POLICY PAPER 87 12 MARCH 2013

# STRENGTHENING EU PRESENCE IN GLOBAL FINANCIAL REGULATION REFORM

Filippa Chatzistavrou | *Research Fellow, ELIAMEP*

Dimitrios Katsikas | *Research Fellow, ELIAMEP*

Yiannis Tirkides | *Senior Research Fellow, Cyprus Center for European and International Affairs (CCEIA)*

## SUMMARY

The institutionalisation and legalisation of the European financial governance will undoubtedly enhance the implementation of agreed regulations and improve supervision; moreover, it has the potential to strengthen the EU's voice by promoting a more unified and coherent external representation of its positions. However, this potential may not be realised unless such changes take into account the institutional characteristics of global financial governance, composed of a variety of organisations that often transcend the traditional public-private dichotomy. The EU should build on its experience in international accounting harmonisation by turning its ad hoc governance initiative with the International Accounting Standards Board (IASB) into a full-blown strategy in all areas of financial regulation. The generalisation of this strategy involves extending the recently established European Supervisory Authorities (ESAs) as institutional platforms to coordinate and represent European views in global financial regulatory negotiations, adapting them to newly added governance structures – namely the European banking supervisory authority – as well as complementing them with appropriate governance structures where this is needed.

This Policy Paper is part of a series entitled "Promoting EU economic interests abroad" which also includes contributions by Richard Youngs (FRIDE) and John Springford (CER), Paweł Świeboda (demosEUROPA), Jonas Parello-Plesner (ECFR) and Agatha Kratz (for ECFR), Daniela Schwarzer (SWP), Federico Steinberg (Real Instituto Elcano) and Diego Valiante (CEPS).

It is a contribution to the project "Think Global – Act European (TGAE). Thinking strategically about the EU's external action" directed by *Notre Europe – Jacques Delors Institute* and involving 16 European think tanks:

Carnegie Europe, CCEIA, CER, CEPS, demosEUROPA, ECFR, EGMONT, EPC, Real Instituto Elcano, Eliamep, Europeum, FRIDE, IAI, Notre Europe – Jacques Delors Institute, SIEPS, SWP.

Four other series of Policy Papers deal with key challenges on defence, EU neighbourhood, strategic resources and migration. The final report presenting the key recommendations of the think tanks will be published in March 2013, under the direction of Elvire Fabry (*Notre Europe – Jacques Delors Institute*, Paris).

# 1. Regulatory reform before and after the financial crisis

The financial crisis exposed a number of problems in the areas of public policy and international finance. In response, extensive legislative initiatives were undertaken in many jurisdictions, most notably in the US and the EU, as well as at the international level. This was often accompanied by a revamping of existing institutions such as the Basel Committee of Banking Supervisors (BCBS) or the introduction of new organisations such as the Financial Stability Board (FSB). These initiatives notwithstanding, in contrast to previous major crises, current financial regulatory reform has not resulted in a major paradigm shift in the area of international finance; changes have tended to be incremental and primarily aimed at closing regulatory loopholes, without questioning more fundamental aspects of the global financial system. This limited agenda is not likely to change given the gradual recovery of the global financial system and the sovereign debt crisis in the eurozone, which have shifted attention away from financial regulatory reform.

The Basel framework for banking supervision, perhaps the most important international financial regulatory framework, is a case in point. Between Basel I and Basel II the BCBS spent more than fifteen years trying to improve a prudential regime that eventually proved inadequate to protect both individual banking institutions and the financial system at large. The Basel framework was organised around the concept of value at risk, that is, the level of capital sufficient to limit the probability of collapse of an individual bank. However, the large number of banks that have experienced serious difficulties during the crisis demonstrates that banking risk was seriously underestimated by the Basel prudential framework.

> "BREAKING THE VICIOUS CIRCLE OF RECURRENT BANKING CRISES BY GIVING REGULATORY AGENCIES MORE POWERS"

Financial markets do not function efficiently during times of crisis. Consequently, it is important to define a regime specific to banking crises for which the rules of intervention of supervisors and public authorities are distinct from those prevailing in normal times. The only way of breaking the vicious circle of recurrent banking crises is to give regulatory agencies more powers to take charge of troubled banks before they really endanger the funds of their small depositors or the stability of the financial system. Prudential policy, on the other hand, should establish simple and verifiable criteria that would trigger the intervention of a supervisor. Solvency ratios, and, more generally, regulatory indicators, need to be simplified. What is needed is a series of simple and easily verifiable indicators that will point to those institutions that may experience problems.

