Christos HADJIEMMANUIL

What is new in EU's financial legislation?

The European financial policy landscape after the crisis

7th Annual Conference on EU Law,
Inštitut za evropske študije,
Kranjska Gora , November 19, 2009

Four stages of European financial-sector policy development

- Pre-1989: Gradual harmonization
- After 1989 (sectoral application of the Single Market programme): "Passport" directives for the various financial subsectors (banking, securities, insurance, collective investment schemes, based on national regulation ("home country control"), subject to minimum harmonization and mutual recognition
- FSAP, 1998-2004 (with further policy programme for 2005-10): attempt to complete legislative harmonization to facilitate wholesale and retail market integration, especially in the securities field
- 2008- : Crisis management and emerging post-crisis approach

Deficiencies of "passport" approach

- Questionable functional equivalence of national regulatory, and especially supervisory, regimes
- Hidden national barriers to entry through the residual application of host-country rules?
- One-country responsibility for emerging cross-national conglomerates; coordination problems
- No clear / common approach to crisis management and resolution

Limited success of the Single Market strategy

- Until the advent of the euro:
  - freedom of movement for financial intermediaries, ensuring an ability to compete across Europe;
  - but continuing territorial and sectoral differentiation of markets
  - inability to ensure that merger & acquistion control at national level would not be used to impede foreign ownership (this was the main barrier to entry!)
- Following the single currency:
  - rapid integration of various previously separate national product markets;
  - parallel emergence of truly pan-European financial group
- Broader trends in banking in recent years:
  - Increasing market dependency: from "originate-to-hold" to "originate-to-distribute" models of credit provision
  - Internationalisation through subsidiaries; greater presence of foreign banks in domestic markets
  - Increasing concentration of banking industry

Novel characteristics of the FSAP stage

- Extensive legislative programmes at EU level (regulatory activism?)
- Attempt to complete legislative harmonization, to facilitate wholesale and retail market integration, especially in the securities field
- New 4-part framework for integration of securities activities:
  MAD, Prospectus Directive, Transparency Directive, MiFID
- Selective use of maximum harmonisation measures
- Certain initiatives with strong private-law aspects (e.g. consumer credit, payments, etc.);
- Last but not least: new regulatory structure with pan-European elements

Lamfalussy four-level process

- Level 1 - framework legislation, voted on by the Council and Parliament
- Level 2 - implementing measures for the Level 1 legislation, led by the Commission
- Level 3 - supervisory committees facilitating the convergence of regulatory outcomes
- Level 4 - enforcement of all EU measures, led by the Commission

	Securities (incl. UCITS)	Banking	Insurance & Occupational Pensions
Level 2	European Securities Committee	European Banking Committee	European Insurance & Occupational Pensions Committee
•Regulatory Committees and policy advisors •Composed of representatives of national ministries •Commission: Chair + secretariat			
Level 3	Committee of European Securities Regulators	Committee of European Banking Supervisors	Committee of European Insurance & Occupational Pensions Supervisors
•Composed of national regulators •Independent committee: chaired by one of their members			

Causes of recent financial turmoil

- No apparent lack of regulatory capital, based on existing definitions
- Overexposure to securitized mortgage-related markets, especially in the US
- Excess liquidity in the global financial system
- Lack of monetary-policy response to asset-price bubble
- Increasing reliance on "originate-to-distribute" approach
- Critical role of credit-rating agencies (Fitch, Moody's, Standard & Poor's)
- Perverse incentives of bank managers
- Role of private equity funds / hedge funds / sovereign funds?
- Role of tax heavens?
- Transmission of crisis:
  - transmutation of credit events into liquidity events;
  - effect of mark-to-market accounting rules

The European response: early phases

- From early signs of turmoil (2Q of 2007) until 3Q of 2009, few practical steps were taken at EU level
- Some work on better Level-3 coordination, e.g. Francq report of Feb 06 and related CEBS work
- Continuing work on cross-border bank M&As, retail market integration, integration of payment systems etc
- Emphasis, including through political declarations, on transparency and heightened confidence, through the acceleration of FSAP-style initiatives in the various sectors and the improvement of Level 3 coordination
  - See, e.g., Eur Commission communication on financial stability, entitled "Europe's Financial System: Adapting to Change" (27 Feb 08)
  - Speech by Commissioner Almunia of 9 Sept 08, emphasising anti-inflationary monetary policy, strict enforcement of Maastricht criteria, new rules on bank capital adequacy and financial market transparency!
- Catastrophic handling of Northern Rock collapse and subsequent nationalisation by UK authorities (Aug 07 - Feb 09)

