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EU FINANCIAL REGULATORY REFORM: A STATUS REPORT

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Highlights

- The EU regulatory response to the crisis has been generally slower than in the United States, for four main reasons: swifter financial crisis management and resolution in the US; structural differences in legislative processes; the EU's front-loading of institutional reform, most notably the creation of European Supervisory Authorities; and the timetable of renewal of the European Commission in 2009-10.
- The EU has nevertheless initiated or completed significant regulatory initiatives in terms of banking, market structures, private equity and hedge funds, rating agencies and accounting.
- Major further challenges loom however, including ensuring a smooth start to the activities of the newly created European authorities; creating a sustainable framework for cross-border banking crisis management and resolution; and the gradual establishment of a consistent financial regulatory philosophy for the EU, to underpin market integration.

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EU FINANCIAL REGULATORY REFORM: A STATUS REPORT

NICOLAS VÉRON, DECEMBER

WHEN MAKING A TRANSATLANTIC COMPARISON of financial reforms, the first factor that should be mentioned is the difference between the time sequence of reforms in the European Union and the United States. The financial crisis started simultaneously on both sides of the Atlantic, with the initial disruption of some financial market segments in August 2007 and the major panic episode of September-October 2008. But the EU and US are not at the same stage of policy reaction, and especially regulatory reform, now. At least four reasons can be identified for this.

The first reason is the fact that beyond the first weeks after the collapse of Lehman Brothers, financial crisis management has so far been, on the whole, much simpler, swifter and more effective in the US than in the EU. Specifically, the stress tests conducted by the US authorities in the late winter and early spring of 2009, while certainly far from flawless, triggered a significant recapitalisation of those institutions at the core of the financial system, which in turn allowed some trust to return to the US interbank market in spite of numerous subsequent failures of smaller banks.

In the EU, the rebound in bank share prices that accompanied the US stress tests also allowed a number of banks to recapitalise under acceptable conditions, but these tended to be the relatively stronger ones, rather than those that most needed an overhaul of their balance sheet. A first wave of EU-wide stress tests, completed in September 2009, had little if any measurable impact, as the results were not disclosed to the public and not open to external scrutiny. In a second wave of stress tests, completed in July 2010, results were published but their quality, and correspondingly the consistency of the stress-testing process across countries, was later found to be severely wanting. As a consequence, EU stress tests have not thus far performed the function of triage that would have effectively triggered the recapitalisation and restructuring that are arguably indispensible to put the European banking system back on a sustainable track. A third wave of EU-wide stress tests is envisaged in early 2011.

Needless to mention, in 2010 the sovereign credit crisis that started in Greece and spread in the euro area came in addition to the unresolved banking crisis. These two crises – sovereign and banking – have reinforced one another. The Greek crisis accentuated the fragility of the banking system, but banking weakness also prevented the restructuring of Greek debt, which would arguably have brought it to a prompt resolution. Conversely, the aggravation of the banking crisis in Ireland after the summer of 2010 played a key role in precipitating the Irish sovereign crisis in November. Similar concerns weigh very negatively on Spain. By comparison, the US 'foreclosuregate' has not resulted, at the time of writing, in a major disruption of the US financial system. While there is vivid debate on the long-term sustainability of US public finances, this has not resulted in short-term financing concerns for the US government. The bottom line is that the US was able to start its discussion of financial regulatory reform in June 2009, with the publication of a blueprint document by the executive branch, in an environment that was essentially post-financial crisis. By contrast, the EU is still in the midst of a financial crisis even as it has started a number of long-term financial reform efforts.

A second factor associated with the difference in timing is the difference in EU and US legislative processes. In Washington, all issues of financial reform (except housing finance which was kept separate, prompting vocal protests from many in

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the then-Republican congressional minority) were discussed at federal level in the context of one single package of legislation, eventually named after Senator Christopher Dodd and Representative Barney Frank. Even though the process was delayed by several months because of unforeseen developments in the discussion of the health care reform bill, it was eventually completed in July 2010, little more than a year after the publication of the Obama administration's initial blueprint. By contrast, in Europe the relevant reform issues were sliced and diced into a number of separate legislative texts. A few of these were finalised as early as 2009 (on harmonisation of deposit insurance regimes, registration of credit rating agencies, and a first revision of the Capital Requirements Directive, known as CRD2), but most are either under discussion or not even yet drafted at the time of writing, including legislation on the organisation of markets for derivatives and securities, and on bank crisis management and resolution. Moreover, these multiple separate texts at EU level are complemented by significant, and not always coordinated, legislative activity in member states, on issues that would typically be discussed at federal rather than state level in a US context. Examples include insolvency procedures for financial institutions and taxation of the financial sector.

