THE GOVERNANCE STRUCTURE FOR FINANCIAL REGULATION AND SUPERVISION IN EUROPE

BY DR. ROSA M. LASTRA*

THE LONDON FINANCIAL REGULATION SEMINAR
LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE
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ABSTRACT

promotes decentralisation with co-operation. I try to cast some light on this debate, by arguing that a single market with a single currency does need some common rules, but does not require a single supervisor. I also argue that the possible centralisation of one function (lender of last resort) does not imply nor require the centralisation of other supervisory functions.

INTRODUCTION

An appropriate regulatory and supervisory framework is fundamental for the competitiveness of Europe's financial markets. Nobel laureates Ronald Coase and Douglas North have stressed the important role that legal norms and institutions play in the functioning of markets. In this line of thought, it is my strong belief that the future of the internal market in financial services will be directly affected by the institutional design of supervision and by the extent to which the legislative process ensures the principles of transparency, market discipline, consultation and flexibility.

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* Senior Lecturer in International Financial and Monetary Law, Centre for Commercial Law Studies, Queen Mary, University of London. E-mail: R.Lastra@qmul.ac.uk This paper is part of a larger research project in the field of international monetary law, as the author is currently preparing a script on *The Legal Foundations of International Monetary Stability*, which is to be published by Oxford University Press. The author would like to thank Apostolos Gkoutzinis for valuable research assistance and Charles Goodhart for helpful comments and suggestions.

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Given the complexity and the dynamic character of the subject matter of this paper, it is important to clarify right from the start the meaning of three key concepts: governance, supervision and regulation. Governance has to do on the one hand with the allocation of power and on the other hand with the exercise of power. Supervision refers to the oversight of financial firms' behaviour (in particular, risk monitoring).[1] Regulation refers to rule-making. However, the words regulation and supervision are often used interchangeably.

The paper focuses on the questions of "who" and "how" with regard to the regulation and supervision of financial markets in the European Union. It thereby leaves aside the important subject of "what to regulate." The latter is dealt with in the Financial Services Action Plan (FSAP), a blueprint of the issues that need to be harmonised in order to complete the single market in financial services by 2005.[2]

The paper is divided into two sections. Section one deals with matters of institutional design with regard to the 'financial architecture' of supervision in the EU. Section two analyses the processes and procedures to adopt financial legislation and regulation in the EU, with emphasis on the so-called the Lamfalussy approach, which aims at bringing about a 'governance change', a bottom-up approach (rather that top-down) in issues of financial integration. The paper finishes with some concluding observations.

SECTION 1. FINANCIAL SUPERVISION IN THE EU

Decentralisation, co-operation and segmentation (by specialist financial institutions conducting distinct financial activities: banking, securities and insurance) are the three principles that characterise the 'financial architecture' of supervision in Europe.

However, there are several forces at play that might alter the current institutional design, in particular, the trend towards unification of supervisory authorities at the level of the Member States and the possible centralisation of supervisory functions at the EU level. The latter issue is related to the role of the European System of Central Banks.

1.1 CONSOLIDATION

The trend towards the consolidation of supervisory authorities has become a driving force for legislative reform in several EU Member States, such as the UK and Germany.[3] The establishment of a single supervisory authority is a regulatory

[1]In a broad sense, supervision can be understood as a process with four stages or phases: licensing, supervision *stricto sensu*, sanctioning and crisis management. For a further elaboration of these four supervisory stages, see pp. 108-144 of my book "Central Banking and Banking Regulation" (1996).
[2]The FSAP sets a schedule for the adoption of 42 directives. See Financial Services – Implementing the Framework for Financial Markets: Action Plan. Commission Communication COM (1999) 232, 11.05.99. See http://www.europa.eu.int/comm/internal_market/en/finances/general/action_en.pdf

[3]France is also considering consolidating supervisory responsibilities with regard to capital markets. A recent legislative proposal (Projet de loi de sécurité financière of 18 February 2003) proposes the

response to the rise in financial conglomerates and complex financial groups.[4] Abrams and Taylor contend that "the structure of the regulatory system needs to reflect the structure of the markets that are regulated."[5]

The unification of supervisory authorities can proceed according to various organisational models. One possible model, which has been favoured in the UK, looks at the various functions involved in the supervisory process (licensing or authorisation, supervision, enforcement and crisis management). Another model, which has been favoured in Germany, organises supervision under a single authority according to business functions.

In the UK, the Financial Services Authority (FSA) was launched in 1997 and became fully operational on 1 December 2001, once the Financial Services and Markets Act of 2000 came into force.[6] The FSA was initially organised according to what Howard Davies,[7] FSA Chairman, referred to as "regulatory functions:" authorisation, supervision and enforcement, in addition to support functions.[8] This approach was preferred at the time over the other three models/approaches considered, namely (1) the establishment of one regulator based upon the a federation of regulators with matching business strings of the previous regime; (2) the wholesale/retail split as the dividing organising principle; and (3) the so-called "twin-

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establishment of a Financial Markets Authority, (*L'Autorité des marchés financiers, AMF)* which will take over the responsibilities of the COB (Commission des Operations de Bourse-Committee for Stock Exchange Operations), CMF (Conseil des Marches Financiers-Council for Financial Markets) and CDGF (Conseil de Discipline et de Gestion Financier-Council for Financial Discipline and Management). The changes are not too far-reaching. Banking regulation remains the responsibility of the Bank of France. The new Financial Markets Authority will be the sole regulator for securities markets and in this respect the new regime consolidates in one entity the fragmentary character of securities regulation in France.

[4]The case for a single supervisor is also supported by other arguments. The number of people employed by a single authority is likely to be lower than the combined staff numbers of multiple authorities. Firms may find it expensive, confusing and time-consuming to answer similar questions to various supervisors; instead of dealing with a multiplicity of authorities, a single supervisor enables 'one stop-shopping' for financial institutions. An excellent summary of the pros and cons of the two models (integrated financial supervisor versus specialist supervisor) is found in Karel Lanno's paper, "Supervising the European Financial System" published by the Centre for European Policy Studies, CEPS Policy Brief No. 21, May 2002. See also Howard Davies, "Euro-regulation," *Journal of International Banking Regulation*, Vol. 1, No. 2, June 1999, pp. 114-115.

[5]See Richard K. Abrams and Michael W. Taylor, "Issues in the Unification of Financial Sector Supervision," IMF Working Paper, 2000, WP/00/213, at p. 3.

[6]The Bank of England Act 1998 transferred responsibility for banking supervision from the Bank of England to the FSA.

[7]See Parliamentary Brief, Vol. 5, No. 3, January 1998, pp. 28-34, Interview with Howard Davies, by Rosa M. Lastra, "The City's Troubleshooter."

