

The Regulatory Response of the European Union to the Global Financial Crisis

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Introduction

The global financial crisis that erupted full force in late 2008 challenged the existing architecture of financial services regulation and supervision. The European Union (EU) was severely affected by the crisis, prompting an intense regulatory debate on the revision of existing rules and the adoption of new regulatory measures in the EU. This chapter outlines the EU's regulatory response to the global financial crisis, asking whether it represents a major break from the past, as might be expected following the most severe financial crisis since the Great Depression, or whether it is an incremental adjustment.

The EU's response to the global financial crisis is an important research topic for three main reasons. First, the EU has devoted considerable efforts to the completion of the single financial market in Europe following the Financial Services Action Plan (FSAP) in 1999 (Commission 1999). After the Plan was completed in 2004, it was agreed that there would be a "regulatory pause," the focus shifting to implementation and monitoring (Commission 2004). However, in the aftermath of the global financial crisis, the EU has made a series of regulatory changes. Second, EU rules to a large extent provide the framework for national regulatory changes in the member states. Third, the EU is one of the largest jurisdictions in the world; it is increasingly active in shaping global financial rules in international forums, as argued in the section on "Reform of the financial services," and it is one of the main interlocutors of the United States in the policy debate on this subject (Posner 2009).

This chapter begins with an overview of financial market integration and regulation in the EU prior to the global financial crisis. The section that then follows outlines the regulatory changes enacted or set in motion by the EU in the aftermath of the crisis. The focus here is on the medium to long-term response, hence primarily the legislative measures proposed or adopted by the EU, rather

than its short-term crisis management measures. The next section provides an overall assessment of the EU regulatory response to the global financial crisis, teasing out the most prominent features and the main drivers of and the opponents to the EU regulatory reforms. It is argued that the reforms enacted by the EU since 2008 constitute a series of incremental changes rather than path-breaking reform. The changes carried out were those that were politically feasible given the compounded polity of the EU and the complex multi-level governance of financial services, rather than “first best” solutions to the problems at hand.

An overview of financial market regulation in the EU prior to the crisis

In the run up to the final stage of Economic and Monetary Union (EMU) and in the first decade after the introduction of the euro, the pace of financial market integration quickened and financial services governance underwent significant changes in the EU. This process was driven by the Commission (Jabko 2006; Posner 2005) and was actively advocated by an increasingly powerful transnational financial industry (Van Apeldoorn 2002; Bieling 2003; Mügge 2010). From the early 2000s onwards, the completion of the single financial market was achieved through a set of legislative measures outlined in the FSAP. These measures aimed mainly at maximum harmonization and focused primarily on securities markets and insurance (Ferran 2004). Subsequently, attention shifted to post-trading,¹ in particular payment services and clearing and settlement of securities (Quaglia 2009). In the same period, new accounting rules were agreed by the EU, basically adopting the international standards issued by the International Accounting Standards Board (IASB) (Leblond 2011; Véron 2007).

The completion of the single financial market was facilitated by the reform of the framework for financial regulation and supervision in the EU in the early 2000s, when the so-called Lamfalussy reforms were enacted in banking, securities markets and insurance (Mügge 2006; Quaglia 2007). Basically, the main innovation introduced by the Lamfalussy reforms was the fact that implementing measures of level 1² financial services legislation were to be adopted by the

1 After a trade is complete, it goes through post-trade processing, whereby the buyer and the seller verify the details of the transaction, approve it, exchange records of ownership, and transfer securities and cash.

2 The Lamfalussy architecture was articulated across multiple institutional levels. At level 1, the EP and the Council co-decided framework legislation (mainly directives) proposed by the Commission. At level 2, the implementing measures (generally directives, less frequently regulations)

Commission through the “comitology” process, which involved committees of member state representatives (the so-called level 2 committees). Committees of national regulators were established to advise the Commission on the adoption of legislative measures (the so-called level 3 committees). They also had implementation tasks and could adopt non-legally binding standards and guidelines (Coen/Thatcher 2008; Quaglia 2008). These committees were the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of Insurance and Occupational Pension Supervisors (CEIOPS).

In the making of EU financial services regulations prior to the crisis, the United Kingdom (Posner/Véron 2010) and the most competitive part of the financial industry (Mügge 2010) were highly influential for a variety of reasons. To begin with, the United Kingdom and the United States hosted the main global financial centers and had a large financial industry, in particular when compared to the rest of the economy (especially in the United Kingdom; Macartney 2010). Their policymakers therefore had widely recognized financial expertise and were regarded as providing state-of-the-art regulation. Moreover, British policymakers invested a considerable amount of technical and human resources in order to shape the regulatory debate in the EU. Interviews conducted by the author prior to the crisis suggest that British policymakers were on average very well briefed about the financial dossiers under discussion in Brussels and eager to lead the negotiations.

In addition, the United Kingdom and the United States hosted large banks that had the resources to lobby policymakers domestically and internationally (Baker 2010; Helleiner 2010). For example, the Basel Committee on Banking Supervision (BCBS), which is the international standard-setting body in the banking sector, consulted extensively on the so-called Basel II accord (BCBS 2004) that set international capital requirements for banks (see Goldbach/Kerwer in this volume). The Committee received more than 200 responses to its consultation documents, two-thirds of which were from industry, mainly from financial institutions located in the United States and the United Kingdom. The European Commission also consulted on the incorporation of the Basel II rules into EU legislation: the Capital Requirements Directive (CRD). In this case, too, there was a large response from financial institutions located in the United Kingdom.

of the level 1 framework legislation were adopted by the Commission through the comitology process, which involved the so-called level 2 committees of member state representatives. At level 3, the committees of national regulators (the level 3 committees) advised the Commission on the adoption of level 1 and level 2 measures and adopted level 3 measures, such as non-legally binding standards and guidelines.

