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An Assessment of the European Financial Reform Process: Accomplishments, Failures and Future Challenges

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Summary

Since the outbreak of the financial crisis the European Union (EU) has been engaged in an ambitious wide-ranging legislative programme intended to reform European financial regulation. This paper aims to critically review the accomplishments, failures and future challenges of the European financial reform programme. While acknowledging that during the past three years significant progress has been made and a number of regulatory and institutional changes have been agreed, and in some cases already implemented, it is argued that overall, the reform has not lived up to the original expectations. Financial industry pressure, international competition considerations, and the ambivalent attitude of European governments towards the transfer of regulatory and supervisory authority to the European level, have slowed down progress and undermined the effectiveness of the agreed reforms. This is worrisome because, as the paper argues the stability of an increasingly integrating European financial marketplace requires the establishment of an integrated European regulatory and supervisory framework.

Introduction

At the height of the financial crisis back in 2008, the European Union (EU) was quick to react to the rapidly deteriorating financial environment with a set of legislative proposals designed to address some of the most pressing problems of the time. This initial response, undertaken in a crisis management context, has gradually evolved into an ambitious wide-ranging legislative programme intended to fundamentally reform all aspects of European financial regulation. Although in recent months the sovereign debt crisis has focused public attention on the on-going efforts to reform EU's economic governance, the financial reform process has been steadily progressing in the background, and a number of significant regulatory and institutional changes have already been agreed and in some cases implemented, while others are on the way of being finalized. These changes will have profound consequences for the operation of the European financial markets and will undoubtedly enhance their transparency, efficiency, and most crucially, stability. Nonetheless, despite its wide scope and high ambition, this reform programme is not without faults and significant challenges remain to be met. The aim of this paper is to offer a critical review of the accomplishments, failures and future challenges of the European financial reform programme. In this context, it will be shown that despite significant progress, pressures from the financial community, international competition considerations, and the ambivalent attitude of European governments towards greater integration in this policy area, have weakened the reform process and have put in doubt the ability of the resulting framework to prevent and/or cope effectively with a future financial crisis. The paper concludes with some suggestions on the direction of the European reform programme. It is argued that in the context of increasingly integrated European financial markets, an effective European regulatory solution is needed. European governments need to weigh the constraints of national politics against the potential costs of another European financial crisis.

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European Financial Reform: A Status Report

The European financial reform initiative is an ambitious programme that covers almost all aspects of financial regulation and supervision. This wide

array of legislative interventions can be grouped into three categories, according to their objectives:

a) Correcting Regulatory Failures/ Closing Regulatory Gaps

The financial crisis revealed a serious lack of understanding on the part of the public authorities, of the risks inherent in a wide range of practices that financial institutions were allowed to engage in during the build-up of the crisis. In this context, the flagship regulatory change concerns the amendment of the capital requirements framework for banks. In the euphoric years before the crisis banks were allowed to attain extremely high levels of leverage, retaining low levels of capital, some of it in the form of various types of "hybrid capital", which proved wholly inadequate to absorb losses of the scale recorded during the crisis. As a result, a significant number of international banks came close to collapse, an outcome averted at a huge fiscal cost for most countries hit by the crisis.[1] To rectify this situation, regulators have agreed a stricter re-definition of capital, which now contains mostly "high quality" forms of capital like equity, they have raised the minimum capital requirements for banks at significantly higher levels (7% of common equity, including a capital conservation buffer of 2,5%, and a total minimum ratio, including other forms of capital, of 10,5%), and they have introduced for the first time new liquidity and leverage ratios, to monitor in a more straightforward way the liquidity and leverage position of banks. These changes have been agreed in the context of the Basle Committee on Banking Supervision (BCBS), and are included in the new "Basle III" framework. This framework is currently in the process of being incorporated in the European legislative framework with the so-called Capital Requirements Directive (CRD) IV, expected in July, the latest in a series of amendments (CRD II and CRD III) during the past three years.

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Another regulatory area whose implications for systemic risk regulators failed to grasp before the crisis, refers to the quality of corporate governance in financial institutions, and in particular their remuneration and bonus policies. Financial regulators did not take into account the fact that the particular nature of financial markets can affect management's incentives in a way that promotes short-termism and risk-taking. This issue acquired political salience of the highest order at the height of the crisis, when it was revealed that the crisis was, at least partly, the result of reckless investment decisions by executives, rewarded for them with exorbitant remuneration packages. The European Commission sought to address the perverse incentives of the previous regime with its proposals in the context of CRD III, mentioned above. The new rules, which have been in effect since January 1st 2011, stipulate that banks have to defer 40% to 60% of bonuses for three to five 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 later years deteriorates.

