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# CRS Report for Congress

## European Union — United States: Financial Services Action Plan's Regulatory Reform Issues

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Walter W. Eubanks
Specialist in Economic Policy
Government and Finance Division



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# European Union — United States: Financial Services Action Plan's Regulatory Reform Issues


## Summary

The Financial Services Action Plan (FSAP) is the European Union's (EU) blueprint, approved by the European Parliament, to transform the 25 member countries' financial markets into a single market. This planned European regulatory reform raises a number of regulatory issues for American firms operating in Europe. Partly because a significant part of U.S. and EU financial services transactions are conducted through European financial institutions on-site in the United States and American institutions on-site in Europe, the House Financial Services Committee has held a hearing on FSAP. Successful integration of EU financial services is expected to increase Europe's economic growth. A European Commission study suggests that the resulting competitive and flexible markets would cause a 1.1% permanent increase in the European gross domestic product. More cost reduction should result when the Single European Payments Area (SEPA) is created. Upon completion in 2010, this electronic payments system will allow individuals and corporations to make electronic payments throughout the Eurozone as efficiently and as safely as such payments are being made on the national level today. The European Parliament had scheduled a December 12, 2006, vote on the Payment Services Directive, but because of disagreements on regulatory issues, the vote was not taken.

The FSAP sets out several "directives," which call for national governments to adopt laws to regulate their financial services industries. In addition, member countries are expected to adopt related international standards like the international accounting standards and the Basel II capital accords for financial institutions. The directive on investments aims to establish a regulatory framework for securities that is expected to promote efficiency and transparency in this marketplace. However, the EU transparency requirements are very costly to American firms in Europe. Consequently, some in the U.S. securities industry warn that U.S. firms will withdraw from Europe if this directive is not changed. The directive was changed. The purpose of the conglomeration directive is to contain and supervise risks arising in cross-sector business groups containing securities firms, credit institutions, and insurance companies.

As part of the FSAP, accounting standards are critical tools in enforcing supervisory control over financial services institutions. On January 1, 2005, all 7,000 EU-listed companies began following the International Accounting Standards Board accounting principles in drawing up their consolidated financial statements. The European Union has implemented Basel II at the same time it is implementing the Financial Services Action Plan. The accounting standards regulations were resolved in time for the EU's January 1, 2005, deadline, but regulatory issues concerning Basel II remain on the national level. Despite these financial services firms' lingering concerns about FSAP and Basel II, their regulators believe that higher rate of economic growth will more than pay for the cost of these reforms. Consequently, the EU is moving forward with these financial services reforms.

This report will be updated as developments warrant.

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# European Union — United States: Financial Services Action Plan's Regulatory Reform Issues

## Introduction

The financial institutions of the United States and the financial institutions of member nations of the European Union (EU) have had a long history of providing financial services to their customers on both sides of the Atlantic. A significant part of this business (banking, insurance, and securities) is conducted through European financial institutions on site in the United States and American institutions on site in Europe. The regulation agreed to for governing foreign institutions hosted in Europe and the United States is called national treatment. National treatment mandates that the host country extend to foreign financial institutions the same regulations and supervision that they apply to their own institutions. The long-standing national treatment agreement is being changed with the European Union's reform of its various national financial services regulatory and supervisory structures. The EU's financial services reform now opens up the possibility that instead of U.S. financial services firms being hosted by 25 separate countries, they may have to deal with only one pan-European regulatory framework. At this stage, American authorities and financial services firms expect to share in the potential benefits the reform offers. On the other hand, they realize that the EU's financial services reform could adversely affect U.S. financial services firms' profitability in Europe. That was one reason the Financial Services Committee of the House of Representatives held a hearing on EU's Financial Services Action Plan (FSAP) on May 22, 2002.