[8]However, significant changes to the FSA structure were made in 2001, "reflecting the view that the supervision function was too large to be undertaken within a single directorate." See Richard Dale and Simon Wolfe, "The UK Financial Services Authority: Unified Regulation in the New Market Environment," *Journal of International Banking Regulation*, Vol. 4, No. 3, March 2003. According to the new organisation chart of the FSA, insurance, pensions and investment services are being supervised in one directorate, and banking and markets/exchanges as well as complex groups in another. A third directorate on "Regulatory Processes and Risk" now comprises a division on Regulatory Strategy and Risk, in addition to the divisions on authorisation and enforcement. See www.fsa.gov.uk

peaks" approach,[9] whereby system concerns and prudential consideration would be kept separate from investor protection and conduct of business rules (i.e., a system of regulation by objective or finality).

In Germany, the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht -BaFin) was established on 1 May 2002, following the adoption on 22 April 2002 of the Law on Integrated Financial Services Supervision (Gesetz über die integrierte Finanzaufsicht - FinDAG). The BaFin is organised according to business functions, rather than supervisory functions. The BaFin consists of three supervisory directorates for banking supervision, insurance supervision and securities supervision/asset management and three cross-sectoral departments dealing with cross-sectoral issues.[10] The change in structure has not signified a change in the substantive laws underlying supervision, such as the German Banking Act (Gesetz über das Kreditwesen – KWG), the Insurance Supervision Law (Versicherungsaufsichtsgesetz – VAG) and the German Securities Trading Act (Gesetz über den Wertpapierhandel – WpHG). The justification for keeping these laws is that, "although financial services supervision has been organised in a single body, this does not mean that existing sectoral differences between the banking and insurance businesses will be disregarded. These differences have led to the development of specific supervisory methods and rules for banks and insurance companies which have proved to be successful.[11]"

The trend towards unification of supervisory responsibilities in some European countries has wider implications at the EU level, as it could pave the way for the creation of a single European Financial Services Authority, in particular if all or most Member States were to adopt such a model in their respective jurisdictions. The possibility of establishing a single EU financial supervisory authority (though still a distant prospect) has been suggested in various circles, including the "Committee of Wise Men on the Regulation of European Securities Markets." Indeed, the Lamfalussy Report states in a fall back remark:

> "[I]f the full review were to confirm in 2004 (or earlier as the case may be) that the approach did not appear to have any prospect of success, it might be appropriate to consider a Treaty change, including the creation of a single EU regulatory authority for financial services generally in the Community.[12]"

I had the opportunity of asking Baron Lamfalussy whether the wording of this statement was intentional when he spoke in London on 3 May 2001 and his answer was positive: the choice of words, 'single EU regulatory authority for financial

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[9]The "twin-peaks" approach was advocated by Michael Taylor, in "Twin Peaks: A Regulatory Structure for the New Century", published by the Centre for the Study of Financial Innovation (CSFI), London, 1995.

[10]The functions of the former offices for banking supervision (Bundesaufsichtsamt für das Kreditwesen), insurance supervision (Bundesaufsichtsamt für das Versicherungswesen) and securities supervision (Bundesaufsichtsamt für den Wertpapierhandel) have been combined in the single state regulator, the BaFin. The BaFin is a federal institution governed by public law that belongs to the portfolio of the Federal Ministry of Finance. See www.bafin.de

[11]Ibid.

[12]http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussy/htm, at p. 41.

services in the Community' was intentional. Hence, this wording indicates a preference for the conceivable creation of an European FSA rather than for the creation of an European SEC.

However, the wisdom of a single supervisor – particularly in large countries – is still doubted by many commentators and policy-makers alike. Personally, I am against the creation of such an authority at the EU level on the grounds of excessive concentration of power and lack of accountability, in particular in countries where there is 'reverence' for the decisions of the authorities.[13]

To my knowledge, there is no empirical evidence that justifies the superior wisdom of any given model of organising financial supervision, whether that be the model of one authority for the entire financial system, the model of one authority for each sector of the financial industry like in Spain (with banks being supervised by the Banco de España, securities firms by the Comisión Nacional del Mercado de Valores and insurance companies and pension funds by the Dirección General de Seguros) or the model of multiple authorities for each sector of the financial industry like in the USA.

<u>A single market in financial services with a single currency does not need a single supervisory authority</u>. The US is an interesting example of a single monetary area and a common market, combined with an extremely fragmented supervisory landscape and a complex regulatory system based upon federal law (financial laws enacted by Congress), state law (laws enacted by state legislatures, particularly relevant in terms of insurance companies), regulation by agencies (the Fed and the SEC have rule-making powers) and self-regulation (in the field of securities, the rules of the SROs). In the US, the creation of such a monopoly supervisory authority is extremely unlikely and, according to Greenspan, "highly undesirable on both political and economic grounds.[14]" Talks have been going on with regard to the reduction of the number of supervisory agencies within the banking sector; that alone generates much controversy.

As acknowledged, the US model of financial regulation and supervision is characterised by its complexity, the multiplicity of regulators, and the demands of federalism. Banking in the USA is subject both to federal law and to state law.

[13] I once asked Howard Davies, FSA Chairman, what his response would be against allegations that the FSA would concentrate too much regulatory power in the same hands. And he said: "The culture in this country as well as in the city is quite open. We have had a great deal of self-regulation and have created an environment in which people do debate regulation and regulatory decisions in a very open way, probably more so than in many other countries, perhaps not more than in the US, but more than in most European countries. ***Here, there is no automatic reverence for the decisions of the regulators, there is a common culture of criticising*** (…). I don't feel as if we are the kind of organisation which is going to sit in its ivory tower, handing its decisions to the financial markets; that is not our culture. (…) Our environment (…) is much less directly and rigidly regulated than anywhere else you can think of, be it the US, Japan or many European countries. (…) If other countries would move in the direction of financial supermarkets then I think the pressure for change in the regulatory structure will match the changes in the market." Supra note 7, at p. 34.

[14] See Alan Greenspan, "Financial Innovations and the Supervision of Financial Institutions" in Proceedings of the 31st Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 1995, at p. 4.

