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An Update on EU Financial Reforms

Nicolas Véron

Nicolas Véron, visiting fellow at the Peterson Institute for International Economics since October 2009, is a senior fellow at Bruegel, the Brussels-based economics think tank in whose creation and development he has been involved since 2002. His earlier experience includes both public policy, as a French government official, and corporate finance. He is the coauthor of *Smoke & Mirrors, Inc.: Accounting for Capitalism (2006)* and writes a monthly column on European finance for leading newspapers and online media in China, France, Germany, Greece, Italy, Russia, and Turkey.

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In the context of a transatlantic comparison, the first thing to be mentioned is the difference between the time sequence of financial reforms in the European Union and its equivalent in 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 through October 2008. But they are not at the same stage of policy reaction and especially regulatory reform now. At least four reasons can be identified for this difference.

The first major reason is the fact that beyond the first weeks following the collapse of Lehman Brothers, financial crisis management has been, on the whole, much simpler, swifter, and more effective in the United States than in the European Union so far. Specifically, the "stress tests" conducted by the US authorities in the late winter and early spring of 2009, though certainly far from flawless, triggered a significant recapitalization 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 European Union, the rebound in bank share prices that accompanied the US stress tests also allowed a number of banks to recapitalize under acceptable conditions, but these tended to be the relatively stronger ones, not those that most needed an overhaul of their balance sheets. A first wave of EU-wide stress tests was completed in September 2009 and had little, if any, measurable impact as its 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 from one country to another, was later found to be severely wanting. As a consequence, EU stress tests so far have not performed the function of triage that would have effectively triggered the recapitalization and restructuring that are arguably indispensable 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, and these two crises—sovereign and banking—have fed each other ever since. The fragility of the banking system was accentuated by the Greek crisis, but it also prevented the Greek debt restructuring that could 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, and similar concerns weigh very negatively on Spain. In comparison, the US "foreclosuregate" has not resulted, at the time of writing, in major disruption in the US financial system; and 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 United States 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 European Union is still

in the midst of a financial crisis even though it has started a number of long-term efforts of financial reform.

A second factor associated with the difference in timing is the difference in legislative processes between the United States and European Union. In Washington, all issues of financial reform (except housing finance, which was kept separate to the vocal protest of many in 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

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months because of unforeseen developments in the discussion of the healthcare 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 significant number of separate legislative texts. A few of these were finalized as early as 2009 (on harmonization of deposit insurance regimes, registration of credit rating agencies, and a first revision of the Capital Requirements Directive known as CRD 2), but most are either under discussion or not even yet drafted at the time of writing, including legislation on the organization 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 at individual member state level on issues that would typically be discussed at federal rather than state level in a US context (such as insolvency procedures for financial institutions and taxation of the financial sector).

A third contributing factor is the fact that in Europe the reform of financial supervisory architecture was given priority over most other agenda items, while in the United States it was granted much less prominence than initially envisaged. This was the case in the reform proposals floated by then-Treasury Secretary Hank Paulson in the spring of 2008. In this area, the starting points were markedly different on both sides of the Atlantic. In the United States, a system of specialized federal

financial supervisory and regulatory agencies has been in place since at least the 1930s, including the Securities and Exchange Commission, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and the prudential supervisory duties of the Federal Reserve System. In the European Union, while the European Commission plays a key role in the legislative process, financial regulation and supervision had remained the remit of national authorities, which regularly met in EU-level committees (with a small central secretariat but no ability to impose a decision on their members) only since the early 2000s. 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, as the United States, embark on a drive toward reregulation of its financial system. If carried out in an uncoordinated manner at a national level, this reregulation would quickly have collided with the commitment to a single financial market enshrined in the EU treaty. Thus, in February 2009 the report of a high-level group chaired by Jacques de Larosière recommended the creation of EU-level public financial oversight bodies, and the corresponding legislation was given priority in the legislative process and eventually adopted in the early autumn of 2010. Thus, on January 1, 2011, the European Union will have a European Banking Authority (EBA), a European Securities and Markets Authority (ESMA), and a European Insurance and Occupational Pensions Authorities (EIOPA), complemented by a European Systemic Risk Board, and the first three (also known collectively as the European Supervisory Authorities) will be established each as an autonomous agency of the European Union. Even though they start with limited powers and resources, these new actors can be expected to play a major role in future EU financial regulatory developments.

