



**COUNCIL OF
THE EUROPEAN UNION**

Brussels, 27 November 2003

15393/03

**EF 65
ECOFIN 389
MI 303**

COVER NOTE

from : Secretary-General of the European Commission,
signed by Mrs Patricia BUGNOT, Director

date of receipt : 25 November 2003

to : Mr Javier SOLANA, Secretary-General/High Representative

Subject: Ninth interim report on the implementation of the Financial Services Action
Plan
- The FSAP enters the Home Straight

Delegations will find attached Commission document SEC(2003) 1372.

Encl.: SEC(2003) 1372



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.11.2003
SEC(2003) 1372

COMMISSION STAFF WORKING PAPER

Financial Services

The FSAP enters the Home Straight

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I INTRODUCTION

The main strategic objective of the Financial Services Action Plan (FSAP), launched in 1999, was to enhance the functioning of underperforming pan-European financial markets and by so doing, improve the prospects for sustainable, investment-driven growth and employment. As such, the FSAP is one of the most important adjuncts to the introduction of the single currency, and one which has radically reduced cross-border trading costs within the euro-zone.

The FSAP is one of the driving forces behind profound changes in the European financial landscape. Expectations have changed, and although there is a long way to go, there is growing market and regulatory belief in the logic of a dynamic, open style European capital market. European capital markets are beginning to restructure and rationalise in anticipation. These changes are evidenced *inter alia* by the convergence of interest rates and spreads; increased cross-border trading; and by the growing presence of financial institutions on partner country markets. More fundamentally, European finance has become less dependent on bank lending. A greater range of financing techniques has meant more options for businesses to fund investment and for consumer savings.

The strengthened regulatory and supervisory framework resulting from the FSAP has also helped European financial markets to weather recent difficulties. The broad based commitment to deliver the FSAP has not been thrown off course by depressed economic conditions and the steep negative correction in equity valuations since the fourth quarter of 2000. So far, the European financial system has itself been resilient to the recent shocks; the risks associated with increased volatility have been spread more effectively and equally over financial sectors.

The Spring 2003 rally in equity markets has relieved much of the pressure on balance sheets¹. The considerable downside risk for the European financial sector has evolved towards a potential for recovery. European equity valuations have moved back into line with historical norms and the prospects for growth and profitability should allow further improvements.

The recovery in equity prices suggests that the dramatic loss of confidence in corporate governance and market integrity has *pro-tem* been arrested. However, excesses remain and efforts to build confidence must continue. Without financial markets that function efficiently, the recovery of the 'real' economy will be suboptimal.

¹ This relief might be partly offset by recent developments in bond markets, where the low level of long term interest rates has had implications for the income flow and discounted liabilities of financial institutions.

Progress in adopting the legislative FSAP measures to timetable has been maintained: 36 of the 42 original measures have been finalised. Since its introduction, the Council and the European Parliament have made every effort to ensure the rapid agreement and implementation of individual legislative measures. Nevertheless, a final push is needed to resolve the remaining key issues and to close outstanding discussions. The Italian Presidency has put the Irish Presidency in a good position to conclude the remaining major FSAP measures (in particular, the Directives on Investment Services and Transparency) before April 2004², ahead of the European Parliamentary elections. Another important milestone has recently been passed: agreement at the end of October by the European Securities Committee (ESC) to adopt the first implementing measures in the area of Market Abuse using the Lamfalussy process.

After this, a major task remains – consistent transposition, and the enforcement of all the adopted measures. As the end of the FSAP cycle approaches, the Commission believes that it is opportune to undertake an assessment of the state of integration of European financial markets. This process will not serve as the basis for a further comprehensive programme of legislative initiatives in the short term³. It will, however, serve as a first step in identifying the priorities for action in the period after the present FSAP (see Section IV 'Looking beyond the FSAP').

