London's moment

Nicolas Véron argues that, rather than keep Brussels at bay, the City should play a leading role in improving Europe-wide financial regulation

In December, the European Union's procedural framework for financial rule-making, known as the Lamfalussy process, is being reassessed. It is likely to bring little change.

However, German supervisory setbacks and the Northern Rock debacle have shone a spotlight on crisis management and prevention, and highlighted how different regulatory settings either helped or hindered efficient public policy. In this light, perhaps a revision of UK strategy looks more justified.

The Lamfalussy process was adopted in 2001 for securities regulation, following a report by a committee of wise men chaired by Alexandre Lamfalussy, the Belgian central banker. The report recommended a four-level approach comprising: level 1, framework principles; level 2, implementation measures; level 3, co-ordination among regulators; and level 4, enforcement. In 2004, the approach was extended to banking and insurance.

This overhaul resulted in several new structures. Level 3 is made up of three committees: the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS), and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). They have sub-committees, generally known by longer acronyms, such as CESR-Fin which deals with financial reporting.

The three level-3 committees together form another committee, known, in impeccable acronymic logic, as 3L3, which is meant to co-ordinate their respective proceedings. CESR has 30 members, CEBS has 48 and CEIOPS 37, if observers are included.

In total, no fewer than 75 agencies are participating, after taking into account the overlaps such as the FSA in the UK or the Irish Financial Regulator, which sit in all three groupings.

One upside is that the Lamfalussy process is considered to have improved consultation with market participants. The downside is the mind-numbing institutional complexity it created, with the risk that the multiplicity of committees blurs responsibilities.

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Also, there is ambiguity on the status of level-3 committees. These have been created as co-ordinating and advisory bodies but there is frequent pressure for them to make regulatory decisions, even though they lack a clear mandate and the weight to impose majority choices on reluctant members.

In the meantime, Europe's financial integration has made rapid progress. Stock exchanges are consolidating. All listed companies now use International Financial Reporting Standards (IFRS), which sharply reduces the differences

between listing locations. Financial firms have started moving cross-border, as illustrated by a glance at the European Union's 15 largest listed banks.

In 1997, 82 per cent of their European assets was held in the home country but last year this share fell to 67 per cent. The European-ising trend is likely to accelerate after the break-up of ABN Amro. By contrast, the share of assets in non-European countries has stayed broadly constant, at 27-28 per cent of the total.

These developments create challenges for regulators. Cross-border stock exchanges such as NYSE Euronext, OMX in northern Europe, or the Milan-London grouping still keep separate national lists due to regulatory fragmentation. This hampers market efficiency.

Enforcement of IFRS is at national level – international issuers could therefore face a variety of national guidelines. And the jumble of participants involved in, say, sudden financial stress involving a large cross-border bank could spell inefficient decision-making with little incentive to co-operate.

This could inflate the costs of crisis management and resolution. Europeans are lucky no such crisis has erupted yet, though it remains a distinct possibility.

Since the start of the process there have been several calls for reform. In October 2004, CESR published the Himalaya Report, which suggested changes. Several members of the original Lamfalussy committee have hinted that they saw the process as a temporary fix rather than a permanent settlement, not least Lamfalussy himself, who described the EU financial regulatory landscape as a "mind-boggling patchwork".

In March 2005, Sir Nigel Wicks declared that "none of us in the Lamfalussy group thought it would be a permanent arrangement. We need to think about the next steps". Norbert

Walter, another of the group's seven members, has long advocated far-reaching reform of financial regulation.

However, the mood in public circles for restructuring the Lamfalussy process is unenthusiastic at best. Following the French and Dutch referendums on the constitutional treaty in 2005, any significant policy move at EU level is regarded with extreme caution.

The European Commission has shown scant leadership. The white paper setting out its financial services strategy for 2005-2010 focuses on the regulatory status quo. This contrasts with the ambitious financial services action plan of 1999-2004.