The reform of financial services regulation in the EU after the crisis

A host of new regulatory initiatives were undertaken by the EU in the aftermath of the global financial crisis, besides the short-term crisis management measures adopted in the midst of the turmoil (Quaglia et al. 2009). These changes are summarized in Table 1, which outlines the list of new rules introduced or substantially amended and their content. The EU's actions that did not result in "hard" legislative measures, such as recommendations on managers' remuneration (Commission 2009) and the communication regarding a new EU framework for crisis management in the financial sector (Commission 2010), are not examined because they are not legally binding.

Deposit and investor guarantee schemes

As far as banking is concerned, the global financial crisis brought into the spotlight the inadequacy of the existing Deposit Guarantee Scheme (DGS) Directive, dating back to 1994. This directive set the minimum level of deposit protection schemes in the EU to 20,000 euros per depositor. When the crisis broke out, the depositor protection coverage ranged from 20,000 euros in the new member states and the United Kingdom to more than 100,000 euros in Italy and France. Moreover, uncoordinated decisions on deposit guarantees taken by the member states worsened the crisis. The most notable case was that of depositors in the United Kingdom who moved their money from British banks to branches of Irish banks in the United Kingdom when Ireland unilaterally introduced an unlimited deposit guarantee in October 2008. This caused a severe draining of liquidity away from the British banks.

At the peak of the crisis, the Commission proposed legislative changes concerning the DGS Directive. These changes, which were hastily agreed in 2009, represented an emergency measure designed to restore depositors' confidence by raising the minimum level of coverage for deposits from 20,000 euros to 50,000 euros subsequently to 100,000 euros. The need for swift action meant that several open issues were not tackled and hence the Directive contained a clause providing for a broad review of all aspects of DGSs. In July 2010, the Commission put forward a legislative proposal on Deposit Guarantee Schemes for banks with a view to addressing the remaining issues (Commission 2010b). As of August 2011, the negotiations between the Council and the EP had not been concluded.

The proposed directive contains measures for the harmonization of coverage and the simplification of arrangements for payout. The payout period is reduced from three months to seven days. In order to facilitate the payout pro-

Table 1 Overview of the EU's regulatory response to the global financial crisis

Regulatory change in the EU: – new rules introduced – existing rules amended – institutions established or reformed	Content of new or amended rules
<i>Banking</i>	
Deposit Guarantee Scheme (DGS) directive amended (October 2008)	Minimum level of coverage for deposits increased; payment time reduced
Proposal for new DGS directive (July 2010)	Harmonization of coverage and simplification of payout
Capital Requirements Directive (CRD) III amended (2008–10)	Higher capital requirements on trading book and securitization; sound remuneration practices
CRD IV to be proposed in summer 2011, following Basel III (December 2010)	Redefinition of capital, higher capital requirements, increase of risk weight for certain assets, leverage ratio, liquidity rules
<i>Securities and investment funds</i>	
Proposal for Investor Guarantee Scheme directive amendment (July 2010)	Minimum level of coverage for investor increased; payment time reduced
Regulation on Credit Rating Agencies (CRAs) (May 2009)	CRAs compulsory registration and compliance with rules concerning conflict of interest and quality of rating
Directive on Alternative Investment Funds Managers (AIFMs) (October 2010)	Legally binding authorization and supervisory regime for all AIFM, European passport for AIFMs
Proposed regulation on OTC derivatives, central counterparties and trade repositories (September 2010)	Reporting obligation for OTC derivatives to trade repositories, clearing obligation for standardized OTC derivatives through CCPs, common rules for CCPs and trade repositories
<i>Accounting</i>	
Commission Regulation adopting amended International Accounting Standards (October 2008); see also IASB revisions (October 2008)	Fair value not applied to certain banks' assets
IASB standards revision in progress	
<i>Institutional framework for regulation and supervision</i>	
Directives on ESRB and ESFS (December 2010), following the de Larosière Report (February 2009)	Transformation of level 3 Lamfalussy committees into European Authorities; creation of a European System of Financial Supervisors at micro-prudential level and of the European Systemic Risk Board dealing with macro-prudential oversight

cess in cross-border situations, the directive designates the host country DGS as a single point of contact for depositors at branches in another member state. The host country DGS would also be responsible for paying out on behalf of the home country DGS. In the preparation of the directive, which would have been legally binding for member countries, the Commission considered setting up a single pan-European scheme. However, it soon realized that there were complicated legal issues that needed to be examined and therefore the idea of a pan-European DGS was shelved for the time being. A report examining this issue will be presented by the Commission by 2014 (Commission 2010b).

The directive on DGS for banks (listed in Table 1) was part of a package on guarantee schemes in the financial sector, which also comprised a review of investor compensation schemes (listed in Table 1) and a White Paper on insurance guarantee schemes, all issued in July 2010. The Investor Compensation Scheme Directive, dating back to 1997, established a minimum level of compensation in cases where an investment firm was unable to return assets belonging to an investor. The Commission's proposal for a revision of this Directive raised the minimum level of compensation for investors from 20,000 euros to 50,000 euros per investor. The payout time was reduced to up to nine months (Commission 2010c).

