FINANCIAL REGULATION

# The Financial Crisis Response: a Mid-term Review

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By early 2011, the European Union (EU) was well advanced in its response to the financial crisis. The "de Larosière" institutions were established, and in relation to the G-20 commitment to regulate all markets, products and institutions and to further streamline the Single Market, proposals were either adopted or were progressing in the discussion process.

The rapid adoption of most proposals, all of them in a single reading so far, indicates that the sense of urgency was great on both sides, i.e. the European Parliament and the Council. Both institutions, together with the European Commission, have done an enormous job in delivering upon the commitments taken.

The question that remains is: will it work by 2013, when most measures should be in place. The amount of regulation has increased enormously, and more is to come, in both primary and secondary legislation. In addition, the new European Supervisory Authorities (ESAs) have been mandated to implement a single rulebook, which is facilitated by the new Lisbon Treaty provisions on comitology. This article will first discuss the role of the ESAs, followed by a brief review of the measures adopted or under discussion.

## The "de Larosiere" institutions

The new regulations creating the European System of Financial Supervisors (ESFS) were adopted by the EU in time for the new bodies to start functioning in 2011. The final compromise did not fundamentally alter the decision reached by the Council on the new bodies in December 2009, but added additional tasks for the authorities, such as the possibility to prohibit or restrict certain financial products or activities (Art. 9), or clarified and strengthened their role, in emergency situations, for example (Art. 18). For the European Systemic Risk Board (ESRB), the most important change was the addition of an "independent" element, with the creation of a Scientific Committee, and the requirement to have a delegate of this Committee on the Steering Committee of the ESRB.





A fundamental change as compared to the "Lamfalussy" Committees is that the authorities have become executive agencies under the control of the Commission. Before, the committees (CEBS, CESR and CEIOPS) functioned fairly independently from the European Commission, but also only had advisory powers. Now, the authorities will have fully-fledged regulatory and, to some extent, supervisory powers, but they can only have these powers to the extent that they derive from the powers attributed, under the EU Treaty, to the EU and the Commission. In other words, the authorities' powers are limited to what the Commission can do under the EU Treaty to contribute to the good functioning of the internal market. "The purpose and tasks of the Authority – assisting competent national supervisory authorities in the consistent interpretation and application of Union rules and contributing to financial stability necessary for financial integration – are closely linked to the objectives of the Union acquis concerning the internal market for financial services".[1] The Meroni doctrine, dating back to an EU Court judgement of more than 50 years ago, continues to be with us.

The profound change that the authorities generate for a more integrated financial market cannot be sufficiently emphasized. Without exaggerating, they can be considered as embryonic federal supervisory authorities, but all will depend on the management of the authorities and the cooperation with national supervisors. Given what the Lamfalussy Committees achieved with limited personnel and budget, there are no reasons for scepticism. It can be argued that the first appointments for the authorities are too low key, not in line with the depth of their tasks or the sea change they should bring about, but we should give them the benefit of the doubt.

The tasks of the authorities can be subdivided into three sorts of powers: regulatory, supervisory and institutional (see box below). The regulatory powers are based upon the need to achieve a much greater degree of regulatory harmonisation in the EU through the achievement of a single rulebook. In practice, the single rulebook will be composed of regulatory and implementing technical standards. Both standards can only be adopted by the ESAs to the extent that they are part of delegated powers, based upon Art. 290, respectively Art. 291 of the Treaty on the Functioning of the EU (TFEU). Both shall be "technical, shall not imply strategic decisions or policy choices and their content shall be delimited by the legislative acts on which they are based".[2] Formally, both standards are adopted by the Commission, following a procedure as described in the regulations, and are limited in time, but the powers may be revoked at any time by the European Parliament or the Council. In practice, the process of regulatory and implementing technical standards will be entirely in the hands of the authorities, with limited control by the European Parliament, and the Commission rubber-stamping the proposals. The ESAs can also adopt guidelines and recommendations, which have no force of law.

