FOREIGN POLICY

EU and the Financial Sector Reform: Ensuring Global Harmonisation

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Reforming global finance: The challenge of harmonisation

Since the outbreak of the global financial crisis, political and regulatory authorities around the world have been engaged in a difficult and ambitious effort to reform financial markets. Given the seriousness of the crisis, the financial reform process attained unprecedented political prominence, sealed with a display of international solidarity and commitment for fundamental reform in the financial sector in the first G20 Summit in Washington in November 2008. The European Union (EU) was fast to act in this area, with the European Commission bringing proposals for reform already in the autumn of 2008, at the height of the crisis. Since then, the Commission has drafted a programme of comprehensive reform, including more than 30 legislative initiatives covering all aspects of financial regulation. Many of the proposed changes have already been agreed and implemented, including a new European institutional supervisory structure, comprising new supervisory authorities for banking, insurance and securities, and a European Systemic Risk Board (ESRB). Other proposals are under discussion and still others are to be presented in the coming months, with a view to adopting all new legislation by the end of 2011, and completing its implementation into national law by the end of 2012. At the same time, the United States (US) has embarked on its own national deliberations for reform, achieving a major milestone with the passage of the Dodd-Frank Act in July 2010. The Act has brought significant changes in all areas of financial regulation, comparable in scope with the European initiatives. Finally, at the international level a host of international and transnational organisations, active in the drafting of financial regulation, are also engaged in a wide array of regulatory initiatives. Significant progress has been made in a number of areas, most importantly with the establishment of the Financial Stability Board (FSB), tasked to ensure the stability of the global financial system, and the agreement on new capital requirements for banks (which is accompanied by new liquidity and leverage ratios) at the Basel Committee on Banking Supervision (BCBS), endorsed by the Seoul G20 Summit in November 2010.

Despite the significant progress that has been achieved, the parallel national, regional and international reform initiatives, do not always proceed at the same pace, and do not always result in similar or even consistent regulatory solutions. The resulting differences stand in the way of a globally harmonised regulatory regime, desperately needed for the effective supervision of a financial system whose global reach has not been affected by the crisis. This problem becomes all the more important as many issues remain unresolved, while the details of many headline agreements are still to be worked out. Failure to coordinate effectively the global financial reform will unavoidably lead to a fragmented and uneven international regulatory landscape, offering opportunities for regulatory arbitrage, with potentially dire consequences for the future stability of the global financial system. Given the interdependence of the European and international financial markets, and the former's impact on the European economy (both features illustrated vividly by the recent financial crisis and its on-going reverberations in Europe), the EU has every incentive to be at the forefront of the international reform effort, and to work for the harmonisation of the global financial regulatory regime.

International financial reform initiatives: current problems and pressures for divergence

The current situation presents three problems that need to be overcome in order to meet the challenge of international harmonisation. The first two have to do with regulation that has already been agreed, and refers to differences that have emerged in the new rules adopted since the crisis in a number of issue-areas, and to pressures already apparent in both the EU and the US to deviate from particular aspects of recently completed international agreements. The last problem refers to the fragmentation of EU's representation in the G20 and other international regulatory *fora*. This last problem is particularly important for the regulatory negotiations that follow, since, despite the problems, the current situation also presents a unique window of opportunity, given that many issues, especially those that concern international aspects of the financial system, remain open.

Differences in regulatory approaches

As mentioned above, while recording significant successes, the international financial reform process has not always been consistent. There are a number of issue-areas where new regulation has moved in different or even opposite directions, providing opportunities for regulatory arbitrage. For example, one of the most significant and high profile issues that has been directly related to the crisis, and which has received different treatment in the two sides of the Atlantic, is the issue of executive compensation in financial institutions. The third revision of the Capital Requirements Directive (DRD III), has introduced significant changes in remuneration issues, in force since January 2011. The new legislation stipulates that banks have to defer 40 to 60% of bonuses for 3 to 5 years, and 50% of any immediate bonus must be paid in shares or in other securities linked to the bank's performance. As a result, bankers will only be able to receive between 20 and 30% of any bonus in upfront cash, while deferred bonuses can be clawed back later if performance in the latter years deteriorates. In contrast, the most important change in this area in the Dodd-Frank Act, introduces only the right of the shareholders to a non-binding vote on executive pay and golden parachutes. It is evident, and European officials have repeatedly pointed this out, that this difference in the treatment of executive pay puts European financial institutions at a competitive disadvantage. A move in early 2011 by US regulators to propose a deferral requirement for three years and the possibility of claw-back clauses reduces the gap between the rules (although it does not completely eliminate it), provided of course that the proposal survives what is certain to be a long and intense deliberation process.