II. STATE OF PLAY ON REMAINING FSAP MEASURES

Since the last Progress Report of 3 June 2003, agreement has been reached on the following:

The Prospectus Directive was adopted on 15 July 2003⁴;

The Directive on Taxation of Savings Income (as part of a broader tax-package including the Code of Conduct for business taxation and the Directive on Interest and Royalties) was formally adopted on 3 June 2003⁵.

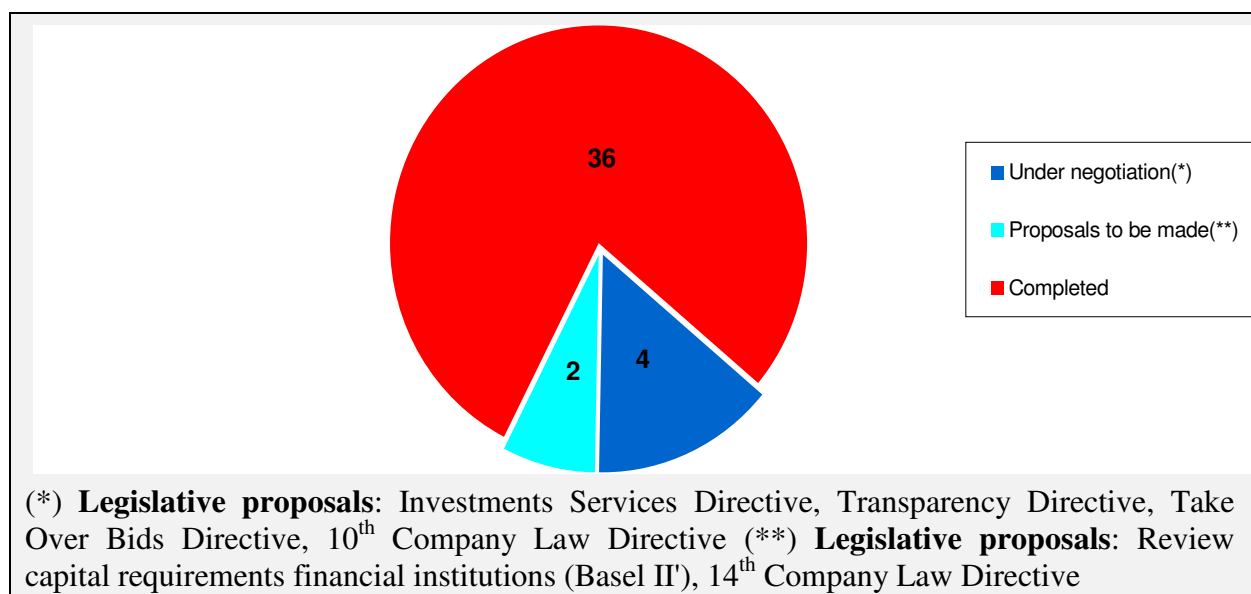
² Agreed by the Heads of State and Government during the Brussels European Council (20 and 21 March 2003).

³ As outlined in the 8th Progress Report, the completion of the agreed FSAP legislative agenda is the first priority of the Commission.

⁴ Directive 2003/71/EC.

⁵ Directive 2003/48/EC on taxation of savings income in the form of interest payments.

FIGURE 1: State of play on individual original FSAP measures⁶



The Commission's legislative Work Programme in the period to April 2004 is outlined in Boxes 1 and 2. These calendars envisage the adoption of four key proposals by European Parliament and Council in the coming four months.