The reform is being conducted through an overarching Financial Services Action Plan (FSAP). Under this blueprint, there are directives, which are the legislative proposals for regulating specific financial services, institutions, or business organization formats. The directives are to be adopted by each member country in the form of national laws. This report provides a brief examination of some of the regulatory issues surrounding the most important of the EU's financial services directives from the EU and the U.S. perspectives, using the same basic format for each directive. The report also examines two new additional financial services standards — the International Accounting Standards and the Basel II Capital Accord — that are to be adopted in conjunction with the FSAP.

## Background

The European Union is in the process of transforming its 25 member countries' financial markets into a single market through directives — laws to be adopted by member countries regulating financial services. Only the 15 existing member nations are voting on these directives; however, the 10 new members are expected to adopt these directives in time. The purpose of these directives is to make the European financial system more efficient by modernizing and providing greater uniformity for the member countries' financial regulatory and supervisory regimes. This would enable them to operate as one, integrated, financial system. For example, the new framework would, among other things, assure regulatory equivalence in all member countries and allow one country's financial institutions to operate in another's marketplace as if they were based in that host country, with no additional layers of supervision. This new coordinated supervisory system would replace the divided and often anachronistic existing system. When implemented, the directives are expected to promote competition in financial services by removing barriers to intra-EU trade in financial services. At the same time, the new system is intended to ensure the safety and soundness of the overall EU financial system by protecting it from systemic risk.

A successful European Union financial integration would have a significant impact on U.S. financial institutions operating in Europe and EU financial institutions operating in the United States. Considering only the banking industry, there were 34 U.S. banking organizations operating in the European Union, as of September 30, 2003, with aggregate assets of $747 billion. On the other side, there were 68 EU banking organizations with assets in their U.S. offices of $1.8 trillion of which $937 billion were banking assets while $871 billion were nonbanking assets.[1] Overall, the U.S. financial firms (banks, securities, insurance, and others) appear to view the EU financial integration efforts as a "win-win" for the European and world economies. U.S. financial firms, which are among the leading players in the global financial market, are expected to be major beneficiaries of EU integration.

The integration of financial services regulations is expected to increase Europe's economic growth. A study by the European Commission suggests that the resulting competitive and flexible markets would pool Europe-wide liquidity, which would benefit the equities and corporate bond markets. That alone is estimated to permanently reduce the costs of equity capital by 0.5 %, triggering a 0.5% increase in investment and employment, which would result in a 1.1% increase in European gross domestic product.[2]

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[1] Mark W. Olson, *The European Union's Financial Services Action Plan*, Testimony Before the Committee on Financial Services, U.S. House of Representatives May 22, 2002, p. 1. [http://www.federalreserve.gov/boarddocs/testimony/2002/20020522/default.htm]. Data updated by the Federal Reserve Board. Since some of the nonbank entities file on an annual basis, the nonbank financial data are the most recent available since December 31, 2002.

[2] European Commission, "Proposal for Directive on investment services and regulated markets — frequently asked questions," *EU Institutions Press Releases, IP/02/1706,*

(continued...)

## The Financial Services Action Plan (FSAP)

The FSAP is the overall framework to integrate Europe's capital markets by the middle of this decade. Now approved by the European Commission, FSAP seeks to modernize prudential supervision and regulation of financial services providers through 42 complex measures. It would establish a single apparatus intended to be capable of the following:

- responding to new regulatory challenges;
- eliminating capital market fragmentation;
- promoting closer coordination among supervisory authorities; and
- developing an integrated EU infrastructure for wholesale and retail financial services.

The FSAP measures include state-of-the-art prudential rules and supervision, which the European Commission considered to be much needed in some member countries. The plan also addresses disparities in tax treatment, and is intended to establish an efficient and transparent legal system of corporate governance, capital adequacy, and protection against money laundering.