Whereas in banking and securities specific directives on guarantee schemes had been adopted respectively in 1994 and 1997, this had not been the case in insurance. Only a few member states have insurance guarantee schemes. With a view to harmonizing consumer protection in this area, the Commission adopted a White Paper on Insurance Guarantee Schemes that envisaged the introduction of a directive establishing compulsory insurance guarantee schemes in all member states, subject to a minimum set of requirements (Commission 2010d). The White Paper was subject to public consultation (still pending at the time of writing in August 2011) with a view to a legislative proposal to be put forward by the Commission at a later date.

Capital requirements for banks and investment firms

The main reform enacted in the banking sector concerned rules on capital requirements. Prior to the crisis, international capital requirements were set by the Basel II accord agreed by the BCBS in 2004 (BCBS 2004). In the EU, the main elements of the Basel II accord had been incorporated into the CRD III³ in 2006. Various revisions of the CRD were carried out in parallel with the inter-

³ The first CRD was issued in 1993, incorporating the Basel I accord into EU legislation; in 1998, the CRD II incorporated the amendments of the Basel I accord; and in 2006 the CRD III incorporated the Basel II accord into EU legislation. Actually, what is generally referred to as CRD III includes two directives: Directive 2006/48/EC relating to the taking up and pursuit

national debate on this issue taking place in the BCBS. The revisions of the CRD in 2009 and 2010 set higher capital requirements on the trading book and re-securitizations; imposed stronger disclosure requirements for securitization exposures; and required banks to have sound remuneration practices that did not encourage or reward excessive risk taking (Commission 2009e). The scope of these changes, however, remained quite limited because a comprehensive revision of the Basel II accord was pending. The Basel III accord was eventually signed in December 2010 (see Goldbach/Kerwer in this volume).

The EU was represented in the BCBS by the European Commission, albeit with non-voting observer status, like the ECB. The central banks and the supervisory authorities of the G20 members, including nine EU member states, were full members of the Committee. Hence, the national authorities, as opposed to the EU authorities (namely, the Commission), were in the driving seat in the negotiations in Basel. An EU position, as such, was somewhat lacking, despite attempts by the Commission to coordinate the positions of the European members of the Committee (confidential interviews, June–July 2011). The balance of power shifted, however, once it was time to incorporate the Basel III accord into the CRD IV (discussed below), which was officially proposed by the Commission, after several rounds of consultation with the national authorities and industry.

The negotiations of the Basel III accord were characterized by a division between, on the one side, the United States, the United Kingdom, and Switzerland, which were keen to impose a stricter definition of capital as well as higher capital requirements (for more details see Goldbach/Kerwer in this volume). On the other side, continental European countries – first and foremost, Germany, France, and Italy – were reluctant to accept tighter rules. In part as a result of the state-led recapitalization in the wake of the crisis, the main British banks were relatively well capitalized when the Accord was negotiated. Hence they were likely to have few problems in meeting the new capital requirements set by the Basel III accord. By contrast, the banks in many continental European countries were undercapitalized for a variety of reasons: a lower degree of state-led recapitalization in the midst of the crisis, and other institutional features in place prior to the crisis (as in the case of the public banks in Germany, see Hardie/Howarth 2009). Furthermore, the impact of stricter capital requirements on lending to small and medium-sized enterprises was a major concern for continental European countries, which have a bank-based financial system, where banks provide funding to the real economy. This was less of a concern for the Anglo-Saxon countries that rely more on financial markets for corporate finance.

of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions.

After the Basel III accord was agreed internationally, the process of incorporating it into EU legislation began in earnest. The main difference between the Basel III and the proposed EU legislation are that the former is not a law, but an international “gentlemen’s agreement” between supervisors and central banks. Hence, it has to be transposed into EU (and national) law in order to become legally binding. The Basel III accord applies to “internationally active banks,” whereas EU legislation applies to all banks (more than 8,000), as well as to investment firms in the EU. These differences had to be taken into account when transposing the Basel III accord into EU law.

In July 2011, the Commission adopted a legislative package designed to replace the CRD III with a directive that governs access to deposit-taking activities (Commission 2011b) and a regulation that establishes prudential requirements for credit institutions (Commission 2011c) – this package is often referred to as the CRD IV. After its approval, the proposed directive will have to be transposed in the member states in a way suitable to their own national environment. It contains rules concerning the taking up and pursuit of the business of banks, the conditions of freedom of establishment and freedom to provide services, and the definition of competent authorities. The directive also incorporates two elements of the Basel III accord, namely the introduction of two capital buffers on top of the minimum capital requirements: a capital conservation buffer identical for all banks in the EU and a countercyclical capital buffer to be determined at national level. Capital requirements are instead set by the regulation which, unlike the directive, will not have to be transposed by the member states and will be immediately applicable.

The proposed EU rules contain prudential requirements for credit institutions and investment firms. It covers the definition of capital, whereby the proposal increases the amount of own funds that banks need to hold as well as the quality of those funds. It introduces a Liquidity Coverage Ratio, the exact composition and calibration of which will be determined after an observation and review period in 2015. It also proposes a leverage ratio subject to supervisory review. Furthermore, the proposal set higher capital requirements for OTC derivatives that are not cleared through CCPs. The use of a regulation which, once approved, is directly applicable without the need for national transposition is designed to ensure the creation of a single rule book in the EU. The regulation eliminates one key source of national divergence. For example, in the CRD III, more than 100 national derogations (differences in national legislation transposing the EU directive) remained.