There are several supervisory authorities at the federal level[15]: the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (in addition to the federal regulators for thrifts, such as the OTS, Office of Thrift Supervision). There are also supervisory authorities at the state level. The securities industry is subject to a combination of federal law and self-regulation (with some elements of state law). The Securities and Exchange Commission (SEC) is a federal agency which oversees the exchanges and the NASD and which administers the federal system for the registration of new issues of securities. The exchanges (such as the New York Stock Exchange) are self-regulatory organisations with powers to promulgate rules for its member firms and listed companies. The NASD (National Association of Securities Dealers) is a self-regulatory organisation with powers – under the supervision of the SEC – to promulgate rules governing voluntary membership broker-dealers in the over-the-counter securities markets, such as the NASDAQ (National Association of Securities Dealers Automated Quotation System).[16] Through this two-tiered structure, as Jackson and Symons point out, "the US Congress intended to strike a balance between the protection of the integrity of the markets and the flexibility necessary to maintain an economically vigorous capital market. The structure was also intended to balance the need for the participation of the market professionals, achieved through SRO self-regulation and the need for an independent watchdog, the SEC.[17]" The recent Sarbanes-Oxley Act of 2002 - which introduces sweeping reforms with regard to corporate governance - does not change much the regulatory structure of US securities markets. Investment companies (mutual funds) are regulated almost exclusively at the federal level by the SEC since the enactment of the 1940 Investment Company Act and the 1940 Investment Advisers Act.[18] Insurance in the USA remains a matter of state law since the McCarran-Ferguson Act of 1945,[19] though pension funds are subject to federal law since the enactment of ERISA (Employee Retirement Income Security Act) in 1974.[20]

[15]The Gramm-Leach-Bliley Act of 1999 represented the breakdown of the Glass-Steagall wall between commercial and investment banking. This Financial Services Modernisation Act 1999 Act expanded the activities permissible for affiliates of banks and created a new category of bank holding company, the "financial services holding company" (FSHC). Under the umbrella of the FSCH (supervised by the Fed), the bank subsidiaries - which are engaged in commercial banking activities – are supervised by bank regulators (OCC, Fed, state regulators) and non-bank affiliates are supervised by specialist regulators according to the type of business undertaken. See, e.g., Jonathan. R. Macey, Geoffrey P. Miller and Richard S.Carnell, *Banking Law and Regulation*, Aspen Law & Business, New York, 2001, pp.33-36 and pp. 443-449

[16]The Securities Act of 1933 established a federal system for the registration of new issues of securities, and the Securities Exchange Act of 1934, created a new federal agency, the Securities and Exchange Commission. Following the stock market crash of 1929, these pieces of legislation were enacted to promote stability and confidence in capital markets and to protect investors in view of the shortcomings and inadequacies of the state "blue sky" laws. The reason why state securities statutes were known as 'blue sky' laws is because some lawmakers believed that 'if securities legislation was not passed, financial pirates would sell citizens everything in the state but the blue sky.' See Howell E. Jackson and Edward L. Symons, *Regulation of Financial Institutions* (1999), at 655-662, 751-755.

[17]Ibid., at 753.

[18]Ibid. at 812-850. Open -end investment companies are otherwise known as mutual funds.

[19]Ibid. at 431-442 and 588-590. The US financial regulatory landscape also comprises other regulators, such as the Commodities Future Trading Commission for financial derivatives (commodity futures and options). Ibid., at 1004-1008.

[20]Ibid. at 611-617.

1.2 CENTRALISATION?

Since the launch of the Euro in January 1999, the European Central Bank is in charge of the monetary policy of the countries participating in EMU (European Monetary Union). Centralisation exists with regard to monetary policy, but decentralisation is the principle applied to banking supervision as well as to the supervision of other areas of the financial sector. In the words of Tommasso Padoa-Schioppa, the abandonment of the coincidence between the area of jurisdiction of monetary policy and the area of jurisdiction of banking supervision is a major novelty brought about by the advent of EMU.[21]

The debate about the degree of centralisation or decentralisation in the allocation of competencies for financial supervision and regulation in Europe needs to take into account the requirements of the principle of subsidiarity. According to Article 5 of the EC Treaty: "[i]n areas which do not fall within its exclusive competence, the Community shall take action in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty." Subsidiarity is also related to the principle of strict conferment of powers (areas not explicitly allocated at community level belong to the Member States) and to the principle of proportionality (not going beyond what is needed to attain the Community objectives; in this case, the completion of the single market and the requirements of monetary union need to be taken into account).

There are two contrasting views on the future of financial supervision in Europe, one that supports decentralisation and the other one that gravitates towards centralisation. The first view is supported by many in the United Kingdom, who think that greater co-operation between national authorities and increased harmonisation through competitive pressures and self-regulation would best pave the road to a more efficient and integrated capital market. An integrated financial market, based upon the directives and principles that constitute the banking policy of the EU, should alleviate some of the shortcomings of different bank regulatory systems throughout the Member States of the Union. The second view, which finds support in some forums in continental Europe, deems that supervision in Europe would be performed better by a centralised agency - or several centralised agencies - rather than by a large number of national authorities.

Centralisation, as an organising principle for European financial architecture, can proceed through several routes:

[21] Tommaso Padoa-Schioppa, "EMU and Banking Supervision," Lecture at the London School of Economics (Feb. 24, 1999), <http://fmg.lse.ac.uk/events/index.html>, also published as Chapter 1 in *Which Lender of Last Resort For Europe?* (Charles A.E. Goodhart ed., 2000). A general recent discussion of the financial architecture of the Euro area is found in Chapter 4 ("Financial Architecture") of the Report on the European Economy of the European Economic Advisory Group (EEAG) at CES IFO (German Institute for Economic Research), Munich, February 2003.

(1) Centralisation according to the model of a "single supervisor" with the creation of an European FSA.
(2) Centralisation according to the model of "multiple supervisors" with the ECB (or a separate agency) in charge of banking supervision and the creation of separate pan-European supervisory authorities for insurance and securities (and perhaps financial conglomerates).
(3) Centralisation of some supervisory functions, such as "lender of last resort," while other supervisory functions remain decentralised (e.g, authorisation, enforcement).

I have already indicated my opposition to the creation of a European FSA. With regard to options (2) and (3) above, it is important to bear in mind the following: (a) the EC Treaty leaves room for granting a possible supervisory role to the ESCB,[22] and (b) according to the principle of subsidiarity, it is conceivable that some supervisory functions could be transferred from the national to the supranational arena (for instance, lender of last resort), while other supervisory responsibilities still remain at the level of the Member States. The possible centralisation of one supervisory function does not imply nor require the centralisation of other supervisory functions.

1.3 THE ROLE OF ESCB

The separation between the monetary and the supervisory functions of a central bank is a most contentious issue in the institutional design of supervision.[23] The central bank has a fundamental role with regard to monetary stability and financial stability. The pursuit of price stability has become the primary objective of monetary policy. Central bankers' duties towards the maintenance of 'financial stability' typically refer to maintenance of the safety and soundness of the banking system.[24] Sound banking is related to three other basis central bank functions: central banks as bankers' banks, central banks as supervisory agencies (when they are entrusted with supervisory functions) and central banks as lender of last resort. In the UK, for instance, issues of systemic stability remain the responsibility of the Bank of England. However, if a