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Finally, significant new legislation has been agreed for the operation of Credit Rating Agencies (CRAs), blamed for failing to rate appropriately the risk of complex financial instruments and major financial institutions before the crisis. This failure has been associated with conflicts of interest related to these agencies' "issuer-pays" business model, where the issuer of a financial security is also the one who pays for its rating. More generally, the operation of these agencies has raised a number of concerns, given that the international rating industry is a highly concentrated oligopolistic market, dominated by a handful of US-based CRAs, whose rating techniques and criteria have remained for the most part opaque. These concerns have become much stronger in Europe during the past year due to the role of CRAs in the sovereign debt crisis. The European Commission moved quickly to address this situation, with a regulation proposal already in October 2008. This regulation, in force since December 2010, has introduced a registration requirement for CRAs for the first time, and it has imposed minimum corporate governance standards and disclosure of their rating methodology. Further legislation is currently under consideration to address among other things, the degree of

[1] *Examples include the Royal Bank of Scotland and Lloyds Banking Group in the UK, Fortis in Netherlands, Dexia in Belgium, France and Luxembourg, Commerzbank and Hypo Real Estate in Germany, and all the major Irish banks.*

competition in the industry and the role of CRAs in sovereign debt rating.

In addition to weaknesses of the previous regulatory framework, the crisis also revealed a series of significant regulatory gaps that allowed large parts of the financial system to operate outside all regulatory and supervisory control. Such is the case of the derivatives market. Over 80% of the vast derivatives' market (notional outstanding contracts of some $615 trillion by year-end 2009) has traditionally operated in an over-the-counter (OTC) framework, that is, transactions have not taken place on organized exchanges but between two counterparties in a private setting. Because OTC transactions do not take place on organized exchanges they have been for the most part unregulated and opaque, and as the recent crisis demonstrated, subject to significant counter-party risk (risk arising from the default of one party in an OTC deal). In September 2010, the European Commission unveiled its proposals for a new regulation on derivatives' markets. The proposals require standard OTC derivatives to be processed through clearing houses – a move aimed at reducing systemic risk through the reduction of counter-party risk. They also postulate that OTC contracts are reported to "trade repositories" or data banks, and that this information is available to regulators.

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Finally, another significant, hitherto unregulated, part of the international financial system that has been targeted by regulators is the so-called alternative investment sector, which includes entities such as hedge funds and private equity firms. The Council has adopted the Alternative Investment Fund Managers Directive bringing hedge funds and other alternative investment funds under a single European financial regulatory framework for the first time. The directive aims to register hedge funds above a certain threshold, ensure that their activities are transparent, regulated and supervised, and that, as in the case of banking, they fulfil capital requirements and follow good governance principles.

b) Strengthening Supervision

The absence of European institutions capable to ensure coordinated implementation of European financial legislation and effective supervision for an increasingly integrating European financial market has been one of the root causes of the financial crisis in Europe. The previous framework based on the "Level 3 Committees" comprising national supervisors who tried to coordinate in an ad hoc fashion the domestic implementation of European legislation, and who performed an advisory, non-binding regulatory role, proved insufficient to provide the functions required for an efficient, stable and transparent European financial market. To address this institutional gap, European authorities have already agreed and implemented one of the most significant changes in the context of the financial reform programme, the establishment of a new European supervisory structure. The new structure comprises two parts. First, a European System of Financial Supervisors (ESFS), which includes three new independent European Supervisory Authorities (ESAs), the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the Insurance and Occupational Pensions Authority (EIOPA). These authorities will have increased powers compared to their predecessors, since they will be able to draft binding pan-European technical rules and standards, to issue binding arbitration decisions in disputes between national authorities, and to intervene directly in domestic financial markets in case of a member state's continued noncompliance with European law, or in cases of emergency. They will also participate in the second pillar of the new European structure, the European Systemic Risk Board (ESRB), mandated to exercise macro-prudential oversight and to ensure that macro-economic risks associated with the financial system are detected early on, a function regrettably absent in the previous regime.