During the EU negotiations, some of the compromises controversially reached in the BCBS unraveled. Hence the EU is an important arena for setting capital requirements, but because of its implementation power rather than be-

cause of its unitary action in the BCBS (as argued above, this was not the case). For example, under the Basel III accord, capital instruments for companies that can issue ordinary shares may comprise only “ordinary shares” that meet certain strict criteria. The EU proposal does not restrict the highest quality form of capital only to “ordinary shares.” However, it takes the same approach as the Basel III accord by imposing the same strict criteria that any instrument would have to meet to qualify as capital. This EU “adaptation” of Basel III rules was required because non-joint stock companies such as mutuals, cooperative banks, and savings institutions, do not issue ordinary shares (interviews, July 2011).

The European Parliament called for the taking into account of “European specificities” in incorporating the Basel III rules into the CRD IV. Hence, MEPs argued in favor of counting minority stakes towards equity capital, a looser definition of assets that could be included in liquidity buffers, and rules to ensure that mutually owned and cooperative lenders (common in some continental member states) were not disadvantaged. All these issues had caused friction within the BCBS and were reopened during the EU negotiations of the CRD IV. The EP was also keen to ensure an “international level playing field.” Of particular concern was the fact that in the United States, the Basel III accord would be applied only to internationally active banks, whereas the new rules will be applied to all banks in the EU; the United States had not yet fully applied Basel II (EP 2010).

Regulating credit rating agencies

In the securities sector, Credit Rating Agencies (CRAs) were singled out among the main culprits of the crisis for failing to rate financial products properly (Brunnermeier et al. 2009). They substantially overrated many complex securities created through the financial activity of securitization and were slow in revising their ratings once market conditions deteriorated. The overgenerous rating of securities was influenced by the strong competition between CRAs to attract clients and by conflicts of interest because CRAs provided a variety of other services to the potential issuers requiring rating. Hence, they had strong incentives to be generous in their assessment of creditworthiness.

Prior to the crisis, CRAs were regulated internationally by a voluntary Code of Conduct Fundamentals issued by IOSCO in 2004 (IOSCO 2004) and revised in the wake of the crisis (IOSCO 2008). The compliance of CRAs with the Code had been monitored in the EU by the CESR which, prior to the crisis, had opposed the idea of specific EU rules for CRAs, opting in favor of the IOSCO “soft” (non-legally binding) rules. After the crisis, the CESR issued a report on CRAs (CESR 2008) which, like its previous report (CESR 2005), continued to

support market-driven improvement, considering the revised IOSCO Code as the standard to regulate CRAs. A second report commissioned by the Commission by the European Securities Markets Experts (ESME)⁴ also warned against the introduction of legislation in the EU. Echoing the concerns of the CESR, the ESME concluded that,

Given the global nature of the business of CRAs and the existing US law, we have doubts as to whether the development of a separate EU law would produce any particular benefits. We think it is important that CRAs are subject to a global approach to their business [...] regulatory cooperation in this sphere is essential to avoid duplication of effort. (ESME 2008)

The French presidency of the EU in the second semester of 2008 implicitly made EU legislation on CRAs one of its priorities. The European Council called for a legislative proposal to strengthen the rules on credit rating agencies and their supervision at EU level in October 2008 (Presidency Conclusion 2008). Influential MEPs supported the regulation of CRAs in the EU. Indeed, the EP produced two reports that discussed this matter (EP 2007, 2008). The (revised) IOSCO Code provided the benchmark for the Commission's draft regulation on CRAs (Commission 2008a, b). However, the Commission argued that the IOSCO rules needed to be made more concrete and be backed by enforcement.

CRAs initially opposed the idea of EU rules on rating. Subsequently, they focused their lobbying activities on the amendment of certain parts of the proposed legislation that were seen as too prescriptive, such as the requirements that regulators should gather information about the model used by CRAs, the quality of people employed and so on. This criticism was also shared by countries that have traditionally been in favor of light touch, principle-based regulation, as evidenced by the response to the Commission's consultation from the British Treasury, the Swedish Finance Ministry, the Finnish Finance Ministry as well as the main CRAs, namely Standard & Poor's, Moody's, Fitch, and AM Best.

The regulation on CRAs was agreed relatively quickly by the EU in less than a year. According to the new rules, all CRAs whose ratings are used in the EU need to apply for registration there and have to comply with rules designed to prevent conflict of interest in the rating process and to ensure the quality of their rating methodology and ratings. CRAs operating in non-EU jurisdictions can issue ratings to be used in the EU provided that their countries of origin have a regulatory framework recognized as equivalent to the one put in place by the EU, or that such ratings are endorsed by an EU-registered CRA (Council of Ministers and European Parliament 2009b).

⁴ This group was set up in 2006 to advise the Commission on European securities markets legislation. Its members come mainly from the financial industry.

The issue of equivalence was particularly controversial. Many policymakers (the EP was vocal on this, see EP 2008, 2009) felt that a mechanism was needed to recognize third-country regulation of CRAs as “equivalent” to the EU, with a view to facilitate the use in the EU of the ratings issued by CRAs located outside the EU. After extensive lobbying, first and foremost by the British authorities, who were worried about the negative effects that this could have for the financial instruments traded in the City of London, the regulation agreed in April 2009 contained provisions for an equivalence mechanism to be operated by the Commission.

