and transition from national accounting standards to IFRS are major contributions to harmonisation and to the improvement of financial disclosures. However, great vigilance is needed to ensure that this progress will continuously improve information accessible to retail investors, rather than only protect issuers against court actions based on insufficient information.
- Corporate Governance: the FSAP only played a minor role in enhancing and harmonising corporate governance practices. The Directive of Takeover Bids failed to remove obstacles to takeover activity in Europe.
- Market Structure: the competition between trading venues resulting from the Markets in Financial Instruments Directive (MiFID) had unintended consequences. Fees charged by regulated markets and clearing houses decreased, but there is no clear evidence that these price reductions were passed on to final investors. EU equity markets are less transparent after MiFID implementation than they were before. On post-market operations, there is a need for new EU legislation as the self-regulatory approach of the “Code of Conduct” has shown its limitations.

Lessons learnt from the financial crisis

The financial crisis revealed the existence of material shortcomings in EU banking regulation and supervision.

To begin with, the liquidity crisis in the autumn of 2008 led some observers to question the very foundations of the risk-based regulatory approach adopted within the FSAP, which may have encouraged herd behaviour of market participants. The so-called Pillar 1 of Basel II and of Solvency II allows firms to calculate capital requirements on the basis of external credit ratings and internal models similarly designed and using similar information. Pillar 3 is based on market discipline and ostensibly tends towards the same result. Market discipline has already resulted in many of the largest banks setting capital levels higher than the required level.

More specifically, the crisis gave rise to a wave of criticism focused on specific regulatory provisions: an overall under-evaluation of risks taken by the financial industry in stress scenarios; a pro-cyclical impact of the combination of existing accounting and regulatory rules; poor assessment of operational risks; ineffective dealing with off-balance sheet operations. Several of these regulatory gaps are now in the process of being filled. However, much caution is needed to avoid unintended effects of increased capital requirements while the situation of banks remains fragile.

A difficult issue that international regulators will have to tackle is one regarding systemic institutions deemed “too big to fail”. The crisis also revealed that deposit guarantee funds offered insufficient protection and were insufficiently harmonised. These issues have been partly dealt with in the revision of the Deposit Guarantee Directive, but further improvements are still needed, as well as extending harmonisation to insurance and securities funds.

The financial crisis also illustrated the magnitude of the threat financial crises may represent to the integration of the European financial market. Apart from the ECB, European institutions were not empowered for effectively managing a crisis. Central banks were able to provide exceptional amounts of liquidity to banks and national governments implemented rescue packages for distressed banks, including burden-sharing agreements in some cases. But the EU "Level 3" Committees did not play a significant role in this area. The Commission has been diligent in enforcing compliance of the rescue packages with competition regulation but has not otherwise much contributed to the shaping of emergency measures.

The Commission has been reactive in drafting a legislative proposal to revise the supervisory framework, following the recommendations made in February 2009 by the High Level Group chaired by Jacques de Larosière. While some criticism has focused on the fact that the proposed framework still largely rests on national authorities, it appears reasonable not to shift all responsibilities to new European bodies with no track record and limited knowledge of local actors, especially in a period when defaults of large financial firms cannot be excluded.

The detailed design of the new institutions has not been decided at the time of writing. The European Parliament will have to ensure that the new European authorities foreseen for each segment of the financial industry are effectively accountable to the European Council and the European Parliament. As the European authorities will be responsible for consistency among national regulators supervisors, their accountability will provide incentives to all authorities in Europe to act for the general good in Europe, rather than for narrow domestic objectives.

Further developments of European financial legislation

The report identifies three possible new area of legislative initiatives by the European Parliament in the near future:

- **Filling regulation gap in the regulation of financial services**

The Madoff scandal highlighted the need for the regulation of investment funds' depositories.

Regulation of hedge funds should be implemented, but the condition for efficiency is that the European legislative initiatives in that area should be consistent with the proposals of the Technical Committee of the International Organization of Securities Commissions (IOSCO). If it is felt that immediate action is needed, supervisors in Europe and the United States could act immediately by closely overseeing or even limiting the leverage provided by investment banks offering prime brokerage services to hedge funds, regardless of their location.

The European Parliament could also consider the completion of the regulatory framework concerning commodity derivatives.

- **Consumer protection**

Although the FSAP was intended to benefit final users, its main impact was on the relationship between different types of financial services providers within EU countries and across borders. There is a case for launching an ambitious plan of action to strengthen and harmonise consumer protection.

Indebtedness of households has dramatically increased over the last ten years in most European countries. Although outstanding loans are now stabilized, over-indebtedness is still increasing. A European initiative is needed to promote responsible lending and borrowing. Such a policy should include all kinds of credits, not only consumer credits. Consistent, preventive and curative policies should be strengthened to tackle over-indebtedness.

INTRODUCTION

The Financial Services Action Plan was an ambitious legislative programme adopted in May 1999 whose main objective was to increase financial integration in Europe. It was translated into European legislation and then transposed into national laws during the following two legislatures (1999-2009). The completion of the FSAP is considered to be the ECON Committee's principal achievement during this period (Committee on Economic and Monetary Affairs, 2009). Two major related developments took place simultaneously, namely the introduction of the Lamfalussy process for financial regulation and the adoption of the International Financial Reporting Standards (IFRS).

The FSAP was driven by four objectives, namely 3 'strategic objectives' and a 'general objective':

- Strategic Objective 1: A single wholesale market
- Strategic Objective 2: Open and secure retail markets
- Strategic Objective 3: State-of-the-art prudential rules and supervision
- General objective: wider conditions for an optimal single financial market

The latter general objective itself covered two components:

- "Addressing disparities in tax treatment", and
- "An efficient and transparent system for corporate governance" (European Commission, 1999).

The FSAP is now almost complete as most directives are transposed into national laws. Except for the Money Laundering Directive[1] and the Directive 2007/14/EC implementing the Transparency Directive, all FSAP directives have been transposed by almost all Member States and checked by the Commission[2]. With the implementation of the FSAP now being almost complete, it is possible to assess its achievements and shortcomings.

A legislative agenda as ambitious as the FSAP could only be a step-by-step process. But the economic and financial crisis which began in summer 2007, and accelerated suddenly in the autumn of 2008 following the bankruptcy of Lehman Brothers, raises the question as to whether priorities were adequately set in the course of the FSAP process. To what extent were the intense debates on the distribution of equity transactions costs (representing a few basis points) relevant, when equity portfolios lost half of their value in a few months? To what extent were the intense debates on quarterly accounts relevant, when banks suddenly had to recognize that they were simply no more able to evaluate the huge accumulation of complex financial products in their balance sheets or in their Special Purpose Vehicles (SPV)? To what extent were the intense debates on the wording of the consumer credit factsheets relevant, when millions of overindebted households could finance consumption thanks to the illusory effects of a continuous inflation in real estate prices?

[1] Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing

[2] http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition

The crisis is generally recognized as the outcome of excessive leverage in the financial system and of fundamental economic imbalances in the distribution of assets and liabilities across countries and economic actors. Economic, budgetary and monetary policies should aim at resolving or mitigating these fundamental issues involving the cohesion of modern societies. However, financial regulation and supervision should at least prevent the financial sector from exacerbating the problems.

Reviewing the FSAP in the light of the crisis leads questioning some implicit assumptions that underlie the fine tuning of FSAP legislation. Examples include:
- The assumption that the capital of banks could safely stay at historically low levels because more sophisticated methods were used for the evaluation of risks.
- The assumption that financial infrastructures (exchanges, clearing houses, settlement platforms, depositories) are commercial activities, which would imply that they are open to competition.
- The assumption that regulators can rely extensively on market discipline.
- The assumption that it is sufficient for conflicts of interest to be disclosed, as opposed to forbidden.
- The assumption that securitization, through spreading the risks to investors, mechanically strengthens the banking system.

This report starts with an assessment of the FSAP's achievements and limitations in the four segments of the financial industry: banking, insurance and pension funds, asset management, and securities markets. The second section is devoted to the analysis of the new policy context created by the global financial and economic crisis. The third section is devoted to recommendations for further action in three areas: filling the gaps of existing regulation, customer protection and accounting standards.

The report does not intend to provide a fully comprehensive analysis into all of the FSAP's dimensions, but to provide a useful input for the European Parliament's work in the face of unprecedented policy challenges.

1. ASSESSMENT OF THE FSAP'S ACHIEVEMENTS

1.1 Banking

The main FSAP directives adopted in the banking sector are the Capital Requirement Directive (CRD)[3] and the Payment Services Directive (PSD)[4]. We also review in this section the Directive on Taxation of Savings[5] and the successive Money Laundering Directives, which apply to banks and other segments of the financial industry.

1.1.1 Prudential regulation of banks

The key FSAP legislation for prudential regulation of European banks and investment firms is the Capital Requirements Directive (CRD), which is based on the provisions of the Basel II capital accord. Like Basel II, the CRD rests on three 'pillars':

- Pillar 1 determines capital level requirements on the basis of risk exposures, the latter being calculated using either standard weightings or internal models (International Rating Based, or IRB banks)
- Pillar 2 determines the conditions of prudential supervision by national authorities.
- Pillar 3 refers to market discipline and transparency requirements.

Moreover the EU decided to add two specific modalities beyond the minimum requirements of the Basel II implementation:

- The CRD applies to all banks in Europe, whereas Basel II is only intended for large international banks.
- The CRD was made mandatory for European banks as of 1 January 2008.

Implementation of Basel II has been a major challenge for banks and regulators. The previous Basel 1 accord (the "Cooke ratio") required banks to hold a level of capital at least equal to 8% of their risk-adjusted assets, the weightings of the latter being flat for each broad category of credit risk, from 0% of assets (in the case of sovereign debt) to 150% (for the debt instruments with the lowest rating by rating agencies). The new rules have forced banks to calculate capital requirements debtor by debtor, using external ratings or internal models. The use of internal models had already been admitted by the Basel Committee for the evaluation of market risk since 1998, but the fact that the use of internal models allowed for lower capital requirements in the new rules was a powerful incentive to use more sophisticated risk measures. According to CRA, banks accounting for 50% to 90% (depending on the countries) of banking assets use models which have been authorised by supervisors (Malcolm *et al.*, 2009).

[3] Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

[4] Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC

[5] Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments

Within a credit institution, the introduction of a risk-based capital requirement had a far-reaching impact on several functions involved in risk control: General managers oversee summary indicators of risk exposure and calibrate risk taking depending on the requirement of shareholder returns and capital constraints. The asset-liability management departments assess the overall risk taken by the firm. In the case of a bank, the risk of interest rates is the main element of this monitoring. Trading desks operate within position limits. Risk measures are used to price financial services and products (Basel Committee on Banking Supervision, 1999). Creditors and surveillance authorities monitor risks taken by the firms. On the whole, a common culture has emerged from the new regulatory framework.

The use of models for measuring risk exposures have been increasingly used by banks since the bond crisis of 1994. A benefit of CRD has been to introduce a common approach of risk among banks and regulators, based on the concept of Value At Risk (VAR), a tool commonly used not only by risk controllers but also on trading desks directly: trading activity is typically constrained by VAR limits, which measure the maximum loss risk exposure with a given probability (for example 99%). VAR proved to be an efficient tool in normal market conditions, but the tails of statistical distributions were less satisfactorily modelled, even though stress tests were foreseen in Basel II from the beginning.

Given the short period of time since the directive has been applied, there is still little usable information on its impact. One of the most significant indicators relates to Pillar 1, namely the ratio of Tier 1 capital to weighted risks. The ECB found that the median Tier-1 ratio for the “Large and Complex Banking Groups” (LCBGs) in the euro area increased in 2008, as compared to 2007 from 7.76% to 8.15%, after having deteriorated in 2007 (ECB, 2009). For a subset of 16 LCBGs, which have published quarterly figures, the ratio remained unchanged in the first quarter of 2009. Higher ratios result from evolutions of the numerator and the denominator: in the aftermath of the financial crisis, weighted risks appear to have diminished following sales of assets, while most banks raised capital to cover their losses. These trends show that the pillar 3 (market discipline) has been more stringent than quantitative capital requirements.

Most limitations of Basel II and CRD have been highlighted by the financial crisis, both from an individual firm’s standpoint and from a systemic standpoint. These limitations are reviewed in the second section of the present study devoted to “The FSAP in the light of the financial crisis”.

However, the danger of pro-cyclical effects of regulatory standards for the banking and insurance industries had been discussed even before the financial turmoil. In particular, when balance sheets are valued at fair value and solvency capital requirements are based on these elements, regardless of the position in the business cycle and regardless of the market conditions that underpin the fair value valuations, there is an inevitable effect of pro-cyclicality. There is now a near-consensus in the prudential community that capital requirements should include an element counteracting pro-cyclicality in order to reduce the contribution of prudential rules in the formation of speculative bubbles, as well as to induce intermediaries to be more conservative in long expansionary phases, and conversely more risk-taking in downturns. Opinions vary on the most appropriate method to implement. Charles Goodhart (2009) argues that counter-cyclical measures to counteract booms are unpopular and difficult to implement on an on-going basis.

This enhances the case for making the shift towards counter-cyclical capital regulation irreversible. On the other hand, the successful example of the dynamic provisioning method in Spain[6] applied since July 2000 shows that independence of supervisors is not an unattainable goal. As proposed by Alexander *et al.* (2009), contra-cyclical rules could be implemented as part of pillar 2 of Basel II.

The measure of operational risk was also recognised as relatively less sophisticated than that for credit risk and market risk, regardless of the financial crisis. The introduction of a capital requirement to protect against operational risk is new in the prudential regulation, although this risk proved to be potentially costly for banks (The case of the rogue trader Kerviel at Société Générale is an example of the related risks[7]). The operational risk stems from weaknesses in internal procedures, technical systems and legal procedures. It could also include the reputational risk. Some events can be dealt with by using statistical methods, for example the delays in delivery of traded securities, but available databases do not go far enough back in time. And exceptional events such as a general computer failure cannot be dealt with by using statistical models. A study on the market impact of methods used by European banks for measuring the operational risk would be useful.

1.1.2 Payments

The Payment Services Directive (PSD) provides the legal basis for the creation of an EU single market for payments and the related project of a Single Euro Payment Area (SEPA). The aim of the directive is that cross-border payments become as efficient as national ones. It is also to mandate transparency of terms and conditions at a pre-contracting level and to foster competition by opening the market to new entrants, the payment institutions. SEPA is an initiative of the banking industry supported by the European Commission and the ECB, whose objective is to make cashless payments in euro, easy, efficient and safe.

The SEPA migration officially started at the end of January 2008 for credit transfers, January 2008 for cards payments and 1 November 2009 for Direct Debit payments. However, in July 2009, credit transfers processed in SEPA format did not account for more than 4.4% of all transactions. Apart from Luxembourg and Cyprus, this percentage was below 3.5% in all other countries[8]. Moreover, the actual time schedule for Direct Debit payments will be delayed in several EU countries. Given the project's loss of momentum, the European Parliament adopted a resolution[9] in March 2009 that reiterated its support to SEPA. It requested the European Commission "*to set a clear, appropriate and binding end-date, which date should not be later than 31 December 2012".*

[6] The provisioning method which came into effect in July 2000 in Spain adds a statistical provision to the general provision. The statistical provision (based on internal models or standard risk weightings fixed by the Bank of Spain) increases when specific provisions are lower than expected provisions. If specific provisions exceed expected provisions, an amount is deducted from the latter. Although the statistical provision is not tax deductible, it reduces fluctuations in banks' profit.

[7] The fraud had a EUR 4.9 billion negative impact on the Group's pre-tax income in 2007. Source: Société Générale, Registration document 2009.