**The U.S. Perspective.** U.S. officials and business interests are generally supportive of the EU's Financial Services Action Plan. U.S. officials want the FSAP to become a reality that is consistent with an open, global financial system in which EU markets reward the most efficient firms operating, no matter what their country of origin. Earlier in the process, some Americans suggested that the Europeans model their system after the United States, which arguably has the best-functioning capital market in the world. But, after the Enron, WorldCom, and other recent scandals, the Europeans considered the U.S. framework as not the most transparent disclosure regime in the world and have developed some alternative mechanisms, leading to some U.S. concerns. The transparency requirements would require firms to publish annual and half-yearly reports, including consolidated financial statements based on international accounting standards. American securities firms assert that these transparency requirements would be costly and difficult for U.S. firms to apply in the EU financial services marketplace.[3] In addition, some U.S. analysts point out that on-site examinations of financial institutions are not emphasized in the FSAP, while these examinations are a critical part of the U.S. financial services regulatory structure. Because of the lack of on-site examinations of the financial institutions' operations, they are concerned that regulatory enforcement could be applied with a bias against American firms.

**The EU Perspective.** Political backing of the FSAP in the EU is very strong and widespread. The main reasons are that the governments of the member countries believe that the plan is feasible and that it could help boost EU economic growth in

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[2] (...continued)
Brussels, Nov. 19, 2002, p. 2.

[3] Arthur Rogers and Joe Kirwin, "EU Passes Investment Bill to Give Firms Cross-Border Access, Protect Consumers," p. 2.

the long run. Many Europeans believe that the dismantling of barriers to financial services could result in the EU becoming a significant rival to U.S. financial firms in the global financial market. The challenge for the European Parliament and the Council of Financial Ministers is to transpose the plan into the national laws of the member countries. Given the huge diversity that currently exists in the member countries' financial regulatory architecture, the EU is expected to allow some flexibility in implementing the plan. However, this flexibility could lead to enforcement difficulties later if significant regulatory differences remain because national legislatures insist on maintaining special privileges for certain firms.

## The Financial Conglomerate Directive (FD)

One of the primary proposals under the FSAP is the directive on the consolidated supervision of financial conglomerates. This directive would establish minimum requirements for group-wide supervision of financial conglomerates and mixed financial holding companies (firms with financial services as well as commercial operations) doing business in the European Union. This form of financial institution is more common in Europe than in the United States where, until recently, such mixes were prohibited.[4]

The purpose of this directive is to contain and supervise the risks arising in cross-sector business groups containing securities firms, credit institutions, and insurance companies. It imposes prudential supervision on a group-wide basis of financial conglomerates and mixed financial holding companies. In short, it attempts to address concerns that there could be a threat to the EU's financial stability if any firm within a large financial conglomerate were to experience financial difficulty.

**The U.S. Perspective.** The Financial Conglomerates Directive is somewhat controversial because it requires EU authorities to determine whether a non-EU parent financial conglomerate is subject to equivalent consolidated supervision in its (non-EU) home country. If equivalent supervision is not confirmed, the directive sets out several requirements to ensure appropriate supplementary supervision. American firms argue that these requirements would raise their cost of doing business in the European Union. For example, if the EU authorities found no equivalent supervisor, they could impose additional capital requirements, levy more regulatory scrutiny on the risk profiles of the group, or test the qualifications of key personnel. The American firms would prefer U.S. supervisory authorities to play a role in deciding whether or not there is supervisory equivalency. The EU Commission and the SEC agreed that for companies with no recognized federal regulator the SEC would be designated their federal regulator.[5]

**The EU Perspective.** Unlike the American rule-based financial supervisory framework, the Europeans are in the process of setting up a single supervisory framework that is mainly based on principles, not rules. They expect this new financial services regulatory framework to be capable of responding to evolving

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[4] See CRS Report RL30375, *Major Financial Services Legislation, the Gramm-Leach-Bliley Act (P.L. 106-102): An Overview*, by F. Jean Wells and William D. Jackson.