In the end, some concerns remained as to whether the EU rules were fully in line with the IOSCO Code and the US legislation on CRAs, which was also revised in the wake of the crisis. This is an important issue because the main CRAs operating in the EU are headquartered in the United States and are therefore subject to US law. At the same time, the EU rules on equivalence could have implications for regulation in the United States. The main difference between the IOSCO Code and the US and EU legislation is that the former is not (nor could it be) legally binding, whereas US and EU laws are legally binding. The US and EU laws prescribe distinctive processes of registration for CRAs in their respective jurisdictions, unlike the IOSCO rules, which do not envisage the registration of CRAs.

In June 2010, the Commission proposed an amendment of the regulation on CRAs adopted in 2009. Since ratings issued by a CRA can be used by financial institutions throughout the EU, the Commission proposed a more centralized system for supervision of CRAs, whereby the newly created European Securities and Markets Authority was entrusted with exclusive supervisory powers over CRAs registered in the EU, including European subsidiaries of US headquartered CRAs, such as Fitch, Moody and Standard & Poor. The ESMA was given powers to request information, to launch investigations, and to perform on-site inspections. The amended Regulation was adopted by the Council and the EP in May 2011 (Council/EP 2011). In the summer 2011, the downgrading by the (mainly US-headquartered) CRAs of the government bonds in the countries directly hit by the sovereign debt crisis gave new momentum to the debate on the creation of the European rating agency, a proposal that was put forward by the EP (2011).

Regulating alternative investment fund managers

Prior to the financial crisis, in policy discussions in international forums, two different approaches could be detected concerning the regulation of hedge funds: one in favor of regulation, sponsored by Germany and France, and one resisting

regulation, championed by the United States and the United Kingdom (Fioretos 2010). During preparations for the April 2009 G20 summit, the split over how to regulate hedge funds re-emerged. Several European countries, led by France and Germany – as suggested by the Sarkozy's and Merkel's joint letter (2009) – with the support of Italy, pushed for a tougher regulatory regime for hedge funds and wanted the funds to be overseen similarly to banks. By contrast, the US and UK authorities favored more disclosure over more regulation (*Wall Street Journal*, March 14, 2009). The G20 agreed “to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include, for the first time, systemically important hedge funds” (G20 2009). This was seen as a victory for the continental call for hedge fund regulation.

The attempt to regulate hedge funds in the EU was given new momentum by the financial crisis (for a more comprehensive account, see Woll in this volume). In June 2009, the European Commission presented its proposal for the draft directive on AIFMs, which included managers of hedge funds, private equity funds and real estate funds, hence covering quite a broad range of financial entities. After intense lobbying from industry, the United States and the United Kingdom, the draft directive was partly revised during the Swedish presidency⁵ of the EU in the second semester of 2009. The main opponents of the directive on AIFMs were the UK and the hedge fund industry, which is based mainly in London. During the consultation phase, they opposed the prospect of EU rules on hedge funds. Once the directive was proposed by the Commission, they focused their criticisms on certain provisions of the draft directive. In the EP, the Socialists called for hedge fund regulation before and after the financial crisis.

An agreement between the Council of Ministers and the EP was eventually reached in late October 2010, and the directive is due to enter into force in 2013. It introduces a legally binding authorization and supervisory regime for all AIFMs in the EU, irrespective of the legal domicile of the alternative investment funds managed. Hence, AIFMs will be subject to authorization from the competent authority of the home member state and to reporting requirements of systemically important data to supervisors. The directive sets up a European passport for AIFMs. Hence, an AIFM authorized in its home member state will be entitled to market its funds to professional investors in other member states, which will not be permitted to impose additional requirements (Council of Ministers and European Parliament 2011).

⁵ Sweden has a significant private equity industry, hence it was seen as having a vested interest in the revision of the text of the Directive.

Regulating over-the-counter derivatives

Prior to the global financial crisis, a large number of derivatives were traded over-the-counter (OTC), not through stock exchanges, and were not cleared through central counterparties (CCPs). Derivatives trading on stock exchanges increases transparency and central counterparties reduce counterparty risk (that is, the risk of default by one party to the contract), so that the default of one market participant would not cause the collapse of other market players, thereby putting the entire financial system at risk. The OTC derivatives comprise a wide variety of products (interest rates, credit, equity, foreign exchange and commodities) with various characteristics. They are used in a variety of ways, including for purposes of hedging, investing, and speculating. OTC derivatives account for almost 90 percent of derivatives markets. The default of Lehman Brothers and the bail out of AIG highlighted the need to obtain more reliable information on what goes on in the OTC derivatives market, which in the past remained outside the perimeter of regulation.

In September 2009, the G20 Pittsburgh Summit agreed that “all standard OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.” Furthermore, they acknowledged that “OTC derivative contracts should be reported to trade repositories and that non-centrally cleared contracts should be subject to higher capital requirements” (G20 2009). In the United States, this issue was dealt with in the Dodd-Frank reform package. The EU moved almost in parallel with the United States. The EP issued a resolution on June 15, 2010 on “Derivatives markets: future policy actions” (EP 2010), which called on the Commission to “use a differentiated approach to the many types of derivative products available, taking account of differing risk profiles, the extent of usage for legitimate hedging purposes, and their role in the financial crisis.” It also called for a “ban on CDS transactions [...] which are purely speculative.” The Commission issued a series of communications on this matter, arguing that there had been “a paradigm shift away from the traditional view that derivatives are financial instruments for professional use and thus require only light-handed regulation” (Commission 2009f). Commissioner Barnier also stressed the importance of EU–US convergence on the regulation of derivatives markets.

