

TO THE COMMISSIONER FOR FINANCIAL SERVICES

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Your five main challenges: the ongoing legislative agenda; the integrity of the single market for financial services; non-bank finance and capital markets development; the new EU landscape of specialized financial agencies; and the EU's role in global financial reform

STATE OF AFFAIRS

The financial services portfolio was sizeable before the European financial crisis started in 2007. It has grown considerably since then, extending into a myriad of highly specialised issues. Your predecessor worked on a tidal wave of 56 different pieces of European Union financial legislation (regulations and directives of the Parliament and the Council), 47 of which he initiated and 37 he finalised. Yours is a massive responsibility, which requires a deep understanding of financial system developments, in addition to legal and political deftness.

The financial crisis that started in mid-2007 has been a learning experience for the Commission, as it has been more broadly for the EU. During the first few years, the crisis was blamed on external factors: the US subprime crisis, then the Lehman Brothers collapse, then fiscal mismanagement in Greece. Home-grown sources of fragility and corresponding supervisory failures were denied or ignored, not least the dramatic increase in European banks' balance sheet size, risk and leverage since the early 2000s. As a result, early crisis response was often insufficient or inadequate, and while much progress has been made, the policy orientation has occasionally appeared inconsistent.

It is impossible to list here all the substantial initiatives of the past few years, and the dense alphabet soup of acronyms they have produced.

However, it might be useful to group the main initiatives by source of original impetus. We identify four such groups:

— *The G20 agenda:* This was defined in summits of the Group of Twenty in 2008-09 and refined in global bodies including the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS) and others. Arguably its most prominent items have been a new BCBS accord on capital, leverage and liquidity, known as Basel III (2010) and largely transposed into EU law by the Capital Requirements Regulation and fourth Capital Requirements Directive (CRR/CRD4, 2013); the FSB's ongoing work on bank resolution and the 'too-big-to-fail' distortion, echoed in the EU Bank Recovery and Resolution Directive (BRRD) of 2014; a series of reforms of global derivatives markets, mostly implemented in the EU through the European Market Infrastructure Regulation (EMIR, 2012) and the Markets in Financial Instruments Regulation and revised Directive (MiFIR/MiFID2, 2014); and reform of selected segments of non-bank credit markets (shadow banking), most of which is still under discussion at the FSB.

— *The Larosière agenda:* In February 2009, a high-level group chaired by Jacques de Larosière advocated a 'single rulebook' to harmonise financial regulation and supervision in the EU. A major step was the creation in 2011 of three European Supervisory Authorities (ESAs): the European Banking Authority (EBA) in London, the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt, and the European Securities and Markets Authority (ESMA) in Paris, complemented by the European Systemic Risk Board (ESRB) hosted by the European Central Bank (ECB) in Frankfurt. The single rulebook includes Technical Standards which are drafted by the ESAs for decision by the Commission. By our count, 37 such standards have been adopted since 2011, mainly on bank capital requirements, derivatives, market abuse and short selling.

Global reform

Single rulebook, new agencies

Banking Union is arguably the most significant policy development in Europe since the euro

Banking union

— *Banking union*: In mid-2012, euro-area leaders started the transfer of responsibility for banking policy to European level. The Single Supervisory Mechanism (SSM) Regulation of 2013 empowers the ECB as supervisor of large banks in the ‘banking union area’ (ie the euro area plus any other EU member state that may voluntarily join the SSM). The Single Resolution Mechanism (SRM) Regulation of 2014 creates a Single Resolution Board (SRB) in Brussels to coordinate the resolution of future bank failures, and a Single Bank Resolution Fund. In the absence of fiscal union, this banking union remains incomplete, with the SRM an awkward hybrid and no central deposit insurance. It does not fully “*break the vicious circle between banks and sovereigns*” as initially promised. Even so, it is arguably the most significant policy development in Europe since the creation of the euro.

Own Initiatives

— Under your predecessor, the Commission also took a number of its own initiatives, often in partnership with the European Parliament and in reaction to perceived demands from the European public. These included curbs on executive compensation and short selling, a reform of audit regulation, constraints on credit rating agencies beyond those suggested at the G20 level, a reform of financial benchmarks, and still unfinished proposals to separate certain activities within bank conglomerates (proposal on structural separation, January 2014). Another notable Commission initiative that is outside your remit but impacts the financial sector is the

Financial Transaction Tax (FTT) project, first proposed in September 2011 and still under discussion.

You also need to heed drivers of change that go beyond the European financial crisis. Globalisation is reshaping international finance and fostering the rise of powerful new financial firms, centres and markets, especially in Asia. Information technology fosters innovative payment systems and peer-to-peer lending or investing platforms, and in the age of ‘big data’, information systems play an increasingly prominent role in most financial segments. These developments also mean massive new demands on European regulators and supervisors. You must adapt fast in order not to be left behind in an increasingly obsolete Western-centric, relationship-based mindset.