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c) Building Crisis Management and Resolution Capabilities

The unwinding of the financial crisis and the way that it was dealt with by authorities illustrated clearly the lack of a crisis management framework and a corresponding strategy at both the national and European levels. The huge bail-outs at the expense of taxpayers have been highlighted as an unacceptable solution that socialized the costs of the reckless practices of financial institutions. In this context, the European Union has been working

towards establishing a crisis management and resolution system. The Commission proposed an amendment to the Deposit Guarantee Schemes Directive (increasing the level of protection initially to €50.000 and later to €100.000), at the height of the crisis in 2008, to deal with the divergent national responses which threatened to destabilize European banking markets at the time. Further amendments have been proposed in this field, including an Investor Compensation Schemes Directive and Insurance Guarantee Schemes to offer a harmonized level of protection to consumers of investment and insurance products as well. Other proposals refer to the establishment of a pan-European system of bank resolution funds, which would be paid in ex-ante by the banks, to allow for the orderly resolution of failing banks during a crisis, winding up procedures for failed financial institutions (e.g. the so-called living wills), bail-in arrangements to transfer at least part of the burden to financial institutions' creditors, and intervention powers for regulatory authorities in times of crisis.

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Conflicts, Compromises and Failures

Although the European financial reform programme has made substantial progress, this does not mean that negotiations have been easy and/or always successful. The reform process has repeatedly run into serious problems and the compromises reached to overcome some of these gridlocks have not always produced a satisfactory outcome. Generally, the reform has stumbled along three fundamental policy dimensions.

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The first refers to the point of equilibrium along the efficiency-stability policy continuum. Initiated in the aftermath of the crisis, the reform's overarching objective is to strengthen the stability of the European financial system. However, there is always a trade-off between the objectives of stability and efficiency in the financial system, given that the former necessitates restrictions to the operation of financial institutions, while the latter usually implies the removal of regulatory constraints, increased openness and competition. The distributional implications are straightforward, since increased regulatory requirements and safeguards to ensure stability, raise the cost of doing business and reduce profit opportunities for financial institutions. Predictably, we have often witnessed a clash between financial institutions which resist efforts to increase their regulatory burden and political and regulatory authorities trying to shore up the stability of the financial system.

This conflict cuts across geographical boundaries and has often resulted in watered-down regulatory proposals following intense lobbying from the financial sector. Thus for example, early radical proposals for reform such as the re-establishment of a "Glass-Steagall" type of division, where commercial and investment banking are separated, or the formation of "narrow banks", which would be fully insured by the state but would engage only in a limited range of traditional banking activities, have been abandoned following strong resistance by the banking community. Indeed, the United Kingdom is the only country where innovative options are still being discussed concerning structural changes to prevent banks from ever becoming "too-big-to-fail". Still, even in this country, where the government had to effectively nationalize two of the biggest financial groups during the crisis, pressure from the banking industry has gradually driven even relatively moderate solutions, such as the requirement to set-up different and/or foreign business units as subsidiaries, out of the agenda. The end-result at this point seems to be a rather vague requirement to "ring-fence" UK retail banking activities (Independent Commission on Banking 2011).

The second policy dimension, along which conflicts of interest emerge, refers to an age-old dilemma of European integration, which is the extent to which authority should be transferred from the national to the European level. This decision, which in effect determines the pace and scope of European integration itself, has significant implications for national policy autonomy, but also bears a significant symbolic connotation as it effectively reflects the degree to which European states are prepared to share their sovereignty. Moreover, the transfer of authority to the European level is usually accompanied by increased funding requirements to support its effective exercise. However, European governments are generally reluctant to approve proposals with significant fiscal implications, and will typically opt for amendments designed to guarantee minimum fiscal burdens,

even at the expense of the effectiveness of the proposed legislation.

Such considerations have been evident in the negotiations of the new ESAs. The new agencies are the result of a series of compromises that have limited their powers in several aspects. Thus, the supervisory structure reflects a balance between national and EU-wide responsibilities, where day-to-day supervision of companies and markets will remain with national authorities, as was the case until now, while the ESAs will basically supervise the implementation of European law by national authorities. This balance between national and European supervisory structures reflects a compromise between mainly the UK, which was wary of further delegation of supervisory powers to Brussels, and continental countries such as France which strived for a more centralized supervisory structure with significant powers. In a similar vein, concerns about the fiscal implications of a new European crisis management system have resulted in a compromise that limits significantly the power of the ESAs to intervene in times of crisis. The problem of "fiscal responsibility", or to put it simply, the question of who pays what in times of crisis, had been one of the root causes of the failure to establish a European crisis management system the years before the crisis, since governments have traditionally been unwilling to set up a system where they might have to pay for the support of financial institutions operating outside their own jurisdiction (Goodhart and Schoenmaker 2006). The same problem was raised in the case of the new ESAs. The compromise reached introduced a safeguard which stipulates that the decisions of the ESAs cannot have material or significant fiscal impact for a Member State. This limits significantly the scope of actions of the ESAs, particularly in times of financial turbulence, and puts in doubt their ability to handle effectively crisis situations.