[8] Source: ECB http://www.ecb.int/paym/sepa/timeline/use/html/index.en.html

[9] B6-0111/2009 European Parliament resolution on the implementation of the Single Euro Payments Area (SEPA).

Besides the short term difficulties for the SEPA migration, the economic model of SEPA has still to be clarified. In particular, the multilateral interchange fee (MIF) for credit debits and card payments[10] will be forbidden from 1 November 2012. In the absence of adequate resources, economic viability and investment ability of SEPA can be questioned. A key driver for the development of SEPA would be its adoption by government authorities, which account for 30% of European payment transaction volume (European Savings Banks Group, 2009).

The governance of SEPA should also be reviewed, as four authorities currently share the responsibility for administering it: the ECB, the European Payments Council (EPC), the European Commission DG Internal Market and Services and DG Competition. In a recent communication, the European Commission proposed new governance for SEPA (European Commission, 2009-1).

The E-money Directive[11], which dates from 2000 and was updated in 2009, should also be mentioned here. This directive allows non-banks, like mobile telephone operators, to issue electronic money. However, at the end of 2007, only 20 electronic licences, of which 14 were in the United Kingdom, had been issued. This slow pace is attributed to heavy prudential requirements foreseen in the directive (Malcolm *et al.*, 2009).

Finally, in the area of payments, the main achievement of the FSAP has been the lowering of cross-border payments costs: the average charge for a payment of €100 fell from €24 in 2001 to €2.50 in 2005, after implementation of the Regulation on cross-border payments[12] which requires that cross-border payments in Euros must be set at the same level as charges for corresponding domestic payments (Malcolm *et al.*, 2009). However, the majority of retail and commercial payments are still executed within the borders of an EU member state. Market analysts estimate that no more than 2% of these payments are EU cross-border transactions (European Savings Banks Group, 2009), an observation that confirms that the cost of cross-border payments is not a major driver in the move towards integration of the European market.

[10] MIFs are fees charged to the receiving bank, and often passed down to the final user. The legality of MIFs charged by Visa and Mastercard on international card transactions has been challenged by the Commission.

[11] Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions.

[12] Regulation (EC) No 2560/2001 of the European Parliament and of the Council of 19 December 2001 on cross-border payments in euro.

1.1.3 Money laundering

The prevention of money laundering and of terrorism financing is a major priority at an international level. In Europe, there was a risk that the integration of the market would facilitate illicit financial activities. Three successive directives were adopted to enhance and harmonise anti-money laundering (AML):

- The first AML directive[13] was adopted in 1991, long before the FSAP. It concentrated on drug trafficking.
- In 2001, the second AML directive[14] extended the scope to more non-financial activities and professions (such as notaries and accountants).
- Finally, the third AML directive included terrorism financing in the scope of AML. It requires firms to implement customer due diligence proportionally to the actual risk ("risk-based" approach) and introduces the concept of "Politically Exposed Persons" who are vulnerable to corruption by virtue of their position in the public life. The directive came into force on 15 December 2007. At the time of writing, it was not transposed in all Member States.

It is difficult to assess the achievements of the FSAP in this area because the volume of illicit financial transactions is unknown. Hence, this is an area where accountability of supervisors is the most difficult to implement. However, a recent study (KPMG, 2007) found that senior management of banks were more engaged in AML issues in 2007 than in 2004, that AML costs have increased by 58% - a figure that was higher than expected - and that "know your customer" processes were more and more widely applied. The study also concludes that there is a wide acceptance of the regulatory efforts.

1.1.4 Taxation of savings income

Taxation of savings remains a major obstacle to European integration of the retail savings market. Many products are designed in a country to exploit specific tax incentives and would not attract any demand from investors in other countries with different systems.

In order to compare the weight of taxes on savings income in various European Countries, Eurostat calculates an implicit tax rate on capital income for households by dividing all taxes on capital by a broad approximation of the total capital income of households.

It is worth noting that capital gains are not included in the denominator. This leads to an overestimation of the average effective tax burden on capital income. Nevertheless, capital gains in the recent period might have been very low in most countries.

[13] Directive 91/308/EEC of the Council of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering.

[14] Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001 amending Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering

Implicit tax rates on Households' Capital Income

	2000	2001	2002	2003	2004	2005	2006	2007
Latvia	1.1	0.7	1.1	0.7	0.5	0.5	1	1.7
Lithuania	2.5	2.5	2.2	1.8	2	2.5	2.6	3.3
Estonia	2.8	2.5	3.3	3.4	2.6	5.3	4.5	5.1
Hungary	6.2	6.7	7.3	7.6	6.8	6.6	8	-
Slovenia	6.9	7.9	7.5	7.8	8.8	7.3	8	7.8
Austria	8.1	9	9.8	8.8	7.8	6.8	7.1	8.5
Portugal	16.3	14.9	15.1	15	11.8	10.3	8.6	-
Greece	8.9	8.7	9.4	9.6	9.7	9.7	9.5	-
Netherlands	8	13	12.9	11.9	10.5	10.4	10.8	10.5
Slovakia	11.8	12.6	13.3	12.5	12	13.4	13.1	12.5
France	13.2	12.8	12.6	13	12.4	13	13.3	12.6
Poland	10	10.8	11.9	12.6	11.7	12.6	13.4	-
Spain	13.6	13.1	13	12.5	12.4	12.6	13.7	14.7
Belgium	13	13.3	13.9	14.5	14.8	15.1	14.9	14.9
Italy	16.7	14.5	14.2	16.1	15.1	15.1	16.8	17.9
Czech Republic	9.2	9.5	10.3	10.5	18.2	17.3	17.6	18.7
Sweden	22.7	15.9	13.6	13.6	15.2	18.7	20.5	19.4
Denmark	19.6	7.7	7.8	13.3	29.8	42	21.9	19.5
United Kingdom	17.1	17.6	18.2	17.4	19.1	18.7	20.4	22.5
Finland	23.1	21.2	19.4	18.7	18.5	21.1	23.2	24.2
Cyprus	7	6.3	8.8	11.1	10.5	11	15.3	27.1
EU 25	**11.3**	**10.5**	**10.7**	**11.1**	**11.9**	**12.9**	**12.6**	**13.8**

Source: Eurostat - "Taxation trends in the European Union" 2009 Edition

A wide range of implicit tax rates are observed across European Countries. Nevertheless, those differences do not necessarily reflect differences in the statutory rates: A high statutory rate can be counterbalanced by a low tax base. Moreover, even with similar average tax rates, the tax systems can vary significantly from one country to another: in some countries, dividends are taxed more heavily whereas in other countries interests are more heavily taxed.

The Directive on Taxation of Savings was adopted in June 2003. It has been applicable since 1 July 2005 in all EU Member States, in ten additional territories and five other European countries, including Switzerland. It only applies to interest. The aim of the directive is to allow European individuals to receive interest in countries other than their country of residence and to be taxed in accordance with the laws of their country. For that purpose, the directive holds that the Member States must automatically exchange information on interest payments to non-residents. An exception was made for Belgium, Luxembourg and Austria that didn’t immediately introduce the rule. For those three countries, there is a transitional period during which they levy a withholding tax at a rate of 15% for the first three years, 20% for the following three years, and 35% thereafter.

On 13 November 2008, the European Commission adopted an amending proposal to the Directive. The aim of this amending proposal was to better ensure the taxation of interest paid through intermediate tax-exempted structures and to extend the scope of the directive to income equivalent to interest obtained through investments in some innovative financial products as well as in certain life insurance products.

The taxation of dividends is not harmonised at EU-level.

On the whole, taxation of savings income is an area where the FSAP did not significantly enhance the integration of the European financial market. This is a major source of fragmentation in the retail market. This is not only a problem for cross-border access to financial products. The European Parliament might launch an in-depth reflection in order to define what should be an adequate savings policy in the EU in order to tackle all the needs of European citizens. Savings play an increasing role in complementing Pay-As-You-Go pension schemes and in meeting the needs resulting from an ageing population and elderly dependents. Taxation on savings should not only be regulated so as to eliminate tax evasion but it should also give the right incentives to European citizens.

1.2 Insurance and pension funds

In the insurance sector, the main achievement was the compromise on "Solvency II" directive[15] adopted by the European Parliament's plenary session on 22 April 2009. Although the focus has been on prudential regulation, the scope of Solvency II is much broader, as it consolidates and reforms 13 previous directives applying to insurance (life and non-life) and re-insurance companies[16]. A timetable has been set for the level 2 implementing measures and Solvency II will be applicable from the end of October 2012.

The second important directive in the insurance sector is the Insurance Mediation Directive (IMD) [17], adopted in 2002 and implemented since 15 September 2005.

The IORP directive has set the framework for pension funds activity in Europe[18].

Finally, the directives relating to the taxation of savings and to money laundering should be mentioned here. They have already been reviewed in the previous section on banking services.

1.2.1 Distribution channels of insurance products

The European passport for insurance companies has been established before the FSAP. Hence, the main achievement of the FSAP concerning integration and harmonisation of the insurance market concerns the distribution of insurance products by independent distributors, as a result of IMD. The directive provides for registration and professional standards of insurance intermediaries, while at the same time removing barriers to intermediaries' cross-border activity.

[15] Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (recast) (COM(2008)0119 – C6-0231/2007 – 2007/0143(COD)).

[16] Including the Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance and amending Council Directives 73/239/EEC, 92/49/EEC as well as Directives 98/78/EC and 2002/83/EC.

[17] Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation.

[18] Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision.

Malcolm *et al.* (2009) found that IMD reduced the number of insurance intermediaries in several Member States. However, it is not always possible to disentangle the impact of the directive and the one of market trends. CEA's statistics[19] do not show a general trend in the share of tied or multiple agents in the distribution of insurance products. Agents have a majority market share in countries like Slovenia, Slovakia and Turkey. Their market share is comprised between 40% and 50% in Bulgaria, Spain, Germany, Italy, the Netherlands and Poland. But it is less than 15% in the United Kingdom, France, Austria and Belgium.

An additional benefit of IMD is the increased professionalism of intermediaries, but it is difficult to find an objective indicator to assess the impact of the directive.

On the whole, there is lack of available statistics to assess the effectiveness of IMD in fostering a more integrated market for insurance: the number of European passports used is not recorded in a consistent manner by Member States.

On the other hand, IMD contributed to a more general trend towards higher professional standards. However, rules applying to the selling of insurance contracts will have to be reviewed and made consistent with the more recent regulation of selling practices and investment advice resulting from MiFID. Indeed more and more life insurance products have the same risk profile as investment funds and should be regulated similarly to investment products in order to avoid regulatory arbitrage.

1.2.2 Prudential regulation of insurance companies

Solvency requirements for insurance companies have been included in two directives since 1973 (non-life insurance)[20] and 1979 (life insurance)[21]. They were updated in two directives adopted in 2002[22] and known as the "Solvency I" framework. The latter have been applicable since 2002 but there was a long transitional period of five years. During that process, it was recognized that a fundamental overhaul of the overall framework was necessary. Indeed, margin requirements were calculated in proportion of liabilities and the sum at risk for life insurance and premium and reserves for non-life insurance. Solvency 1 was not a risk-based approach and discussions on a new prudential approach started even before this first directive was implemented.

[19] The CEA is the insurance and reinsurance federation. CEA's statistics cover approximately 94% of total European premium income.

[20] First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance

[21] First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance

[22] Directive 2002/13/EC of the European Parliament and of the Council of 5 March 2002 amending Council Directive 73/239/EEC as regards the solvency margin requirements for non-life insurance undertakings; Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance.

On 22 April 2009, the European Parliament adopted the Solvency II directive, which replaces the former basic requirements of Solvency 1.

Solvency II rests on the same 3 pillars as CRD: capital requirements; qualitative requirements and supervision; and market discipline (reporting and transparency).

The Solvency Capital Requirement (SCR) and the Margin Capital Requirement (MCR) are based on an overall assessment of risks borne by the company. SCR is calculated in order to guarantee that the net asset value of the company will be positive over a 1-year period with a confidence level of 99.5%. As an alternative to the standard formula, insurance companies are allowed to develop internal models that may use a different time period or risk measure as long as the output of the internal model provides policyholders and beneficiaries with an equivalent level of protection. The MCR is a lower level of capital requirement. If breached, it triggers the withdrawal of authorisation.

The Solvency II rules are based on the actual value of assets and liabilities. As for banks following CRD, Solvency II will incite insurance companies to improve their risk management functions and force supervisors to be more involved in the understanding of methods and models used by the industry with regard to risk measurement. The new directive is not yet applicable (the new system will apply from the end of October 2012) and hence it is too early to asses its market impact. Nevertheless, adoption of Solvency II can be considered as a major achievement of the FSAP.

Implementation of the directive in due time will be a very difficult challenge, involving the Commission, CEIOPS and national regulators. There is a fear that level 2 and level 3 measures impose additional requirements on the agreed standard framework. Regulators and supervisors are caught between pressure from the industry to reduce capital requirements and those of public opinion to increase the safety of their assets. This remark will also apply to European authorities which will have a major role to play in order to avoid national discrepancies in implementation measures. From that standpoint, accountability of CEIOPS, ESBR and ESFS will be most important to ensure that there is no major gap between the directive and its implementation.

Finally, the new directive takes into account the assessment of consolidated risk profiles in line with the groups' economic reality and it strengthens the role of the Group Supervisor. But Group support is not yet recognised as a source of risk mitigation. However, Solvency II includes a clause of revision on this topic within three years.

1.2.3 Integration of the European pension funds market

To a backdrop of an ageing European population, pension funding is a major issue. The drop in the population of working age to the number of pensioners will probably translate into a decrease on the returns of both Pay As You Go (PAYG) schemes and pre-funded schemes[23]. Several studies show that most PAYG pension schemes will not be sustainable - see for example Chateau (2006) about France and Germany. However, institutional frameworks for the financing of pensions remain highly diverse across Member States while the public debate on the parameters of pension financing remains national.

In theory, cross-border pension funds should be beneficial to their members thanks to economies of scale. The IORP Directive allowed for the provision of cross-border pension services. It is a first step towards a single market for occupational pension schemes. The Directive has been applicable since 23 September 2005 but was only fully implemented in 2007. The Directive also impacts investment policies, by the reference of the "prudent person" rule.

There were only 70 cases of cross-border pension activity at end of June 2008 (CEIOPS, 2008-1), a figure unlikely to rise given the consensus of the European Commission and CEIOPS that no further legislative initiative is necessary in that area[24].

1.2.4 Prudential regulation of pension funds

Prudential regulation of occupational pension funds is still on the European legislative agenda and a consensus has yet to be reached concerning this topic.

The prudential rules applying to some categories of institutions operating employer-sponsored occupational pension plans were defined in the 2003 IORP directive. But the "Solvency 1" prudential rules foreseen in that directive are not risk-based and in practice Member States use diverging methods and assumptions to calculate technical provisions as shown in a CEIOPS survey (CEIOPS, 2008-2). The IORP directive was not revised and it was decided that Solvency II would not apply to pension funds.

The insurance industry advocates that the framework of Solvency II, reflecting the specificities of the pensions industry, should apply to pension funds in order to provide a level-playing field to all actors offering the same services in Europe. They argue that products and risks being the same, the same rules should apply. Among other things, this would mean applying the quantitative capital requirements (pillar 1) to pension funds submitted to article 17 of the IORP directive, which underwrite liabilities or provide guarantees to members of pension funds. In the same spirit, an impact assessment study should also be run to determine which parts of Solvency II should apply to other pension funds. Pension institutions consider that they are not financial institutions and that their social objectives need to be recognised and specific rules be applied.

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[23] In a PAYG pension scheme, benefits are paid directly from employers and current workers' contributions. In a funded scheme, contributions are invested in a fund to meet benefits.