Another significant issue-area where differences have emerged is the harmonisation of accounting standards. The G20 has asked the International Accounting Standards Board (IASB), whose standards the EU has adopted since 2005 for the consolidated accounts of all listed companies, and the US Financial Accounting Standards Board (FASB) to redouble their efforts to produce a single set of global accounting standards and complete their convergence project (on-going since 2002) by June 2011. The G20 also asked the accounting standard setting bodies to improve and harmonise their standards for various aspects of financial instruments and loan-loss provisions. Despite significant overall progress with their convergence project, the IASB and the FASB have issued different proposals for dealing with fair value for financial instruments, with the FASB opting for an all-out fair value approach, while the IASB proposed a mixed approach that combines fair value and amortized cost. Given the controversial role of fair value accounting for financial instruments during the crisis, and the fact that to some degree these differences reflect a deeper rift between the American and European accounting approaches to fair value, achieving the goal set by the G20 is far from guaranteed. Indeed, in June 2010 the two bodies announced that they would not be able to reconcile their differences by the June 2011 deadline set by the G20, and postponed the completion of a number of projects for the end of 2011. Although a December 2010 decision by the FASB to revise its previous approach for the use of fair value for the classification and measurement of financial instruments is a significant step towards convergence, new IASB proposals on hedge accounting are moving in a direction that increases the differences between IASB and the FASB in this issue-area, raising new problems for the timely completion of the convergence project.

National / Regional implementation of international agreements

Differences are not only found in regulations and standards developed by different regulatory bodies, but also in the national and / or regional implementation of internationally agreed rules. There is evidence that the consistent implementation of some of the international agreements that have been reached these past two years is already undermined by conflicting national regulations and industry pressure. The most worrisome developments in this context relate to the adoption of the new Basel III agreement, regarding the capital requirements for banks, which arguably is the single most important piece of international financial regulation. Already a potentially significant conflict between Basel III and the Dodd-Frank Act has been identified, as the latter bans the use of credit rating agencies' assessments for regulatory purposes in financial regulation, while the former continues to rely on them for measuring risks and determining the capital requirements. As US regulators have not been able to come up with a credible alternative to credit ratings these past few months, there are fears that the implementation of Basel III will be delayed (and will probably be inconsistent with international practice, as it will rely on different ratings) in the US, which it should be noted, has not yet fully implemented Basel II. This has caused concern in Europe, which however faces pressures of its own to provide a "European version" of Basel III. A number of European banks, backed in some cases by national politicians, have been making public their disagreement with many of the Basel III requirements, particularly the introduction of the leverage and liquidity ratios. Indeed, they are already engaged in significant lobbying efforts to introduce deviations from the original Basel rules in the context of the deliberations on the draft of the fourth update of the Capital Requirements Directive (CRD IV) that will transpose Basel III into European law.

European fragmentation in international *fora*

This is an issue already identified by previous TGAE contributions, and one that remains relevant and significant in the current situation. The fragmentation of European representation in international *fora,* such as the G20, undermines the regulatory position of Europe at the international scene, while also weakening the prospects of effective international cooperation by increasing the diversity of national voices in international negotiations. This situation is troubling, since there are still a lot of important regulatory issues that remain open, particularly those with significant international implications, such as the regulation and supervision of systemically important financial institutions (SIFIs) and the management of cross-border financial crises. These issue-areas require close cooperation between regulatory authorities at the international level and the adoption of consistent regulations at the national and / or regional level.

Enhancing EU's contribution to global harmonisation: Some recommendations

Ensuring the coordination of the regulatory initiatives taking place at the national, regional and international levels is absolutely necessary, if they are going to be effective in preventing a future global financial crisis. Protectionism and national vested interests should not derail the international effort, because in the end, the interpenetration and interdependence of international financial markets will ensure the spread of a future crisis to all countries, irrespective of the particularities of their regulatory regime. Given the weight of the European financial markets, and its wider economic significance, the EU has a special interest and responsibility in safeguarding the stability of the global financial system. In this respect, the Polish, Danish

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and Cypriot Trio Presidency has a particularly important role to play, as it will preside over the last stage of the European financial reform process, due to be completed by the end of 2012, and more generally over a period when all remaining significant issues in international negotiations are going be decided and implemented. In this context, the following recommendations aim to help the next EU rotating Presidency address the problems described above, and advance EU's contribution to the harmonisation of global financial regulation:

- The Polish, Danish and Cypriot Trio Presidency should ensure that EU assumes a leading role in the coordination of financial regulatory reform at the national, regional and international levels.
- There should be efforts, in cooperation with other jurisdictions and/or international organizations, to discuss and coordinate possible revisions and/or amendments of current regulations that lead to significant national differences and offer opportunities for regulatory arbitrage.
- The EU should resist unjustified deviations from internationally agreed regulations, in their transposition into European law.
- Other jurisdictions (most importantly the US) should be persuaded to desist from similar deviations from international agreements, requiring at the very least the adoption of regulations with equivalent results.
- When developing its own rules in the context of the European financial reform process, the EU should make every effort to ensure their conformity with existing internationally agreed principles and regulations.
- The next Trio Presidency should try to forge a unified position among European representatives in international *fora,* consistent with the view of the EU. This is particularly important for issues that have not yet been addressed in the European financial reform process. A unified position would allow Europe to exert more influence in the construction of the new international financial regulatory regime, but also, by reducing the diversity of national voices in the context of international negotiations, enhance the prospects of greater international cooperation.