[22]See Rosa Lastra, "The Division of Responsibilities Between the European Central Bank and the National Central Banks Within the European System of Central Banks," *The Columbia Journal of European Law*, Volume 6, No. 2, Spring 2000. Alexandre Lamfalussy expressed his personal views on the subject in an article published in the Financial Times on 8 February 2000 on "Regulation under Strain". He wrote then that a 'loose co-operative framework may be appropriate for navigating in fair weather, but not when a storm is blowing.' Furthermore, he added: 'We must avoid becoming trapped in a sterile debate of what is better: supranational institutions or improved co-operation. There might be a need for supranational institutions in some areas, but not in others. Centralised decision-making might go hand-in-hand with monitoring and implementation by national authorities.' This pragmatic approach is commendable.
[23]See Charles Goodhart and Dirk Schoenmaker, "Should the Functions of Monetary Policy and Banking Supervision be Separated?," *Oxford University Papers* Vol. 47, 1995, pp. 539-560.
[24]As Christos Hadjiemmanuil and Mads Andenas point out ("Banking Supervision and European Monetary Union," *Journal of International Banking Regulation*, Vol. 1, No. 2, June 1999, at p. 96), "the concepts of 'financial stability' and 'bank safety and soundness,' which guide prudential supervision, are broad and imprecise. They do not provide operational criteria for administrative action, but require application of discretion on an individual basis."

crisis arises, the Bank of England consults with the FSA and the Treasury according to the rules set up in a Memorandum of Understanding (MoU).[25]

The ESCB has a clearly defined mandate with regard to monetary stability, but only a limited role with regard to the safeguard of financial stability. According to Article 105.5 of the EC Treaty, "The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."

Though the Draft Statute of the European System of Central Banks included prudential supervision as a fifth basic task of the ESCB, the final version of the Statute (Article 25) and Article 105 of the EC Treaty only granted the ECB a limited supervisory role, due to opposition of some countries - notably Germany - to such an inclusion (for fear that it could conflict with the sacrosanct goal of price stability). Hence, prudential supervision is a 'non-basic' task of the ESCB (Article 105.2), though Article 105.6 leaves the door open for a possible future expansion of such supervisory role, following a simplified procedure (simplified in the sense that it does not require the formal amendment of the Treaty, but not likely to be exercised lightly due to the requirement of unanimity)[26] Article 105.6 of the EC Treaty – which is often referred to as the **enabling clause** - reads as follows:

> "The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning the policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings."

According to Article 105.2 of the EC Treaty, the ESCB is entrusted with the "smooth operation of payment systems." Because payment systems are largely conducted – though not necessarily nor exclusively – through the banking system, it is often difficult to dissociate payment system supervision (a basic ESCB task) from banking supervision which for the most part remains a national competence, not a Community competence. However, the Treaty and the Statute do establish that dissociation and, as anything that is enshrined in a legal text, it has legal consequences. For instance, in the case of an explicit payment system gridlock, the ECB has competence to act as lender of last resort (LOLR). This point is actually borne out by the fact that the Bank of England has had to put up substantial collateral with the ECB to take part in TARGET (Trans-European Automated Real-time Gross-settlement Express Transfer) whereas this is not the case for the NCBs of the "in-Member States" participating in TARGET in their capacity as agents of the ECB.

However, if a crisis does not originate in the payment system, it is not clear from the language of the Statute and the language of the Treaty whether the ECB has

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[25]This MoU between HM Treasury, the Bank of England and the FSA was released on 28 Oct. 1997. See www.fsa.gov.uk.

[26]I further elaborate on these issues in an article I wrote on "The Division of Responsibilities Between the European Central Bank and the National Central Banks Within the European System of Central Banks," *The Columbia Journal of European Law*, Volume 6, No. 2, Spring 2000.

competence to act as LOLR. According to some commentators a degree of 'constructive ambiguity' is desirable in the case of crisis management, and ambiguity is what the EC law provides. Ambiguity provides scope for different – or even contrasting or possibly conflicting – interpretations. The silence on this point has been interpreted by some as a positive sign of the desire of the Treaty negotiators to assign responsibility at the ESCB level with respect to LOLR operations and by some others as a negative signal of those same negotiators on the same point. The latter argue that the LOLR responsibility remains at the national level because it has not been specifically transferred. That is, the national central banks – in their capacity as national agencies – are ultimately responsible for the decision on whether or not to grant emergency liquidity assistance.

However, in my opinion, the wording of the subsidiarity principle leaves the door open for a possible Community competence, which could be exercised either directly by the ECB or by the NCBs in their capacity as operational arms of the ESCB. In addition, the second indent of Article 18.1 of the ESCB Statute – regarding credit operations – could be interpreted creatively to allow for such a role. Furthermore, in the case of a general drying-up of liquidity that is due, for example, to a sudden drop in stock market prices that triggers a market-wide liquidity shortfall, the ECB could act through what has been called the "market operations approach" to lending of last resort.[27]

The Banking Supervision Committee of the ECB[28] has recently published a "Memorandum of understanding on high level principles of co-operation between banking supervisors and central banks of the EU in crisis management.[29]" However, whether or not the existing co-operative arrangements will really work remains to be tested. It will take the first pan-European crisis to cast some light on this issue…

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1.4 A MULTIPLICITY OF COMMITTEES AT THE EU LEVEL

It is interesting to observe that the trend towards consolidation of supervisory authorities at the national level co-exists with a multiplicity of committees at the EU level. The EU financial architecture remains extremely fragmented and segmented (by specialist12 0 0 12 379.790 1S788 292.1007 Tm(i)Tj12 0 0 12 46397028 292.1007 Tm(nancii)Tj12 0

sectors of the financial industry.[30] According to the new structure, 'Lamfalussy Level 2 Committees' – akin to the European Securities Committee or ESC – are to be established for banking, insurance and financial conglomerates,[31] and 'Lamfalussy Level 3 Committees' – akin to the Committee of European Securities Regulators or CESR – for banking and insurance. (The Council stated that while the new level 2 Committees should be set up in an advisory capacity to begin - so as to give the European Parliament the opportunity to assess their responsibilities - the level 3 Committees should be set up as soon as possible). Below is a chart of the new architecture for financial sector rule-making:[32]

Technical rules	**Banking**	**Insurance and Pensions**	**Securities and UCITS**	**Financial Conglomerates**
Lamfalussy Level 2	Reformed Banking Advisory Committee (BAC) Advised by ECB	Reformed Insurance Committee (IC)	Securities Committee	New Financial Conglomerates Committee (FCC)[33]
Lamfalussy Level 3	Level 3 Banking Committee Advised by the Groupe de Contact and Banking Supervision Committee of the ECB	Reformed Insurance Conference	Committee of European Securities Regulators (CESR, formerly FESCO)	

The 'Lamfalussy framework' does not imply the centralisation of supervisory and regulatory responsibilities. There is no transfer of competencies from the national to the supra-national arena. The level 2 and level 3 Committees are a form of supervisory co-operation. Hence, the extension of the Lamfalussy framework to banking and insurance reconfigures the current framework of co-operation but does not alter the principles upon which it rests: decentralisation, co-operation and segmentation.