Box 1

Legislative work-programme 4th quarter 2003 and 1st quarter 2004

Proposals scheduled for adoption by EP/Council

- Revision of the Investment Services Directive
- Transparency Directive
- Take Over Bids Directive
- 10th Company Law Directive

Apart from the Investment Services Directive, scheduled for adoption early next month⁷, the following proposals need to be adopted in the coming months:

- Following two rounds of consultation, the Commission presented a final proposal for the Transparency Directive on 26 March 2003⁸. The Directive aims at increasing the transparency of listed companies to improve investors' trust and encourage a more rational and efficient allocation of resources, without increasing the administrative burden. Work in Council and European Parliament started this year. It is hoped that the Directive can be adopted in a single reading before April 2004;

⁶ The following measures or non-legislative proposals are not included in the “proposals to be made” or “under negotiation”: the Follow-up to the High Level Group of Company Law Experts, the EU Legal Framework for Payments, a Report on the implementation of the Settlement Finality Directive, the Follow-up to FIN-NET, the Follow-up to the Action Plan to prevent fraud and counterfeiting in payment systems, the Implementation of the Code of conduct on business taxation.

⁷ On the agenda of EU's General Affairs Council of 8 December 2003.

⁸ COM (2003) 138 Final.

- In October 2002, the Commission presented a new proposal for a Directive on Take Over Bids⁹, taking into account the recommendations of the High Level Group of Company Law Experts. Together with the European Parliament and the Council, the Commission has shown its willingness to work towards an acceptable compromise on this crucial file. General agreement has been reached on the harmonisation of rules governing the bid procedure, and the steps to protect minority shareholders. However, opinions differ on how to create a new balance between the power of management and shareholders. New compromise proposals are presently under discussion. As this directive is crucial for the successful integration of European financial markets - and one of the key measures of the FSAP – it needs to be adopted in the next four months. It is the Commission's view that the final compromise should contain a meaningful harmonisation of the key provisions;

- A first proposal for the 10th Company Law Directive on cross-border mergers was tabled in 1985 and remained blocked for a number of years on the issue of workers' participation. In December 2001, the Commission withdrew the proposal. As a follow-up of the short term priorities included in the communication on Company Law and Corporate Governance of 21 May 2003¹⁰, the Commission presented a new proposal on 18 November 2003. The proposal will soon be under discussion in the Council and European Parliament. Although the proposal has only been issued in November, if both institutions manage to adopt this directive in a single reading, it might be possible to have the Directive implemented within the deadline set for the FSAP.

Box 2

Work Programme 4th quarter 2003 + 2004

Expected Commission Proposals

- Review capital requirements for financial institutions
- Follow-up to the Action Plan on Company Law and Corporate Governance
- 14th Company Law Directive
- Modernisation of 8th Company Law Directive (statutory audit)
- International Accounting Standards 32/39
- Communication on Clearing and Settlement
- Third Money Laundering Directive
- Reinsurance Supervision
- EU Legal Framework for Payments in the Internal Market
- Insurance Solvency II (preparatory work)

9 COM (2002)534 – 2 October 2002.

10 COM (2003) 284 Final.

Elsewhere, the Commission continues to focus its efforts on bringing forward the remaining key FSAP measures¹¹:

- An ambitious timetable underpins the implementation of a revised capital framework for banks and investment firms by 2006/2007, following discussions in the G10-Basel Committee. This should increase the risk-sensitivity of banks' and investments firms' supervisory capital requirements. It should increase the stability and safety of the European financial services sector and improve the efficiency of asset allocation. The Commission services third consultation document was launched on 1 July 2003¹². The consultation period ended on 22 October. The Basel Committee intends to reach agreement on the new Capital Accord by no later than the middle of 2004. The Commission remains on target to present its proposal for a new directive within a short period after agreement in Basel so that the global implementation date for the new framework (end of 2006) can be met in the EU;
- The Commission published its Communication on Company Law and Corporate Governance on 21 May 2003¹³. This includes an Action Plan comprising a balanced mix of legislative and non-legislative initiatives, and proposing a chronological prioritisation of the foreseen measures. It fully respects the subsidiarity and proportionality principles of the Treaty, and is flexible in application but firm on the principles. The Action Plan was endorsed by the Competitiveness Council on 22 September 2003¹⁴. In the follow-up phase, adequate consideration will be given to the comments received during the public consultation period that ended on 31 August. The first initiatives will be launched by the Commission in the coming months;
- The 14th Company Law Directive on cross-border transfer of 'seat' (their centre of activities and/or their registered office) is another short term priority included in the Communication on Company Law and Corporate Governance of 21 May 2003¹⁵. This initiative represents one of the two measures where a Commission proposal for a directive is still pending. A directive will not be proposed before September 2004 as first the aforementioned broad orientations will need to be endorsed and the proposal is dependent on pertinent decisions of the European Court of Justice;
- Since 1998, the Commission has continuously worked on the improvement of audit quality through the Committee on Auditing. The Commission has issued Recommendations on quality assurance and auditor independence. To reinforce these initiatives, the Commission issued a Communication setting out priorities on statutory audit on 21 May 2003¹⁶. The modernisation of EU legislation on audit in the 8th Company Law Directive has been identified as a short term priority. The Commission will come forward early 2004 with a new Directive that would replace the existing 8th Company Law Directive. This will effectively be linked to the work