[5] Regulatory Roundup, *American Banker*, Feb. 12, 2004, p. 5.

market conditions and structures to make a more efficient market environment for better decision-making. Under this framework, regulatory cooperation among supervisory authorities is critical to ensure even handed enforcement. The American-type rules system leaves less room for interpretation and is, therefore, less flexible. For most EU-member countries, regulatory rules are expected to play an increasingly important role in their financial framework.[6]

## The Investment Services Directive (ISD)

The investment services directive is another critical directive and is the legislative framework for the regulation of firms in the securities industry. An earlier version of this framework was adopted in 1993. It established the conditions under which authorized investment firms and banks provide specified services in other member countries on the basis of home country authorization — European-wide national treatment, or the one passport framework. However, it left standing most restrictions to cross-border investment services activities in Europe. The new directive as reviewed by the Committee of European Securities Regulators (CESR) and now approved by the European Parliament prescribes a set of flexible market oriented principles that are expected to deliver increased innovation and competition.[7] The committee believes that parts of the European capital market are still too fragmented into national securities markets that do not allow international competition. In addition, in recent years more investors have become active in these markets offering a more complex range of financial services and instruments.

Like the other regulatory directives, this new directive on investments aims to establish a uniform regulatory framework for securities that is expected to promote efficiency and transparency in this marketplace. To accomplish this, the EU plans to develop a 25-country integrated financial trading infrastructure for securities, and to establish mechanisms through which the necessary cooperation among supervisory authorities will be possible. Furthermore, a greater emphasis than in the past is being placed on protecting investors and fostering market integrity. While the scope of the ISD is broad (covering 25 countries), the directive pays a great deal of attention to details. It includes principles for policing conflicts of interest, organizational requirements for multifunction firms and trading facilities, and requirements for client-order handling, and large dealer-brokers making public their bid and offer prices for specific transactions.

**The U.S. Perspective.** U.S. authorities broadly welcome the European Union's Investment Services Directives as a regulatory framework that could bring

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[6] Joe Kirwin, "U.S. Regulators Initiate Effort to Avert Conflicts, Regulatory Problems, BNABanking Report, June 14, 2004, p. 1. [http://ippubs.bna.com/IP/BNA/bar.nsf/SearchAllView/024904D7F23C851E85256EB0007B6338?Open&highlight=EU,COMMISSION]

[7] Arthur Rogers and Joe Kirwin, "EU Passes Investment Bill to Give Firms Cross-Border Access, Protect Consumers," *BNA Banking Report,* April 5, 2004. p. 1. [http://pubs.bna.com/nwsstnd/ip/BNA/BAR.NSF/ecdc890eafc6d5bd85256b57005946be/8dbe96020a307d8285256e6b0016ad58?OpenDocument]

increased innovation and competition to the European securities marketplaces.[8] The Securities and Exchange Commission (SEC) has been particularly active in cooperating with the European Commission on developing this directive. U.S. businesses also welcome this directive and have commented extensively on the documents themselves. The American Chamber of Commerce commented that the directive was too detailed, covering provisions that were functionally unnecessary. To illustrate, the directive places a blanket pre-trade transparency requirement on brokers. The Chamber of Commerce argued that this requirement does not give the brokers the necessary flexibility to work order execution most efficiently for their customers. Some in the U.S. securities industry have even suggested that U.S. firms will withdraw from Europe if this directive is not changed. They argue that the regulations will be costly, difficult to apply and could drive business out of Europe.[9]

**The EU Perspective.** The European Union is trying to establish a comprehensive regulatory regime governing the execution of transactions of financial instruments regardless of trading methods or country of trade origination. The Europeans believe that it would provide a coherent risk-sensitive framework for regulating order-execution arrangements in all EU financial markets. However, in order to get agreement on this framework, it must be flexible because the existing national regulations often serve to protect narrow local interests. Consequently, the directive's emphasis on market integrity and investors' protections are its main selling points among participants in the European marketplace. But the fact that exemptions to already agreed-upon provisions are given to certain financial services sectors by the European Commission is an indication that the EU is not fast approaching agreement on the ISD.

