The Four-Level Approach to Regulation and Supervision in Europe: Achievements, Concerns and Challenges

The Lamfalussy Framework

The Committee of Wise Men on the Regulation of European Securities Markets, chaired by Alexandre Lamfalussy, was set up in July 2000 by the Ecofin Council and handed in its final report on 15 February 2001. Its key proposals, including a new, four-level approach to financial regulation, were endorsed in March 2001 by the Stockholm Summit. After negotiations with the Commission, the European Parliament also agreed, and the new process became operational in February 2002.

This is, of course, only one aspect of the challenge of European integration. In Baron Lamfalussy's own words, *"the proper working of the four-level regulatory approach is only one, relatively modest, precondition for major progress towards integrated financial markets in Europe. Others are arguably as much, or perhaps even more, important: harmonisation of supervisory structures and practices; improving the post-trading infrastructure; lifting the obstacles to integration relating to differences in taxation and legal systems; coming to grips with accounting standards; and not least, tempering the deep-seated protectionist instincts of our governments."*

The starting point was the recognition that the prevailing legislative and regulatory arrangements displayed some major weaknesses. First, the process was too slow: it took in many cases four to five years between the Commission starting work on a draft directive and its effective implementation by the Member States. Second, it was too rigid: existing directives could not be swiftly adjusted to rapidly changing market circumstances; instead, every change, however minor, required a full-blown Commission proposal to go through the lengthy and often creaking co-decision process. Third, the system produced low quality legislation, with numerous examples of directives which displayed a lack of understanding of how markets really operated. Finally, many texts were ambiguous, which gave good excuses to the national authorities for inconsistent, or even conflicting, implementation at the national level.

Several factors combined to produce these shortcomings. The most obvious was that the European legislative process ignored the distinction between primary and secondary legislation – even though in almost all our Member States it is a widely used distinction. This overburdened the legislative process and led to the above mentioned rigidities. Another harmful factor was a bias in favour of a "top down" approach, with only imperfect consultation with the interested parties, and almost none before initiating a legislative process. This bias eventually proved ill-suited to the fast-changing world of finance.

The four-level approach of the "Lamfalussy process" was specifically designed to remedy these weaknesses.

- First, it relies on drafting framework directives which concentrate on the basic, political, "core" principles (Level 1), leaving Level 2 to decide on the implementing technicalities, and to adjust these technicalities to the changing requirements of the marketplace.
- It entrusts the Committee of European Securities Regulators (CESR) with a crucial role in advising the Commission on Level 2 technicalities, on the ground that CESR members are arguably closer to market practices than the Commission's staff and representative of Treasuries.

EUROFI - Immeuble Monceau - 31 rue de Berri - 75008 PARIS - France
Tel: 33 / (0)1 53 89 35 66 Fax: 33 / (0)1 53 89 35 78
e-mail: cahen.didier@wanadoo.fr

- It insists that both the Commission and CESR enter into a structured and continuous sequence of consultation with all stakeholders on matters relating to both Level 1 and Level 2.
- It gives a dual role to CESR, acting as adviser on implementation technicalities to the Commission (Level 2) and ensuring consistent transposition and implementation by Member States (Level 3). This is done with the hope to reduce the probability of inconsistent implementation; since members of CESR play a key role in defining technicalities, they are well placed to detect inconsistencies.
- Finally, adequate resources are to be devoted to enforcement (Level 4).

Achievements

This is still an early phase of implementation, and some aspects, most notably levels 3 and 4, have still barely been tested.

However, a recognised achievement is that **the FSAP has been essentially completed**: the framework legislation (Level 1) is in place, and the Level 2 regulations are well advanced.

There is also a widespread sentiment that **on the whole, the quality of the regulations has improved**, in the sense that both the Commission and CESR made constructive and informed efforts to find reasonable compromises between the various and frequently diverging interests of the many participants in the marketplace, and that acting in this way, they displayed satisfactory professional competence. There seem to have been no major instances of stakeholders complaining about ignorance of how markets are working or bureaucratic "top down" approach. The principle of systematic consultation and full transparency has been generally applied by the Commission and CESR, and the process has not been disrupted by any heavy-handed intervention by Member State governments or the European Parliament, as could have been feared.