An additional element, as so often in EU discussions, is defensiveness over geographical location. The secretariats of the level-3 committees have been shared by the Union's three largest economies (CEBS in London, CESR in Paris, and CEIOPS in Frankfurt), and these countries are reluctant to venture into any discussion over that arrangement before enough time has passed for the Lamfalussy review. It is difficult to imagine this review will go beyond the usual platitudes.

Unless, that is, the UK position changes. This is where the story could become interesting.

Recent events linked to the summer's credit turmoil have changed the international regulatory debate. Beforehand, every country aimed at defending its model of regulation. Now, people are not quite so sure.

BAFin, the German equivalent of the FSA, is redefining its organisation in the wake of the failures in August of IKB and SachsenLB. In France, Philippe Marini, an influential parliamentarian, advocates integrated supervision (yes, post-Northern Rock) to counter the current lack of exchange between the regulatory silos that deal with securities, banks and insurance. In Spain, the questionable involvement of the securities regulator CNMV in the Endesa case earlier this year is leading to soul-searching.

Moreover, the political balance has been shifted by European financial integration. Powerful market participants have traditionally tended to defend their national regulators' turf and to maintain a suitably cosy relationship. But as they expand across national boundaries, the downsides of regulatory fragmentation come sharply into focus.

Not long ago, companies such as Royal Bank of Scotland, UniCredit, Santander, BNP Paribas, the London Stock Exchange and the bourses that now form NYSE Euronext had limited activity outside their home countries. For them, boosting cross-border regulatory consistency may bring synergies, economies of scale and business opportunities.

The City of London has become the undisputed hub of European finance. It brings together a unique concentration of financial skills and infrastructure. All other European financial centres have accepted that the winning strategy is not to dispute this leadership but to differentiate and find a successful niche, as Boston has in the US with asset management or Chicago with derivatives.

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But because the City's rise has assisted Europe's financial integration, it has a stake in the orderly operation of Europe's financial markets. The liquidity crisis has concentrated minds. It may become the case that the UK's interest could be best served by ensuring Europe's financial regulation becomes more efficient and credible, rather than, as until now, by "keeping Brussels at bay" and making sure none of the continental developments has a material effect on London's practices.

This would entail re-engineering in order to identify the regulatory objectives in need of strong cross-border co-ordination or pooling, and also to redistribute decision-making according to the subsidiarity principle.

This principle states: "the Community shall take action only if and in so far 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". Some new instruments may be required at EU level, preferably with a limited mandate and perhaps under strong oversight by national parliaments as well as the European one.

The regulation of stock exchange companies, supervision of the largest cross-border financial groups and the consistent enforcement of IFRS would be obvious areas for European-orientated reform. These could be based on the principles of risk-based regulation and supervision that have served the City well for the past decade, rather than the stiffer regulatory traditions of most of continental Europe.

In other words, rather than oppose a pan-European supervisor by using the shield of national sovereignty, the UK may want to sponsor a paradigm shift and advocate a different approach.

That could be: to reorganise supervision at national level, including most conduct-of-business regulation; and to devise adequate ad hoc solutions at European level for those tasks for which financial integration has rendered the national approach insufficient.

This would be a great change of perspective. But the UK taking up a leadership role would be a natural consequence of its increased responsibilities for European financial markets.

And the alternatives to this are unappetising. Without its leadership in promoting reform, the UK risks either suffering the costs of, and being exposed to, the risks of a dysfunctional European financial market, or of finding itself isolated from continental regulatory consolidation, as happened in the monetary area when the ECB was established.

Hard choices were delayed by the initial Lamfalussy compromise and by generally benign market conditions. Meanwhile, cross-border financial integration since the start of the decade has accelerated the obsolescence of many of Europe's regulatory arrangements. The 2007 Lamfalussy review is unlikely to address convincingly these challenges.

But market participants and forward-looking governments may be well advised to start thinking about the next steps.

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