## The Directive on Insurance (DI)

National insurance regulations are still in place in the EU, even though there are several recently adopted EU insurance directives. In early 2002, the European Union adopted two directives increasing solvency margin requirements for both life- and non-life-insurance firms, in an update of previously adopted directives. Work has just started on a fundamental review of the insurance solvency system (dubbed Solvency II). According to the European Commission, which initiates legislation in the EU's legislative process, the review's objectives will parallel those of the revisions of the Basel Capital Accord. The framework directive was to be presented in early 2005, but has yet to be presented. In late 2002, the European Union adopted a life assurance directive which simplified into a single text all previous directives in the area of "life assurance." But there are still disagreements among the EU members.[10]

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[8] See the EU Committee of American Chamber of Commerce in Belgium, "Position Paper on Investment Services Directive," *The EU Committee*, March 24, 2003, p. 1.

[9] Patrick Blum, "Pressure mounts on EU over new securities rules," *Financial News,* Feb. 2, 2004, p. 1.

[10] Patrick Tracey, "European Regulators Say Rules for Insurance Contracts Fall Short," *BNA Banking Report*, Aug. 11, 2003, p. 1.

**The U.S. Perspective.** Even though the U.S. financial services industry as a whole has not expressed concern with the final version of the new directive, there may be cost provisions related to the guarantee fund and solvency margin requirements that would limit some U.S. companies' interest in taking advantage of the new provisions. While the directive's language is worrisome to many U.S. firms, it has been standard language in many of the EU financial services directives since the late 1980s. It has never been invoked other than as a negotiating tool in the global financial services negotiations. However, it is taken seriously as a possibility, particularly because of the considerable differences in insurance regulatory structures between the United States and European Union. U.S. insurance regulation is carried out at the state level with only rough coordination through the state-based group, the National Association of Insurance Commissioners (NAIC). By contrast, EU regulation is at the national level and, increasingly, the rules are set in a pan-EU framework. A Financial Conglomerates Directive would require regulation in every EU country under a single supervisory coordinator if an insurance entity operates within a financial conglomerate. But there has been little new movement on this reform package.

**The EU Perspective.** The insurance directives provide individual members with more powerful means to retaliate against non-EU countries who do not provide national treatment to EU insurance firms. The insurance directives include a reciprocal national treatment clause providing for procedures in the event that EU firms are determined to be denied comparable competitive opportunities. Under rules set out in the directives, possible actions range from negotiations with the third country to seek national treatment by the European Commission on behalf of the European Union, to placing restrictions on firms from that country in the EU market until the situation for EU firms in its home country is resolved. Consequently, denying one EU member national treatment could cost the denying country's insurance companies opportunities in all EU countries.

## International Accounting Standards (IAS)

Accounting standards are critical tools in enforcing supervisory control over financial institutions, particularly in terms of corporate governance. The European Union made January 1, 2005 the deadline by which all estimated 7,000 EU-listed companies must follow the International Accounting Standards Board accounting principles in drawing up their consolidated financial statements. At the same time that deadline was set, the U.S. Financial Accounting Standards Board and the International Accounting Standards Board pledged cooperation in achieving convergence of U.S. and international accounting rules. On March 12, 2004, the European Commission announced that the U.S. Securities and Exchange Commission (SEC) would recognize foreign companies' use of the International Accounting Standards (IAS) when reporting financial results. However, the SEC and European Commission are in ongoing accounting standards talks. The United States uses generally accepted accounting principles (GAAP) in contrast to the European Union's country-modified IAS. The main difference is that GAAP is rule-based and IAS is a principles-based standard, which is more flexible than GAAP. With the implementation of the Sarbanes-Oxley Act, the European Commission engaged in a regulatory dialogue with U.S. authorities, in particular concerning equivalence in corporate governance.[11]

**The U.S. Perspective.** Even though the SEC has agreed to accept IAS for EU companies listed on the U.S. stock exchanges, the SEC would like to see more discrete rules concerning the accounting for financial derivatives.[12] U.S. financial services firms expect to benefit from the uniform IAS in the EU. Both U.S. and EU firms are currently incurring additional costs to doing business in the European financial markets because of multiple accounting standards.