Concerns

- First, **the regulatory process remains on the whole fairly slow**. It still takes three to four years between the Commission starting work on a draft Directive and its effective implementation by the Member States. The market abuse directive was adopted on 3 December 2002, the Prospectus Directive was adopted on 15 July 2003, the Markets in Financial Instrument Directive (MIFID) on 27 April 2004, and political agreement was reached on 11 May 2004 on the transparency Directive. According to the European Commission[1], the average time taken to negotiate the four first directives under the Lamfalussy process from the finalisation of proposal stage to the adoption averaged around 20 months.

  Level 2 measures implementing the Market Abuse and Prospectus Directives were adopted in April 2004 but Level 3 is largely untested and undefined. Enforcement (level 4) will require a major effort. The commission services will need to have sufficient resources in the future to enable it to concentrate on proper enforcement of the Lamfalussy measures in 25 Member States working in 20 languages.

[1] Commission staff working document, "The application of the Lamfalussy process to EU Securities markets legislation", 15 November 2004.

EUROFI - Immeuble Monceau - 31 rue de Berri - 75008 PARIS - France
Tel: 33 / (0)1 53 89 35 66 Fax: 33 / (0)1 53 89 35 78
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On the whole, four years after the agreement on the adoption of the Lamfalussy process, it is difficult to demonstrate that this process has significantly sped up the legislative process.

- **The real degree of reactivity of Level 2 regulation under the Lamfalussy process is still largely untested**. Neither the European Securities Committee chaired by the European Commission nor the European Parliament has been at all active in reviewing Commission's Level 2 texts.

  Asset management, a domain where UCITS laws are forever challenged because financial innovation is going faster than regulation, offers an opportunity to reform existing regulations. The UCITS III Directive extended the investment opportunities of cross-border funds to money market instruments, certain fund units, bank deposits and certain financial derivatives. But it has failed to promote the single market for investment funds. Since the text was approved, there has been an explosion of management activity and investor interest in hedge funds, real estate funds and other investments outside the scope of existing UCITS legislation.

  According to the Expert group on asset management established by the European commission (2004), 30% of the fund industry is trying to operate without the benefit of any over-arching EU legislative framework. Its report has identified a strong demand for measures such as simplification of fund registration, moves to facilitate cross-border mergers of funds and asset pooling, and more freedom of choice for fund managers to choose depositories across borders. The Lamfalussy process offers tools to adapt existing UCITS regulations, except if another approach creating new legislation with risk-based regulatory framework of activities based on principles (on management companies, their distributions practices, advice given to consumers…) other than product definition was chosen[2].

- **Too many implementation details tend to slip back from Level 2 into Level 1** as a result of lobbying efforts by market participants. If this develops on a large scale, one of the main objectives of the process – to enhance the adaptability of regulations to changing market circumstances – could well be jeopardised.

- **There are some manifestations of "consultation fatigue"**. Consultation, done properly, is a necessary condition for the improvement in regulatory quality, but it is also a fairly time-consuming process. It is unclear that the proper balance has been reached.

  The flood of directives triggered by the FSAP put quite a pressure on the resources of all participants in the consultation process. This applied, incidentally, as much to the Commission and CESR as to market participants.

  On the industry side, a related concern is the **varying degree of participation** of various groups of stakeholders in the consultation procedures. While large investment banks are well involved in the consultation process, other groups, such as institutional investors, even more so retail investors, and in some instances issuers, are frequently less well represented which can lead to imbalances in the representation of stakeholders' interests.

[2] See Peter Norman, "Tweak the old banger or overhaul the lot ?", Financial Times, 14 February 2005.