In September 2010 the European Commission proposed a regulation on OTC derivatives, CCPs, and trade repositories. This measure, which at the time of writing (August 2011) is under discussion, envisaged reporting obligations for OTC derivatives to trade repositories; clearing obligations for standardized OTC derivatives through CCPs; and common rules for CCPs and trade reposi-

tories. To be authorized, a CCP would have to hold a minimum amount of capital. Trade repositories would have to publish aggregate positions by class of derivatives, offering market participants a clearer view of the OTC derivatives market. The European Securities and Markets Authority (ESMA) would be responsible for the surveillance of trade repositories and for granting and withdrawing their registration. In order to be registered, trade repositories must be established in the EU. However, a trade repository established in a third country can be recognized by ESMA if it meets a number of requirements designed to establish that such a trade repository is subject to equivalent rules and appropriate surveillance in that third country. Interestingly, the regulation also foresees the need to conclude an international agreement to that effect and stipulates that if such an agreement is not in place a trade repository established in that third country would not be recognized by ESMA. CCPs in third countries would be able to operate in the EU subject to equivalence clause (Commission 2010e).

Prior to the crisis, the United Kingdom and the United States had opposed any regulation of derivatives markets (Helleiner/Pagliari 2010). After the crisis, when the Commission consulted on the proposed regulation on derivatives, the UK authorities raised objections to forcing “standardized” OTC derivatives contracts into clearing houses, whereas the Nordic countries were critical of measures contained in the regulation designed to prevent short selling (*Financial Times*, December 17, 2009), a feature that was strongly supported by France and Germany.⁶

Accounting standards

As far as accounting is concerned, the crisis reopened the never settled divide between the (mainly Anglo-Saxon) supporters of mark-to-market accounting, and those criticizing it, primarily in continental Europe (Donnelly 2010; Posner 2010). It also reopened the debate on the governance of the IASB. The EU partly succeeded in its long-standing goal of increasing its influence in the governance of the IASB, whereby the Commission was given observer status in the newly created Monitoring Board of the IASB (for a more detailed account see Lagneau-Ymonet/Quack in this volume).

As a response to the crisis, the EP, the Commission, and policymakers in France and Germany urged the IASB to limit the use of mark-to-market accounting (Nölke 2010). The IASB waived its due process procedures and amended its standards, allowing banks to reclassify financial instruments from the trading book (subject to mark-to-market valuation) to the banking book

⁶ Germany unilaterally and controversially banned short selling as the crisis unfolded.

(subject to historical costs). Shortly afterwards, the Commission endorsed the amended standards (Commission 2011a). Other amendments concerning the valuation of collateralized debt obligations and impairment rules were undertaken by the IASB following its due process, but with strong political pressure from the EU authorities.⁷ Despite having urged the IASB to amend its standards, once the IASB did so, the Commission did not approve them. Reportedly, this was due to the resistance of French, German, and Italian banks and politicians in these countries to the new rules, which would have led to significant losses in their derivative portfolios (Bengtsson 2011).

Reforming the institutional framework for regulation and supervision

The global financial crisis triggered the reform of the EU framework for financial regulation and supervision. The crisis revealed the weaknesses of existing macro-prudential oversight in the EU and the inadequacy of nationally-based supervisory models in overseeing integrated financial markets with cross-border operators. It exposed shortcomings in the consistent application of Community law (the lack of a European rule book), as well as insufficient cooperation between supervisors in exchanging information and in crisis management (de Larosière Group 2009). In 2009, a group of high level practitioners and financial experts, chaired by the former governor of the Banque de France, produced a report on the issue, which was named after the chair of the group. Building on the de Larosière Report, in September 2009, the Commission put forward a series of legislative proposals for the reform of the micro- and macro-prudential framework for financial supervision in the EU. The Commission proposals were eventually agreed by the Council and European Parliament in autumn 2010 and were implemented in early 2011.

The main institutional innovations were the establishment of the European Systemic Risk Board, its chair to be elected by and from among the members of the General Council of the ECB and in charge of monitoring macro-prudential risk; the transformation of the so-called level 3 Lamfalussy committees (discussed in the second section on the overview of financial markets) into independent authorities with legal personality; an increased budget and enhanced powers. The newly created bodies – namely the European Banking Authority, the European Insurance and Occupational Pension Authority, and the European Securities Markets Authority – were charged with the tasks of coordinat-

⁷ For example, the Commission wrote several letters to the IASB on this issue, to which the IASB responded. The Chair of the IASB also appeared before the Council of Ministers to discuss the matter.

ing the application of supervisory standards and promoting stronger cooperation between national supervisors.⁸ Nonetheless, the new agencies have limited competences and it remains to be seen whether they will be able to regulate the financial sector effectively.

In the negotiations on these institutional reforms, disagreements arose in the Council and between the Council and the EP concerning the powers of the newly created bodies, as well as the role of the EP in the proposed architecture. In the Council, there were (mainly British) concerns about giving the new authorities powers over national regulators and the possibility of supervising individual financial cross-border institutions (*European Voice*, March 4, 2009; April 6, 2009). Besides the United Kingdom, Ireland and Luxemburg were also reluctant to transfer powers away from national supervisors to bodies outside their borders (*Financial Times*, March 20, 2009; Buckley/Howarth 2010). Moreover, the UK government was reluctant to grant decision-making powers to EU-level bodies while public funds to tackle banking crises came from national budgets. To this effect, Gordon Brown, the British Prime Minister, secured a guarantee that the new supervisory system would not include powers to force national governments to bail out banks. The United Kingdom also stressed that the EU's supervisory architecture should fit in with global arrangements and should support the development of "open, global markets" (Darling 2009). That said, a number of member states, particularly those with large financial centers – namely the United Kingdom, France, and Germany – favored the limited reform approach and were hesitant about transferring substantive power to the EU level (Buckley/Howarth 2010). This led to a significant reduction in the scope of the Commission proposals during the negotiations in the Council.