[30]This Council Decision is available at http://ue.eu.int/pressData/en/ecofin/73473.pdf. See also the Report of the EU Economic and Financial Committee on "Financial Regulation, Supervision and Stability," http://www.europa.eu.int/comm/internal_market/en/finances/cross-sector/consultation/efc-report_en.pdf, Brussels, 9 October 2002, and the Note of the European Commission [Internal Market DG Financial Institutions] to the Ecofin Council, Brussels, 3 December 2002, http://www.europa.eu.int/comm/internal_market/en/finances/cross-sector/consultation/ecofin-note_en.pdf

[31]The Financial Conglomerates Committee was established by Article 21 of Directive 2002/87/EC of 16 December 2002 regarding the supervision of financial conglomerates. It is interesting to observe that the structure of the recently created BaFin in Germany would fit in well with these new Lamfalussy Level 2 Committees.

[32]Appendix 1 reproduces the whole chart. Supra note 30.

[33] Supra note 31.

As I have already pointed out, the financial landscape in the EU is characterised by a multiplicity of committees. The trend, however, seems to gravitate in the direction of creating even more committees or reconfiguring existing committees. For instance, the EFC in its report on "Financial Regulation, Supervision and Stability" suggests that the Financial Services Policy Group be reconfigured and renamed as Financial Policy Committee, to give political advice and oversight on financial market issues to the Council and to the Commission, as well as to provide for cross-sectoral strategic reflection. The ECOFIN Council in a decision of 18 February 2003 established this Financial Policy Committee, which started functioning in March 2003.[34] As the Council Decision states, this new Financial Policy Committee will report to the EFC in order to prepare advice to the Council (ECOFIN) taking into account the established role of the COREPER…

My final thought with regard to the reform of European financial architecture is that though it is commendable to foster co-operation, such co-operation should proceed along the lines of the consolidation and streamlining of existing committees, rather than through the creation of new committees, which bring about a duplicity or multiplicity of supervisory forums, often leading to a confusion or to an overlap of lines of responsibility and membership, to a cumbersome and unduly complicated decision-making process and, possibly, to bureaucratic inefficiency.

The future architecture of financial supervision in the EU also needs to take into account the needs of an enlarged EU.[35] A community of 25 or more members is more complex to govern that a community of 15. The future of Europe needs to combine efficiency with democratic legitimacy, as the European Convention, under the chairmanship of Valéry Giscard D'Estaing has acknowledged in its work so far (a draft Constitutional Treaty was published in October 2002).[36]

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[34]Council Decision (Doc. 6264/1/03) available at http://ue.eu.int/pressData/en/ecofin/74571.pdf. See Appendix 2 with regard to the structure of this reconfigured Group. Supra note 30.

[35]The accession negotiations with ten candidate countries in Central and Eastern Europe are well advanced. The EU Commission considers that Cyprus, Malta, Hungary, Poland, the Slovak Republic, Lithuania, Latvia, Estonia, the Czech Republic and Slovenia – will be ready for membership from the beginning of 2004. See "Strategy Paper and Report of the European Commission on the Progress Towards Accession by Each of the Candidate Countries," Brussels, 9.10.2002, COM (2002) 700 final, http://www.europa.eu.int/comm/enlargement/report2002/strategy_en.pdf

[36]At some point in the near future, the debate about the financial architecture of supervision in the EU will no doubt be linked to the European Convention project and to the emerging European Constitution. It is interesting to observe that one of the members of the European Convention, Mr. Elmar Brok, contributed recently (7 March 2003) amendments to the draft constitutional text in which he suggests that the prudential supervision of credit institutions and the stability of the financial system should be a shared community competence. See Elmar Brok, Discussion Paper 111, CONV 325/2/02 REV 2, 27.01.2003, Article 71(1)(p), http://register.consilium.eu.int/pdf/en/02/cv00/cv00325-re02en02.pdf

SECTION 2. FINANCIAL REGULATION IN THE EU

In this section of the paper, I analyse the processes and procedures to adopt financial legislation and regulation in the EU. As I have already pointed out, though the terms regulation and supervision are often used interchangeably, properly speaking, regulation refers to the establishment of rules, and supervision refers to the oversight of financial firms behaviour (in particular risk-monitoring). Though, in my opinion, a single market in financial services does not need a single supervisor, it does need however some common rules. However, the process of adopting common rules does not require *per se* the existence of a centralised authority. Common rules can also be adopted through the adoption of a Treaty or a model law, through the adoption of harmonised principles, through the adoption of common standards ('soft law' as in the case of the Basel Committee on Banking Supervision) and through other regulatory techniques, whose analysis exceeds the scope of this paper. Common rules can (and do) co-exist with different national systems of financial legislation.

Even if supervision remains at the national level, it should be based to a large extent on community regulation of the matter. In the banking sector, a substantial degree of market integration has been achieved through the adoption of a series of banking directives, even though there are still significant national differences with regard to tax laws, company laws and others that create opportunities for regulatory arbitrage.

A bit of history helps explain the evolution of the legislative processes to adopt financial regulation in the EU.[37] The approximation of legislations in the field of banking and finance as required in Article 100 of the original EEC Treaty had been difficult before 1985. Indeed while the Commission had succeeded in the approximation of laws (mainly through regulations) in the fields of quality, composition, labelling and control of goods, industrial property rights, public procurement, technical or administrative barriers to trade, industrial safety and hygiene, etc., the Commission had failed to approximate laws in other fields such as banking and financial services, transport, energy, telecommunications, etc., due to stark differences across Member States in the structure of their services industry, due to the political implications of the liberalisation of some 'key' services and due to the existence of exchange controls.[38] A new strategy was needed, with new political initiatives and more flexible techniques for integration.

The new strategy first envisaged in the 1985 White Paper on the Internal Market and legally enshrined in the 1986 Single European Act was rooted in the generalisation of the concept of mutual recognition on the basis of prior minimum harmonisation (rather than full or detailed harmonisation) and on the principle of home country control. Directives became the preferred legislative instrument to

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[37]See "Central Banking and Banking Regulation," 1996, supra note 1, at pp. 217 et seq.

[38]The Single European Act also gave momentum to the liberalisation of capital movements, one of the four freedoms of a true single market and a precondition for the full liberalisation of financial services.

achieve financial integration.[39] The use of directives is consistent with the principles of minimum harmonisation and mutual recognition. Regulations, as opposed to directives, are consistent with the principle of full or detailed harmonisation. And regulations leave no freedom to Member States with regard to their national transposition.