EUROFI - Immeuble Monceau - 31 rue de Berri - 75008 PARIS - France
Tel: 33 / (0)1 53 89 35 66 Fax: 33 / (0)1 53 89 35 78
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- **The differences in scope and powers of national regulatory systems could lead to a risk of inconsistency in implementation and enforcement.** The Eurofi Report of November 2002 had already noted that *"it is essential that national regulators and supervisors should offer equivalent instruments, status, competences, enforcement capabilities and decision making processes for the effective implementation of the principle of mutual recognition"*. Similarly, the "Himalaya report" published by CESR in October 2004[3] states that many provisions under the FSAP directives *"cannot work if the relevant authorities do not have equivalent and rigorous powers to supervise, investigate, sanction and exchange information"* – which they currently do not have. As the Himalaya report notes, *"in the EU, there are different approaches at this juncture about the role of regulation in restoring market confidence. The spectrum of views range from those who focus more on market failure analysis and the economics of regulation to those who focus more on measures to build investor confidence and thus allow markets to function properly with a better interaction of supply and demand".*
- **Harmful protectionist behaviour could still wreck the credibility of the process.** To quote again the "Himalaya report", *"Securities regulators could be tempted to apply a directive in a manner that protects the interest of their national market places. Would this provoke breaches in the level-playing field? How can CESR intervene to prevent this behaviour? Is naming and shaming sufficient and could it be applied under the present liability rules? At what moment should the Commission act at Level 4?"* It is unclear that the present framework brings satisfactory answers to these questions.
- Finally, **the question remains whether the current framework**, with executive regulatory decision-making power still resting overwhelmingly with national regulators, **is well adapted to almost-fully integrated markets**. In fact, in its analytical paper, CESR stresses that *"this analysis would be incomplete if it would not flag that the need to consider supervisory tools carrying a trans-national dimension is closer than it was four years ago when the Committee of Wise Men, chaired by Baron Lamfalussy, was set up"*.

Banking & Insurance

While this is not the primary focus of this paper, important questions are also raised in the context of the Lamfalussy process' extension to banking and insurance, which was eventually put in place in 2004. While better coordination between bank regulators is no doubt useful, there are lingering debates about the ability of the four-level approach to provide efficient tools for addressing cross border integration issues major and the question of market crisis at European level[4].

More generally, the rationalisation of the structure of prudential supervision has been advocated by European financial industry groups which claim that, if local supervision of

[3] Preliminary Progress Report, "Which Supervisory Tools for the EU Securities Markets?" – CESR, October 2004.

[4] See A. Lamfalussy, Pierre Werner Lecture, Banque Centrale du Luxembourg, 2004. Mr Lamfalussy proposes, in particular, that consideration should be given to exploring the desirability and the feasibility of entrusting the ECB with an operational responsibility in the supervision of a limited number of banks. The ECB would have to share its responsibility with the national authorities – be they national central banks or other agencies. *"I realise that such course of action could carry disadvantages. But if we want to enhance our crisis prevention capabilities, what practical alternative could be envisaged?"*

EUROFI - Immeuble Monceau - 31 rue de Berri - 75008 PARIS - France
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subsidiaries of multi-state firms does not add demonstrable value, it should be abandoned in favour of effective group-level supervision. In that respect, the European Financial Services Round Table publication on "lead supervision" has drawn particular attention. This proposal envisages that a single supervisor should be appointed subject to an obligation to cooperate closely with local supervisors in jurisdictions where subsidiaries are located. Finding effective solutions to this issue is considered by many market participants as a crucial precondition for the development of large European-based financial institutions, which could further drive market integration.

Conclusion

EU financial markets are developing but continue to lag behind US markets. The relative fragmentation in European markets is a deterrent to many underwriters, issuers and investors. For the moment, some players with their main base in the US are often doing better in taking advantage of cross-border business opportunities in Europe than EU-based firms.

Achieving a single market requires a pragmatic, gradual European approach to regulation, and approach to oversight that takes market needs into account, and avoids institutional dogma. The Lamfalussy framework, as it has been implemented so far, is an important step in this process, but there remains further work down the road.

The key question remains whether the concept of coordinated regulation by technically autonomous national regulators correctly addresses the challenges of an increasingly integrated European financial market. In any case, divergences in national regulatory arrangements should not be allowed to widen, and should rather be reduced as far as possible. Market participants should remain candid in monitoring the effective value added by the current framework, and in discussing the advantages and disadvantages of the possible creation of a more integrated regulatory framework. Of course, Eurofi intends to continue to play an active rule in this discussion.

Eurofi Contact Persons:

*Nicolas Véron**, founding partner of ECIF, rapporteur for Eurofi; email n.veron@ecif.info*

Didier Cahen, Secretary-General of Eurofi; phone +33.1.53.89.35.66, email cahen.didier@wanadoo.fr

EUROFI - Immeuble Monceau - 31 rue de Berri - 75008 PARIS - France
Tel: 33 / (0)1 53 89 35 66 Fax: 33 / (0)1 53 89 35 78
e-mail: cahen.didier@wanadoo.fr