[24] Report from the Commission on some key aspects concerning Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (IORP Directive), 30 April 2009 – COM(2009) 203

However, the discussion should mainly take into account the interest of final stakeholders. Here again, there is still a lack of consensus. Supporters of full harmonisation argue that applying the same regulations to all providers will allow for cross-border provision of services and a reduction of costs resulting from economies of scale. But opponents highlight the fact that higher capital requirements will increase the cost to pension fund members. Adverse consequences of an increased funding requirement would be to force pension funds to increase contributions and it might also be a disincentive for corporate sponsors to develop occupational schemes. According to this view, there is a need for a trade-off between higher protection of existing beneficiaries and a wider coverage of European population. However, the Solvency II framework is already applied in the Netherlands, although with a lower confidence level (97.5% versus 99.5% in Solvency II) and with allowance for longer recovery periods (up to 15 years versus up to 9 months in Solvency II). In addition it should be recognised that, partly due to accounting rules, defined contribution funds tend to overtake defined benefit funds.

Finally, there is no consensus on the adequacy of the Solvency II provision in measuring long-term liabilities of pension funds. The one-year measurement of risk in Solvency II is questioned by academic literature. Several authors argue that the relative riskiness of stocks relative to bonds and bills tends to be smaller for long-term investors. Campbell and Viceira (2002) show that US stocks have essentially the same degree of riskiness as bonds for holding periods longer than 50 years. Bec and Gollier (2008) show that French stocks are 10 times riskier than bonds for a holding period of 1 year, but this relative riskiness decreases by a factor 2 for a holding period of 25 years.

However, this phenomenon, known as “mean reversion” in stock returns, has not the same reality in all countries: Jondeau and Rockinger (2009) show that the highest mean reversion on a 10-year time horizon is observed in the UK, the Netherlands and Norway. The next group is France and Sweden, while the lowest mean reversion is observed in Germany, Italy, Denmark and Spain. Moreover, Jondeau and Rockinger (2009) show that the best performance is obtained by a dynamic investment strategy reallocating the portfolio when parameters recognised as having an impact on stock returns[25] change. But this result raises regulatory difficulties, as the latter cannot assume the ability of investors to time the market.

The European Parliament faces a difficult issue because of the number of stakeholders, the technical complexity of the topic and its far-reaching implication for European citizens. Findings to be taken into account for the final decision are:

- Market impact measures are necessary. A recent study undertaken by the OECD found that application of Solvency II would raise technical provision by 25% on average (Jordy *et al., 2007)*.
- The general principles of Solvency II should be applied to pension funds: Being risk-based, forward-looking and transparent, these prudential rules would better protect members of pension funds. It would also incite pension fund managers to use internal models measuring the risks of their ALM policy.

[25] These parameters include the ratio of stock price to dividend and the inflation rate

- The investment behaviour of pension funds has an impact on financial markets functioning. Alexander *et al*. (2008) show that long-term investors are "risk absorbers" because they do not depend on market liquidity, as opposed to "risk traders" who will sell their assets if they cannot fund them. The liquidity of global financial markets in a crisis is necessarily affected by requirements to mark-to-market the assets of long-term investors and any regulation that would higher their sensitivity to short-term shocks would thus increase systemic vulnerability of the whole financial industry and markets.

Finally, these considerations might lead the European Parliament to pass specific legislation that would be based in principle on the same 3 pillars as Solvency II. But pillar 1 and pillar 3 would then have to be specifically tailored. Meanwhile, "level playing field arguments" developed by the insurance industry are valid in cases where the same service is indeed provided. This will lead to a difficult revision of Solvency II, even before the latter directive is implemented.

An additional remark made is that the debate on prudential requirements tends to focus attention on defined benefit pension funds. But the share of the latter is continuously diminishing, as most new pension funds are defined contribution funds. The European Parliament might be willing to take a legislative initiative on it, the objective being to promote such pension funds which would be able to meet the needs of an ageing European population. Similarly to UCITS, the defined contribution European pension funds could even become a brand successfully exported in third countries.

1.3 Asset Management

1.3.1 The single market for investment funds

The first legislation applying to Undertakings for Collective Investment in Transferable Securities (UCITS)[26] adopted before the FSAP in 1985 proved to be successful, as testified by the fact that the "European UCITS brand" is a much appreciated one, even among non-EU investors. Three revisions of the original directive were then enacted as part of the FSAP. UCITS III consists of two directives, the "Management Directive"[27] and the "Investment Directive"[28].

[26] Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

[27] Directive 2001/107/EC of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with a view to regulating management companies and simplified prospectuses

[28] Directive 2001/108/EC of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS

The most recent directive, "UCITS IV"[29] will be applicable as of 1 July 2011, but major asset managers are already preparing a pan-European offer, using provisions facilitating mergers of funds and the removal of administrative obstacles that still exist in the cross-border selling of funds.

Between 2005 and 2009, distribution of the main countries of UCITS domiciliation changed significantly, with Luxembourg and Dublin gaining strong market shares, at the expense mainly of Italy and, to a lesser extent, Spain and Germany. Most market participants attribute this move to three factors:

- Responsiveness and flexibility of Luxembourg and Irish authorities.
- Taxation of savings income. For example, tax evasion is significant among German tax payers and the taxation of capital gains in Italy plays in disfavour of local funds.
- Competing products, especially structured products, have gained market shares at the expense of UCITS in some countries, like Germany.

Net assets of UCITS by country of domiciliation (in %)			
	2005 Q1	2009 Q1	Difference 2009-2005
Belgium	2,2	2,1	-0,1
France	23,9	25,7	1,8
Germany	5,2	3,9	-1,3
Ireland	8,3	11,4	3,1
Italy	8,5	4,1	-4,4
Luxembourg	25,1	29,1	4,0
Spain	5,5	4,2	-1,3
United Kingdom	9,1	8,9	-0,2
Other countries	12,1	10,6	-1,5
Total	100	100	

Source: EFAMA

We calculated the ratio of investment fund holdings by national residents in each country to the net asset value of UCITS domiciled in the same country. Calculations show that two countries are massive "exporters" of UCITS to other countries – namely Ireland and Luxembourg. This ratio is inferior to one in all other countries except Poland and Slovakia. In other words, except those two latter countries, all others are "net importers" of UCITS domiciled in other Member States, mainly Luxembourg and Ireland. The auto-sufficiency ratio is the smallest in Austria (7%) and Germany (21%), these countries thus being the most open to non-national funds. The ratio is comprised between 90% and 100% in four countries that can thus be defined as slightly open: the United Kingdom, France, Greece and Spain. From 2003 to 2007, the ratio decreased in all countries except Luxembourg, Sweden, Poland and Belgium. The sharpest decrease (i.e. the sharpest opening of the market) was observed in Austria, Germany, Denmark and Portugal.

[29] Directive of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) 2008/0153 (COD)-

UCITS European legislation therefore contributed to the integration of the European savings market. On the other hand, one should not overestimate the industrial importance of such cross-border flows. Funds domiciled in Luxembourg or Dublin are frequently managed from the home country of the asset manager, with only back-office functions actually located in Luxemburg or Dublin. UCITS 4 directive should reinforce this trend: asset management companies registered in their home country A will be able to freely commercialise funds domiciled in country B to investors based in country C, without being based in country B.

The specialisation of two national authorities for registering and supervising investment funds can be questioned. On the one hand, many market participants consider that those countries offer better regulation, i.e. a better understanding of products and more efficiency in dealing with the files they receive from the industry. On the other hand, problems raised by the responsibility of depositories in the Madoff/UBS case could suggest that asset managers tend to turn to these authorities because they are less restrictive, hence less safe for investors. However, it can be argued that if the depository regulation is going to be harmonised in Europe, the balance would be rather on the first interpretation, as no other significant market failure happened for cross-border funds. But the safety of the cross-border funds can be attributed to the fact that they are promoted by large and well-known asset management companies. Luxembourg and Dublin authorities can rely on supervision in the home country of major asset managers and have a mere role in registering specific products.

1.3.2 Costs of pan-European UCITS

The European Commission has recommended increasing disclosure of UCITS Total Expense Ratio (TER) to retail investors in the Simplified Prospectus (European Commission, 2004)[30]. More transparency was expected to increase the competitive pressure and to lower fees. Comparing costs before UCITS directives implementation in 2003 and two years after (2005), we find that these expectations have not been met.

The Total Expense Ratio (TER) consists of a management fee (commission paid to fund managers) plus 'other' charges incurred with running the fund (share registration fees, fees payable to auditors, legal fees, custodian fees.). Moreover, the compensation of asset managers may include performance fees. Transaction costs resulting from trading of a fund’s assets are not included.

After UCITS directive implementation, TER slightly increased in all countries except Spain. TERs show very different levels across countries, the highest being in Poland. The lowest costs are recorded in France, partly because of the high relative weight of monetary funds: monetary funds’ TERs are lower than the ones of other types of funds’ costs in all countries.

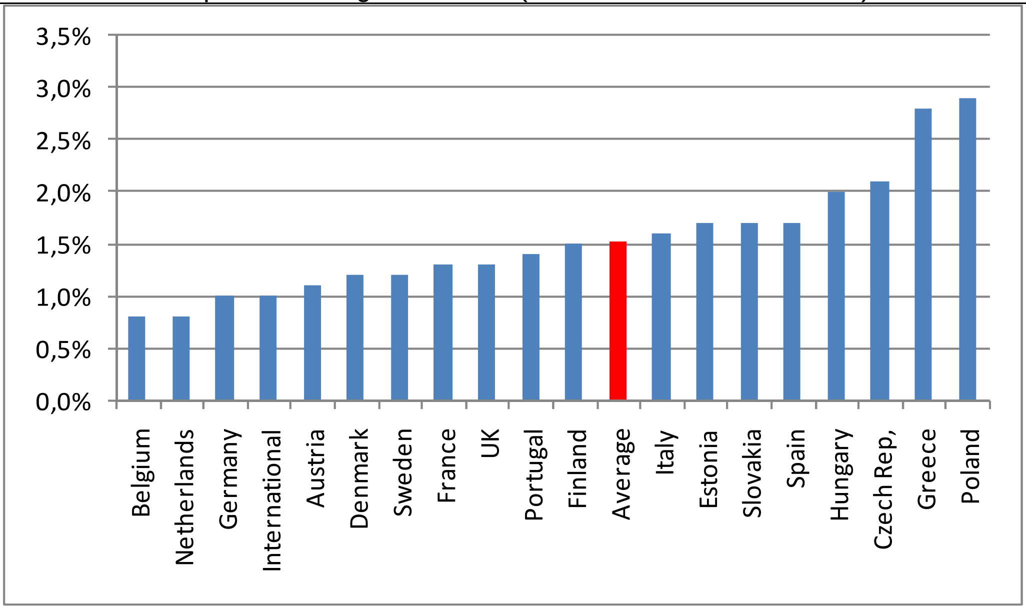
Looking at the components of TERs, the slight overall increase results from an increase of management fees and a decrease of other costs.

[30] Commission Recommendation of 27 April 2004 on some contents of the simplified prospectus as provided for in Schedule C of Annex I to Council Directive 85/611/EEC

One of the main explanations for the favourable trend in those "other costs" is related to the growing size of funds over the period. The UCITS IV Directive will facilitate the mergers of funds, a factor that should allow for further benefits of scale. An INVESCO Think Tank estimated that fund mergers might deliver between 5 and 15 basis points in costs reductions (INVESCO, 2005).

More worrying is the increase of management fees over the period. The graph below shows management fees for equity funds. The average management fee is 1.5%, but it varies from one to three between Belgium and Poland.

Graph 1: Management fee (in % of net assets, 2005)



Source: Lipper

A detailed analysis run by Lipper (Moisson, 2008) shows that annual management fees charged by cross-border funds (funds domiciled in Luxembourg or Dublin and marketed cross-border) have generally risen each year, from 1.39% in 1998 to 1.57% in 2008. This rise only concerns retail funds, with an average management fee rising from 1.9% of net assets in 1994 to 2.5% in 2003 and almost 2.6% in 2008. On the contrary, average TER for institutional equity funds fell from 1.4% in 1994 to 1.2% in 2003 and 1% in 2007.

The interpretation given by Lipper for the rise of TER borne by retail funds investors is that asset management companies compete for gaining market shares in European domestic markets by offering growing distribution fees to local networks. Locally domiciled funds in countries where foreign funds are widely distributed (like Germany) showed the same trend and German banks raised their commissions too. As distribution fees are charged as part of the management fees, the latter inexorably increased.

Hence, retail investors benefited from the fall of "other costs" that maintained the TER stable. But if the European passport for funds had not triggered an increased competition from cross-border funds, the European savers would have benefited from decreasing total costs.

It is obviously not the European Parliament's task to monitor fees charged to investors. However, the Parliament might be willing to ask for such monitoring by the European Commission or the Committee of European Securities Regulators (CESR), as the "Forum of users" FIN-USE already asked for[31].

1.4 Securities markets

The FSAP included a number of directives concerning securities markets. Several of them impacted the ability of securities issuers to raise funds and their required quality of disclosures, accounting and corporate governance. Some of them had an impact on final investors, while the universe of market undertakings was reshaped by the successive Investment Services Directive (ISD), then replaced by the Market in Financial Instruments Directive[32] (MiFID)

1.4.1 Raising funds across borders

The FSAP's goal is to increase the financial integration of European markets. Two major directives, the Prospectus Directive[33] and MiFID were adopted to facilitate fund raising.

Impact of the Prospectus Directive

The purpose of the Prospectus Directive is to enhance mutual recognition and harmonisation of prospectuses, in order to avoid that issuers have to go through the approval process in each country where they intend to raise funds. Though the concept theoretically already existed, in practice, it was rarely used because of its lack of automaticity. The growing number of European passports granted for prospectuses indicates that the conditions for an integrated securities market are in the process of being met.

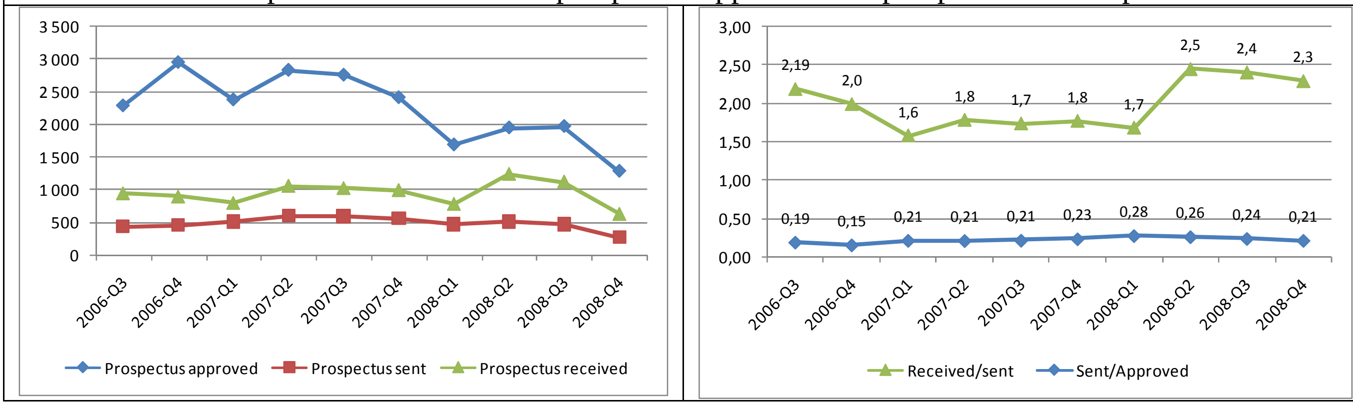
Data published by CESR show that the proportion of prospectuses that included a cross-border passport increased regularly from 15% before implementation of the directive to 28% at first quarter of 2008 and then declined to 21%. The number of Member States per Prospectus sent to authorities in host countries decreased in the first months after implementation of the directive, but in 2008 it increased to slightly more than two Member States per prospectus on average. More than half of the prospectuses sent to host countries were approved in two countries only, namely the United Kingdom and Luxembourg. These two countries were already centres in Europe for the listing of debt instruments. The Prospectus Directive has further strengthened the position of London.