CHALLENGES

We identify five clusters, which combine operational and institutional concerns – assuming there is no new round of EU Treaty revision, the potential implications of which for financial services have been left outside the scope of this memo.

Crisis management and resolution, banking union build-up and regulatory streamlining

The lead players on crisis management and resolution within the Commission are your colleagues responsible for Competition and Economic and Monetary Affairs, but you also need to follow these developments closely and assess their legislative implications. The ECB’s comprehensive assessment of euro-area banks, and subsequent restructuring of the weaker ones, is the central front at this point. Close coordination and alignment between the ECB and the Commission is needed for this crucial transition to succeed in restoring trust in Europe’s banking system.

Ongoing
legislative agenda

Beyond this phase of repair, the implications of the financial regime change brought by banking union will gradually highlight new challenges. The vision of a ‘single rulebook’ remains far from realised. The respective responsibilities of the ECB and national authorities in the regulation of banks’ conduct remain unsettled. Banks are subject to widely divergent insolvency frameworks which question the very notion of a single resolution mechanism. All regulated financial firms other than banks and credit rating agencies remain supervised at

national level: for example, the ECB will rely on audits of supervised banks by audit firms that are organised and regulated on a country-by-country basis. This creates scope for tensions, regulatory arbitrage and ultimately instability.

Your legislative agenda will remain daunting for the foreseeable future. Significant pieces of EU legislation are still pending, eg on money market funds, financial benchmarks and structural separation. Meaningful flaws or unforeseen effects are likely to be identified in recently adopted regulations, directives and binding standards, justifying their revision. The sheer novelty of many aspects of the recent reform flurry made it impossible to get everything right at the first attempt. To compound the challenge, your services employ general-purpose civil servants rather than lifelong financial experts. Most of their sector expertise is built up on the job, often with a sharp initial learning curve. Under the pressure to tick as many regulatory boxes as possible, principles of what the Commission used to call ‘better regulation’, such as substantial consultation of stakeholders and economic cost-benefit assessments, have sometimes been practically suspended even when they were still given lip service. As a result, the regulatory burden on economic agents has occasionally been heavier than necessary.

Risk of
intra-EU split

Single market integrity

The United Kingdom, home of Europe’s major financial hub in the City of London, is outside of the banking-union area, as are several other EU countries. This poses unprecedented challenges for the single market, the protection of which is at the core of your mandate. You have a duty to address these as much as possible, even though you cannot solve the broader political questions that affect the relationship between the UK and the EU.

The UK has sued the ECB on aspects of its policy to provide liquidity to central counterparties that clear transactions in euro. The ECB can also be expected to call for more harmonisation of rules within the banking-union area than is achievable for the EU as a whole. The ESAs have a mandate to foster and enforce convergence across the EU, but the Commission’s rejection or amendment of several of their draft rules has raised doubts about their standing, and their intergovernmental governance framework is widely seen as a brake on their effectiveness. The

new policy emphasis on macroprudential instruments, while broadly welcome, also creates risks for the single market, because much of the decision-making on these instruments remains at national level. Beyond the ESAs, your own services also have enforcement powers but have used them only sparingly in the recent past. We identified only 44 infringement cases opened in a financial services context since 1998, and only 19 since mid-2007.

Europe's comparatively underdeveloped non-bank finance and capital markets

The domination of Europe's financial system by banks has become a drag on the European economy. The crisis fallout is a sequence of bank restructuring, deleveraging and consolidation that still has several years to run. These trends create both a need and an opportunity for the dynamic development of non-bank credit channels, through both market-based finance and non-bank financial intermediaries. If accompanied by adequate monitoring and regulation, the result can be a more diverse and more resilient financial system, and also more effective monetary policy transmission.

This pro-market narrative has gained ground in recent years, illustrated by recent calls for the revival of securitisation. But many EU and national policies still tend to repress the development of non-bank finance. Banking advocates have been successful in painting these segments as dangerous 'shadow banking', and the default attitude is often to erect new regulatory barriers rather than to foster their development. Examples of unnecessary market repression also include curbs on credit rating activity, and aspects of the Commission's proposal on bank structural separation.

The new EU institutional landscape

Until 2010, the Commission was largely alone at EU level in dealing with financial services matters. Now, the EBA, EIOPA and ESMA, the ESRB, the supervisory arm of the ECB and the soon-to-be-established SRB all have important tasks, not to mention your competition policy colleague's expanded role in bank restructuring. Your control over each of these new agencies is limited, even though you retain formal authority over the three ESAs' rulemaking activity and the SRB's resolution decisions. Moreover, and as emphasised above, the adoption by the Commission of an activist approach in rejecting or rewriting the

Bank dominance

New EU-level actors

ESAs' draft technical standards carries obvious risks for the credibility of the ESAs and ultimately of the EU itself.