**The EU Perspective.** Currently, national financial services markets in Europe have no uniform accounting standards. Consequently, the adoption of the IAS for all listed companies in the EU from 2005 onward helped to eliminate barriers to cross-border trading in securities by ensuring that company accounts throughout the EU are more transparent and can be easily compared. This automatically increases market efficiency by reducing the cost of raising capital for firms. But the European banking and insurance industries earlier refused to comply with IAS Board rules concerning fair value accounting principles for derivatives, and European Commission and the SEC were willing to exempt European companies from compliance with these rules. But, on November 19, 2004, the EU Commission gave final approval to the controversial internal accounting standards dealing with financial instruments such as derivatives. While some American firms argued that the EU has instituted a weaker standard than what is being applied in the United States, they consider it a significant step forward.[13]

## The Basel II Capital Accord

Basel II is a separate set of capital requirements for financial institutions which could be adopted by any financial business in the world. The European Union, however, intended to implement Basel II[14] at the same time it implements the Financial Services Action Plan. However, the EU wound up implementing Basel II first, while plans moved ahead after the Europan Parliament voted to move to Basel II on September 28, 2005. All EU financial institutions, regardless of size, have started operating under the Basel II capital standards since late 2005.[15]

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[11] European Commission, "Nine months left to deliver the FSAP," *Eighth Progress Report on the FSAP,* June 3, 2003, p. 14.

[12] Patrick Tracey, "European Accrual Accounting Idea gets Cautious Welcome From IASB,"*BNA Banking Reports,* Mar. 22, 2004, p. 2.

[13] Steve Burkholder, "Securities Industry Group Seeks Reform of Derivatives Accounting," *BNA's Banking Report*, Dec. 6, 2004, p. 1. [http://ippubs.bna.com/IP/BNA/bar.nsf/SearchAllView/E8A3979F5E51CB7885256F600017FBFE?Open&highlight=EU,COMMISSION]

[14] See CRS Report RL31984, *The New Basel Capital Accord: A Return to Bank Supervisory Judgments,* by Walter W. Eubanks, for more details on the implementation of Basel II.

[15] BNA, "European Commission Lauds Basel II Vote by Parliament, Urges Member States

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Basel II is a new financial supervisory framework that regulates the amount of capital that the owners of a financial institution must set aside as their financial institution takes on additional risk. The accords are rules based on the notion that a financial institution is less likely to fail if its owners are required to put more of their own money at risk as the institution takes on additional risk. Basel II is generally seen as an improvement over Basel I, which is the capital framework most developed countries' financial institutions are currently operating under. The improvement in Basel II comes from a more comprehensive risk-sensitive measurement framework that is able to adjust capital adequacy more rapidly than Basel I. Basel II relies more heavily on financial institution managements' and regulators' judgments of the methods used in determining risk and required capital than the set formula approach of Basel I.

**The U.S. Perspective.** As with the EU directives, there are concerns for some, mostly small, U.S. financial institutions if U.S. regulators join the EU and require all U.S. financial institutions to operate under Basel II. The smaller institutions would face significant costs in setting up and operating capital models that could pass supervisory scrutiny, and are widely expected to remain under the simpler rules of the older Basel I accord in the United States.[16] The blanket application of Basel II to EU financial institutions is intended, in part, to assure at least minimum uniformity across what are otherwise very unlike institutions with respect to capital standards. That position is different from the one taken in the United States. The United States' intended limited adoption of Basel II has created some friction with EU regulators.