Despite the relative success of the new strategy in advancing the Community's goal of creating a single market, it has also limitations. These limitations have become apparent in the process of integrating capital markets in Europe, where the legislative process has often been criticised for being too slow and rigid to adapt to market developments.[40] On past experience, the adoption of directives in the field of financial regulation takes 2-3 years, followed by a 1-2 year period for national implementation. By the time that a directive is finally implemented, it is time to change it again. In the absence of other legislative instruments, directives have often dealt with both broad framework principles on the one hand and very technical issues on the other hand. This has resulted in a mix of ambiguity in some cases (for instance, when the political consensus is lacking) and excessive prescription in some others. The legislative process has also often proven inadequate to deal with the needs and concerns of market participants. Though bank-dominated systems have traditionally prevailed in Europe (with the exception of the UK), the development of capital markets in recent years requires a greater deal of dialogue, consultation and co-operation between the many parties involved: lawmakers, supervisors, self-regulatory organisations, market intermediaries, issuers and investors.[41] The techniques needed to regulate securities markets (disclosure requirements, fiduciary rules) have a much larger component of market discipline and consultation than the regulatory techniques typically applied to lending and deposit taking (mandatory rules, capital requirements).

In response to these criticisms, in July 2000 the European Council set up the Committee of Wise Men on the Regulation of European Securities Markets under the chairmanship of Alexandre Lamfalussy. The mandate given to the Wise Men was confined to the workings of the law-making process concerning securities markets regulation in Europe, with the aim of speeding it up and making it more flexible in order to respond to market developments. The Wise Men were asked to identify the imperfections of this process and to come up with recommendations for change. The mandate of the Wise Men was not to identify what should be regulated, nor to look at other relevant issues such as international implications or prudential considerations.[42]

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[39]The Single European Act in its Declaration on Article 100a of the EEC Treaty stated that: "[T]he Commission shall give precedence to the use of the instrument of a directive if harmonisation involves the amendment of legislative provisions in one or more Member States." The Amsterdam protocol also states in its point 6: "[D]irectives should be preferred to regulations."

[40]See Rosa Lastra "Regulating European Securities Markets: Beyond the Lamfalussy Report," book chapter in M. Andenas and Y. Avreginos (eds.), *Financial Markets in Europe: Towards a Single Regulator?* Kluwer Law International, 2003.

[41]See "EU Securities Market Regulation. Adapting to the Needs of a Single Capital Market," Report of a CEPS Task Force, March 2001; Chairman: Alfred Steinherr, Rapporteur: Karel Lannoo.

[42]Some times, the process of financial integration has been hindered by issues other than the 'legislative processes.' For instance, the recent failure to agree on a Takeover Directive is an example of the 'political difficulties' that remain to achieve further integration in the EU.

The Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (the Lamfalussy Report)[43] was published on 15 February 2001 and the European Council in its Resolution of 23 March 2001 adopted some of the proposals recommended in the Report. The major novelty of the Lamfalussy Report is its four-level regulatory approach (namely framework principles, implementing measures, co-operation and enforcement) whose aim is to speed up the legislative process for the regulation of securities markets. Of these four levels, the main innovation is the distinction between 'core principles' in Level 1 and non-essential 'technical implementing matters' in Level 2, which mirrors at the EU level what happens at the national level with the distinction between primary legislation and secondary regulation. According to Baron Lamfalussy, the Report brings about a 'governance change,' a bottom-up approach (rather than top-down), which could also be applied to other areas of European integration.[44]

However, there is an inevitable tension between the quality and the democratic nature of the legislative output and the need for speed and flexibility. At the national level, this tension, this trade-off has been solved through the distinction between primary and secondary law. By definition, primary law – the legislative process – is rigid and slow, but 'democratically accountable,' while secondary law – the regulations and rules issued by regulatory agencies – is flexible and quick, but 'less democratically accountable.' At the EU level, the tension between legitimacy and flexibility is illustrated by the misgivings of the European Parliament with level 2. The EP, through a resolution of 5 February 2002, finally endorsed the Lamfalussy Report, albeit with a number of safeguards. The EP did not manage to get a *call back* clause, which would have given it a right to block (or call back) implementing powers, as that would have meant a change to Article 202 of the EC Treaty. However, as a compromise, it did manage to get a *sunset clause*[45] which establishes a time limit of four years with regard to the delegation of powers for the adoption of technical rules. For instance, under Directive 2003/6/EC (Market Abuse Directive), the Commission may only adopt level 2 legislation until April 2007. Another safeguard is the requirement to receive from the Commission equivalent treatment to that given to the Council. The Commission had promised not to go against the predominant views of the Council as regards key implementation issues.[46] The latter is often referred to as the *aerosol clause*, as it was first used in the case of EU legislation on chlorofluorocarbon emissions from spray cans in the 1970s.

The Parliament and the Council delegate the adoption of Level 2 technical implementing measures to the Commission, with the assistance of the European

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[43]Supra note 12.

[44]See Alexandre Lamfalussy , "Reflections on the Regulation of European Securities Markets," SUERF Studies, Vienna, 2001, at pp. 16-17.

[45]See point 17 of the "European Parliament Resolution on the Implementation of Financial Services Legislation" (2001/2247(INI)) of 5 December 2002. The EP passed this resolution on the basis of the solemn declaration made before Parliament the same day by the Commission and the letter of 2 October 2001 addressed by the Internal Market Commissioner to the chairman of Parliament's Committee on Economic and Monetary Affairs, with regard to the safeguards of the European Parliament's role in this process.

[46]EP Resolution of 5 December 2002, point 12.

Securities Committee,[47] advised by the Committee of European Securities Regulators (CESR).[48] It is important to understand that the rule-making powers remain with the EU Commission and not with the ESC. The technical implementing measures are adopted by the Commission with the assistance of the ESC and the CESR. Hence, this level 2 implementation is not comparable to the rule-making powers of the SEC in the US, where the SEC is the one that adopts the rules.

In my opinion, it would be better to have just one (not two) European Securities Committee/Commission.[49] Such Committee would have delegated powers to adopt securities rules (under the current Lamfalussy approach, Level 2 implementing measures are adopted by the EU Commission with the assistance the ESC and the CESR) and the broad legislative guidelines and standards would be still be set according to the regular EC legislative process. The idea is that given the need for expertise, flexibility, technical competence and de-politicisation in capital markets, a specialised and de-politicised committee/commission – accountable to the EU Parliament, Commission and Council – as well greater reliance on self-regulation might be better suited to regulate securities markets than the current *status quo*.

Whether or not the main aim of the Report – a faster and more flexible legislative process – is realised or not remains to be seen. The Lamfalussy approach has been already applied to some recent legislative measures, such as the new Prospectus Directive[50] and the Market Abuse Directive.[51] A revised proposal of the Investment Services Directive was published in November 2002[52] and is expected to be adopted in 2004. The experience so far shows that it is difficult to distinguish between framework principles and implementing measures. This is a most sensitive balancing act, the distinction between political – level 1 – and technical – level 2 – measures.