By contrast, the EP argued that the Commission's proposals did not go far enough and was adamant that the powers of the ESAs should be safeguarded and its own oversight role enhanced. Hence, the EP called for the strengthening of the financial and human resources available to the ESAs. It also called for the presidency of the ESRB to be given to the president of the ECB, so as to augment the authority of this newly created body. MEPs inserted provisions to enable the ESRB to communicate rapidly and clearly. They defended the powers of ESAs to take decisions that are directly applicable to individual financial institutions in cases of manifest breach or non-application of law, and where there is disagreement between national authorities. The EP was keen for the ESA to be able to temporarily prohibit or restrict harmful financial activities or

⁸ The Commission also proposed a directive amending the existing directives in the banking, securities and insurance sectors and a Council Decision entrusting the ECB with specific tasks in the functioning of the ESRB.

products already covered by specific financial legislation or in emergency situations (*Financial Times*, July 2010). On all these issues, the EP was able to get what it wanted.

The question of which authority (the Council, the EP and the Commission) has the power to call an emergency in the EU's banking sector was a major point of contention. However, in the end the Council – hence national governments – retained the sole power to declare a crisis. The EP was also unsuccessful in arguing that the three authorities should be located in the same city, Frankfurt, for efficiency reasons (EurActive 2010). However, they secured the inclusion of a review clause requiring the Commission to report back every three years on whether it is desirable to integrate the separate supervision of banking, securities, pensions, and insurance; on the benefits of having all the ESAs headquartered in one city; and on whether the ESAs should be entrusted with further supervisory powers, notably over financial institutions with pan-European reach. As far as accountability is concerned, the EP was given the power to veto the appointment of ESA chairs. Indeed, in February 2011 the EP postponed its decision on the proposed candidates for the European supervisory authority chairmen on the grounds that it needed more guarantees from the Commission and the member states regarding the independence of all senior executives of the authorities, appropriate budgetary and human resources, and an improved personnel selection procedure. Moreover, the ESRB President is to keep the chair and vice-chairs of the EP's Economic and Financial Affairs Committee updated on ESRB activities through confidential discussions.

An overall assessment

In the aftermath of the worst financial crisis since the 1930s, the EU embarked on a significant revision of its financial services regulation. It is not easy to evaluate regulatory reform in the EU (as elsewhere) in the wake of the crisis. Analytically, it is difficult to identify measurement standards or benchmarks against which to assess such a reform. Practically, many of the new measures adopted have still to enter into force. Hence, necessarily, this assessment is provisional.

Three main features of the regulatory measures adopted or officially proposed by the EU stand out. First, the reforms enacted either regulated activities or financial institutions that were previously unregulated in the EU and its member states (CRAs), or at the EU level (AIFMs), or at the national, EU and international level (OTCDs). In other instances, they imposed heavier, more prescriptive and more burdensome requirements on financial entities that were

already regulated prior to the crisis, as in the case of higher capital requirements for banks and new liquidity management rules (Basel III), or they put in place more substantial protection for depositors (the DGSD). That said, several key controversial issues, such as the problem of financial institutions too big to fail⁹ and the management of cross-border banking crises, were not addressed, even though the Commission is likely to come forward with proposed legislation on an EU framework for crisis management in the financial sector later in 2011 (Commission 2011a).

Second, although with some notable exceptions, the new or amended rules were generally resisted by the UK, Ireland, Luxemburg, and a variable mix of Nordic countries, depending on the specific legislative measures under discussion, as well as by the actors representing the country (head of state, minister, ambassador). These were the main members of what Quaglia (2010a, b) identified as the “market-making” coalition, which prior to the financial crisis called for a market-friendly approach to financial regulation in the EU. The market players primarily affected by the new or revised rules, such as CRAs and AIFMs, initially resisted the proposed rules. Subsequently, they engaged in intense lobbying with a view to having the proposed rules amended on the grounds that they would be over-prescriptive and costly to implement, creating potential regulatory arbitrage vis-à-vis countries outside the EU. This argument was also used by banks that lobbied on certain aspects of the Basel III Accord and the CRD IV. The concern about international “regulatory arbitrage” has traditionally been at the forefront of British policymakers’ minds, given the fact that London is a leading financial center which hosts many non-British owned financial institutions and successfully competes with other financial centers worldwide to attract business (interviews, London, May 2007; July 2008).

A somewhat special case was the revision of the Basel II Accord, which resulted in the Basel III Accord, as well as the parallel revisions of the CRD. Despite the fact that banking regulation and integration is fairly advanced in Europe (the first banking directive dates back to 1977), the EU was deeply divided in the negotiations on the Basel III accord. The United Kingdom favored strict new rules on capital requirements, whereas France, Germany, and Italy called for “softer” rules and a longer transition period. As explained in the third section on the reform of financial services, this had much to do with domestic political economy considerations related to the existing low level of bank capital and the banking–industry link on the Continent.