A third contributing factor is the fact that in Europe, the reform of the financial supervisory architecture was given priority over most other agenda items, while in the US it was granted much less prominence than initially envisaged, for example, in the reform proposals floated by then-Treasury Secretary Hank Paulson in the spring of 2008. The starting points were markedly different on both sides of the Atlantic. In the US, a system of specialised federal financial supervisory and regulatory agencies has been in place since at least the 1930s, including the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the prudential supervisory duties of the Federal Reserve System. In the EU, while the European Commission plays a key role in the legislative process, financial regulation and supervision remained the remit of national authorities, which only since the early 2000s started to regularly meet in EU-level committees (with a small central secretariat but no ability to impose decisions on their members). This situation was perhaps workable in the broadly deregulatory era that preceded the crisis, but became increasingly seen as untenable when the crisis made Europe, like the US, embark on a drive towards reregulation of its financial system, which if carried out in an uncoordinated manner at national level would quickly have collided with the commitment to a single financial market enshrined in the EU treaty. Thus, in February 2009, a high-level group chaired by Jacques de Larosière recommended the creation of EU-level public financial oversight bodies. The corresponding legislation was given priority in the legislative process and was eventually adopted in the early autumn of 2010. Thus, on January 1, 2011, the EU will have a European Banking Authority (EBA), a European Securities and Markets Authority (ESMA), and a European Insurance and Occupational Pensions Authority (EIOPA), complemented by a European Systemic Risk Board. The first three (also known collectively as the European Supervisory Authorities) will each be established as an autonomous EU agency. Even though they start with limited powers and resources, these new actors can be expected to play major roles in future EU financial regulatory developments.

A fourth factor may have been related to the timing of the renewal of the European Commission, which was delayed in 2009-10 by considerations related to the adoption and implementation of the Lisbon Treaty, a matter essentially unrelated to the financial and economic crisis. While the Obama

administration took office in January 2009, the European Commission was a lame-duck throughout 2009, and it was only in early 2010 that Michel Barnier replaced Charlie McCreevy as Commissioner for the Internal Market and Services, a portfolio that includes financial regulation. Moreover, Commissioner McCreevy had started his own term as Commissioner in 2004 assertively promoting a strong deregulatory agenda and was therefore largely seen as incapacitated when the events of late 2008 imposed a different policy orientation. This year, he has taken additional blame for his responsibility for the Irish property bubble of the 2000s, as Irish finance minister from 1997 to 2004.

REFORM AREAS

In terms of **banking reform**, the EU has initially focused on two limited if significant adjustments. First, it harmonised key provisions of national deposit guarantee schemes, as the unfolding of the financial crisis in October 2008 illustrated the danger of disruptive arbitrage behaviour that could be fostered by differences between national deposit insurance regimes. Second, it mandated that the originators of securitisation products should retain a minimum five percent economic interest so as to keep them incentivised to continuously monitor the corresponding credit risks. This latter legislation (CRD2) was adopted in 2009 and is a relatively rare occurrence of a financial regulatory reform that was adopted first in the EU, and then in the US in a near-identical form as part of the Dodd-Frank Act.

In 2010, the EU adopted additional legislation (known as CRD3) which aims at constraining the remuneration patterns that banks may adopt for their traders and executives. The limitations are on the structure of remuneration packages rather than on the amounts paid. This has so far not had an equivalent in the US, predictably leading to complaints by the EU financial industry that it has been put at a competitive disadvantage.

The initial Capital Requirements Directive was adopted in 2006 and was largely based on the Basel 2 capital accord, unlike in the US where capital requirements have so far remained primarily set on a national basis. The finalisation in September 2010 of the Basel 3 capital accord, and its endorsement in November by G20 leaders at their Seoul summit, open the way for new EU capital requirements legislation, not yet drafted but already known as CRD4. It remains to be seen how fully Basel 3 will be endorsed by CRD4, especially the leverage ratio which did not exist in Basel 2 and has met much opposition from prominent European financial firms.

As in the US, resolution authorities and processes are an important part of the crisis management framework in the EU. However, in the EU, corporate and bankruptcy laws are set at national level, and there is no EU-level banking charter, which makes harmonisation in this area more difficult. In spite of the failure of coordination that was seen in the Fortis Bank case in early October 2008 (which saw unilateral nationalisation of that bank's Dutch operations by the government of the Netherlands, while most operations in Belgium and Luxembourg were taken over by BNP Paribas), no credible policy framework has yet been introduced in the EU for addressing cross-border banking crises, even though the level of cross-border integration is very high, to the extent that in many EU countries most of the banking sector is in foreign (but almost exclusively EU) hands. The European Commission's suggestions on the design of national resolution funds, published in May 2010, have so far been met with skepticism or indifference by several member states. Draft legislation on crisis resolution and management is expected in early 2011 and may prove one of the more controversial items of the current EU legislative agenda.