U.S. financial regulators, headed by the Federal Reserve (Fed), intend to require Basel II for only the most important, internationally active institutions and presume that other major institutions (mainly banks) will also join the system. The Fed expects 20 large banks will be operating under Basel II by the implementation date at the end of 2008. Those 20 banks account for about 99% of the foreign assets held by the top 50 domestic banking organizations and approximately two-thirds of U.S. domestic banking assets.[17] Regulators will allow other banks to choose whether or not to apply Basel II or retain the Basel I standards. Because of the cost and complexity of Basel II, especially for smaller banks, this regulatory decision implies that the overwhelming majority of the roughly 8,000 U.S. banks are not likely to be operating under Basel II. Instead, these small banks are likely to be operating under Basel I or under Basel IA, a new capital standard which is more sensitive than Basel I, but not as costly or complicated as Basel II. The regulators are reviewing comments from the industry on the Basel IA proposal. Since U.S. implementation will follow the Europeans' implementation, and since the Basel II and IA is expected to use capital more efficiently, the European Basel II banks will enjoy the benefits of

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[15] (...continued)
Approval," *BNA Banking Report* ,October 10, 2007, p. 1.

[16] Roger W. Ferguson, Jr. *Basel II: Scope of Application in the United States*, statement before the Institute of International Bankers, New York, New York June 10, 2003, [http://www.federalreserve.gov/boarddocs/speeches/2003/200306102]

[17] Ibid.

these new standards putting U.S. banks at a disadvantage until the United States implements its capital standards at least a year later (in 2008) than the Europeans.

**The EU Perspective.** As mentioned above, the European Union is planning to issue a revised capital requirement directive due to come in force at the end of 2006 to parallel the Basel II implementation. All financial institutions in the EU will eventually be required to operate under Basel II regulations. The financial institutions of Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain are currently operating under Basel I and will convert to Basel II quickly. It is not clear, however, that Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic, and Slovenia currently comply with Basel I. As a result, the European Union is now reviewing capital standards and adequacy in all member countries, particularly the 10 new members, as part of the EU Financial Services Action Plan.[18] The main objective of the review is to bring the existing regulatory frameworks of these countries into line with the rest of the European Union. Eventually, the aligned system under Basel II is expected to foster a comprehensive, risk-sensitive management environment throughout the European Union.

Several reasons are given for planning to universally adopt Basel II for all banks and other financial firms. First, the EU's monetary authorities believe Basel II is superior to Basel I. Second, Basel II is relatively easier for the European Union to adopt than for the United States. There are fewer institutions in the EU. For example, in most EU countries fewer than 10 banks account for more than 90% of their banking assets. Furthermore, almost all EU banks conduct a significant amount of international banking, and many are owned or operated by foreign banks. Consequently, most European financial institutions are international, and Basel II is expected to help create a level competitive playing field.

## The Payment Services Directive (PSD)

The European Union is developing an electronic payments system to allow national financial services providers to offer EU-wide electronic payment services. This system could have implications for U.S. banks mainly because it could cut U.S. international banking costs. SEPA is expected to allow individuals and corporations to make electronic payments throughout the Eurozone as efficiently and as safely as in the national context today. SEPA is to have similar unifying effects in electronic payments as the Euro banknotes and coins have had since their January 2002 introduction. Because of that introduction, businesses and individuals in the Eurozone are able to make cash payments within and across 13 countries using a single purse of currency. Since the use of paper checks and cash is significantly more costly that electronic payments, the EU banking system is expected to be significantly more efficient and less costly with SEPA.

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[18] European Commission, "Capital Requirements: Commission Publishes Consultation Results," [http://europa.eu.int/comm/internal_market/regcapital/docs/qis3/2003-05-quis3-results_en.pdf]

The European Parliament had planned to take a December 12, 2006, vote on the Payment Services Directive that the European Commission published in 2005,[19] but because of disagreements on regulatory issues among the member countries, the vote was not taken. This directive is aimed at facilitating SEPA by removing most of the legal and regulatory barriers in the Eurozone. The European Commission found huge price differences in providing payment services. The difference was as high as eight times among member payments systems. In addition, in some Eurozone countries the standard execution time for payments is one day while in others it takes up to three days.[20]