[31] FIN-USE was established by the European Commission to formulate opinions of users of financial services in the Internal Market. For the position of FIN-USE on UCITS costs, see FIN-USE annual report 2007-2008, p.2-3

[32] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC

[33] Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC

Graph 2: Total number of prospectus approved and passported in Europe



Source: CESR

Impact of MiFID

A securities issuer will typically apply for several exchange listings in order to get a broad base of investors. This will facilitate further fundraising from those investors and thus diminish the cost of capital. The MIFID European passport allows regulated markets to install trading screens in all EU countries without having to apply for new licenses in each host country. It thus makes it less useful for issuers to be listed in all countries where they wish to raise capital. Moreover, the cost of maintaining a listing on multiple market places and the technical networks that now facilitate cross-border investments resulted in a more general trend for companies to concentrate their listing on one exchange. Many European companies thus decided to delist their equities from secondary market places. Most of them kept their listing in their domestic country and removed listings from other countries in Europe and other continents. This trend started before the implementation of the FSAP. As a consequence, several exchanges recorded a decrease in the number of their foreign (European and non-European) listed companies. However, some European exchanges were also able to attract primary listings of non-European companies, the leading one being the London Stock Exchange, with 681 non-UK listed companies, 233 more than in 1999. Significantly, no more than 166 among these non-UK companies are European ones, of which 103 are listed on the regulated market and 63 on the Alternative Investment Market. ISD and then MIFID thus adequately accompanied a more general trend. It widened one of the channels of access to an international pool of investors, namely a broader access to secondary markets.

Increased integration of European financial markets

Both the openness of the primary market and of the secondary market should in theory translate into higher availability of EU funds for EU issuers and more investments in Europe by European investors. The Coordinated Portfolio Investment Survey (CPIS) run by the International Monetary Fund (IMF) enables it to measure the origin and destination of foreign investments, for equity instruments and debt instruments[34].

[34] Available on IMF website http://www.imf.org/external/np/sta/pi/cpis.htm

While highlighting the increasing contribution of EU investors to the financing of EU issuers, it is notable that the share of European assets in foreign investments of EU investors remained stable between 2001 and 2007. These statistics also show that the European debt market is more integrated than the equity one.

EU investors account for more than 40% of total foreign (listed and non-listed) equity securities in all EU countries except in the United Kingdom and in Denmark. They are superior to the average in all Eastern European countries except the Czech Republic. The debt market is more homogeneous, the minimum share of EU investors in foreign debt securities outstanding being 50% (the United Kingdom again).

In terms of investments, the United Kingdom appears to be the least integrated country, with a share of EU investors in all foreign investors being respectively 22% and 30% for debt securities and equity securities.

1.4.2 Quality of information

Improving and harmonising the quality of information provided to investors is not only a regulatory goal as such, it is also a factor that facilitates fundraising over time by increasing public confidence in market investment products, including those issued in European countries outside of investors'.

The Transparency Directive[35] and the Prospectus Directive improved the completeness and accessibility of information delivered to savers, although no detailed impact assessment on the quality of information provided to investors has been realised so far.

Interviews realised in the framework of the recent "Study on the impact of the Prospectus Directive on EU Financial markets" (CSES, 2008) suggest that the new regime has improved the quality of information available to investors, particularly in Member States who previously had no complete regulatory framework prior to the implementation of the directive. But the prospectus is used as an ex-post legal document for the issuer, rather than a real source of information for investors, especially private investors. Indeed there is no limit to the size of the prospectus and issuers tend to add more and more information to protect themselves against any legal action that could be based on insufficient disclosures.

The Transparency Directive improved the quality of periodic and *ad-hoc* information disclosed by securities issuers. However, some implementation or clarification measures have still to be implemented. For example, the definition of "important event" - to be published in the half-yearly statements issued by public companies – is yet to be clarified.

Similarly, the UCITS prospectuses are much too long and too complex for an unsophisticated private investor. The "Key Information Document" foreseen in UCITS IV should, therefore, improve understanding of the products by investors.

[35] Directive 2004/109/EC of the European Parliament and of the council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC

To summarize, ongoing, periodic and *ad-hoc* information disclosures are assessed for their accessibility, but studies on the quality of the content are very rare. It would be necessary to compare the quality of information before and after implementation of directives. Such an analysis of a significant number of listed companies should be run in all European countries.

1.4.3 Accounting standards

Compared with the cautious wording of the original FSAP of May 1999 ("Map out strategy [… that] should prefigure mechanism for vetting international benchmark standards so that these can be used (with no national variations) by EU listed companies" (European Commission, 1999), the European Union has been swifter and bolder in its approach to accounting harmonisation. In 2000, it set out the project to make International Financial Reporting Standards (IFRS) mandatory for all listed EU companies, and in 2002 a regulation (No. 1606-2002) was adopted, with unanimity of the Council (including ten then-accession countries as observers) and near-unanimity in Parliament, that set a framework to mandate each individual IFRS standard through an 'endorsement mechanism' which allows the Commission, after a qualified-majority vote of the Accounting Regulatory Committee of member state representatives, to adopt or reject it. In the meantime, the international standard-setting organization reformed its governance and funding framework through the creation of the International Accounting Standards Committee Foundation (soon to be renamed the IFRS Foundation) and the formation within it of the International Accounting Standards Board (soon to be renamed the IFRS Board), both effective in 2001. These reforms enhanced the IASB's autonomy from the accounting profession and its national representative organizations.

The EU's adoption of IFRS was a remarkably bold move, accounting standards being a crucial infrastructure of business life. As previous attempts at EU accounting harmonisation had failed in the 1970s and 1980s, the choice to leap directly from national to international standards was a rational one, and a further motivation was the increasing tendency of dynamic European companies, whether major established companies or dynamic start-ups, to shift to US accounting standards (known as Generally Accepted Accounting Principles of GAAP) on the occasion or in anticipation of a listing on the New York Stock Exchange or NASDAQ. By choosing IFRS, the EU was consistent with its commitments to subsidiarity and global economic integration, and avoided the alternative option of being dependent on US GAAP standards, which fall under the ultimate responsibility of the US government even though the standards-setter, the Financial Accounting Standards Board, is technically a private-sector organization. Regulation 1606-2002 struck a reasonable balance between EU sovereignty and the commitment to international harmonisation. On the one hand, it left Europeans the option of not adopting a standard they wouldn't like and thus being able to exert some pressure on the IASB on key items of standards content, a possibility which has proven effective in October 2008 when the EU forced the IASB to amend the IAS 39 standard on financial instruments. On the other hand, it concurred with the ultimate aim of a single set of standards at an international or even global level by denying the Commission the possibility to amend or rewrite standards, which would be effectively synonymous to the creation of an EU variant of IFRS, or 'EU GAAP' – as is currently the case for example in China, with standards that are largely inspired by IFRS but differ from them on many specific issues.

Furthermore, the transition from national standards to IFRS, completed in 2006 by most listed companies and in 2008 for an additional set of firms, was well prepared by companies, auditors and regulators and eventually went remarkably smoothly, compared with the dire predictions of chaos by many observers including some within the IASB itself. Early assessments of the transition's impact, before the outburst of the financial crisis in the summer of 2007, were generally positive, especially from the investment community which is the primary group of users of financial information. This operational success in turn triggered widespread adoption of IFRS throughout the world, with most significant economies except the US, Japan and Russia being expected to mandate IFRS to listed companies in their respective jurisdiction by 2012 at the latest. Another notable success was the decision in late 2007 by the US Securities and Exchange Commission (SEC) to eliminate the requirement for non-US companies listed in the US ("foreign registrants") to publish a costly 'reconciliation' between its accounts using US GAAP and the accounts for the same period using third-party standard. Overall, many observers found the IFRS adoption framework robust enough before the outburst of the crisis.

1.4.4 Corporate governance of public companies

The lack of harmonisation of corporate governance may hamper the integration of the European market as mutual confidence in the behaviour of the various corporate stakeholders is a very important component of any European social consensus and of competitiveness of the economy. Following the financial crisis, this question became even more important: for example, the compensation of executives has aroused strong reactions in the public debate which challenge the legitimacy of executives in their business responsibilities.

Initially, the FSAP did not include any ambitious plans for corporate governance: taking into account that corporate arrangements were based on long-standing national traditions, the only commitment of the Commission at the launch of the FSAP was to conduct a review to identify legal or administrative barriers that could have frustrated the development of a single EU financial market. However, the European Company Statute adopted in October 2001 was seen as an important step towards the market-driven emergence of corporate governance patterns in the EU.

In 2002, the "Winter report" (Winter, 2002) proposed the requirement of listed companies to include statements on corporate governance in their annual reports. Following the publication of the Winter report, in 2003 the European Commission published an Action Plan on Modernising Company Law and Enhancing Corporate Governance in the EU (European Commission, 2003). The Commission recommended enhancing corporate governance disclosure, strengthening shareholders' rights and modernising the Boards of Directors. The only legislative initiative has been related to independence and compensation of directors[36] and to the compulsory report on corporate governance and the role of supervisory Boards of listed companies[37].

[36] COM/913/EC Commission recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies

[37] 2005/162/EC Commission recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board

A further recommendation was published in April 2009 to complement the 2004 recommendation on remunerations[38]. Beyond the idea of pay for performance through disclosure of the compensation policy, already included in the previous recommendation, the Commission added new principles, namely the benchmarking of directors' compensation to other executives, limits to the severance pay and the balance between fixed and variable compensation. It also aims at promoting the long-term interest of the company through minimum holding of part of the shares until the end of employment and at improving shareholders oversight of the compensation policies.

Up to now, the European Union adopted a flexible approach. For example, the Prospectus Directive and the Transparency Directive do not include any disclosure requirements regarding corporate governance. Recital 15 of the Prospectus directive even foresees that the directive does not prevent Member States, national authorities or exchanges in their rulebook to impose specific requirements regarding corporate governance. Corporate governance is not covered by the Lamfalussy process unless initiatives in that area specifically address financial services.

The European Commission promotes corporate governance by recommendations, which are not submitted to the European Parliament. The European Parliament also contributed in a useful manner by its reports on the most topical issues in the public debate. For example, the Van Burg report of the European Parliament (ECON, 2005) "looks forward to the Action Plan for Corporate Governance being developed further; welcomes the convergence of national codes of corporate governance based on the "comply or explain" principle; welcomes the establishment of the European Corporate Governance Forum." (page 10 of the report)

Although it is part of the Commission Action Plan on Modernising company law and enhancing corporate governance (and not of the FSAP), the "shareholders right" directive[39] should be mentioned here. The Directive had to be transposed by 3 August 2009 into national laws. It tackles the issue of timely access of shareholders to the complete information relevant to general meetings and the exercise of voting rights by proxy.

The assessment of initiatives taken in the field of corporate governance highlights the difficulty to force Member States to implement rules in an area where practices have deep and long-standing roots in the culture and the social organisation of each country. Apart from the shareholders right directive, whose stake is relatively limited, the European legislator could not impose binding rules. The Takeover Bid Directive[40] is an extreme illustration of such a statement: The Directive allows Member States to opt out of most significant provisions, such as poison pills or multiple voting rights. Moreover, the reciprocity exception allows Member States to exempt companies from the application of the rules. In practice, most Member States maintained their national exemptions. The directive did not bring significant changes in this key area of corporate governance.

[38] Commission recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, C(2009) 3159

[39] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies

[40] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids

1.4.5 Portfolio diversification

The integration of European markets is expected to be beneficial to investors, not only because of increased competition by non-domestic financial services providers, but also thanks to a widening universe of investments both in terms of products and geographical location.

Available statistics to measure investment diversification are incomplete. Most macro-financial data (based on national accounts) does not distinguish holdings of assets according to a geographical breakdown. Micro-data, derived from surveys, should measure the number of households holding a given type of product. However, there are no European surveys on financial assets of households and existing data is always national, irregular and non-harmonised across countries. There are only fragmentary pieces of information on that subject.

- Bank deposits, which remain the main component of households' financial portfolios in most continental European countries, are still mainly domestic, except in border regions where clients can more easily open an account with foreign banks.

- From 1999 to 2007, there was a general decrease in the relative weight of private investors' direct holdings in total capitalisation of quoted shares, from 16.5% to 13.2% (FESE, 2008). Italy, Denmark, Belgium and Poland are the only exceptions and show increases in the share of private investors in total capitalisation. In the light of this, several directives (Prospectus, Transparency, MiFID) should nevertheless make it easier for private investors to buy stocks or bonds issued by issuers located in other European countries. Moreover, the European commission has strictly enforced non-discrimination in tax incentives. Where such incentives are conditioned on the holding of domestic securities, it had to be expanded to securities from any EU country. However, with the little information that is available, it is shown that European savers did not significantly widen their universe of investment.

    - The share of foreign quoted shares held by French households in their aggregate equity portfolio increased from 15% to 25% from 2002 to 2006. It came back to 15% in 2007 and 2008[41]. The number of households holding foreign securities doubled, from 0.9 million in 2001 to 1.8 million in 2007.

    - Foreign shares (quoted and non-quoted) held by Italian households represented a stable percentage – around 10% - of their equity portfolio in the last 10 years[42]. The number of Italian households holding foreign quoted shares is very small. It decreased from 1.1% of the number of households in 2001 to 0.7% in 2006.

[41] Source: Banque de France

[42] Source: Banca d'Italia

- In practice, the use of the European passport for occupational or public pension funds, individual pensions and life insurance contracts is very rare. Tax incentives are the main factor in the development of these products and they are reserved for citizens of the country concerned.

- As already described above, the European passport for UCITS has enabled fund promoters to expand their offer on a pan-European scale. Moreover, the European Commission enforced non-discrimination in tax incentives for these products as for securities directly held. As a result, both national and pan-European funds have increasingly widened their universe of investment to the whole of Europe.

1.4.6 The dismantling of exchange monopolies

The dismantling of exchange monopolies was achieved in two steps. First, the Investment Services Directive generated competition between regulated markets (former "exchanges") but it allowed Member States to keep a so-called "concentration rule" protecting regulated markets from competition by other trading venues. By placing the concept of competition between various trading venues at the core of the market architecture in Europe, MiFID gave rise to four types of legal concepts:

- Regulated markets take over all functions run by former exchanges.
- Multilateral Trading Facilities (MTFs) are electronic platforms for the secondary trading market, but they do not offer any primary market to securities issuers.
- Systematic Internalizers are banks or investment firms matching the orders of their clients internally.
- OTC trading is all trading not falling within the previous categories. It was expected that OTC trading would be residual, with most orders being channelled through regulated trading venues.

Each type of trading venue has to comply with specific transparency and reporting rules.

In addition, two types of trading venues not foreseen in MiFID appeared:

- "Dark pools" legally are MTFs but they tend to move away from the concept originally planned by the legislator because of their lack of transparency
- Crossing networks legally are part of OTC trading but their functionality tends to bring them close to MTFs.

In May 2009, the breakdown of trading and reporting volumes, as calculated by the Federation of European Stock Exchanges, shows that regulated markets no longer enjoyed a majority share of the market. The share of OTC trading increased dramatically in 2009, with a share of 41% of all executed trades in May 2009 (FESE, 2009), up 26% on October 2008. Trading on regulated markets was halved while OTC trading remained stable. This is due in part to MiFID implementation, which has liberalized OTC trading, and to the financial crisis, which has dramatically reduced algorithmic trading on electronic regulated markets.