Policy response after Lehman's collapse

- Drastic change of perceptions and proliferation of national, and to a certain extent European, responses, following the collapse of Lehman Bros on 13 Sept 09
- Extensive national bank rescue packages
- Barroso stimulus package (primarily an accumulation of national rescue stimulus plans)
- European emphasis on balance between bank recapitalisation / asset support efforts and European aid-to-industry principles: prior approval of national schemes
- Amendment of European bank deposit guarantee framework, to increase protection
- New legislative measures regarding CRAs, alternative asset managers
- Revision (potentially drastic) of Basel II bank capital framework
- De Larosière report, 25 Feb 09: new institutional structure for financial regulation

The de Larosière report

- High-level group headed by former IMF Managing Director and ex-Bank of France Governor Jacques de Larosiere
- Recommended reform of financial supervision in the EU, with a view to correct flaws in the patchwork of national supervisory regimes
- Taking into account MS resistance to loss of regulatory competence, did not propose unified supranational regulatory / supervisory authority
- Introduced two-level approach to reform:
  - A European framework for the oversight of broad systemic risks
  - Enhanced coordination amongst national supervisors, organised in pan-European sectoral agencies, in day-to-day supervision
  - Close connection between the two (systemic-macroprudential and microprudential) aspects
- Suggested gradual transition over a period of four years
- Proposed a somewhat similar division of roles on the international plane (systemic early warning role for the IMF / responsibility for regulatory convergence for the FSF, now FSB)

Main recommendations

A. Systemic risk

- New European Systemic Risk Council (ESRC) to be chaired by the ECB president and to include members of the General Council of the ECB, a member of the Commission and chairs of the three existing pan-EU supervisory (Level 3) committees for banking, insurance and securities
- Establishment of an effective risk warning system under the auspices of the ESRC and the existing Economic and Financial Committee, which is made up of national treasury officials
- If the ESRC thinks a local supervisor is taking inadequate action to deal with risk, it could take further action
- Improved banking crisis handling, e.g. through MS agreements on more detailed criteria for burden sharing or responsibility for bailing out a failed cross-border bank.

B. Front-line supervision

- Three new European authorities (ESAs) would replace the existing Level 3 committees (CEBS, CEIOPS, CESR), with
- An integrated European System of Financial Supervisors (ESFS), comprising the new authorities, to be set up by 2011-12
- Existing national supervisors would continue to carry out day-to-day supervision
- Colleges of supervisors would be set up for all major cross-border insitutions
- The ESFS would be independent of political authorities but be accountable to them
- It should rely on a common set of core harmonised rules

- In addition to the competences currently exercised by the Level 3 committees, the authorities should have, inter alia, the following key-competences:
  - i. legally binding mediation between national supervisors;
  - ii. adoption of binding supervisory standards;
  - iii. adoption of binding technical decisions applicable to individual financial institutions;
  - iv. oversight and coordination of colleges of supervisors;
  - v. designation, where needed, of group supervisors;
  - vi. licensing and supervision of specific EU-wide institutions (e.g. Credit Rating Agencies, and post-trading infrastructures);
  - vii. binding cooperation with the ESRC to ensure adequate macro-prudential supervision

---

C. Substantive issues

- Fundamental review of Basel II rules on capital requirements for banks, such as stricter rules for off balance sheet items.
- Common EU definition of regulatory capital should be adopted
- European rules for registration and supervision of credit rating agencies
- Wider reflection needed on mark-to-market accounting standards, blamed for exacerbating the impact of the credit crunch on banks
- Strengthened oversight and governance of the International Accounting Standards Board (IASB), whose accounting standards are used in the EU,
- Adoption of Draft Solvency II capital standards for insurance companies
- Harmonised insurance guarantee schemes should be set up
- Regulation should be extended to "parallel" banking system, including through registration / transparency requirements for all major hedge funds; additional capital requirements should be imposed on banks owning or operating / engaging in significant activity with hedge funds
- OTC derivatives should be standardised; at least one central clearing house for credit default swaps should be created

---

- Supervisors should oversee the suitability of compensation / bonus policies at financial institutions
- To tackle absence of truly harmonised set of core rules in the EU, future legislation should avoid possibilities for inconsistent transposition and application, while the Commission and the Level 3 committees should identify national exceptions that could be removed; more stringent national measures should, however, remain permissible
- A coherent and workable regulatory framework for crisis management should be introduced, and all relevant authorities should be equipped with crisis prevention and intervention powers, while legal obstacles to cross-border interventions should be removed
- More detailed burden sharing criteria should replace existing MoUs between MSs