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[47]The European Securities Committee (ESC) functions as a regulatory committee in accordance with the 1999 Decision on 'comitology' to assist the Commission on implementing measures under Article 202 of the EC Treaty. This ESC, acting in an advisory capacity, should be consulted on policy issues by the Commission. The ESC is composed of high-ranking officials – State Secretaries in the Finance Ministries of the Member States or their personal representatives – and is chaired by the European Commissioner responsible for the Internal Market in Financial Services. This 'comitology' procedure is recognised under Articles 202 and 211 of the Treaty. Council Decision 1999/469/EC lays down the procedures for the exercise of implementing powers conferred on the Commission (the comitology framework).

[48]The Committee of European Securities Regulators Committee (CESR) was formally set up on 11 September 2001 as an independent advisory group to the Commission (outside the comitology process) and is composed of national securities regulators, building on the structure established by FESCO (Forum of European Securities Commissions).

[49]See Statement No. 10 of the European Shadow Financial Regulatory Committee (of which I am a member), available at www.ceps.be

[50]Amended Proposal for a Directive of the European Parliament and of the Council on the Prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC/*COM/2002/0460 final – COD 2001/117 * Official Journal C 020 E, 28/01/2003 P. 0122-0159, available at http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0460en01.pdf

[51]Directive 2003/6/EC of the European Parliament and of the Council on insider trading and market manipulation (market abuse), available at http://europa.eu.int/eur-lex/en/com/pdf/

[52]Proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC/* COM/2002/0625 final – COD 2002/0269*/ available at http://europa.eu.int/eur-lex/en/com/pdf/2002/com 2002_0625en01.pdf

The discussions in Stockholm in March 2001 and the preparatory discussion of the central features of the Report illustrate the mutual suspicions among national and European institutions (and between the latter) and the struggle of competencies between the Commission, the Council the European Parliament, as well as the latter's concerns about accountability and transparency. [53] The fear is that if EP fails to co-operate in the full co-decision procedures at level one (out of concern for not being sufficiently involved at level two[54]), that could imply a greater potential for delay and certainly an end to the ambition to have the new framework operational produce flexible rules.[55] The EP's misgivings about not being involved in the decisions by the Securities Committee have resulted in the fact that it [the EP] proposed over 100 amendments in the case of the draft market abuse directive.[56] *Plus ça change?*

The EP's concerns about accountability and transparency are of great relevance in the ongoing debate with regard to the establishment of Lamfalussy Level 2 Committees for banking, insurance and financial conglomerates.

The extension of the Lamfalussy framework from securities regulation to financial sector rule-making generally[57] has important implication for several key EU legislative initiatives, in particular the Risk Capital Action Plan.[58] Indeed, if (or when) a new Capital Adequacy Directive is adopted at the EU level in line with the forthcoming Basel II, it is expected that the Commission will choose to adopt a framework directive and to delegate a great deal of technical implementing measures to a committee or committees (possibly to a level 2 Lamfalussy banking committee - reformed BAC[59] - together with the ESC).[60] The ECB, according to Article 105.4 of the EC Treaty, would also be involved in the legislative process in an advisory capacity.[61]

The risk capital proposals provide an example of the challenges confronting regulators supra-nationally and internationally. In the USA, the Fed, the OCC and the FDIC have reached a compromise to only apply Basel II on a mandatory basis to a

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[53]I explore the issue of accountability in a couple of articles on "Public Accountability in the Financial Sector," (2001) and "How Much Accountability for Central Banks and Supervisors?" (2001).

[54]The EP had voted in 2001 for the introduction of a *call back* provision that would have allowed it to halt legislation at level 2. The Commission, however, considered that to extend the EP's power to call back a proposal on substantive grounds was not compatible with the EC Treaty.

[55]See Lamfalussy Report, supra note 12, at p. 30. Ibid. at pp. 6 and 36.

[56]I am quoting here from Lannoo, supra note 4, at p. 11.

[57]See Appendix 1.

[58]With the intention of having a new EU framework operational in 2006, the Commission published a working document on capital requirements for credit institutions and investment firms on 18/11/2002, http://europa.eu.int/comm/internal_market/en/finances/capitaladequacy/workingdoc/cover-doc_en/pdf

[59] The creation of a reformed BAC would require an amendment of Articles 57 and 60 Directive 2000/12/EC of the European Parliament and the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, Official Journal L 126, 26/05/2000

[60]See Lannoo, supra note 4, at 14.

[61]Article 105.4 of the EC Treaty states: "The ESCB shall be consulted :

- on any proposed Community Act in its field of competence;
- by national authorities regarding any draft legislative provision in its field of competence (…).

The ECB may submit opinions to the appropriate Community institutions or bodies or to national authorities on matters in its field of competence."

few large internationally active banks.[62] However, a new EU Capital Directive would affect all credit institutions and investment firms in all EU Member States. The European Shadow Financial Regulatory Committee (ESFRC) in its recent statement of 12 May 2003[63] expresses its concerns about the implications of the US approach for a level playing field and the repercussions of this approach for banking systems outside the G10. However, the ESFRC also recognises that there is some merit in differentiating between small and large institutions with regard to the implementation of the risk capital proposals, given the complexity of the new [Basel] approach.

Another issue to be considered with regard to the different way in which small and large banks are treated (or may be treated) by the authorities is the adequacy of the current supervisory structure in the EU for pan-European financial institutions.[64] Making an analogy to the football leagues in Europe, where the Champions League is run by UEFA and the national leagues are run by the national football federations, it is conceivable that in future large pan-European banks may be supervised by an EU institution (the ECB or an European Banking Commission) and smaller banks by national supervisors.

CONCLUDING OBSERVATIONS

This paper has explored what I call "the unfinished agenda" of the governance structure of financials supervision and regulation in Europe. Though supervision still remains firmly anchored at the national level, since the advent of EMU a debate is going on with regard to the wisdom of centralising some supervisory functions at the EU level. The EC Treaty, through the so-called enabling clause (Article 105.6), leaves the door open for the possible transfer to the ECB of specific tasks concerning policies relating to the supervision of credit institutions and other financial firms (excluding insurance undertakings). However, I argued in this paper that the possible centralisation of one supervisory function or task (lender of last resort) does not imply nor require the centralisation of other supervisory functions

Several Member States of the European Union, such as the UK and Germany, have taken steps towards the creation within their domestic jurisdictions of a single supervisory authority for the whole financial sector. In the eyes of some commentators, this trend could pave the ways towards the creation of a single European Financial Services Authority. A fall back remark in the Lamfalussy Report explicitly mentions this possibility (which would become easier to accomplish from a practical point of view if all or most Member States were to adopt such a single regulatory structure). However, in my opinion, the creation of such a regulatory

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[62]Testimony of John D. Hawke, Jr., Comptroller of the Currency before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the Committee of Financial Services of the United States House of Representatives, February 27, 2003 (Statement required by 12 U.S.C. 250). John D. Hawke, Jr also presented some remarks before the Centre for the Study of Financial Innovation, in London on 13 March 2003.