Market share in equity trading volume – May 2009				
Regulated markets	MTFs	Systematic internalizers	Crossing networks	OTC trades reported to regulated markets
47%	8%	3%	29%	13%

Source: FESE

We cannot provide a comprehensive analysis of the new trading landscape, which would not be compatible with the format required for the present study. However we provide some brief indications that might be useful to the European Parliament for assessing the views of market participants who challenge the output of the directive for stemming market fragmentation and opacity.

- Exchanges benefited from a very favourable environment in the last decade. In 2007 (before MIFID became applicable), exchanges pre-tax earnings margin (pre-tax earnings/revenues) amounted to around 50% in Europe. The Return-On-Equity reached 21.1% in the world and almost 30% in Europe (against 11% in the Americas and 26% in the Asia-Pacific region.) While ISD had little impact on their activities, new trading venues foreseen (and unforeseen) by MiFID, strongly compete on their core business. In response to competition from new entrants, exchanges lowered the fees they charge to their members. The fall is more pronounced for retail orders (-38%) than for institutional ones (-30%)[43] but no data exists to our knowledge on the extent to which these savings have been passed on to retail investors. As far as the wholesale market is concerned, institutional investors benefitted from a reduction in fees charged for each transaction, but this benefit has been offset by the decreasing average size of transactions resulting in more transactions being necessary to execute an order of a given size. Clearing fees fell more sharply than trading fees. Exchanges tend to offset the decrease in trading fees by diminishing their fixed costs and by an increase in listing fees, at the expense of corporate issuers. Exchanges also try to recover market shares by running, not only regulated markets, but also MTFs and dark pools.

- There were 11 MTFs run by investment banks and brokers and 8 MTFs run by exchanges at the end of April 2009. Two of them predominate: Chi-X and Turquoise concentrate 87% of all MTFs volumes (March 2009, source Thomson Reuters Share reports, quoted by CESR, 2009)[44]. Up to now, MTFs have been successful mainly for trading of securities listed on the largest exchanges. The market share of the three main MTFs (Chi-x, Turquoise and BATS) in total trading in components of the Blue chips indices arose to 20-25% in March 2009[45].

[43] Source: Equinox Consulting
[44] Source: ThomsonReuters, quoted in (CESR, 2009)
[45] Source : Transaction Auditing Group, quoted in AMF (2009)

- Although systematic internalizers were a topic of intense debate during the legislative process, this phenomenon has been very limited so far. According to CESR, there were no more than 11 SIs at end of April 2009, the majority of them being located in the United Kingdom. Their market share is low. It should nevertheless be noted that this regime is based on self-assessment by firms to qualify their operations. Several Sis are less transparent than what had been foreseen. They are required to publish quotes, but in practice some of them only quote one side of the market for a given security, while others commit to execute only one share at the price they quote (CESR, 2009).

- There are nine “dark pools”[46], which are somewhat more transparent than pure OTC trading but less transparent than regulated markets and MTFs. “Dark pools” are market venues on which all trading is run using the transparency waivers authorised by national regulators. MIFID foresees that it is the prerogative of national authorities to waive the pre-trade transparency obligations applying to secondary equity markets. This provision was intended to deal with difficulties encountered when market participants seek to execute exceptionally large orders. It resulted in a systematic lowering of market transparency. The opportunity of such development can all the more be questioned when regulated markets organise these specific segments of the market and put pressure on their regulators to be authorised to create opaque dark pools able to compete with crossing networks developed by banks. There is a risk that the “brand” of European regulated markets will be depreciated by investors.

- “Crossing networks” were developed by some banks. Although they systematically match orders received from clients, these networks legally are pure OTC markets so long as their promoters do not apply for an MTF licence and provided that the supervisor has decided not to require them to get an MTF licence (which is the case in France, the Netherlands and the United Kingdom). Hence, they do not need any waiver to transparency requirements from regulators. They also escape from other important requirements, such as equal treatment of clients and market surveillance. Crossing networks are not even required to disclose their overall trading volumes as they do not exist legally as such. However, some of them disclose statistics which are neither controlled nor comparable to other trading venues.

The new trading venues’ landscape is confusing for investors unable to get the best execution on their orders, and confusing for corporate issuers unable to monitor trends in their shareholding structure. Transparency waivers diminish the overall market transparency and they make it difficult for investors to check that their broker obtained the best execution of their orders. The European Parliament could consider the elimination of dark pools and crossing networks, without penalising market participants willing to execute very large orders. More generally, the several drawbacks of the fragmentation of equity markets resulting from MiFID raise the question as to whether the fundamental assumptions of MiFID were right. The excessive level of fees charged by exchanges to their members could have been reduced by other means, if it had been recognised that market infrastructures are natural monopolies and should be managed as utilities serving the general interest of all their users.

[46] Source: CESR (2009)

1.4.7 Clearing and settlement

MiFID does not regulate clearing and settlement operations as precisely as securities trading because a further specific directive tackling these issues had been planned, that was to be adopted later on. This specific directive was never drafted.

The only provision concerns cross-border access to clearing and settlement platforms. Most of the progress in that area actually happened outside the legal framework. In 2003, the Giovannini reports (Giovannini, 2001; Giovannini, 2003) pointed out a list of barriers that were a hindrance to the smooth clearing and settlement of trades in Europe. Although several of the barriers identified by the Giovannini report have now been removed, the vertical consolidation of exchanges and post-trade industry remains an obstacle to an integrated, safe and competitive European market. In the light of this, the ECB has proposed an integrated settlement system, Target 2 Securities (T2S), which was endorsed by the EU Council of Finance Ministers on 17 July 2008. T2S will be developed and operated by the National Central Banks of Germany, Spain, France and Italy. In parallel, the Euro system will set up a collateral management system, CCBM-2, for domestic and cross-border operations. Although some stakeholders have challenged the legal basis for intervention by the ECB in this field, the financial crisis made central solutions even more necessary and the Ecofin Council re-affirmed its support to T2S in December 2008 as a means to reduce systemic risks.

In the absence of any harmonisation of clearing and settlement, surveillance authorities in the home market of clearing and settlement infrastructures tend to play a less important role than authorities of regulated markets or MTFs using clearing and settlement services. This might lead to an infringement of the level playing field and regulatory arbitrage.

In parallel, trading and post-trading infrastructures are committed to a code of conduct composed of three building blocks: price transparency, access and interoperability, service unbundling and accounting separation[47]. The follow-up of the Code is monitored by a “Multilateral Monitoring Group of the Code of Conduct on Clearing and Settlement” set up by the Commission. However, the rules of the Code are not binding and supervisors are not involved in their enforcement. A weak implementation at the national level, especially of interoperability between clearing houses, might challenge the goal of MiFID to strengthen competition between trading venues.

For their part, in May 2009 CESR and the European System of Central banks (ESBC) published recommendations for securities settlement systems and recommendations for central counterparties in the European Union[48]. These recommendations are a consistent set of principles and rules. They are addressed to public authorities but they are not binding.

[47] Code of Conduct on clearing and settlement, 7 November 2006

[48] Ref. CESR/09-446

There is a need for a directive that includes the provisions of the code of conduct and imposes sanctions in case of infringement. The European Parliament will play a key role in assessing arguments developed by market undertakings, especially on the issue of competition versus centralisation of clearing. Fees charged by clearing houses tend to decrease as a result of competition and there are questions on the systemic risk that a single clearing house would represent. But the necessity to post margins at several clearing houses and to adapt to different settlement rules remains a cost and the risk related to clearing of securities, which are delivered in a maximum delay of 3 days, is much lower than the risk related to clearing of leveraged derivative markets. In the United States, the existence of one clearing house (DTCC) is not considered as a systemic risk.

Clearing of OTC derivative products will also be on the legislative agenda in the coming months or years. Global outstanding amounts of OTC derivatives grew very rapidly over the last ten years (+22% per year on average). The largest component of these positions is related to interest rate instruments (mainly interest rate swaps, other contracts being forward rate agreements and options) (Davydoff and Naacke, 2009).

The CDS market became a very significant segment of the OTC market and reached an outstanding value close to US$60,000 billions at end of June, according to BIS. It decreased to US$42,000 billion after the Lehman Brothers' collapse and the crisis of the interbank market. The CDS market is still dependent upon e-mail and voice channels and it suffers from very frequent errors (13% of CDS trades according to ISDA).

In Europe, growth of OTC markets was driven by firms based in the United Kingdom. London is the largest centre in the world for OTC derivatives trading, with a market share of 44% of all interest rate contracts traded and 39% of Foreign Exchange derivatives.

The growth of OTC trading has not been accompanied by a parallel regulation. From an operational standpoint, OTC trades are very different from listed derivatives because they may last for years. The surge in OTC trading can threaten processing systems of intermediaries, which were originally conceived for exchange traded products. Market participants recognize that a more comprehensive regulation would not necessarily be detrimental to OTC trading. On the contrary, more secure processing could encourage the industry to use these instruments.

In its amendments to the CRD, the European Parliament called for a study on the functioning of the CSD market and the European Commission published a communication on derivatives market safety (European Commission, 2009-3). The European Parliament might be willing to bridge a gap in MiFID and ensure that adequate standards apply to private initiatives.

2. THE FSAP IN THE LIGHT OF THE FINANCIAL CRISIS

The first signals announcing the financial crisis appeared in the summer of 2007 when some firms had to freeze funds they were unable to evaluate. It was primarily a liquidity crisis affecting financial institutions in need of external financial resources. This is the reason why insurance companies and asset management companies did not suffer such an acute crisis as banks did. Insurance companies have little debt, low off-balance sheet risk exposure and they are basically pre-funded by premiums. Moreover, they have few connections with other intermediaries and are therefore at low risk of contagion. Other than some specific cases (some mono-liners), only insurance conglomerates with a banking activity faced significant liquidity problems. As far as asset management companies are concerned, they are not allowed to jeopardise their balance sheet by trading on the markets.

2.1 Regulation of banks

2.1.1 Flaws in prudential regulation

As explained in the first section of this study, the CRD is the FSAP directive that had the greatest impact on the banking sector.

The monumental supervisory failures that have been revealed during the financial crisis cannot generally be blamed on Basel II or its transposition in the EU through the CRD. The EU timetable means that many of these failures occurred before CRD was fully implemented. However, its content was already known and has influenced the thinking of public authorities and the risk control systems implemented by banks.

In a study realised at end of 2007 for the European Parliament, Alexander *et al*.(2007) consider that the overall design of Basel II and CRD is a key factor in triggering and worsening financial crisis in general and more specifically the present crisis, because the emphasis on banks' own risk management systems and on market discipline reinforces the homogenizing process on the behaviour of market participants, which leads everyone to simultaneously become a seller when a financial crisis arises. As a consequence, considerable pressure was placed on supervision (pillar 2) to counteract behaviour exposing markets to systemic risk. Supervisors were not in a position to exercise that huge responsibility.

The Basel Committee published a recommendation (Basel Committee on Banking Supervision, 2009) aiming at strengthening stress tests, which included taking into account the liquidity profile of each bank. Indeed, the liquidity constraint is lower for a bank receiving stable deposits from its non-financial clients (households and corporations) than for a bank needing to securitize the loans it grants. Besides these "fine tuning" measures, the European Parliament could initiate further works aimed at mitigating the unintended effects of the existing prudential framework. This could be done through two amendments to CRD: first, the legislator could question the lower required capital for IRB banks as compared to those using the standard approach; second, less emphasis might be placed on market discipline.

A second wave of criticism focused on specific provisions of CRD. The report of the High Level Group chaired by Jacques de Larosière, commissioned by the President of the Commission, identified several flaws of prudential regulation (Larosière, 2009): An ineffective dealing of off-balance sheet operations, overconfidence on recent economic data and good liquidity conditions, excessive reliance on external ratings, reliance on models based on too short horizons and insufficient involvement of Supervisory Boards.

The crisis leads to questioning fundamental tenets of Basel II.

First, one of its causes has been the overall under-evaluation of risks taken by the financial sector. An assumption of Basel II that has driven all preliminary works to this agreement was that the overall capital charge should not be increased. This now appears highly questionable as a major cause of the financial crisis has been the weakness of banks' capital. This supports the notion of a general increase in capital requirements. Specifically, the Commission published a proposal of Directive[49] amending CRD, in a manner consistent with proposals of the Basel Committee, to increase the capital requirement for market risks by adding a requirement based on stress scenario to the ordinary scenario based requirement. This new provision is expected to roughly double current trading book capital requirements[50]. Moreover, capital requirements would be added in the trading book to capture rating downgrades and capital requirements for securitized positions would be aligned with those applying to the banking book. One important practical consideration in the implementation of such new requirements, however, is the risk that more stringent capital requirements worsen the credit crunch. Therefore, implementation of additional capital requirements should be gradual, as recommended by the Larosière report. Another concern emanating from the European banking industry is that a rapid implementation of this additional requirement would breach the level playing field with American banks. The latter are already considered as benefiting a competitive advantage: the same level of risk often entails lower capital requirements in the US than in Europe because of differences in accounting standards.

Second, the very basis of risk assessment under Basel II (and subsequently the CRD) has been called into question, with the extensive loss of credibility suffered by both credit ratings, especially in the case of structured financial instruments and banks' internal models. There is no obvious fix for the inadequacies of those risk assessment processes that are recognised by CRD. The only workable approach to fix them over the long term is to encourage innovation and the emergence of new, better methods to assess financial risk. This may be achieved by lowering the barriers to entry into the market for risk assessment services (Véron, 2009).

[49] Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of compensation policies, SEC(2009) 974 and SEC(2009) 975.

[50] Source: Explanatory memorandum of the European Commission, "3. Impact assessment", August 2009.

Finally, operational risks are a grey area of Basel II and CRD. The sophistication of models supposed to measure credit risk and market risk are in sharp contrast with the simplistic methods and the lack of historical data to tackle operational risk. However, operational defaults proved to be a potential source of risk for firms and the financial system. Setting up specific European capital requirements is not an easy task, because these issues are discussed within the Basel Committee. However, the European Parliament could introduce a proposal in the global debate on capital requirements, to cover risks of OTC trading. Extending clearing to more OTC trades will diminish the counterparty risk related to these operations. But they will not eliminate operational risks due to opacity, absence of standardization and legal weaknesses. An additional capital requirement could be proportional to the volume traded or outstanding positions in OTC contracts.

2.1.2 Corporate governance

There is wide recognition that weaknesses in corporate governance of financial firms is at the core of the financial crisis. The public debate and legislative initiatives in Europe, based on the G20 statements, the ECOFIN recommendations and the Larosière report tend to focus on two issues:

- Compensation of staff whose activity involves material risk-taking for the firm. Beyond the public debate on the level of compensations, traders should not have incentives to act in ways that undermine effective risk management.
- Internal control procedures

Compensation policies applying to trading activities and other activities exposing the firm to market risk face several difficulties:

- They raise cultural and ethical problems that can hardly be tackled by regulation.
- Politicians demand that variable compensation is related to performances, but high trading profits can then trigger high bonuses, rarely admitted given the background to the financial crisis.
- Traders or even entire trading teams can move to another workplace or employer offering better compensation. The quality of trading teams being a significant part of intangible assets of a financial firm, it is, therefore, difficult to enforce a stringent policy in a specific country or in Europe.

As a first step, following Statements of the G20 Summit in London on 2 April 2009 and the recommendations of the Larosière report, the European Commission published a recommendation on remuneration policies and practices in the financial services sector[51], in parallel with a recommendation on the compensation of directors of public companies. Then, the principles promoted in the recommendation were included in the proposal of a directive amending the Capital Requirement Directive. This proposal will be on the top of the agenda of the European Parliament. It would oblige credit institutions and investment firms to have compensation policies that are consistent with effective risk management.