The multiplicity of rulemaking parties can be seen as inevitable, as in the US, where multiple federal financial agencies have long coexisted. Nevertheless, it carries risks of turf conflict, regulatory arbitrage and policy inefficiency.

External realignment

During most of the 1990s and 2000s, the EU was at the forefront of championing and adopting global financial standards. Examples of EU global leadership include the adoption of International Financial Reporting Standards (IFRS) in 2002 and the adoption of the Basel II capital accord in 2006. In both cases, albeit for different reasons, the US did not adhere to the international standard.

The crisis, however, has changed this. EU compliance with global standards has become spottier than many Europeans acknowledge. On Basel III adoption, and in sharp contrast to Basel II, the EU has been a laggard rather than a pioneer. Like the US, the EU was late to adopt the corresponding legislation (CRR/CRD4); but unlike the US, the EU has also deviated from the international template on several important counts, including the definition of capital and the treatment of insurance arms of bank conglomerates. The EU remains far behind the US in implementing the G20-defined reform of derivatives markets, which magnifies the risk of market fragmentation. Your predecessor also repeatedly expressed dissatisfaction with choices made by the global accounting standard-setter, even though the EU has continued to adopt IFRS standards. This change in the EU's behaviour is not coincidental. It is more difficult to align the respective agendas of the Commission and of global standard-setters in the current era of re-regulation than it was in the pre-crisis period. But the negative implications of some EU choices for the global financial policy framework might not have been fully considered in the European decision-making process.

There is a parallel challenge relating to EU representation in global financial bodies. With the G20's elevation to 'premier forum' in 2009 for its members' international economic cooperation, and the corresponding broadening of the membership of the likes of the

BCBS and the FSB, the EU is less dominant in many bodies than it used to be. This might make the EU feel less committed to the global standards: US Trade Representative Michael Froman was recently quoted as noting that the “*EU often only recognises standard-setting bodies where EU members cast the bulk of the votes*”. Furthermore, banking union and other EU policy developments towards centralisation of financial policy might lead non-European jurisdictions to increasingly question why individual EU member states should be represented alongside EU institutions at all in such bodies.

RECOMMENDATIONS

General approach

You need to determine early on your general financial services policy philosophy. There are two major pitfalls to avoid. First, the financial sector will, in the name of growth, keep calling for deregulation and reversal of the tightening of the last few years, ignoring potential risks to financial stability. Second, self-styled reform advocates will encourage you to go for radical and seemingly simple measures for the sake of financial stability, without considering their economic cost in terms of making the financial system less efficient.

In reality there is no easy fix. Certain regulatory initiatives might be beneficial to both growth and stability, eg banking union in our judgment. Others might harm both, eg reducing accounting transparency by authorising fudges on asset measurement, as the Commission regrettably advocated in October 2008. The key is to better understand the financial system and how it might react to new policy initiatives, keeping in mind that this understanding will remain incomplete and largely practical. Absolutist positions are often suboptimal, in multifaceted debates that include bail-in versus bail-out in resolving banking crises, the pros and cons of asset risk-weighting in setting regulatory capital ratios, or curbing the size and complexity of financial institutions. Economists have not yet captured finance in general-equilibrium models, the way they have with other aspects of the economy. If only for that reason, there is an irreducible element of empiricism in financial regulation. This reinforces the need for ‘better regulation’ that avoids ideological certainties and takes into account feedbacks from on-the-ground observation.

Finding the
right balance

Diversity is good for finance; Europe has been too reliant on banks

You should keep in mind the benefits of diversity in the financial system. Europe has been too reliant on banks, and should create better conditions for properly monitored market-driven development of non-bank intermediation and disintermediated capital markets. It should not seek convergence of all banks towards a single business model or risk-assessment methodology, or of all asset managers towards a single investment strategy. It is easy for both regulators and supervisors to operate under the illusion that they understand financial risk better than market participants, but this is often not the case. Policy should avoid both overly prescriptive regulation that would be harmful or circumvented or both, and leaving excessive space for supervisory judgment that might eventually be captured. The balance must be continuously reassessed and readjusted, and is bound never to be perfect.