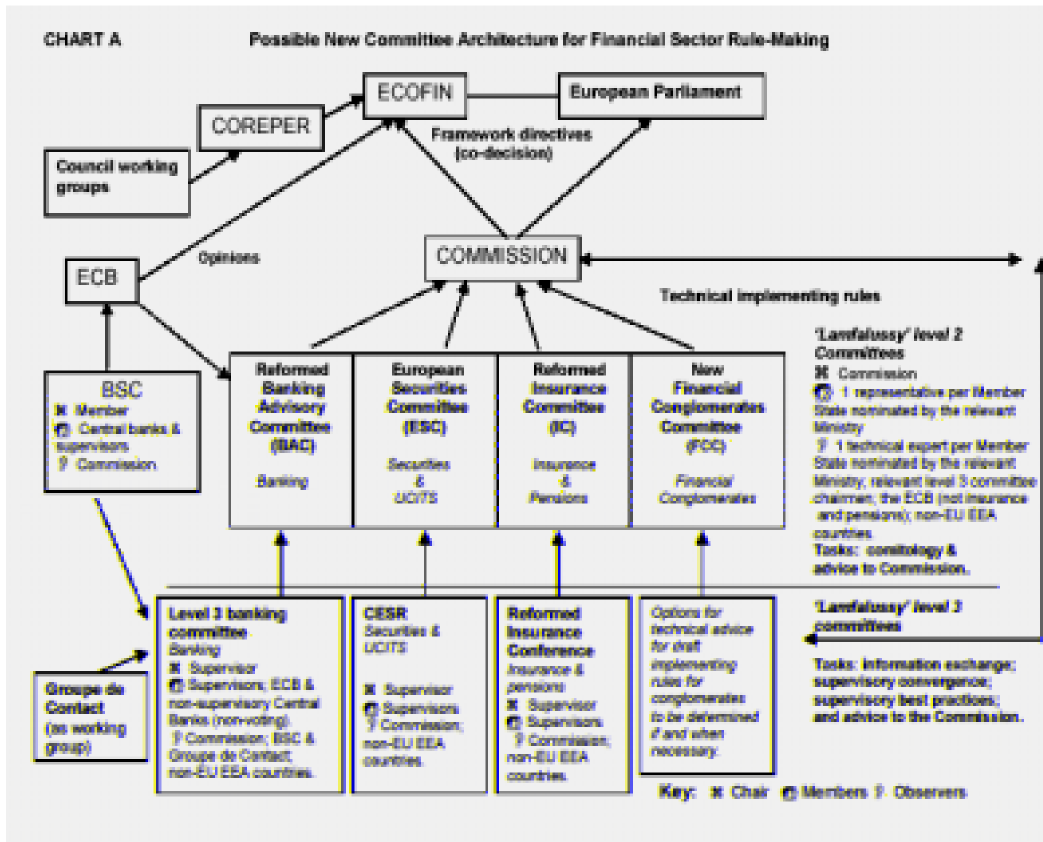
[63] See www.ceps.be

[64] I further analyse this issue in the script I am currently writing on *The Legal Foundations of International Monetary Stability,* which is to be published by Oxford University Press.

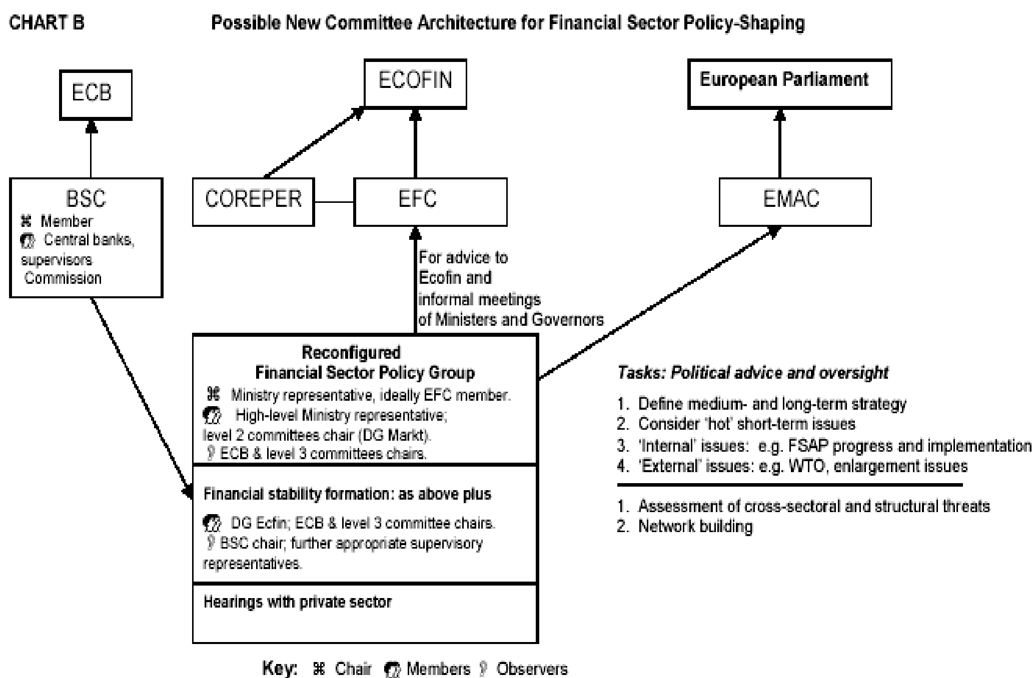
Leviathan would be highly undesirable on the grounds of excessive concentration of power and concerns about accountability and transparency. What Europe needs is the streamlining, consolidation and rationalisation of the current structure of multiple committees (often with overlapping responsibilities and membership). Interestingly, the trend towards unification of supervisory responsibilities at the level of the Member States co-exists with a multiplicity of Committees at the EU level. Financial supervision at the EU level still follows a model characterised by segmentation (by specialist financial institutions conducting distinct financial activities: banking, securities and insurance) co-operation and decentralisation.

I also analysed in this paper the processes and procedures to adopt financial legislation and regulation in the EU. Though a single market with a single currency does not need a single supervisor/regulator (the US, for instance, has multiple supervisory authorities in each sector of the financial industry), it does need some common rules, some common financial standards. I examined the so-called Lamfalussy approach to the regulation of securities markets in Europe and the expansion of this approach to banking, insurance and financial conglomerates. I emphasised the 'procedural character' of the Lamfalussy Report, as the mandate of the Wise Men who produced the Report was confined to the workings of the law-making process concerning securities markets regulation in Europe, with the aim of speeding it up and making it more flexible to respond to market developments. I questioned however whether this aim will be achieved in the light of the misgivings of the European Parliament about level 2 delegated rules. Consistent with my belief that a multiplicity of Committees often leads to inefficiency and overlap of responsibilities, I also expressed my preference for one European Securities Committee/Commission rather than two.

APPENDIX 1



APPENDIX 2



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