1. European Parliament and Council, Recital 17, Regulation, "Establishing a European Supervisory Authority", PE-CONS 40/10, No 1095/2010, 9 November 2010, available at: http://register.consilium.europa.eu/pdf/en/10/pe00/pe00040.en10.pdf
2. *Ibid.*, Art. 10 resp., Art 15

**Box 1: Powers of the European Supervisory Authorities (ESAs)**

- formal rule making powers
  - Regulatory technical standards (Art. 10)
  - Implementing technical standards (Art. 15)
  - Guidelines and recommendations (Art. 16)
- mediation, binding delegation btw supervisors (Art. 21, 28, 31)
- individual decisions in emergency situations (Art. 18)
- participation in College of Supervisors (operational standards)
- supervision of national supervisors (Art. 30)
- control of financial activities and products (Art. 9)
- sanctioning powers (Art. 30)
- constitution of supervisory data bases (Art. 8)
- specific supervisory tasks: The European Securities and Market Authority (ESMA) to licence credit rating agencies (CRA), trade repositories, and Automated Publications Arrangements (APAs), participate in supervision of Central Counterparties (CCPs) and Centralized Securities Depositaries (CSDs), decide upon eligible over-the-counter (OTC) derivatives and third country hedge funds and managers (under the Alternative Investment Fund Managers Directive – AIFMD)

The supervisory powers of the new authorities can be subdivided into categories: direct and indirect. Indirect supervisory powers relate to those that contribute to improve the financial supervision from an EU perspective. They are composed of mediation between national authorities, and eventual delegation of powers amongst them, the participation in colleges of supervisors, and the supervision of supervisors. The latter is probably the most important element, as it allows for effective comparison of the performance of national supervisors (Art. 30), and the possibility to adopt recommendations. The ambition is to arrive at a common European supervisory culture (Art. 31).

Direct supervision is composed of decisions on individual cases in emergency situations, and specific supervisory tasks, which are most developed for the ESMA for the time being. Individual decisions by the ESAs can only happen in situations where there is a manifest breach of EU law by national authorities, following the procedure described in Art. 18. However, such decisions may not impinge upon the fiscal responsibilities of the Member States (Art. 38), an issue that provoked heated discussions in the Council.

The momentum the authorities already have is clear from the specific supervisory tasks, which are rapidly emerging, specifically for the ESMA. The ESMA is the sole authority to license credit rating agencies (CRAs) in the EU, and – under draft legislation – in the licensing of trade repositories for over-the-counter (OTC) financial instruments (draft European market infrastructure regulation –EMIR – legislation) and automated publication arrangements (APA's) or data vendors (under the Markets in Financial Instruments Directive – MiFID – review consultation). The ESMA will also participate in the supervision of Central Counterparties (CCPs) in the draft EMIR legislation and soon also of Centralised Securities Depositaries (CSDs). The ESMA will, with the Commission, decide upon those OTC derivatives that will be eligible for central clearing in CCPs and give advice on access of third-country hedge funds and managers under the Alternative Investment Fund Managers Directive (AIFMD). The ESMA is thus certainly an embryonic federal securities authority.

A problem that remains is the division of tasks in between the three ESAs and with the ESRB. The division of roles amongst the three ESAs is functional, but some issues may fall through the cracks, as they do not clearly belong to a certain authority. This relates to horizontal financial services issues, such as consumer finance, retail investment products or the supervision of bank-insurance companies. As regards the interaction with the ESRB (and indirectly the European Central Bank –ECB), for some issues, the regulation or financial services Directives require coordination, for others, it does not. It is at this stage too early to say how important the role of the ESRB will be – it all depends upon the authority the entity will acquire, and how its mandate will be occupied. However, given the macroeconomic implications of ratings, the ESRB is not given any role in the supervision of CRA's, the clearest exclusive ESA competence for the time being. The assessment of the methodologies used by CRA's is something where the ESRB know-how could have been used. On the other hand, the close participation of the ECB in the stress test in July 2010, and in the other tests to come, demonstrates that in practice there will have to be close cooperation with the most reputed European financial institution (but also that the ESRB will need to position itself carefully when cooperating with the ESAs).