¹¹ Detailed information about progress on all FSAP measures remains available through a regularly updated overview on the Commission's website.

¹² See: http://europa.eu.int/comm/internal_market/en/finances/capitaladequacy/index.htm.

¹³ COM (2003) 284 Final.

¹⁴ The Brussels European Council called for the endorsement of the Company Law and Corporate Governance Action Plan by the end of 2003.

¹⁵ COM (2003) 284 Final.

¹⁶ Commission Communication 'Reinforcing the statutory audit in the EU' - COM (2003) 286 Final.

that the Commission has been doing with the US Public Company Accounting Oversight Board (PCAOB) to develop a cooperative approach to the oversight of international auditors;

- The implementation of International Accounting Standards (IAS) for listed companies by 2005¹⁷ will bring about transparency and greater comparability in the field of financial reporting through high quality standards. All existing IAS except IAS 32 and 39 were endorsed by European Finance Ministers on 15 July 2003. The pressure is high to have all IAS endorsed by 2005, the date that the requirement enters into force. Over the coming months, the IAS Board is continuing its work on improving IAS 32 and 39 on financial instruments. It is important that a broad consensus on these issues can be found;
- On Clearing and Settlement, the Commission expects to come forward with a Communication early January 2004. This Communication will outline the direction for future work to facilitate a market-driven improvement in the efficiency of clearing and settlement of cross-border securities transactions;
- Following the events of 11 September 2001, the legal framework to combat money laundering and terrorist financing will need further strengthening through a third Money Laundering Directive;
- Early next year, the Commission will present a proposal for a Directive on Reinsurance Supervision. The proposed Directive will aim to harmonise methods for reinsurance supervision in the EU, abolish some remaining trade barriers for cross-border reinsurance activities and provide greater policy holder protection. A prudential framework would be set up which would take into account the recommendations of the Financial Stability Forum and the IMF. This framework would lead to greater macro-economic stability and less systematic risk in the insurance sector;
- The Commission has come forward in November 2003 with a Communication on the EU Legal Framework for Payments in the Internal Market, taking account of extensive consultations that have taken place during recent months. The Commission will come forward with a proposal for legislation late Spring 2004;
- The intention of the Insurance Solvency II work is to create a consistent risk-based insurance solvency system that is compatible with international developments in supervision and financial reporting. Extensive work will continue over 2004; the first legislative action would be the presentation of a proposal for a framework directive by 2005.

III. GETTING THE MOST OUT OF THE FSAP

During the FSAP process, the Commission has followed the Lamfalussy recommendations¹⁸ and moved to regular and systematic consultation of all interested parties on all proposals and emerging policy thinking. In carrying out such consultations, the Commission strives to strike

17 Regulation (EC)1606/2002 - 19 July 2002.

18 Final Report of the Committee of Wise Men on the Regulation of European Securities Markets - February 2001.

the right balance between giving sufficient time and opportunity for comment and renewed consultation, and the tight timetable set by European Heads of State and Government¹⁹. In their responses to these consultations, Member State governments and industry have constantly reaffirmed their overall support for the underlying objectives of the FSAP. Open and thorough consultation is proving to be a strength and is improving the quality of legislation.