A fourth factor may have been related to the timing of 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 retained lame-duck status throughout 2009. It was only in early 2010 that Michel Barnier replaced Charlie McCreevy as Commissioner for the Internal Market and Services with a portfolio that includes financial regulation. Moreover, Commissioner McCreevy had started his 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 in the Irish property bubble of the 2000s, as Irish finance minister from 1997 to 2004.

REFORM AREAS

In terms of **banking reform**, the European Union initially focused on two limited if significant adjustments. First, it harmonized key provisions of national deposit guarantee schemes, as the unfolding of the financial crisis in October 2008 illustrated the danger of disruptive arbitrage behavior that could be fostered by differences between national deposit insurance regimes. Second, it mandated that the originators of securitization products should retain a minimum 5 percent economic interest so as to keep them incentivized to continuously monitor the corresponding credit risks. This latter legislation (CRD 2) was adopted in 2009 and is a relatively rare occurrence of financial regulatory reform that was adopted first in the European Union and then in the United States in a near-identical form as part of the Dodd-Frank Act.

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In 2010, the European Union adopted additional legislation (known as CRD 3) that 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 corresponding amounts paid. So far this does not have an equivalent in the United States, predictably leading to complaints by the EU financial industry that it is put at a competitive disadvantage.

The initial Capital Requirements Directive was adopted in 2006 and was largely based on the Basel II capital accord, unlike in the United States where capital requirements have so far remained primarily set on a national basis. The finalization in September 2010 of the Basel III capital accord, and its endorsement in November by G-20 leaders at their Seoul summit, open the way for new EU capital requirements legislation, not yet drafted but already known as CRD 4. It remains to be seen how fully Basel III will be endorsed by CRD 4—especially the leverage ratio, which did not exist in Basel II and has met much opposition from prominent European financial firms.

As in the United States, resolution authorities and processes are an important part of the crisis management

framework. However, in the European Union corporate and bankruptcy laws are set at national level, and there is no EU-level banking charter, which makes harmonization more difficult in this area. In spite of the failure of coordination in the case of Fortis Bank in early October 2008 (resulting in unilateral nationalization of that bank's Dutch operations by the Netherlands' government while most operations in Belgium and Luxembourg were taken over by BNP Paribas), no credible policy framework has yet been introduced in the European Union for addressing cross-border banking crises—even though the level of cross-border integration is so high that most of the banking sector in many EU countries 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.

On the whole, Europeans have been generally reluctant so far to envisage additional requirements for what the current 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 United States resulted in the adoption of the “Volcker Rule” under which banks were supposed to divest or close proprietary trading activities—has not been actively addressed yet in most countries or 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). The initial proposals suggest the European Commission's willingness to limit as much as possible the differences between the European policy framework and that adopted in the United States 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 United States 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**, by 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 registra-

tion of most such funds with securities authorities as well as obligations of public disclosure. Somewhat similar provisions are currently envisaged in the United States as part of the implementation of the Dodd-Frank Act.

Rating Agencies were not regulated in the European Union until the crisis; legislation in 2009 submitted them to registration requirements. However, Commissioner Barnier made it clear that he considered this insufficient and that a

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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 whether 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 International Financial Reporting Standards (IFRS) Foundation in which the IASB is hosted. In October 2008 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 yet unclear what legislative proposals may result from this process.

CHALLENGES AHEAD

Several challenges loom beyond the complexity of this EU legislative program, 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 on January 1, 2011, but whose senior management (chairs and chief executives) have not yet been appointed at the time of writing. The initial steps

of these new bodies will be crucial in establishing their initial credibility and enabling the future development of their responsibilities. A particular concern is their governance framework, which centers 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.

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 that 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 capitalized 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 European Union. 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.

At a broader level the European Union faces the challenge of strengthening its capacity to produce high-quality rules for an increasingly complex financial system. This is partly a question of adequate resources, but not only. In the two decades before the financial crisis, the European Union was able to rely on a momentum toward global convergence that was largely driven by the private sector in an environment of deregulation and provided a powerful external engine for intra-EU harmonization. But the context has been radically transformed through the crisis. The shift toward reregulation on both sides of the Atlantic, the increasing multipolarity of global finance, and the rise of emerging economies as major centers of financial activity make the prospect of global convergence of financial rules more elusive. In this new environment, the European Union 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 exist. 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.

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