⁹ Shortly before the Bank of England took over banking supervision, Governor Mervyn King controversially called for the breaking up of the big banks. He also remarked that “if a bank is too big to fail [...] it is simply too big” (The Guardian, June 17, 2009).

By and large, the new or revised rules, as well as the reshaped institutional framework were actively sponsored, or at least strongly supported, by France, Germany, Italy, Spain, and the EP (especially, the Socialist groups). These were the members of what Quaglia (2010a, b) identified as the “market-shaping” coalition which was active in the making of EU financial regulation well before the financial crisis. The proposed EU measures were seen as necessary to safeguard financial stability and protect investors. Some of the proposed rules, such as those concerning AIFMs, CRAs and OTCDs, also embodied the deeply ingrained Continental dislike of “casino capitalism” (Strange 1997), which was seen as serving the fortunes of the City of London (interviews, Berlin, April 2008; Paris, July 2007; Rome, December 2007; Madrid, March 2009; Lisbon, November 2008).

In the main continental countries, unlike in the United Kingdom, there was limited concern over potential international regulatory arbitrage, or rather they were keen for the EU to act as a pace-setter in international financial regulation. In their response to the Commission’s consultation on the proposed measures, many respondents – notably France and Germany – argued that “Europe should play an instrumental role in shaping a global regulatory regime” and that “an EU framework could serve as a reference for global regulation” (Commission 2009b: 8). Although, in the end, those resisting the new rules or parts of their content did manage to have the original legislative proposals amended, the very fact that the rules were proposed in the first place suggests that the balance of regulatory power has shifted in favor of a less market-friendly regulatory approach, which has at least temporarily gained ground in the EU (for a similar argument, see Posner/Véron 2010).

Internationally, the EU and the main member states have often played an important role in the debate on the reform of financial regulation. During the French presidency of the EU in the second semester of 2008, Nicolas Sarkozy argued that the G8 should be enlarged to include emerging economic powers such as Brazil, China, India, Mexico, and South Africa (Sarkozy 2008). In October 2008, the French President, accompanied by Commission President José Manuel Barroso held a meeting with US President George W. Bush, paving the way for the first summit of G20 leaders in Washington, DC in November 2008 (Hodson 2010). Since then, G20 Summits have been held in London and Pittsburgh in 2009, and in Toronto and Seoul in 2010. With the backing of the EU, the G20 has de facto replaced the G7 and G8 as the most important forum for international economic and financial cooperation.

Prior to the G20 summits, the EU attempted to coordinate its positions internally. For example, prior to the G20 summits in Washington and Pittsburgh the Council issued an “agreed language” (Council 2008, 2009b). The EU

also agreed on a (rather general) set of priorities prior to the G20 summit in London (Council 2009a). These meetings at the EU level were often preceded by bilateral or multilateral meetings of the main member states, in which the Franco-German alliance was prominent. Prior to the G20 summit in London, the French President and the German Chancellor sent a joint letter to the presidency of the EU, outlining their priorities for the G20 in London (Sarkozy/Merkel 2009). At that summit, several EU priorities were achieved. The decision to enhance the oversight of systemically-important hedge funds and credit rating agencies met European demands. The most overt success for France and Germany was the G20 stance on tax havens, even though the issue had not been included in the EU agreed language. There was no commitment to additional fiscal stimulus, which was vetoed by Germany, but supported by the United Kingdom and the United States. The United Kingdom, however, supported and achieved an increase in the IMF's financial resources. At the G20 in Pittsburgh the EU, France, and Germany in particular, called for and partly achieved rules on bankers' bonuses and exit strategies from fiscal stimuli (Hodson 2010).

With the exception of the Basel III Accord negotiated by the BCBS and accounting standards set by the IASB, the EU did not wait for international action and acted as a (limited) reform promoter in its own right. The regulation on CRAs is much more prescriptive than the IOSCO code, and so is the AIFM directive, whereas the report produced by IOSCO on hedge funds was not even able to agree on whether hedge funds or funds managers should be regulated. The issue of DGS was also discussed by the IMF; however, the EU issued legally binding legislation. At the G20 meetings, the EU and its member states often called for regulatory reforms, even if at times there were different priorities among the European members of the G20, as in the case of the tax havens.

Third, the pace of reform was somewhat piecemeal in the EU. This has partly to do with the interlocking mechanisms of policymaking in the EU, where there are several veto players. The main agenda-setter of the reform efforts was the Commission, which is the only body that can officially propose legislation in the EU. Of course, the Commission did so after consulting the member states informally and after holding open public consultations. In certain cases the Commission was spurred to act by initiatives of the EP, as in the case of CRAs, and by the market-shaping member states, as in the case of AIFM. The Council and the EP were the main decision-makers because they had the power to adopt or amend the legislation proposed by the Commission. Often, the member states had different priorities and they were worried about potential regulatory arbitrage with jurisdictions outside the EU. Lobbying from the financial industry, which was keen to limit the extent of regulatory change at the

national, EU, and international levels, watered down the proposed reforms in some cases, such as AIFM.

What is perhaps most remarkable in the politics of financial services regulation in the EU after the crisis is the political salience that the previously obscure topic of financial regulation has acquired. Prior to the crisis, financial regulation in the EU was mainly a “technical” policy area: there was very limited involvement of politicians and it was of marginal interest to the wider public. It was, however, an arena where the competing interests of the member states and the financial industry played out. After the crisis, heads of state and government, such as Sarkozy and Merkel, became interested in financial regulation, at times adopting populist stances to appease public opinion.

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