Note drafted by the Eurofi Secretariat

ADAPTING EU LEGISLATIVE PROCESSES TO EU AMBITIONS

In favour of a more flexible and common EU legislative process for an innovative and competitive financial market

Research and innovation are core ingredients for a secure, competitive European financial sector. Innovation made possible by new, digital technologies is accelerating the transformation of the financial industry and creating new disruption in all financial sectors.

The inexorable shift to digital big-tech and fin-tech, blockchain technology, machine learning or automation processes through intensive data use has triggered criticism that the current European legislative process needs to become more alert and responsive. Many observers consider that the EU regulatory process is too slow, delivers complex and, sometimes, contradictory frameworks and fails to respond efficiently to technological change (e.g. emerging platform models offering a horizontal offer of services).

Excessive regulatory granularity contained in EU primary legislation (Level 1) is also a source of concern. With so much detail enshrined in Level 1, adapting rules as new technology emerges is too slow and too painful an exercise. In addition, little has been achieved through the recent European Supervisory Authorities (ESAs) review - a lost opportunity to correct multiple weaknesses in the EU's supervisory structure.

Increasing the flexibility of the EU legislative process, thus allowing it to respond to technological change and market developments, by adopting implementing rules faster and on a more flexible basis should be a key priority for the new Commission.

The EU regulatory approach should favour regulations (instead of directives) and be founded on a more principle-based approach. EU authorities should have the power to issue no-action letters. Improving consistency when implementing and enforcing regulations across the EU is also an urgent necessity.

Clarifying these common financial priorities at the highest political EU level would certainly provide political momentum and facilitate the improvement of the efficiency and the flexibility of the EU legislative process in line with the rapidly changing financial markets.

Clarifying common financial priorities at the highest political level, and delivering on time

Up to now the political will to further integrate banking and financial markets has been limited despite the evident economic benefits and the new, formidable challenges arising from digitalisation, cybersecurity and the likelihood of Brexit. Regrettably, over the past few years, the EU decision making process has become overly complex, factional and Member State driven, many of whom want to protect the status quo without sufficient reference to or consideration of the European public good and the need to deepen European integration. In addition, unnecessary rivalries between the Commission and the co legislators (EU Parliament and Council) are resulting too often in sub-optimal compromises.

This is the reason why the European Council, on the basis of Commission proposals, taking account of the views of the European Parliament, should explicitly define the overall level of ambition and priorities and define a new, holistic approach to achieve dynamic and competitive banking and capital markets in Europe. The key measures, limited in number, should be chosen primarily in terms of their economic impact and include a strict timetable set for delivery.

Ideally there should be a Tripartite political agreement between the Commission, EP and the European Council.

More use of EU regulations - directly applicable in the Member States - can speed up the EUs' legislative processes...

Regulations should be favoured over directives. The use of directives requires long implementation processes, entails the risk of inconsistencies in the national implementation of Level 1 acts and is exacerbated further by the usual inconsistencies in the transposition of Level 2 rules.

Therefore, EU regulations directly applicable in all Member States should be preferred technique wherever possible, defining with Level 2, the single European rulebook for the Single European financial services and capital market.

Re-establishing a clear distinction between Level 1 and Level 2 will also allow innovation to flourish

The Lamfalussy report, adopted on February 15, 2001, laid out a 4 level structure in order to clarify and rationalize the EU decision-making process and to foster a harmonized implementation of rules (see annexe).

The Lamfalussy process clearly distinguished between Level 1 legislation (primary legislation) and Level 2 delegated acts and implementing measures (secondary legislation). At Level 1, the co-legislators – the European Parliament and the Council, representing EU citizens and Member States respectively - should set out the core principles, allowing the European Supervisory Authorities to develop at Level 2 the detailed rules, based on the realities of the market.

Importantly, by keeping detail at Level 2, it also allows the regulatory bodies to respond more quickly to emerging market trends and risks such as innovation and technological change.

Unfortunately, as K. Swinburne clearly explains in the Eurofi Helsinki Magazine, this clear separation has rarely been maintained. Instead, Level 1 legislation has been fought over frequently resulting in a series of detailed, complex, prescriptive compromises subject neither to rigorous cost-benefit analysis nor to quality testing.

As long as EU institutions and member states cannot rely on a single supervisor, they are inclined to try to construct "harmonization" by putting many details in the level 1 primary legislation. This is probably one reason why national legislation generally precedes European legislation, (e.g. crowdfunding, crypto-assets, climate disclosure...) which leads subsequently to market fragmentation, something difficult to roll back. Of course, ex-ante national regulatory innovative initiatives may be a first shaping step and contribute to the emergence of the necessary European dimension (if needed) but most of the time they lead to fragmentation along national lines.

Consequently, it is surely time for a more disciplined and fact-based legislative approach – a return to the fundamentals of the Lamfalussy approach. According to K. Swinburne, "It would be a good start, for example, to agree that no Level 1 legislation should include data, formulae or thresholds, or anything that requires calibration on an ongoing basis. Such matters need to be promptly reviewed and adjusted as markets evolve and should not be hard-wired into Level 1."

Re-establishing a much clearer distinction between Level 1 and Level 2 will support financial innovation. With so much detail now enshrined in Level 1, adapting rules as new technology emerges has become a slow and difficult exercise, disadvantaging consumers and businesses. All requirements should be technology neutral.