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Finally, a third policy dimension that has weighed significantly on national authorities' considerations refers to the implications of the new harmonized rules for the position of their domestic banking industry in international financial competition. In fact, such distributional preoccupations had bedevilled the construction of a European framework during the previous two decades, resulting in a regulatory and supervisory structure that was incomplete in its scope and inconsistent in its application, shortcomings that proved detrimental for the stability of the European financial system during the crisis. Preoccupations about the effects of the proposed regulation on the international competitiveness of the domestic financial industry have dominated the negotiations of several issue-areas in the context of the European financial reform programme.

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One of the most noticeable examples has been the case of the hedge funds' legislation. One of the main contestation points in the course of the negotiations played out along a UK/Continental Europe divide, with France being the leader in the push for reform, and London resisting granting powers to Brussels over this area, since 80% of hedge funds and 60% of private equity firms operating in Europe are located in the UK. Moreover, the UK (where the vast majority of non-EU funds are based), was extremely critical of the Commission's earlier proposals for "third-country" funds, describing proposals for some form of "equivalence" standards, as protectionist. The discussion prompted interventions at the highest political level, the most impressive being the request of Gordon Brown in March 2010 to postpone the issue for after the UK elections. Ultimately, a compromise was reached where there is going to be a European "passport" for third countries, which however will be granted following a transition period of two years and only on the vague basis of adequate regulatory and supervisory cooperation from third country authorities.

Challenges Ahead

As we saw above, the European financial reform programme has made substantial progress in many issue-areas, but has also failed to meet the expectations for reform raised in the aftermath of the crisis, in others. However, the programme is not over yet. A number of significant legislative interventions are yet to be finalized, so there remain substantial challenges to be met before final judgment can be passed on the programme's contribution to a more stable and secure European financial marketplace. Unfortunately, it is already clear that the same kinds of conflicts as the ones

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described above are impeding progress in many of the remaining reforms.

Thus for example, resistance from the European financial community threatens to undermine the implementation of agreements already achieved at the international level. European banks have long been arguing against the adoption of binding leverage and liquidity ratios and have been lobbying intensely their governments and the European Commission, in view of the new European legislation required for the transposition of Basle III (which stipulates such ratios) into European law. Banks have sought to moderate the impact of the ratios, by influencing their design, delaying their introduction, and if possible convincing European authorities to abandon their introduction as binding requirements. The effectiveness of such lobbying efforts can be considerable, particularly when these are combined with national authorities' concerns over international financial competition. In the past few months we have repeatedly witnessed European governments taking up their financial communities' pleas and pressing the European Commission for a more "flexible" implementation of the Basle III agreement in Europe. As a result, recent press reports indicate that the upcoming CRD IV will probably leave decision for these ratios for the future, following an observation and review period.

The exclusion of some of these additional ratios by the EU would weaken the effectiveness of the new regime in Europe and would thus undermine the stability of the European financial system. Moreover, such an exclusion would set a dangerous precedent that could lead to different national and/or regional versions of the framework agreed at BCBS, eroding international harmonization and creating opportunities and incentives for regulatory arbitrage. Such a development would undermine the painstaking progress that has been achieved to-date and increase the vulnerability of the international financial system. The danger of such an unwinding should not be underestimated. In recent weeks we have witnessed the exchange of letters between the EU internal market commissioner and the US Treasury secretary, accusing each other, with rather strong language, of dragging their feet in the implementation of international agreements and of trying to convey an unfair advantage to their respective financial communities by adopting lighter versions of the agreed rules.

On another front, the reluctance of European governments to set-up a truly European crisis management mechanism is leaving Europe vulnerable to the next financial crisis. The admission of defeat can be read in the European Commission's own consultation communication on the issue where it states that, "in principle, an integrated framework for resolution of cross border entities by a single European body would deliver a rapid, decisive and equitable resolution process for European financial groups, and better reflect the pan EU nature of banking markets",[2] but then goes on to acknowledge that due to technical, legal and funding issues, and the absence of a European agency that could undertake such a role, the proposed approach is based on increased cooperation of resolution authorities in the current context of cross-border supervisory colleges, which however would have no binding powers, over resolution schemes. The establishment of a truly integrated European framework for crisis management and resolution of cross-border financial groups remains according to the Commission's own admission, a long-term objective.