Notwithstanding the creation of the ESAs as a form of Commission-based executive agencies, it will be extremely important that, in the start-up phase, the Commission respect their independence "in practice", to allow them to emerge, over time, as federal supervisory authorities. The former "level 3" committees were always insisting on their independence, which was, in the case of the Committee of European Securities Regulators (CESR), part of its statutes. The independence as stated in the ESA regulations, however, is limited to the chair, the supervisory and management board (Art. 42 and 46), and does not apply to the ESAs as an institution. Respect for the committees' independence will be even more important for the new authorities' supervisory tasks, as the Commission has limited expertise in this domain.

## The G-20 follow-up and single financial market completion

As regards regulatory matters, the consensus among the EU Member States was greater on the G-20 commitments than on single financial market improvements. The progress achieved on the former seemed more clear-cut than on the latter, which has led some commentators to argue that "Europe" had disappeared as an objective for rulemaking. But it also indicates that the Commission should have acted as the G-20 did at a global

level: garner support at the head of state or prime minister level for a new "Financial Markets Action Plan", which was insufficiently done. Urgent single financial market reform matters were given only very limited attention in the Europe 2020 agenda, unlike the attention given to the financial services action plan in the Lisbon Agenda. It was not interwoven or consistently argued within the Europe 2020 objectives of smart, sustainable and inclusive growth.

By early 2011, new rules on issues related to many elements of the G-20 commitments had been enacted or proposed, with discussions being well advanced (see table in annex). The only element remaining was the implementation of the new Basel III rules, which were published by the Basel Committee on December 15, 2010. In this sense, the EU and the United States (US), which adopted the Dodd-Frank Bill in June 2010, containing its response to the crisis and the G-20 commitments, seem to be more or less advancing in parallel.

On core Single Market issues, several proposals have been made, but the consensus among the Member States was less clear, and the discussions less advanced. This was exemplified in the discussions on the reform of deposit protection or the harmonisation of bank resolution schemes, both matters that demand a fundamental change if the EU wants to move to a truly Single Market. Both elements will be briefly discussed below.

The most important G-20 related measures concern the regulation of hedge and private equity funds in the AIFMD, the introduction of a mandatory licence for rating agents in the rating agencies (CRAs) regulation, and the centralised clearing of derivative financial instruments in the draft EMIR. A key characteristic of the former two pieces of regulation is that protectionism has increased importantly. In the AIFMD, third-country alternative fund managers' access to the EU market is subject to a long five-year transition period, and may still be refused at the end of this period.[3] In the CRAs regulation, for banks and investors to use ratings produced outside the EU, these ratings must be locally endorsed by a licensed rating agent.[4] The key problem with the draft EMIR regulation is the need to find a balance with the US concerning the requirement of eligibility of derivatives for central clearing, and the governance and risk-control procedures of clearing houses.

Regarding Single Market related measures, there is little consensus amongst Member States. Two examples will suffice. For the reform of deposit protection schemes, although the Commission did not propose a single EU-wide fund, as the European Parliament had proposed in its reading of the ESAs, even the proposal of mutual borrowing between funds – a step towards joint liability and a single fund – went too far, according to several large Member States, including Germany and France. The related discussion on bank resolution was still at the level of consultation at the time of writing, but it promises to be as sensitive of an issue, if not more. As long as there is not a unified approach to problem-banks, there will be no level playing, and no Single Market. Hence, banks headquartered in Member States with bigger treasuries will have an advantage over those from smaller states.

A symbolically important measure is the EU-wide regulation of mortgage credits, on which a proposal was made by the Commission on 31 March 2011. Real estate bubbles are seen as one of the causes of the financial crisis, and the non-existence of EU-wide rules contributed to the disintegration of the single financial market. Problems in some markets no longer remained confined to national boundaries, but rather had EU-wide ramifications, either affecting banks in other jurisdictions, or deteriorating the country's fiscal position as a result of bank bail-outs. A harmonising effort is part of the measures to improve and further align banking supervision in the EU, and to avoid spill-overs of lax regulation in certain jurisdictions, affecting the reputation of the sector as a whole.

A remarkable development from a Single Market perspective is the increased use of regulations rather than Directives. Although before the financial crisis the issue was often presented as a means to achieving greater harmonisation, it took a financial crisis to get it changed, and already five of the adopted measures are regulations, with more coming. In addition, all the financial crisis related measures adopted so far passed in a single reading of the European Parliament and the Council, demonstrating the consensus amongst these institutions in the urgency to respond.