**The U.S. Perspective.** SEPA is a work in progress on a number of fronts. Consequently, it is difficult to know all the implications of its existence for U.S. banks. However, if the rule to exclude non-European banks from the construction of the system is extended to non-member use of the system itself, SEPA might have negatively impact U.S. banks' profits. It is generally expected that SEPA will offer U.S. banks located in the Eurozone a level playing field to compete with European national banks due to the long-standing policy of national treatment. But, since member states in the Eurozone might amend the provisions of the directive to accommodate individual member countries' infrastructures and practices, U.S. banking might be disadvantaged by resulting modifications or amendments. U.S. banks' Eurozone operations could become more costly with SEPA if U.S. banking institutions are forced to provide 13 different sets of consumer notifications, for example. On the other hand, since U.S. banks are technologically competitive in the Eurozone, U.S. banks might be capable of exploiting opportunities more quickly than their European competitors.

**The EU Perspective.** The European Union's government in Brussels supports SEPA, while the national member states are divided in their support mainly because the national banking systems will have to make investments in advanced technology beyond what they are currently undertaking on the national level. While the national governments are likely to benefits in the long run, the short-run costs are not being supported or subsidized by EU government in Brussels. From the European banking industry's perspective the strongest incentives to create SEPA is the prospect that cross-boarder payments will increase beyond the 3% that is occurring now. At the same time, SEPA is expected to be more competitive allowing other national banks to compete in the national payments markets. Thus, established national banking institutions would be exposed to competition from other EU banking institutions. Even though more EU-wide transactions and more opportunities for banking business and profits will exist, some institutions are likely to be made worse off with SEPA.

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[19] [http://www.europarl.europa.eu/omk/sipade3?PUBREF=-//EP//NONSGML+REPORT+A6-2006-0298+0+DOC+PDF+V0//EN&L=EN&LEVEL=2&NAV=S&LSTDOC=Y]

[20] Ibid., p 2.7.

## Conclusion

The European Union has initiated its Financial Services Action Plan in order to receive the economic benefits that are expected from removing the remaining barriers to intra-European trade in financial services. The Europeans expect as much as a 1.1% permanent increase in the European Union's gross domestic product (GDP) as a result of FSAP. United States regulators have generally supported the regulatory reform mainly because U.S. financial services firms have had a long-standing business presence in Europe. Consequently, U.S. businesses expect to share in the economic benefits that could result. Yet, there are areas of the action plan about which American financial services firms have some serious concerns. The same is true for the electronic payments system, SEPA.

Of highest concern is that these reforms are very likely to increase the costs for all financial services firms of doing business in the European Union. The costs are the results of compliance with the additional regulations of the reforms. For example, the reform calls for additional transparency in providing financial services. Some argue that the increased documentation could be a significant expense for American firms especially when considering the multiple languages that are required. In addition, Basel II could require additional capital from American firms doing business in Europe.

The Americans are also concerned that the European plan emphasizes cooperation among financial institutions' regulators and flexibility in enforcing the provisions of the FSAP. Throughout the plan, the emphasis is on principles, not rules. Many analysts believe that rules are more easily enforced than principles because rules are often less subjective than the application of principles to concrete situations.

The European Union believes that the built- in flexibility is more suited for the European Union framework, where financial services regulations fall under different national and sub-national ministries. In order to get the directives adopted by the national governments, the regulatory framework must be able to accommodate compromise through a cooperative process. Because of this flexibility, some Americans are more skeptical about the European regulatory framework producing a more level playing field for all financial services providers in Europe. For example, under the International Accounting Standards Board rules, securities derivatives must be valued using a certain methodology. But the European Commission has provided exemptions to those rules to many large European financial services firms. Another example is that American and European financial services firms in the United States are subjected to on-site examinations. On-site examinations do not play a significant role in the FSAP blueprint so far. Consequently, enforcement of regulatory requirements is feared likely to be less stringent in the EU. Despite these concerns, both the Europeans' and the Americans' regulators believe that the higher rate of economic growth and profits will more than pay for the cost of these reforms.