R. Ophèle in his article for the Eurofi Helsinki Magazine also states that the necessary distinction between legislative and delegated acts should be strictly respected. Level 1 legislation should be restricted to setting out framework principles, leaving technical details to Level 2 or 3. He adds that "EU co-legislators must set realistic implementation dates for all stakeholders, including regulators and regulated entities. And a rational sequence between various levels of texts: Level 1 provisions should only come into force after the necessary key Level 2 measures have been published".

No action letters would improve the efficiency of the EU regulatory framework

As a bare minimum, European authorities need the legal tools to avoid the deadlock which may occur when Level 1 or Level 2 texts are in practice unenforceable or require international cooperation.

When the time comes for implementation, we must be able swiftly to correct legislative provisions that obviously cannot be applied, do not meet the objective set, or create distortions of application between jurisdictions. In such situations, as R. Ophèle explains "EU institutions should have the power to issue no action letters, i.e. an emergency mechanism to suspend the application of the provisions concerned, in an exceptional and coordinated manner across Member States; it would protect stakeholders from proceedings for non-compliance with these rules".

Improving consistency when implementing and enforcing regulations across the EU, in order to avoid fragmentation along national lines

If we really want to develop a Capital Markets Union, we must strengthen the European Supervisory authorities and ESMA in particular. However, the proposals that have just ended, the objective of which was to strengthen the ESAs, have not led to any substantial change.

The time has come to really rebalance and strengthen the distribution of competences and responsibilities in favour of the European authorities if we want innovative and competitive financial markets. Also, it is necessary to apply clearly and consistently the EUs' equivalence regimes.

In this context, the following recommendations for strengthening ESMA are important:

1. Enable ESMA to ensure a better harmonisation of the implementation of the common rules. No one disputes this objective. However, ESMA should be able to conduct investigations directly to ensure that the rules are respected. ESMA, together with the Member States, should be able to define a framework and monitor its application on the spot.
2. Focus ESMA's role on wholesale transactions and leave retail transactions to national authorities
3. Assign to ESMA what cannot be done well at the national level; in particular, the supervision of CCPs (Central Counterparties) should be its responsibility.
4. Brexit opens up new and important challenges: as Europe's most important financial market is leaving the EU, it is essential that the new regulatory system in Europe should be coherent and does not open the door to unfair competition and nationalistic regulatory arbitrage. ESMA should develop a collaborative role between London and the EU and the Commission should draw up a more practical, de-politicized regulatory approach.

ANNEX

The Lamfalussy architecture

The Lamfalussy report, adopted on February 15, 2001, laid out a 4-level structure for clarifying the decision-making process of the EU and fostering harmonized implementation of rules.

- At level 1 the European Parliament and Council adopt the basic laws proposed by the Commission, in the traditional co-decision procedure. As this procedure is usually complex and time-consuming, the Lamfalussy report recommends using it only for setting out framework principles.
- At level 2 the Commission can adopt, adapt and update technical implementing measures with the help of consultative bodies composed mainly of EU countries'

representatives. This allows the Council and Parliament to focus on the key political decisions, while technical implementing details can be worked out afterwards by the Commission.

- At level 3, committees of national supervisors are responsible for advising the Commission on the adoption of level 1 and 2 acts and for issuing guidelines on the implementation of the rules.
- At level 4 the report advocates a stronger role for the Commission in ensuring the correct enforcement of EU rules by national governments.

This 4-level regulatory approach recommended by the Lamfalussy report was first adopted in the securities sector and then extended to banking, insurance, occupational pensions and asset management. Enormous efforts were made by the Commission and the regulators during the years 2001-2008 to implement a national wide consistent application of regulation.

But, unfortunately, much of this energy was wasted. Indeed, the Level 3 Committees of national supervisors (CEPS, CERS and CEIOPS) had one common fundamental weakness: they were consultative and had no legal decision-making powers. Therefore, in the event, different national positioning and "options" continued to marr the system.

This process evolved following the establishment of the European Financial Supervision and the creation of the European Supervisory Authorities (ESAs) after the de Larosière report (February 2009).

Post crisis reform: The European Supervisory Authorities

Following the de Larosière report three Authorities were to be created and to replace the Level 3 committees: EBA (European Bank Authority), ESMA (European Securities and Markets Authority), EIOPA (European Insurance and Occupational Pensions Authority). They became operational in January 2011.

The responsibilities of the ESAs include defining common practices and standards for the regulation and supervision of banking, market and insurance activities, and ensuring the consistent application of these measures within the single market.

Their role is to harmonize the national application of directives and regulations. In order to avoid the pitfall of the Lamfalussy powerless Committees, the Authorities were given precise powers:

- to write binding technical standards (the "common rule book"), in conformity with the principles contained in the directives;
- to mediate disputes between two national supervisors within a cross border college of supervisors;
- to mediate in the case of diverging interpretations at the level of national rules;
- to survey, license and register Credit Rating Agencies and CCPs (Central Counterparties);
- to enforce common rules for stress-tests;
- to play a coordination role in crisis situations.

In a very short period of time the ESAs have established themselves and are respected by market participants, Member States, the EU institutions and globally for the professional way in which they have undertaken their duties. In this way the ESAs have contributed to a smoother functioning Single Market for financial services.

The objective however has only partially been achieved since the implementation of EU law is not always consistent across the Union. There remains significant potential to enhance regulatory and supervisory convergence in the Single Market. Integrated financial markets may require more integrated European supervisory arrangements to function effectively, while more centralised supervisory arrangements can, in turn, foster market integration. The ESAs can play a key role in this symbiotic relationship between market integration and supervisory convergence and should be given more direct responsibility for supervision in targeted areas.