While the use of regulations eases the job for the Commission and the new authorities, as they will be directly applicable, the amount of rules covering the financial sector has grown enormously, and more are to come. Generally speaking, we are only at level 1, and the amount of rules will further grow in regulatory and implementing technical standards. This raises the question of whether it will work by 2013, when all the measures should be in place, and whether investors' confidence will be restored.

## Conclusion

The combined effect of a new institutional structure and new and more direct rules brings sea change for financial markets. It should bring the single financial market project back on track, and cause European financial integration to progress again. But much work remains in making it function on a day-to-day basis, on which it is too early to pass judgement. The response to the financial crisis was a remarkable example of global regulatory cooperation in the G-20, which seems to not to have lost too much of its steam, yet. However, the same commitment is not so convincingly present with regard to remedying Single Market imperfections, as revealed by the crisis.

3. See Mirzha J. de Manuel Aramendía, "Third Country Rules for Alternative Investments: Passport flexibility comes at a price", ECMI/CEPS, 16 December 2010, available at: http://www.ceps.eu/book/third-country-rules-alternative-investments-passport-flexibility-comes-price
4. See Karel Lannoo, "What reforms for the credit rating industry? A European perspective", ECMI/CEPS, 13 October 2010, available at: http://www.ceps.eu/book/what-reforms-credit-rating-industry-european-perspective

## Annex. Financial crisis related regulation at EU level

| Measure | Purpose | Status | Context |
|---|---|---|---|
| Credit rating agencies regulation | • Introduce single licence<br>• Adapt to existence of ESMA | • Adopted April 2009<br>• Amendments June 2010 | G-20 |
| Capital requirements Directive (CRD) amendments:<br>• Securitisation, large exposures<br>• executive remuneration, trading book and complex products<br>• leverage ratio, capital buffers, liquidity regulation | • min. 5 % retention<br>• extra charge for high pay packages<br>• higher capital charge for trading book, more and better capital, minimum liquidity | • Commission Directives (adopted April & June 2009)<br>• Directive (CRD III, July 2010)<br>• Consultation (April 2010), draft Directive July 2011? | G-20 |
| Alternative investment fund managers Directive (AIFMD) | Regulate non-regulated segment of fund industry (hedge funds and private equity) | adopted November 2010 | G-20 |
| Depositaries of funds | Segregate fund managers from depositaries | Consultation (May 2009) | Single market |
| Regulation on OTC derivatives, central counterparties and trade repositories (European Market Infrastructure Regulation, EMIR) | Transparency, mandate central clearing for eligible OTC derivatives, licence for trade repository | Draft September 2010 | G-20 |
| Short selling regulation | Prohibition of naked short selling of all types of financial instruments, including credit default swaps on government debt securities | Draft September 2010 | Single Market |
| European Systemic Risk Board regulation | Indentify macro-financial risks | adopted November 2010 | G-20 |
| European Banking Authority regulation | Coordinate banking regulation and supervision | adopted November 2010 | Single Market |
| European Insurance Authority regulation | Coordinate insurance regulation and supervision | adopted November 2010 | Single Market |
| European Securities Markets Authority regulation | Coordinate securities markets regulation and supervision | adopted November 2010 | Single Market |
| Omnibus Directive | Adapt existing rules to ESFS | adopted November 2010 | Single Market |
| Deposit guarantee schemes Directive | • Increase minimum level to €50,000<br>• Further harmonisation | • adopted October 2008<br>• draft 12 July 2010 | Single Market |
| Investor compensation schemes Directive | • Further harmonisation | • draft 12 July 2010 | Single Market |
| Market in financial instruments Directive review (MiFID II) | Extend price transparency to non-equity products, further regulation of trading platforms | Consultation December 2010 | Single Market |
| Crisis resolution procedures | Coordinate national winding-up rules for banks | Consultation (October 2009, May 2010, January 2011) | Single Market |
| Bank tax | Coordinate national rules | | (G-20) |
| Mortgage lending | EU-wide harmonisation | Draft Directive (March 2011) | Single Market |