[51] C(2009) 3177, 30 April 2009

The approach of the Commission is flexible (appropriateness of policies would be evaluated taking into account the size, the internal organization, the nature, the scope and the complexity of the firm). It does not impose quantitative rules but for the first time, compensation policies would be subject to supervisory oversight. Supervisors would be empowered to require firms to rectify any problem or to increase capital requirements in case of non-compliance. Violations would be punishable by supervisors.

The most important issues relating to the proposal of the Commission are the following:

- Due to the **flexibility** of the proposed approach, the effectiveness of the new regulation will largely rely on national supervisors. It would be advisable that national authorities report to their respective Committees on that matter, in order to spread best practices and to benchmark national supervisory practices on the best practices. However, the capacity of national supervisor to implement policies diverging from international standards is doubtful, as showed by recent developments (August 2009) in the United States and Europe. Additional capital requirements to tackle operational risks generated by excessive variable compensations could be envisaged.

- It applies to banks and investment firms only. The European Parliament will have to consider whether it is appropriate or not to include the **insurance** sector and **asset managers**. Banks' defaults have focused the attention of public authorities. However, it might be necessary to implement regulation in other segments of the financial industry.

- The new regulation would not include any reference to the compensation of **compliance activities and officers**, whereas imbalance of compensation of the staff in charge of these responsibilities and the staff with risk-taking activities is widely recognize as essential. There is a risk that the European regulation on that issue lags behind national standards. For example, in the United Kingdom, FSA added a compensation code of practice into its handbook, which includes a section on the compensation of employees in risk and compliance functions and a provision that risk and compliance functions of other staff should have a significant input into the setting up of individual compensation awards.

2.2 Questions raised on Solvency II

Some questions raised in the Basel II provisions in the aftermath of the financial crisis are also to be raised on Solvency II.

The first question relates to pillar 1, namely capital requirements. As for banks, Solvency II design was based on the assumption that overall capital of insurance companies did not need to be increased and that it should rather be reallocated by taking into account the actual risks involved in each activity. This assumption proved to be false in the case of banks. The fact that no major default happened in the insurance sector does not prove that insurance companies are better capitalised than banks. Indeed, insurance companies are not subject to the same liquidity constraint as banks, and it is possible that cases of insolvency are still hidden. The life insurance contracts expose insurance companies to financial risk in the event of adverse markets and to liquidity risk, if investors want to recover their assets.

However, it can be argued that the two factors at the origin of the banking crisis do not exist in the insurance sector. First, the credit risk and the market risk which proved to be wrongly assessed by banking models represent only a part of the insurance companies' activity. A dramatic change in the structure of banks' balance sheets happened in the last decade, with a decrease in the share of traditional assets (credits) and liabilities (stable clients deposits) and an increase of assets and liabilities towards markets and other financial intermediaries. The fundamentals of the insurance industry did not change so dramatically. However, trends of some segments of the industry will have to be closely monitored. In particular, it is doubtful that the yields offered by companies to policyholders of guaranteed life insurance contracts can remain higher than the ones of bank deposits or bonds much longer.

The second question raised by the financial crisis relates to pillar 3. By nature, market discipline increases herd mentality in investors and thus contributes to worsen financial crisis. It is pro-cyclical because all market participants use similar models and similar data. Such drawbacks also exist as far as the investment portfolio of insurance companies is concerned. It is a source of weakness, both at the systemic level and the micro-prudential level.

2.3 Systemic institutions

In the last 20 years, there was a majority opinion that financial institutions growth and complexity should not be hampered by regulation. The largest firms were supposed to benefit from economies of scale, diversification of risks and wider access to global financial markets.

Large cross-border or 'pan-European' banks have emerged since the late 1980s and their market position was strengthened again by acquisitions of distressed banks in the financial turmoil. In Europe, 11 financial groups had total assets surpassing a €1,000 billion in 2007. Ten of them are banking groups and only one (Allianz) is an insurance group. Two financial groups (Allianz and Munich Re) had a presence in 17 Member States (Kamerling and Makipaa, 2008) The market share of the top 10 groups varies across countries. It is less than 50% in the United Kingdom, Luxembourg, France and Germany, but it is over 80% in Malta, Greece, Cyprus, Estonia, Lithuania, Latvia and Finland.

Their regulation and supervision is a challenge which has been underlined by developments of the financial crisis. The Financial Conglomerates Directive[52] adopted in December 2002 is a positive achievement of the FSAP. It was a first attempt to tackle the specificities of supervision, when a group is involved in different financial activities, mainly banking and insurance activities. The Financial Conglomerates Directive came into effect in 2005. It is a significant but limited attempt to take into account the complexity of financial groups without affecting the tasks and responsibilities deriving from sector-specific directives. In particular it aims at ensuring that the same capital is not used several times within the group and it foresees that a single co-ordinating authority is responsible for supervising the whole entity.

[52] Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

Part of the challenge ahead for the European Union will be to determine if a specific regulatory regime is warranted for those financial firms deemed systemic. Although the Lehman Brothers case highlighted that governments may in some circumstances decide to let large banks go bankrupt, the rescue of systemic banks remains the most likely output when they default. If formal criteria are developed for determining systemic status, they may include:
(1) Size: Large financial players may be deemed "too big to fail" and will therefore be provided with special protection by authorities. Moreover, there is an obvious contrast between the level of individual Member States, where the banking industry is in many cases already highly concentrated (Kamminger and Makipaa, 2008), and that of the EU as a whole, where the level of banking concentration is considerably lower than in the United States;
(2) The number and intensity of connections with the rest of the financial sector[53];
(3) The leverage ratio and the growth rate of certain risky operations
(4) The absence of deposits and the dependence on the interbank market, as liquidity weaknesses of large banks may raise systemic problems.

Moreover, in some cases, no individual firm in a segment of financial activity raises systemic risk alone, but the whole sector behaviour does. An example of such a situation was observed with sub-prime credit originators in the United-States.

It will be difficult to set quantitative criteria to identify and specifically supervise "systemic" financial firms. As stated by Charles Goodhart (2009), "*while there are ways to measure the systemic impact of any particular institution's failure on the rest of the financial system, they are novel, untried in practice, and time and state varying*". Given the interests at stake, it can be anticipated that this particular issue will greatly mobilise the attention of policymakers, and will also be impacted by the decisions made on parallel developments in the United States.

2.4 Financial supervision

2.4.1 Performance of the FSAP and Lamfalussy supervisory framework

The lack of a consistent cross-border prudential framework has long been identified as a significant threat for financial stability in the European Union. From this standpoint, the crisis has both confirmed previously expressed fears, and brought experience that may be helpful in future policy developments.

Many of the European banks, which have failed or needed large-scale direct or indirect emergency public intervention since August 2007, have been mainly national in scope, such as Northern Rock, IKB, the German Landesbanken, Hypo Real Estate, Natixis, Caja Castilla-La Mancha, or the three leading Irish banks. In such cases, the national authorities had the right geographical remit to address events, even if their response has proved less than fully adequate in some cases. However, in a number of other cases, most notably Fortis, Dexia and Icelandic banks, the cross-border aspects have played a crucial role. Three key lessons stand out.

[53] In the United-States, Governor Daniel K.Tarullo considers that "too-interconnected-to-fail, must be subject to regulatory requirements and consolidated supervision" – speech At the North Carolina Bankers Association Annual Convention, 15 June 2009.

The first lesson, from the Icelandic experience, illustrates the magnitude of the threats such experience may represent to the integration of the financial European market. Specifically, the Turner Review (FSA, 2009) examines the problems met by FSA in dealing with issues raised by the bankruptcy of the Icelandic bank Landsbanki and the consequences on the operations of its branch in the United Kingdom. The report envisages the hypothesis of increasing host country supervisors' powers on local operations when they have concerns about the supervisory resources of the competent authority in the home country, or the financial resources to fund the home deposit insurance and the bank rescue. The report recognises that "*the likely impact of such powers would be that bank supervisors would require banks headquartered in small Member States to operate cross-border in a subsidiary fashion*." This would amount to violating the passporting rights in Europe, and unequal treatment of firms depending on their country of registration. However, the report notes that already in the current legal framework, FSA would be able to gather information from banks and home country regulators on the liquidity of banks operating as branches in the UK and to impose tougher liquidity requirements on local branches and subsidiaries. But the crisis proved to entail a risk of challenge to integration of the European market.

The second lesson, from the experience of Fortis and Dexia, is that contrary to what had been anticipated by observers before the crisis, Member States have been able to find 'burden-sharing' arrangements on an *ad hoc* basis, i.e. ways to divide among themselves the financial weight of emergency intervention.

The third lesson is more general: Central banks played their role to solve the acute crisis of the interbank market in the period following Lehman Brothers's default. National governments played their role in implementing emergency rescue packages to avoid any systemic default and restore public confidence. But the three level 3 Committees (CEBS, CESR and CEIOPS) did not play any significant role and the main visible intervention of the European Commission was to check rescue packages compliance with a maintained fair competition between distressed banks supported by the governments and healthy financial firms. The Lamfalussy framework (rather than the FSAP) proved to be inefficient in this context.

2.4.2 Improving the FSAP supervisory framework

The crisis has triggered a move towards stronger institutional set-ups that could become irreversible. The High Level Group chaired by Jacques de Larosière has recommended the creation of a new set of institutions comprising a European Systemic Risk Council, in charge of macro-prudential tasks and a European System of Financial Supervisors mainly consisting of the transformation of existing 'Lamfalussy' committees (level 3) on banking, insurance and securities into fully-fledged supervisory authorities. These proposals were largely endorsed by the European Council in its meeting of 18-19 June 2009, and the related legislative process will be one of the first issues on the agenda of the new European Parliament.

Some concerns have been expressed on the inability of European authorities to impose decisions to Member States that would have a budgetary impact when a financial institution needs to be rescued[54]. These concerns might lead to question whether the expected benefits would be delivered by the reform. However, as noted above, national governments proved to be able to get burden sharing agreements when a bank defaults. One of the policy options will be to define precisely cases where exclusive responsibility of Member States is involved, for example when governments have to decide measures other than recapitalization of distressed banks, such as temporary loans, guarantees, insurance against defaults or "bad banks".

Questions have also been raised as to whether there was sufficient European integration of ongoing supervision. However, the establishment of new institutions in charge of the day-to-day monitoring of cross-border firms would be a great risk to the system, as agents of the new authority would initially not have deep knowledge of markets and institutions. It should be recognized that national regulators did not prove to have a perfect understanding of all the activities of the firms they supervise, but the performance of a newly established authority will obviously be very difficult at the start of its new duties. In addition, the financial system is still exposed to risks of default of some financial institutions. However, the orientations of the June Council meeting can only be seen as the start of what promises to be an ongoing and gradual process of institutional build-up.

The new supervision framework will have several positive impacts:

- A rapid adoption of the new framework will be pivotal in dealing with further possible defaults in the financial sector: the crisis is not over.
- A strong institutional plan approved by the European Parliament will greatly contribute to renewing public confidence, a pre-requisite to long-term oriented savings behavior and the return of growth.
- The new institutional framework should be able to tackle further financial systemic risks much earlier and in a more efficient manner.
- On an ongoing basis, implementation of the Larosière group recommendations – which include a common rulebook in Europe in order to correct the present discrepancies in the implementation of European regulation – would also strongly contribute to strengthen banks supervision.
- It reflects the new legitimacy of Europe in the supervision of the financial sector by giving binding powers to financial institutions, including registration of specific players (Credit rating agencies).
- Thanks to its ability to solve its home problems rapidly, Europe will have the necessary authority to maximize its influence with regards to international bodies where common rules and initiatives have to be approved and implemented on a global basis (Basel Committee, FSF, IOSCO, IMF, IASC).

[54]Such a restriction is proposed because it is considered that leaving the burden on national taxpayers while supervision would be undertaken by a supra-national body would constitute "*a version of taxation without representation*". For this reason, Charles Goodhart (2009) advocates placing responsibility of macro-prudential control with the host country central bank.

At this stage, the main policy options cover the exact mandate, governance and funding framework for the European Supervisory Authorities. For the above mentioned reasons, the new supervision architecture should be implemented as soon as possible, but the European parliament will seek to avoid any rush that could lead to reforms with unintended consequences.

The proposed reform involves numerous bodies, whose responsibilities should be precisely delineated, in order to avoid any gap or overlap, starting with the relationship between the ESRB and the ESFS. Both institutions do not have the same objectives. While the latter will prioritize consumer protection, the former will be in charge of reducing systemic risks. The Central Banks will play a central role in the ESBR. They provide liquidity to banks and may thus have conflicting interest with consumers. This would not prevent compulsory transmission of information by the ESFS to ESBR when the difficulties of firms might raise systemic risks.

One of the issues concerns the role of the Commission in case of emergency action. The main intervention of the Commission in the recent rescue packages set up by governments was to ensure that competitive law was not infringed. It would have been the case if a bank had benefited from excessive support distorting competition with more healthy banks. This role has to be maintained. However, there is no major argument in favour of an exclusive initiative power of the Commission.

Another question relates to whom warnings and recommendations of the ESBR should be sent and how the European Parliament and the European Council should be informed. The Council should be informed, as governments may have a role to play in preventing specific risks of default and in financing possible rescue packages. However, it will be essential to maintain confidentiality of some alerts in order to avoid triggering panic reactions that would materialize the risk mentioned to the Council. It will also be very important that the new authorities report to the European Parliament on a timely basis, if not on a continuous basis. Accountability of new bodies and authorities to the Parliament is a necessity to ensure their legitimacy and therefore their efficiency.

Finally, developments in the US will be closely monitored and may have ripple effects on future European debates. If, as has been proposed by the Obama administration, the Fed is granted sweeping authority to regulate any financial firm whose impact is deemed potentially systemic, it is to be expected that pressures will build up for a similar framework to be implemented in Europe.

2.5 “Fair value” accounting

The crisis has put IFRS under the spotlight, with many banks and banking representatives asserting that ‘fair value’ accounting, an accounting principle applied under IFRS to some, but far from all, categories of financial instruments (the frequently used characterization of fair value accounting as ‘mark-to-market’ is partly misleading, as it foresees marking to a financial valuation model rather than market prices when there are no observable transactions that would provide a reasonable basis for valuation), played a causal role in some developments of the crisis. However this assertion has not been backed by empirical evidence.

So far, the main available documents, such as a SEC's study published late December 2008 and the July 2009 report of the Financial Crisis Advisory Group, a semi-independent body set up by the IASB, tend to suggest that IFRS actually have not been culprits for this crisis. Even so, restricting the scope of fair value accounting has been strongly advocated by several Member States, which in late 2007 and 2008 were largely relayed by the European Commission. Under heavy pressure from the EU in October 2008, the IASB loosened its rules about financial instrument classification, enabling financial firms to lower the share of their balance sheet on which the fair value principle applies. In July 2008, the IASB has released an exposure draft redrawing the boundaries between the respective scopes of fair value and amortised cost.

This move has also marked an apparent departure from the earlier emphasis on convergence with US GAAP, as FASB almost simultaneously took a different position that would substantially extend the scope of fair value accounting. In successive meetings of the G20, heads of state and government have reaffirmed their commitment to a single global set of high-quality accounting standards. However, in 2008 senior European figures, such as Banque de France governor Christian Noyer, specifically hinted at the possibility of the EU charting its own path by disconnecting its standard-setting from the IASB.