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On the whole, Europeans have been so far reluctant to envisage additional requirements for what the financial jargon designates as systemically important financial institutions (SIFIs). Likewise, the debate on whether to mandate the separation of certain functions from banking groups, which in the US resulted in the adoption of the 'Volcker Rule' under which banks were supposed to divest or close proprietary trading activities, has neither been actively addressed yet in most countries, nor at EU level.

Another big set of possible reforms affects **market structures**, including the proposed European Market Infrastructure Legislation (EMIL) and a revision of the Markets in Financial Instruments Directive (MiFID). Here the initial proposals suggest a willingness on the part of the European Commission to limit as much as possible the differences between the European policy framework and that adopted in the US as part of the Dodd-Frank Act, in part out of concern about the potential harmful effect of regulatory arbitrage. On the face of it, it would thus seem that this is an area where the US effectively set a transatlantic standard by moving first. However, it should be noted that the eventual legislation could end up being somewhat different from the European Commission's initial proposals.

The regulation of **private equity and hedge funds**, in the EU through the Alternative Investment Fund Managers (AIFM) Directive, has given rise to considerable expense of political energy. This project originated before the crisis and the legislation was only adopted in the autumn of 2010 after lengthy debates in the European Parliament. The final version is significantly less radical than initially envisaged and will result in the registration of most funds with securities authorities as well as public disclosure obligations. Somewhat similar provisions are currently envisaged in the US as part of the implementation of the Dodd-Frank Act.

Rating agencies were not regulated in the EU until the crisis; registration requirements were placed on them by 2009 legislation. However, Commissioner Barnier has made it clear that he considered this insufficient, and that a more restrictive approach was needed. The corresponding new legislation is currently in a public consultation phase and will be further debated in 2011. One key aspect of this discussion is if the eventual legislation will allow rating agencies to keep a globally uniform methodology, even as they are directly regulated in an increasing number of separate jurisdictions.

In **accounting**, the European Commission has repeatedly exerted pressure on the International Accounting Standards Board (IASB) and the Trustees of the IFRS Foundation, which hosts the IASB, most visibly in October 2008, when the IASB in a politically charged atmosphere had to adopt an amendment allowing banks to reclassify assets across accounting categories, and in October 2010 for the appointment of a new IASB Chair. However, this has not so far resulted in the consideration of new legislation in this area. The Commission has also recently launched a public consultation on reform of the **auditing** sector, but it is as yet unclear what legislative proposals may result from this process.

CHALLENGES AHEAD

Several challenges loom in addition to the complexity of the EU legislative programme, most of which remains to be completed. Only three are mentioned here, with no pretense of being exhaustive.

One immediate challenge is the establishment of the three new European Supervisory Authorities (EBA, ESMA and EIOPA), which are scheduled to start work on January 1, 2011 but whose senior management (chairs and chief executives) have not been appointed at the time of writing. The initial activities of these new bodies will be crucial in establishing their credibility and enabling the future development of their responsibilities. A particular concern is their governance framework, which centres on supervisory boards formed of member-state representatives and in which the adequate consideration of the EU interest, as opposed to diplomatic arrangements among individual countries, cannot be taken for granted.

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A perhaps less pressing, but no less important, challenge is the definition of a credible policy framework for the management and resolution of cross-border banking crises, a discussion which is unlikely to be put to an end by the legislative proposals expected from the European Commission in the first half of 2011. In the global context, the absence of such a framework, in spite of the discussions fostered by the Financial Stability Board on international SIFIs, is likely to result in more independently capitalised and funded national subsidiaries, whose assets can be ring-fenced in a relatively straightforward way in the event of a crisis. However, such a model, which has largely been adopted (at least for retail banking activities) by leading international banking groups such as Citi, HSBC or Santander, sits uneasily with the commitment to a single market for financial services within the EU. In April 2010, the IMF proposed the introduction of an EU-level bank resolution authority, but this proposal has not yet attracted a critical mass of support in the EU policy community.

On a broader level, the EU faces the challenge of strengthening its capacity to produce high-quality rules for an increasingly complex financial system. This is partly, but not only, a question of adequate resources. In the two decades before the financial crisis, the EU was able to rely on a momentum towards global convergence that was largely driven by the private sector in an environment of deregulation and provided a powerful external engine for intra-EU harmonisation. But the context has been radically transformed during the crisis. The shift towards reregulation on both sides of the Atlantic and the increasing multipolarity of global finance, with the rise of emerging economies as major centres of financial activity, make the prospect of global convergence of financial rules more elusive. In this new environment, the EU will have to devote more effort to define its own model of financial regulation, which on many aspects cannot refer to a global standard that does not, or no longer, exists. The creation of the European Supervisory Authorities, if successful, can contribute to the emergence of a distinctively European regulatory philosophy that would be more than just a compromise among member states' positions. But this can probably only be a gradual and relatively slow process.