Crisis management and resolution, banking union build-up, and regulatory streamlining

Consistency & subsidiarity review

To address the need to clean up and streamline after the tidal wave of the last few years, you might consider the formation of a high-level committee to review the overall consistency and appropriateness of financial legislation and regulation in the EU. Criteria should include compliance with the subsidiarity principle, economic cost-benefit assessment and the minimisation of competitive distortions, including between banking-union countries and other EU member states. The UK Independent Commission on Banking (Vickers Commission) of 2010-11 might serve as benchmark in terms of process, including the establishment of a full-time secretariat of experts seconded from several agencies for more than a year to allow for high quality of in-depth analysis.

This is not the place to enter detailed recommendations on specific draft pieces of legislation. We nevertheless advise restraint on the contentious issue of structural separation, as the BRRD already gives wide discretion to supervisors to impose structural constraints on banks to ensure their resolvability, and predictability for investors is desirable in view of the banking restructuring wave that is expected to follow the transition to banking union. As in the US with the Volcker Rule, you should focus on prohibiting proprietary trading by banks, and leave to supervisors the intricacies of the implementation of this principle.

Single market integrity

You need to establish with the UK and with banking-union countries relationships based on trust, and to carefully avoid the twin risks of discrimination and special favours. When proposing new initiatives, not least on capital market development, you should favour EU-wide approaches over those limited to the euro or banking-union areas.

You should also ensure that EU financial policies are appropriately implemented and enforced, which is far from being the case now. Your recent predecessors and services have tended to neglect their enforcement responsibilities given the high priority of producing new rules, not least out of concern about antagonising individual member states whose support was deemed necessary to pass legislation. You should devote more resources and impetus to enforcement, and actively support the ESAs in their enforcement function.

Enforcement

Europe's comparatively underdeveloped non-bank finance and capital markets

Dynamic European capital markets and non-bank intermediation should be the main focus of your policy development agenda. This should be primarily framed in terms of development of relevant market segments, rather than their systematic integration at EU level (which could be at odds with subsidiarity) or increased regulation (in some cases, proper monitoring or even deregulation could be preferable). Securities regulation should allow for better investor protection, particularly enhanced disclosure requirements and their proper enforcement, for which you should champion more direct authority for ESMA. Prudential regulation should not create unnecessary disincentives for regulated financial entities to participate in securities

Capital markets
development

financing, as is arguably the case with, for example, the Solvency II insurance legislation. Single market enforcement and competition policy should also be actively deployed to identify and remove existing barriers to more efficient capital markets in the common EU interest.

Insolvency reform

Insolvency legislation is a prominent and difficult area for reform. Two strands are identified here: harmonisation of national insolvency frameworks, to clarify and strengthen the rights of private-sector creditors and encourage the financing of high-growth service innovators with few tangible assets, including through loan securitisation; and the creation of a single European insolvency regime for banks, at least those that are subject to the direct authority of the SSM and SRM, in order to fulfil the promise of a genuinely 'single' resolution regime as an alternative to insolvency. Both would be long-term endeavours, requiring close cooperation with your colleague for justice. We believe both would merit inclusion among your strategic priorities.

The new EU institutional landscape

Resist lure of micromanagement

The new reality is one of multiple financial authorities at the EU level. You should not view yourself as the master of them all, but rather as the guardian of their effective functioning and workable delineation of responsibilities. Avoid undermining the ESAs by unduly rejecting or amending their draft standards. Champion their reform and better align their governance with the European public interest, without trying to impose the same framework on all three. In particular, the EBA's governance should be further revised to make it a more neutral mediator of possible differences, especially between the SSM/SRB and the Bank of England or Swedish authorities. ESMA should be empowered to enforce consistent IFRS implementation across the EU, as noted above, and its scope should also be gradually expanded to directly supervise more wholesale infrastructure players, such as clearing houses and audit networks with a pan-European reach.

External realignment

Lead by example

The EU's position on global financial policy needs clarification, both on compliance and representation. The EU's interest is to reclaim its standing as a champion of global standards, by correcting the CRR to make it fully compliant with Basel III, by resisting calls for a financial reporting path separate from IFRS and removing the EU's decade-long deviation from IFRS on financial instruments accounting, and by even-

The new reality is of multiple EU-level authorities: don't try to be master of them all

tually revising the BRRD to adapt it to the FSB's future common bank resolution framework. As for representation, you should ensure that the EU is properly represented by the best qualified agency in all relevant global bodies. This need not be the Commission in all cases. The ECB and EBA should become full members of the BCBS, where they are currently observers, and you may also let ESMA replace the Commission on the IFRS Foundation's Monitoring Board. You should also exercise restraint in defending the status quo when it comes to the additional representation of individual EU countries in such bodies, which is being made gradually redundant by European-level representation. Finally, you could defuse the current tension surrounding the Transatlantic Trade and Investment Partnership negotiations by accepting that international financial regulation has become a global public good rather than a transatlantic preserve, and favour more engagement of large emerging economies in the global standard-setting process.