In terms of governance, tensions which were latent already before the beginning of the crisis have been exacerbated by it. In late 2007, the Trustees of the IASC Foundation started to envisage the creation of a monitoring board of public authorities that would vet their own appointments and reappointments, and thus mitigate the criticism of the Foundation (and by extension the IASB) as a self-appointed group of unaccountable individuals. This was eventually implemented in early 2009, with the Monitoring Board comprising two representatives of the International Organisation of Securities Commissions (IOSCO), one of which represents emerging economies; the US SEC; the Japanese Financial Services Agency; the European Commission (which had yet to sign its formal adhesion to the Board at the time of writing); and the Basel Committee on Banking Supervision with observer status. However, neither the composition of the Monitoring Board, nor its relationship with the IASC Foundation, have been a matter of consensus and there is a widespread recognition that this arrangement is, at best, a temporary step towards a more sustainable institutional structure.

In terms of IFRS implementation, the crisis has also highlighted a less-than-perfect consistency in the way the standards are applied in different jurisdictions. The distinctive promise of IFRS compared to national accounting standards, cross-border comparability, is jeopardized if implementation is inconsistent. The EU has introduced a coordination process among enforcers (generally securities regulators) through a specialized committee of the Committee of European Securities Regulators (CESR-Fin), but this is considered by many market participants insufficient to ensure effective consistency.

2.6 Guarantee schemes

2.6.1 Bank deposit guarantee schemes

Emergency measures taken after Lehman Brothers' default successfully prevented any panic of deposit holders in distressed banks. However, in one case (the Icelandic bank Landsbanki) the guarantee fund proved unable to meet its commitments. In other cases (Northern Rock in the United Kingdom), the government announced it would cover all deposits, whatever their amount.

Panic was prevented despite several flaws in European regulation. Guarantee schemes in Europe are incomplete and only partly harmonised. The level of guarantee of banking deposits varies across countries. In October 2008, the Commission proposed urgent legislative changes that came into force in March 2009[55]. The minimum guarantee has been raised from €20,000 to €50,000 by 30 June 2009 and €100,000 by 31 December 2010. The payout delay, which used to be 3 months (extensible to 9 months), has been reduced to 20 working days as a first step, and 10 working days by June 2011.

However, there are still several harmful discrepancies between national deposit guarantee funds, which should be tackled in a future directive:

- In terms of funding mechanisms: in some countries, there is still no pre-funding of guarantee funds. This makes the ability of funds to meet their commitments more uncertain and moreover it is pro-cyclical as funding calls are done in difficult times.
- In terms of eligible bank clients: private depositors and Small and Medium Companies should be protected, and there is a need for a harmonised definition of SMEs for the purpose of this protection. Such harmonisation is necessary to avoid time-consuming verifications which would put into question the reduced payout delay.
- In terms of mandate of the funds and the relationship with supervisory authorities: in some countries, funds play a preventive role and can manage the transfer of clients' accounts from a weakening or distressed bank to another bank; in other countries they don't.
- In terms of cross-border coverage.

The European Parliament will have to make a decision about implementing either a full harmonisation of the level of guarantee (€100,000) in order to maintain fair competition between national banking systems or a minimum level to provide a flexible answer to differences across countries in the cost of living. The highest priority given to consumer protection and the small number of depositories that actually transferred their assets from one country to another when the financial crisis was at its most acute, might lead the European Parliament to decide on minimum harmonisation, leaving the option to implement higher protection to Member States.

The Commission announced a new proposal of a directive on these issues by the end of 2009.

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[55] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay.

2.6.2 Insurance guarantee Schemes

Last-resort protection mechanisms in the insurance sector are fragmented. A report by Oxera (2007) finds that only 13 Member States operate an Insurance Guarantee Scheme and there is no harmonisation of these funds in Europe at this stage. As a consequence there are different levels of policy holder protection in the EU. This discrepancy with the banking sector is all the more a source of difficulty as insurers tend to sell "retail investment substitutes" with characteristics very similar to UCITS or bank deposits.

Implementing a European insurance scheme would not expose it to any significant moral behavioural hazard if there is a ceiling to the amount of guarantee.

However, the cost of the default a major insurance company in some concentrated national markets would be difficult to finance. Hence, a European scheme would be more efficient than national ones in order to pool the costs involved. Moreover, it would imply a maximum harmonisation of the guarantee, thereby discouraging regulatory arbitrage.

On the other hand, maximum harmonisation does not take into account the differences in the standard of living across Member States. In countries where households' wealth and income is lower on average, it might be less expansive and perceived as sufficiently protective to have a lower guarantee. Moreover, a single European guarantee fund might not have the necessary knowledge of the market to organize the transfer of policies from the distressed company to a wealthy one.

Finally, it should be noted that there is no obligation in Europe to set up a pension guarantee fund, although some Member States did create such a fund, as for example did the United Kingdom in the wake of the Maxwell scandal.

2.7 Credit rating agencies

Credit Rating Agencies (CRAs) were a pivotal factor in the outbreak and spread of the sub-prime crisis to the global economy. Rating agencies directly participated in the structuring of portfolios of securitised loans. Investors were wrongly influenced by the high-grade rating of many products.

The FSAP did not include any regulation of CRAs and it can even be considered that the reliance on external ratings in prudential regulation (mainly CRD) contributed in an over-confidence of investors in ratings that proved to be based on wrong models.

The European Parliament and the European Council approved a new regulation[56]:

- All responsibility concerning rating agencies is given to CESR. Applications will be submitted to CESR and a college of securities regulators deciding in a consensual manner.
- CRAs will have to comply with rules tackling conflicts of interest, quality of rating methodology and transparency.

[56] Regulation of the European Parliament and of the Council on Credit Rating Agencies, 2008/0217 (COD)

The European Parliament could consider further issues for the medium-term future:

- Which type of authority should be in charge of rating agencies' surveillance? There is a tendency to follow the existing framework like in the US, where the authority in charge of securities and markets, the SEC, is the competent authority supervising CRAs. This option can be justified by the use of ratings by investors and more generally by the fact that the issues at stake are transparency issues. However this choice can be challenged from a technical standpoint: securities and market authorities are less competent in the area of credit risk than banking authorities. Hence the latter might be better placed to oversee rating agencies. As the new regulation foresees that securities authorities are in charge of rating agencies, there is a risk that the controls will only be formal, without going into the details of the methodology and models used by rating agencies. The quality of the registration and surveillance will have to be controlled.

- Conflicts of interest: The conflict of interest resulting from the compensation by the securities issuers proved to be highly detrimental to investors in the case of structured products. The fact that rating agencies got substantial revenues from their participation in the securitisation process has been a disincentive for assessing in depth the quality of models they used in the rating process. The business model of CRAs should be re-assessed and the possibility for CRAs to be remunerated by investors rather than by rated issuers should be considered in the medium term.

- Increasing transparency of the performance of their ratings: The new regulation foresees that CRAs will be made available from a central repository established by CESR information on their historical performance data and information about past credit rating activities. However, it should be noted that the comparison of ratings with actual probabilities of default makes sense only if such probabilities exist. It is clearly not the case for sovereign issues, which might be the next financial bubble, nor for issues by "too big too fail" banks.

2.8 Short selling

Facing a sharp fall and high volatility of equity shares, especially shares issued by financial institutions, US regulators and some national regulators in Europe suspended short selling and imposed higher disclosure or reporting of short positions at fall 2008. Such initiatives were based on the belief that short sales accelerated the fall of share prices, especially shares of financial firms.

As short selling is not covered by any European directive, regulatory initiatives in Europe were not coordinated and their precise content varied from one jurisdiction to another. Before the financial crisis, there was no restriction on short selling in the United Kingdom, France, Germany and Italy. Authorities in these countries hastily imposed a ban or partial restrictions on short selling, although the definition of short selling was different in each jurisdiction[57]. Some regulators have renewed these measures in the course of 2009, either in their entirety or partially.

[57] For more details see: Cinquegrana (2009)

However, the efficiency of such regulatory initiatives has been questioned. No regulator banned short positions taken on derivatives markets. On the other hand, prohibitions applied to short sellers although the majority of them run long-short positions. For example, Ekkehart Boehler, Charles Jones and Xiaoyan Zhang show that the ban of short selling for almost 800 securities from 18 September 2008 in the United States had no impact on the price of the concerned securities. It only resulted in broader bid-ask spreads and higher volatility[58].

In fact, short selling is recognised to contribute to price discovery and market liquidity. It facilitates hedging and more generally risk management.

Although the measures taken to counteract the fall of equity markets in the fourth quarter of 2008 did not prove to be effective, there are cases of malfunctioning of the market resulting from short selling. For instance, in October 2008, short sellers of Volkswagen shares considerably increased the price of the share, when they had to unwind their positions in a market that has dried up due to the exercise of undisclosed call options by Porsche. However, besides crisis periods, short selling can threaten investors safety if it happens that the seller is not able to deliver the sold securities in due time. Even in a period of normal functioning of markets, it is advisable to restrict short selling allowances to market participants who have arranged a secured settlement at the right date (D+3) and to require sellers to regularly inform the regulator about their trades and positions.

IOSCO recently released a consultation paper that recognizes the contribution of short selling to a smooth functioning of markets, while willing to address three regulatory concerns:

- Disorderly markets including an “overshoot” on the downside.
- Market abuse, for example price manipulation.
- Settlement disruption, when the seller has not arranged borrowing ahead (IOSCO, 2009-2).

IOSCO recommends harmonised regulation to be implemented within the framework of four principles:

- Short selling should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets.
- Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities.
- Short selling should be subject to an effective compliance and enforcement system.
- Short selling regulation should allow for appropriate exceptions, including market markers activity.

[58] Quoted by Cinquegrana (2009)

Short selling should be on the agenda of the European Parliament to avoid disorderly initiatives being taken by national regulators. The most important components of such a directive should be:

- Forbidding any “naked” short sellings, because inability of the seller to deliver securities can be a major disruption in the functioning of markets and public confidence.
- Disclosing major short sales, a necessity for the price discovery process: indeed, it is key for market participants to assess whether a flow of sales will soon be offset by symmetrical purchases when the short sale is unwound.

3 NEXT STEPS FOR EU LEGISLATION

There is a case for the European Parliament to take legislative initiatives to fill in the remaining gaps of regulation for harmonising customer protection. There is also a need to improve the enforcement of accounting standards.

3.1 Filling the gaps of regulation

3.1.1 Investment funds depositories

The Madoff case has highlighted the shortcomings of EU rules on investment funds depositories (see box 1).

The European Commission announced a consultation on the role of depositories in order to clarify their obligations. Similarly to the draft directive on Alternative Investment Funds, the new legislation would clarify obligations of the depositories when assets disappear, including in the case of fraud. The depositories would not be accountable for such disappearance only if they can demonstrate that it could not have been avoided. Due diligence in case of sub-contracting to a third depository would be regulated.

Box 1: The Madoff/UBS case

In the Madoff case, the role of the Luxembourg regulator CSSF is questioned by investors. CSSF had pointed out serious breaches of duties by UBS Luxembourg as a depositor. But no sanction was applied for those faults. Furthermore, CSSF admitted the obligation of restitution of assets deposited with the bank but it referred the case to the court because of a clause in the subscription form of the SICAV, providing the bank with a discharge of any liability in case of failure of the US broker. This clause had not been included in the Prospectus.

3.1.2 Hedge funds

Hedge funds are not at the origin of the current financial crisis but incited their subscribers to withdraw their funds and primary brokers to deleverage, forcing managers to be massive sellers of securities. Issues raised by the development of hedge funds were already topical in 1998, when the near-collapse of the hedge fund LTCM triggered a bank liquidity crisis in the United States, leading to the FED having to orchestrate a rescue package. This crisis was a precursor of the present turmoil.

The major regulatory issue to tackle is thus related to prime brokers (investment banks) before the crisis[59]. Investment banks have engaged in fierce competition to finance hedge funds and provide them with trading services. This competition has lowered the margin required by primary brokers for the credit granted to hedge funds before the crisis and a sharp increase of these margins when the crisis broke. The high concentration of the brokerage business was an additional factor for the brutality of this reversal. The CDO market became illiquid when some much indebted funds faced higher margin requirements from their primary brokers. Blundell-Wignall (2007) find that hedge funds held more than 46% of the CDO market and 80% of the most risky tranches (equity)[60].

On 23 September 2008, the European Parliament adopted a resolution requesting the Commission to submit a legislative proposal covering hedge funds and private equity actors. The Commission endorsed the principle of a closer regulatory and oversight of hedge funds and private equity funds, and it published a proposal of directive on Alternative Investment Funds (AIF)[61] which covers main categories of non-UCITS funds: hedge funds, private equity funds, real estate funds, commodity funds and infrastructure funds. Contrary to the regulation applying to UCITS, the Commission's proposal is to regulate the largest fund managers, rather that the funds themselves. Regulation would cover capital, organisational and transparency requirements. Licensed fund managers would benefit from a European passport to sell funds to professional investors. Depositories would be liable to the funds for any loss suffered by them as a result of non-compliance with the standards of the directive.

Although it is widely recognised that the existence of a large "shadow banking system" is a source of systemic risks, there is a lack of consensus on the content of regulation that should apply to hedge funds, hedge fund managers and prime brokers. Any regulatory framework has to be sufficiently attractive to convince the industry to use it. It is feared that excessively stringent regulation would incite hedge fund managers to leave the EU (mainly the United Kingdom) to Switzerland or off-shore centres. This would not only be detrimental to the industry, it would also make for ineffective regulation. It would be all the more the case if funds domiciled outside the EU are given a European passport with no other constraint than an agreement of exchange of fiscal information signed between the home EU country and the country of origin of the fund, as proposed in the Commission's proposal.

Hence, the EU should rather influence the regulatory global forum than regulate on a stand-alone basis, following the report of IOSCO Technical Committee published in June 2009, which recommends securities regulators to apply a set of principles in their regulatory approach (IOSCO, 2009-1). Only hedge funds domiciled in countries which do enforce IOSCO recommendations should be allowed for selling in Europe.

[59] For a detailed description of the role of hedge funds in the financial crisis, see: Cartapanis (2009)

[60] Blundell-Wignall A (2007), "Structured products: Implications for Financial Markets", OECD Financial Market Trends, n°93, Vol.2007/2

[61] COM (2009) 207 – 30 April 2009

If it is felt that such regulatory processes will be too long, supervisors in Europe and the United States can immediately act by closely overseeing or even limiting the leverage provided by investment banks offering primer brokerage services to hedge funds, regardless of their location. An agreement with American and Japanese authorities would be sufficient to implement such measures efficiently, since most major investment banks providing prime brokerage services are headquartered either in the United States or in Europe.

3.1.3 Commodity derivatives

There are few commodity derivatives markets in Europe, the main ones being ICE Futures for energy derivatives and the LME (London Metal Exchange) for metals. In 2008, Europe accounted for 18% of global trading in commodity futures.

Number of commodity futures contracts traded in 2008 (in 000)	
Budapest SE	15
NYSE Liffe (European markets)	11 787
ICE Futures Europe	152 324
London Metal Exchange	105 862
Memo : Dalian Commodity Exchange	313 218
Memo : Shanghai Futures Exchange	140 263
Memo : CME Group	513 100

Source: IOMA/WFE

The European regulation of commodity derivatives is incomplete.

Commodity derivatives are included in the list of financial instruments covered by MIFID, but there is no clarity on the universe of products covered. Furthermore, commodity derivatives are not subject to transparency requirements. Commodity derivatives are subject to large price moves. Both supply and demand factors and financial factors due to investors who are increasingly considering commodities as an asset class contributing to portfolio diversification, play a role in these moves, although their is no consensus on their relative weight. The European legislators should consider the opportunity to improve transparency on cash and derivative markets in order to asses the origin of prices' evolutions. Such transparency does not necessarily consist of a real time dissemination of prices and traded volumes. In the United States for example, the CFTC requires "index traders" to disclose their open positions and it limits the size of permitted speculative positions. This would help to disentangle the impact of the "real economy" market participants from the behaviour of financial investors.