The direction of the discussions in the issue-areas described above, does not permit great optimism about the outcome of the European financial reform project, particularly since several major issues are still at early stages of deliberation. For example, the task of shedding light to the shadow banking system through the regulation and supervision of hitherto "invisible" financial entities has only made modest progress to-date. Given that this aspect of the international (and European) financial system was at the core of the financial crisis, one can only hope that authorities in Europe and elsewhere will be able to come up with the reforms that will ensure the stability of the European (and global) financial system.

Conclusions

In the aftermath of the financial crisis, Europe sought to reform its financial regulatory and supervisory

[2] *(European Commission 2010, 12)*

framework. Although progress has been made in a number of issue-areas, neither the pace nor the content of the reforms have satisfied the aspirations raised at the beginning of this endeavour. The negotiation process to-date has often been dominated by an intergovernmental rationale that primarily seeks to avoid disturbing national vested interests. However, the crisis demonstrated beyond any doubt the precariousness of financial stability in conditions of deepening financial integration. Analysts have described the conundrum faced by policy makers in this context, with the concept of the "financial trilemma", which states that financial stability, financial integration and national financial policies are incompatible (Schoenmaker 2011). In a world with high levels of financial integration national policies designed to ensure financial stability will prove ineffective. This means that stability in the increasingly integrated European financial marketplace requires an integrated European regulatory and supervisory framework.

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Indeed, in the absence of such a framework, European governments' efforts to serve their national interest will be self-defeating. For example, the absence of a European crisis management and resolution framework before the crisis due to fiscal considerations, led to ad hoc, isolated and uncoordinated national crisis management interventions, at an extraordinary fiscal cost, immeasurably higher than the fiscal burden that European governments would have paid in an ex ante established crisis management and burden-sharing regime. Moreover, the absence of such a comprehensive framework, threatens not only to reduce the effectiveness of many of the measures already agreed, but could potentially increase the risks to the stability of the European financial system. For example, while the migration of standard derivatives to Central Counterparties (CCPs) is a step in the right direction in order to reduce counterparty and systemic risk, the absence of an effective European framework for the regulation and supervision of these pan-European organizations, would prove fatal, since the reverberations from the failure of a CCP would dwarf those from the collapse of Lehman Brothers. Finally, it should be kept in mind that financial integration has intensified not only in Europe but also internationally. Therefore, the view that somehow Europe could have its own version of global rules, without undermining global and therefore European financial stability is illusionary. If we have learnt one thing from the recent crisis is that in conditions of global financial integration contagion of financial instability cannot be contained solely through national or even regional efforts. The spirit of international cooperation displayed at the height of the crisis should not be allowed to wane. National and/or regional exceptionalism would undermine the progress that has been achieved to-date, and leave both Europe and the rest of the world vulnerable to the next financial crisis.

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For these reasons, European governments and authorities should redouble their efforts to reform the European financial regulatory and supervisory framework. To negate the risks described above, these efforts should be based on three basic insights that emerge from the preceding discussion:

- The benefits of an integrated European financial marketplace cannot be safeguarded without a corresponding integrated European policy framework that will ensure the stability of that market. To be effective, such a framework needs to be endowed with adequate financial resources and significant policy competencies.
- Even if such a framework is established however, its ability to prevent future financial crises will be limited, unless a more ambitious approach to reform is adopted. The financial crisis has not affected the deepening of financial integration or the progress of financial innovation. Unless the way financial markets themselves operate is changed, authorities will be engaged in a never-ending regulatory catch-up. Even though most radical proposals have been abandoned, alternative options exist, as for example a tax for short-term cross-border financial transactions, which would slow down the breakneck speed of financial integration, without requiring extensive restructuring of the current system. Such options should be considered.

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- Finally, a European version of internationally agreed rules would undermine the effectiveness of the international harmonization process and thus the stability of the international and European financial system. Therefore, deviations from international agreements should be resisted, while pressure should be applied to other major jurisdictions to do the same.

Previous European financial reforms focused on opening up the market and promoting integration, without paying due attention to the issue of financial stability. The crisis demonstrated that increased competition and integration has to be accompanied by a robust framework that ensures the stability of the system. In this sense, the crisis represents a unique opportunity for Europe to reform its financial regulatory and supervisory framework and rectify the mistakes of the past. It remains to be seen whether European governments are up to the task.

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