With the FSAP drawing to its close, the focus is shifting from intensive legislative drafting, negotiation and adoption of the FSAP. The emphasis will now turn to the delivery of the FSAP. Effective and complete delivery of the full package of measures is the only way to reap the benefits.

Europe is still at a relatively early stage in unlocking the benefits from the higher overall growth potential, lower cost of capital²⁰, employment expansion and smoother absorption of volatility in an integrated market²¹: the legislation is not yet complete, and transposition and implementation has only just begun. Proper and common enforcement must ensure that these common rules are indeed applied coherently all over the EU, in all 25 Member States. It is increasingly difficult for national authorities to enforce financial rules in isolation from each other: what happens in one jurisdiction will impact on others. European regulators must cooperate effectively to ensure the implementation of equivalent standards, based on European rules.

This is not just true at a European level, but at an international level as well. Europe needs to work together with its international partners to ensure equivalent standards of regulation, avoid unnecessary duplication of regulation and remove regulatory and legal barriers to market access. The EU-US Financial Markets Regulatory Dialogue is aimed at avoiding such conflicts and promoting, upstream, the resolution of existing problems. EU and US authorities have continued, and will continue, to work together on this.

A key area where this is needed urgently is audit registration. The Commission has been discussing with the PCAOB over the last months to explore cooperative ways to resolve the issue of registration of European audit firms in the US. The issue has been put in the broader context of how to appropriately regulate audit firms that provide audit work to companies listed on EU and US capital markets. This exchange of views has shown that in many areas there is a considerable convergence of views and conceptual approaches. This facilitates work towards a two-way approach that will optimise the allocation of international resources to ensure high audit quality in global capital markets. Under this approach, if both oversight and inspection systems meet certain principles on adequacy, transparency and independence, there will be mutual reliance to the maximum extent possible on home country oversight, inspection, investigations and sanctions of audit firms. This approach will minimise unnecessary duplicative regulatory burdens for audit firms, optimise the allocation of resources on regulation and oversight and improve global investor protection.

19 April 2004 has been fixed as a deadline for the delivery of the FSAP (and 2003 for measures on securities) by the Heads of State and Government at the Brussels European Council (20 and 21 March 2003).

20 See also the report of the European Mortgage Federation and Mercer Oliver Wyman on Financial Integration of European Mortgage Markets (<http://www.hypo.org>).

21 See Seventh Progress Report:
http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm.

Implementation and enforcement

To optimise the delivery of the FSAP, the Commission has identified three broad policy objectives where more work is needed over the coming year and where all parties involved should focus their efforts²²: (1) Common Implementation and Enforcement, (2) Handling the Global Dimension, and (3) Optimising the FSAP - identifying and resolving new challenges.

A crucial adjunct to the FSAP has therefore been the enhancement of arrangements for the effective supervision of financial institutions and the management of financial crises with a cross-border dimension. FSAP legislation has established a clear allocation of responsibilities for the supervision of financial institutions, and laid down clear obligations for their cooperation with authorities in other Member States in the event of concerns.

A key development in this regard is the emergence of structured arrangements to allow regulators and supervisors to organise their cooperation and mutual agreements (the networks of regulators recommended by the Lamfalussy Committee of Wise Men). Related initiatives, such as the Brouwer Report's recommendations on financial stability and crisis management and their follow-up, are also helping to ensure that the channels for real-time cooperation and day-to-day practice of financial supervision will function expeditiously, as and when required.

On 5 November 2003, the Commission adopted a package of measures aiming to establish a new organisational architecture in all financial services sectors. This package is needed urgently if the FSAP is to be implemented and enforced effectively and if supervisors and regulators are to cooperate successfully on the implementation of any new capital accords.