The Market Abuse Directive does not cover commodity derivatives. However, the Enron case in the electricity market in 2001 and the Amaranth case in the natural gas market in 2006 signalled a need for enforcing market abuse legislation for commodity and commodity derivative trading. There is a consensus that the definition and regulation of insider trading on those markets should be consistent with the Market Abuse Directive.

Concerning market surveillance, commodity derivatives can fall into the scope of securities regulators, as they are included in MIFID. But physical commodity markets are not, and a specific authority competent in both cash and derivative trades could be created. This new European agency would mirror the existing international Energy Agency, taking into account differences between agricultural products, non-precious metals, precious metals and energy.

3.2 Harmonising customer protection

In the aftermath of the financial crisis, the attention of policy makers and supervisors concentrated on emergency measures to save distressed financial firms and to better oversee and mitigate their risk takings in the future. But public confidence is widely recognized as the key factor for a return to economic growth. This should lead to a strengthening of regulation aimed at protecting the users of financial services.

Users of financial services were supposed to benefit from the FSAP through increased competition among financial firms and a more diversified product offers. But protection of savers and borrowers actually remained in the hands of national host countries and most attempts to harmonise regulations in that area were incomplete in terms of services, financial instruments and firms. The next generation of European regulation should remedy this deficiency.

3.2.1 Selling practices

The European Parliament could consider an ambitious approach to selling practices. The latter were often dealt in the FSAP as a mere complement to the integration of the market. Harmonisation of the protection of consumers was implemented when it was felt that it was a condition empowering home country authorities to licence and oversee firms providing services in all EU countries. But the protection of consumers was often left to the national law in host countries. After the enhancement of prudential rules and the establishment of the new institutional framework regarding supervision, the next generation of European law in the coming years would consist of marketing and selling rules.

The Commission could be mandated to organise an in-depth and complete consultation process. Consumer associations should be strongly supported to enable them to dedicate resources comparable to the ones of professional lobbies in the financial industry and to be fully associated and efficient in the preparation of this legislative programme. From that standpoint, the existing Fin-USE worked as a panel of experts but consumer associations did not have the necessary time to join that panel. New procedures that associate consumer representatives should be envisaged.

It is not the goal of the present study to anticipate on the outcome of this process. For illustrative purposes, the following initiatives could be envisaged:

- MiFID does not cover most independent financial advisors. Article 3 of the directive allows Member States to exempt individuals from the application of the directive who provide investment services if they do not hold securities or deposits of their clients. The numerous independent financial advisors in Europe fall into that category. Such exempted individuals do not benefit from the European passport. Several countries opted for that exemption, even though the national regulation they apply to investment advisors is often copied from MiFID. A possible minimum harmonisation of investment advice could be considered by the European Parliament. The goal of such harmonisation would be to strengthen consumer protection, rather than setting up a European passport for all investment advisors.

- The creation a single risk indicator for all investment products, as proposed by BEUC (2009), could be envisaged.

- Advertising should be subject to regulation and controls by the supervisors.

- Firms should be required to set up internal procedures to ensure that all rules are observed by commercial staff.

- Supervisors should take the initiative to make public warnings when complex or risky products are widely proposed to savers.

- The “financial advisor” denomination is misleading when it covers employees whose compensation is linked to selling targets product by product. Clients should be informed about these compensation arrangements.

- Savers should be able to meet truly independent financial advisors, whose compensation is not linked to any commercial indicator. This means that independent advice should be partly subsidised.

- Redress is hardly accessible to final users of financial services because damages are often smaller than the cost of an individual action. In case of misconduct, it should be made easier for consumers to claim compensation, including through class-actions.

- Financial education should be promoted very cautiously, not only because of its high cost. Training in the management of the household budget is useful, but studies have shown that financial education on market products can be counterproductive if it leads to over self-confidence of savers. Willis (2008) quotes several empirical studies showing that more financially literate savers are more often fraud victims and that further education could lead to worse investment performances because education alerts savers to more financial information and choices. Furthermore, some financial education programmes promote a “blame-the-consumer” mentality. Finally, consumer associations fear that financial education becomes an excuse for not developing procedural regulations for new types of risky products.

3.2.2 Substitute retail products

MiFID and IMD apply to different financial instruments. But the latter have been defined according to their legal status, rather than their risk profile. Some products with different legal status can have similar risk profiles. The European Commission intends to propose a harmonised regulation for so-called "Packaged retail investment products"[62] that do not fall in the scope of harmonised regulation:

- Investment funds other than UCITS
- Unit-linked life insurance contracts
- Structured securities: certificates, structured notes, warrants
- Structured term deposits

Investment funds other than UCITS and unit-linked life insurance contracts are the most important components of this heterogeneous list of products.

The growing popularity of unit-linked contracts until 2007 can be attributed to:

- Tax incentives applicable in several jurisdictions for all life insurance contracts, including unit-linked ones. In some cases, tax authorities even encouraged savers to switch from guaranteed contracts to unit-linked contracts[63].
- Supply side pressures, whereby insurers promote products that reduce their own risk.
- Increased demand, especially in countries that have recently joined as Member States. Growing private pension systems are based on these products, contribute to the rising importance of unit-linked products. Until 2007, the increase in unit-linked products can also be related to the low interest rate environment, which gave policy holders an incentive to choose products that are linked to equities and other assets with a higher expected return than interest bearing securities.

Following the financial turmoil, many savers stopped investing in unit-linked products, but the stock remains important, notably in Luxembourg (85% of total life products), Ireland (70%), Poland (45%) and Italy (40%); and has a less important weight in other countries such as the United Kingdom (25%), France (25%), Belgium (20%), Spain (15%) and Germany (10%).

The development of complex securities is a different story. It is the output of regulatory arbitrage, these products being less regulated than investment funds (in the case of certificates and notes) or options traded on regulated markets (in the case of warrants). National regulators implemented specific rules to define criteria under which these products can be proposed to the public. Their development also put pressure on regulated UCITS, for example, in Germany.

[62] For a more detailed presentation of these products, see the Communication of the Commission to the European Parliament and the Council, "Packaged retail investment products", 30 April 2009

[63] In France, the so-called "Amendement Fourgous" allowed investors to switch from guaranteed "contrats en euros" to unit-linked contracts by taking into account the date when the initial contract was subscribed to calculate the period of time necessary to benefit from tax exemptions (8 years).

The Commission intends to propose horizontal regulation of information and selling practices for all these products. In terms of information, the benchmark would be the Key Information Document (KID) recently introduced in UCITS 4 directive. In terms of selling practices, the goal of the Commission would be to harmonise and extend current existing provisions in MIFID and IMD. There is a wide acceptance of this initiative.

While the objectives of harmonisation and simplification of information provided to savers cannot be disputed, the European Parliament might consider the reasons behind the development of substitute investment products:

- In several countries, life insurance products development is driven by tax incentives. As taxation is not fully harmonised, such products cannot easily be sold cross-border. This is an obstacle to the integration of the European market. Member States should be encouraged to converge when setting the conditions for benefiting from these tax incentives and the latter should also be a benefit to savers who subscribe to a life insurance contract in other EU countries.

- It is hard to find any explanation for the development of certificates and other structured products other than regulatory arbitrage. Some certificates provide investors with a high leverage. However, the UCITS 3 directive has already defined the maximum leverage and risks that an investment fund can bear in order to be eligible for UCITS status and to be sold to the public. One can only wonder why prudential rules which apply to UCITS should not apply to other similar products when they have a different legal status.

3.2.3 Responsible lending and borrowing

Indebtedness of households dramatically increased over the last ten years in all European countries, except Germany and Austria. Rising property prices forced households willing to buy their home to recourse to credit. Symmetrically, the increasing supply of credit by banks has kept real estate prices rising. In order to keep the credit burden sustainable, the duration of loans granted by banks was extended. Reimbursement of capital and payment of interest payments for many households will last for 30 years or more.

This trend has increased the incidence of over-indebtedness. Over-indebtedness refers to situations where a household cannot meet its financial commitments (mortgages, consumer credit, utility and telephone bills and rent) without reducing its minimum standard of living expenses. A recent study on over-indebtedness (OEE, 2008) showed that the likelihood of being overindebted has strong associations with persistent low income, adverse financial shocks, over-borrowing and poor money management. Data from the European Survey on Income and Living Conditions show that 10% of households had been in arrears on at least one payment in the previous 12 months. Eurobarometer data states that 13% of households report having difficulties meeting credit and other recurring commitments. Although there are no harmonised statistics in Europe in that area, all indicators correlated with over-indebtedness show an increase in 2009, due to reduced income and rising unemployment.

The subprime crisis has shown that over-indebtedness is not only a social issue. It can also lead to major financial turmoil. But only a minority of European countries have legislative requirements for lenders to check affordability, including a requirement to check the creditworthiness of potential borrowers, and the countries where there are effective controls and sanctions are even rarer. While in some countries lenders associations have adopted codes of conduct, infringements to such codes are not sanctioned. There is still no European policy to prevent over-indebtedness, other than comparing “best practices”.

Regulation of consumer credit was not included in the FSAP but the Consumer Credit directive[64] was adopted on 23 April 2008. It must be transposed in national laws before 12 May 2010. The directive standardises the information to be included in advertising, the pre-contractual information and the credit agreements. It requires the lender to assess the creditworthiness of the consumer. Consumers will have a period of 14 calendar days in which to withdraw from the credit agreement, a longer period than the one existing in several national laws where such a withdrawal right is foreseen. The directive will apply to any credit inferior to €75,000. This threshold is higher than the one currently existing in most countries. More households will thus be protected by the provisions of the directive.

The consumer directive should have a positive impact on consumer protection and it can be part of a policy tackling over-indebtedness, as the latter most often originates from revolving credit and other types of consumer credit. However, this directive does not apply to mortgage credits, which are the main components of households’ indebtedness. The European Commission published a white paper on 18 December 2007, proposing to ease the cross-border supply of mortgage credit, harmonise pre-contractual information, enhance responsibility of lenders and facilitates early repayments (European Commission, 2007). The European Commission also launched a public consultation on responsible lending and borrowing[65].This initiative could lead to a proposal of a directive aimed at extending credit worthiness assessment to mortgage credits. The intention is also to regulate credit intermediaries and to establish standards for credit advice as there are no such standards in that area similar to the ones included in MiFID for investment products. An innovation would also be the envisaged requirement for a consumer to provide relevant, complete and accurate information to the bank, in order to enable the latter to check his creditworthiness.

In the current economic situation, the European Parliament might prioritize borrowers’ protection, rather than further hypothetical integration of the market. Such an approach can only be holistic, by taking into account all debts rather than regulating credit supply, segment by segment. The European Parliament will have to ensure that a legislative initiative (if any) is part of overall European policy tackling over-indebtedness.

[64] Directive 2008/48/EC of the European Parliament and of the Council on credit agreements for consumers and repealing council directive 87/102/EEC.

[65] « Public consultation on Responsible Lending and Borrowing in the EU », European commission, Internal market and services DG, 15 June 2009.

Measures aimed at preventing over-indebtedness include appropriate standards for advice, but also financial education and to developing money management skills. There is a need for dissuasive sanctions in case of noncompliance with responsible lending requirements, including the possibility for courts to re-open credit agreements if inadequate checks have been made. Some topics, like sharing credit information and interest ceilings, should also be reviewed. Arrears management is an area where the industry can regulate, but in the case of infringement, adequate sanctions should be taken. Finally, while it is likely difficult to harmonise bankruptcy provisions as their modalities depend on the legal system in each country, it is important to ensure that such provisions exist, as well as non-judicial procedures, for efficient, fair and rapid debt settlement.

3.3 Accounting standards: governance, objectives, implementation

The objective of global accounting harmonisation has been repeatedly reaffirmed by the G20 and remains at this point the best strategy for the European Union. In this context, the EU can and should keep its IFRS adoption framework as set out by Regulation 1606-2002, including an endorsement mechanism that does not envisage modifications or rewriting of IFRS in a way that would be specific to the EU. Also, to prevent international fragmentation, the EU should consider “Full IFRS” (or IFRS as published by the IASB) as its international reference for purposes of mutual recognition with non-EU jurisdictions, including the US, and prepare for the phasing out of recognition of US GAAP for companies listed in the EU. Simultaneously, the EU should remain prepared to not adopt IFRS standards it considers detrimental to accounting quality.

The current governance framework of IFRS standard-setting is unsustainable and must be made more accountable to stakeholders of financial information, among which the global investment community and national governments (and the EU) are the most prominent. The IASC Foundation should engage in a more in-depth reflection of its mandate, governance and funding, based on extensive public debate and consultation, which have been missing in the previous steps. A feasible target date could be 2011 or 2012 for the introduction of comprehensive reform on this aspect. In this, the EU should respect the autonomy of the IASC Foundation while remaining an active contributor to the elaboration process.

In view of the severe tensions between prudential and transparency considerations that have emerged during the crisis, the EU should envisage clearer differentiation between capital regulation and public disclosure requirements. Basing capital regulation on public financial accounting may lead to short-term pro-cyclical effects that can be mitigated with appropriate filters and buffers in the calculation of capital requirements. Conversely, the proper functioning of public equity markets requires that investors receive disclosure about issuers situation and performance that reflect the market conditions of the moment. These different requirements should be clearly acknowledged by the EU regulatory framework. They are also highlighted by the experience of past systemic crises, in which a high degree of transparency has been associated with a relatively quick and efficient crisis resolution (e.g. Sweden 1992-93) and, conversely, the crisis has tended to be protracted and more severe when financial firms have been allowed to hide latent losses over an extended period (e.g. US savings and loans in the 1980s, or Japan in the 1990s).

In terms of implementation, the EU should create an Office of the European Chief Accountant to ensure consistent enforcement of IFRS throughout the EU by delegation of national enforcement authorities. This office could be located within the European Securities and Markets Authority, which is being created in the context of the implementation of the Larosière Report.

CONCLUSION

Four priorities emerge from the assessment of the FSAP's achievements and limitations for the European Parliament to deal with in the coming months and years. Priority 1 is the most important in the short term and it is on the critical path for the success of other initiatives. Priorities 2, 3 and 4 are of similar importance. Their ranking only mirrors the time necessary to fully implement them.

- **Priority 1**: Set up the institutional framework of supervision, as proposed by the Larosière Group and endorsed by the European Council.

- **Priority 2**: Eliminate gaps in the coverage of regulation. We identify four main gaps in existing regulation:
  - Safety and transparency of regulated markets should be preserved, smart pools should be eliminated, OTC trading should be as standardized as possible and it should be integrated to regulated markets and/or to official clearing when possible. Interest of corporate issuers should be taken into account more than in the past: the FSAP increased their regulatory and legal costs, and the pressure on trading fees charged by exchanges to brokers should not be offset by an increase in listing fees.

  - Hedge funds should be regulated and, what is more important, leverage provided by banks to hedge funds should be closely supervised.

  - A prudential regulation of pension funds is needed. Such a regulation should take into account the specificities of long-term pension commitments and the necessary level playing field with insurance companies. A revision of Solvency II should not be rule out.

  - Credit Rating Agencies should be subject to further consideration in order to progressively diminish their interference with prudential rules. A new CRA business model should be encouraged.

- **Priority 3**: Eliminate remaining discrepancies in national regulations and supervision practices. The "common rule book" proposed by the Larosière Group in the prudential area should be extended to all other areas.
  - This will stop the supervisory competition between Member States.

  - This will allow for a further integration of the European market, the emergence of stronger players in the global economy and more significant benefits for final users of financial services, be they households, companies or public institutions.

- **Priority 4**: Focus the next generation of European financial legislation on consumer protection.

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