The package establishes two new committees of supervisors, the Committee of European Banking Supervisors (CEBS)²³ and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)²⁴ with more or less immediate effect, as called for by the ECOFIN Council in December 2002, and the European Parliament in the Van den Burg Resolution of November 2002.

The package also proposes that two new committees, the European Banking Committee (EBC) and European Insurance and Occupational Pensions Committee (EIOPC) replace the existing Banking Advisory Committee (BAC) and the Insurance Committee (IC). Furthermore, the package proposes the transfer of responsibilities for UCITS²⁵ from the UCITS Contact Committee to the existing European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR). To avoid duplication of committees and to avoid pre-empting the views of both the European Parliament and the Council, these elements of the package will only come into effect if and when both institutions agree.

22 See Eighth Progress Report:
http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm.

23 Commission Decision taking effect on 1 January 2004.

24 Commission Decision taking effect on 24 November 2003.

25 Harmonised collective investment undertakings that can operate throughout the EU.

Box 3

Commission initiatives to improve implementation and enforcement²⁶

The Communication on 'Better Monitoring of the Application of Community Law'²⁷ comprises a wide set of measures to improve the prevention of infringements of Community Law and to rationalise the investigation of presumed infringements.

The Internal Market Strategy (2003-2006)²⁸ has tabled some additional proposals for promoting effective and even-handed enforcement of EU legislation throughout the Single Market.

The SOLVIT mechanism has been established to help individuals to overcome obstacles when trying to take full advantage of Internal Market rules, by real-time problem-solving links between national administrations.

Networks of financial regulators and supervisors have been developed in the securities field as proposed by the Lamfalussy Report and endorsed by EU Finance Ministers and the European Parliament²⁹, and proposals are on the table to extend this approach to all financial sectors (including banking, insurance & occupational pensions and UCITS).

IV. LOOKING BEYOND THE FSAP

The Commission believes that there is much to be gained by launching a wide-ranging, transparent and bottom-up assessment of the effectiveness of FSAP measures to date, and to map out the state of integration of EU financial markets following the completion of the legislative phase of the FSAP. The overall objective of this stock-taking is to arrive at a broad understanding of the extent of any remaining gaps in the regulatory, supervisory, administrative, and public policy framework. This will increase understanding of the impediments to undertaking cross-border financial business (for instance in the retail sector).

This assessment will be a key input in developing a consensus on policy challenges that could be usefully addressed at European level. However, the process should not be viewed as the prelude to an ambitious new legislative programme. At this stage – beyond already programmed commitments – there are no preconceived notions whether or not EU-level action is necessary or on the future scale and content of any such action. Where action is not necessary or would be counter-productive - where costs will outweigh benefits - action should not be attempted. Nevertheless, it should be clear that targeted legislative action in response to specific market failures or regulatory gaps may be an appropriate response and should not be *a priori* ruled out.

The Commission has already set work in hand to identify structural changes in the financial landscape. To this end, the Commission continues to develop a series of financial indicators that will serve as a regular policy guidance tool for understanding deficiencies in the financial

26 See for more detailed description the Eighth Progress Report:
http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm.

27 COM (2002) 725 Final, adopted 11 December 2002.

28 COM (2003) 238 Final. See for full text:
http://europa.eu.int/comm/internal_market/en/update/strategy/index.htm.

29 Resolution of 5 February 2002.

integration process and prioritising areas for remedial action. The first results were presented to the ECOFIN Council of Ministers on 3 June 2003.

Open and transparent process and consultation

Given the Commission's strong commitment to the consultation³⁰ and involvement of interested parties at all stages of the policy formulation process, this assessment exercise will be carried out in a visible and open way³¹. To enjoy full political legitimacy, the Commission will mobilise strategic input from the full range of stakeholders – including consumers/investors - in the process. The setting up of the FIN-USE forum of financial services users – to ensure that the needs of the demand side are also taken into account – is a clear example of this commitment being put into practice³². National and EU regulatory and supervisory authorities are also involved at all levels – in discussing policy orientations and considering feedback from industry. This broad-based approach is necessary to develop a "bigger picture", and to seek to build up consensus on the added-value of EU-level action.

The Commission also hopes to benefit from discussions with the European Parliament and from hearings with its panel of independent experts. Particular attention has been paid to developing a better understanding of the state of financial markets in the new Member States.

The stock taking process

The preparatory work of the assessment project will take place at the level of the principal financial sectors in the form of sectoral expert groups. These have been constituted to cover the following areas: banking, insurance, securities, and asset management. The composition of the groups ensures a geographically balanced coverage of all main business lines and functions.

Apart from identifying impediments to the effective integration of markets for different financial products, services and transactions, the expert groups have also been tasked with helping the Commission to understand which market failures give rise to the biggest opportunity costs for Europe. To this end, the sectoral groups will focus primarily on the prioritisation of remaining impediments to cross-border business and their impact on the realisation of conditions for the smooth functioning of European financial markets. To ensure a coherent strategic view, the stock-taking process will be organised in such a way that a coordinated view is taken of issues which may cut across sectoral boundaries and that the output of the different sectoral groups will be combined in one overall assessment.

Member States, meeting in the Financial Services Committee (FSC), are also seeking to develop a collective view on progress to date and remaining challenges. To facilitate its work in this context, the FSC decided on 9 July to set up an ad-hoc subgroup to prepare a report from the FSC to the Council on (i) the benefits of financial integration, (ii) the state of integration and (iii) those areas where progress needs to be made as a matter of priority in

30 Commission Communication "European Governance: Better lawmaking", COM (2002)275 final, and Commission Communication "General principles and minimum standards for consultation of interested parties by the Commission", COM(2002)704 final.

31 A press release explaining the process and launching the groups of experts advising the Commission in their personal capacity was published on 27 October 2003.

32 In monitoring structural changes in the European financial landscape, the Commission has created the FIN-USE forum to involve dedicated experts from the user perspective as much as possible in the work of the Commission. In identifying the impediments in the assessment process, the Commission will also consult the FIN-USE forum.

order to create a truly integrated financial services market in the EU. The ECOFIN Council of 15 July 2003 provided the FSC with the necessary mandate to start work in these areas. The Commission believes that there is scope for synergy and complementarity between its stocktaking and the high level policy assessment being undertaken by the FSC. The two processes are being closely coordinated. The FSC Report will certainly provide an important additional political perspective on the remaining challenges.

To facilitate the involvement of, and input from, all interested parties, the Commission plans that the material emerging from the sectoral groups will also be subjected to public comment during the Summer of 2004.

Finally, the working papers and material from the sectoral groups could serve as basis for a high level Forum in the Summer of 2004. This Forum would bring together the key decision-makers, experts and industry leaders. This event would have two purposes. First, it would represent an occasion for political stock-taking of the progress on the FSAP. Second, it would allow for high level exchanges between key policy makers and industry leaders on remaining challenges. In this respect, the event would not be an end in itself – rather it would be a stepping stone to the development of new ideas and strategies.

Box 4

Milestones in the process of preparing the EU Financial Policy Forum	
October 2003:	- Constitution of 4 sectoral expert groups (banking; insurance; securities; asset management);
Spring 2004:	- Publication of Commission report on the economic benefits of financial integration, including empirical scene-setting for the policy discussions; - Issuing of FSC report to prepare a political debate in the ECOFIN Council on priority areas for further action; - Finalisation of the reports from the Commission and sectoral expert groups on the overall assessment of the state of integration;
April/May 2004:	- Presentation by the Commission to the FSC and the various sectoral committees of the overall assessment;
Summer 2004:	- High level conference "European Financial Policy Forum";
Autumn 2004:	- Synthesis report conclusions of Forum and public consultation.