Basel III, while retaining the framework of Basel II, tries to incorporate elements of this approach, including new liquidity and leverage ratios. Internationally, however, delays in implementation and deviations in the form of national exceptions are increasing, raising concerns about its effectiveness. In Europe too, the European Commission, the European Parliament and the Council are engaged in tough negotiations for the incorporation of Basel III in European law; the final compromise is likely to be well below the standard agreed at the BCBS, undermining further the credibility of this flagship international reform initiative.

On the institutional side, Europe is finally addressing its financial fragmentation. The crisis prompted Europe to take steps towards a comprehensive Pan-European regulatory framework from early on, including the establishment of a European Systemic Risk Board (ESRB) and three new independent pan-European agencies: a European Banking Authority, a European Insurance and Occupational Pensions Authority and a European Securities Authority. This framework is now being complemented by the decision of eurozone leaders at last October's summit to establish a Single Supervisory Mechanism (SSM) for banks. The process of setting up a fully-fledged banking union will take years to complete but the first steps have been agreed with the adoption of the Roadmap for the completion of EMU at the European Council meeting of 14 December 2012. The SSM will ultimately encompass all 6,000 eurozone banks; there will be a common bank recapitalisation policy, a single resolution mechanism and increased harmonisation of deposit guarantee schemes. It is scheduled to be operational by 2014.

The institutionalisation and legalisation of European financial governance will undoubtedly enhance the implementation of agreed regulations and improve supervision; moreover, it also has the potential to strengthen the EU's voice by promoting a more unified and coherent external representation of its positions. However, this potential may not be realised unless their design take into account the institutional characteristics of global financial governance.

## 2. Global financial reform: a case of soft law governance

Recent international regulatory initiatives launched since 2008 constitute a process of institutional reform and legalisation that remains largely based on network forms of public and private governance, and international soft law standards and rules. Most of the new agreements on bank regulation and supervision, derivatives, hedge funds and so on remain non-binding, reinforce private regulation and provide flexibility in enforcement and implementation at national level without delegating authority to a third party.

In general terms, the choice of merely soft law arrangements expresses the preference of states and regulators to implement standards and practices generated at the international level through informal consultations and negotiations. The interest in favouring soft law arrangements as an optimal instrument of governance can be explained by the fact that softer commitments reduce transaction and sovereignty costs. Non-binding norms, as a prime tool of compromise and learning, facilitate political bargaining and improve information sharing. In fact, soft law agreements reduce systemic risk in the international financial system while promoting competitive equality amongst financial institutions. Moreover, soft law arrangements leave decision-making authority to national bodies and can be incorporated into national law in a manner that respects national sovereignty.

However, the severity of the global financial crisis has increased, to some degree, the legalisation process in the area of international financial supervision with new forms of institutionalised governance. For example, hedge funds and derivatives transactions, previously self-regulated, were brought under the public international regulatory umbrella. In the case of the FSB, there have been signs of adopting a more restrictive regulatory framework. The FSB centralises policymaking authority in a single regulatory and standard-setting body with wider membership, including the G20 countries and the European Commission. Despite all this, the FSB is in an ambiguous position, due, among other factors, to conflicting interests among participating countries. Otherwise, the renewed global regime is still based on the exchange of information, the cooperation of national regulators and the coordination of regulatory activities in order to supervise the transactional activities of banks and other financial institutions. Therefore, international bodies have limited regulatory authority in general.

While the pace of interactions and changes in global financial governance is accelerating, the EU is called upon to act in these shifting circumstances. The challenge here is to develop reliable financial structures and instruments based on soft law and transnational governance within the highly formal institutional framework of European governance.

# 3. Regulatory coordination, bargaining and EU regulatory capacity

"MARKET POWER IS A NECESSARY BUT INSUFFICIENT CONDITION FOR SUCCESS IN INTERNATIONAL REGULATIONS NEGOTIATIONS"

In terms of market power – business volume and sophistication – European financial markets are a major force in the global financial system. More specifically, the European Union is one of the two most important jurisdictions in global finance (along with the United States). This market power would normally put the EU into a privileged position to influence the regulatory shakeup of the global financial sector. However, while market power is a necessary condition for success in international regulatory negotiations, it is not always a sufficient one, particularly when there is a divergence of regulatory preferences among the great economic powers. In such cases, institutional power – the ability to indirectly influence the agenda and work of international institutions – becomes a crucial negotiating tool. Recent scholarship has shown that domestic institutional regulatory arrangements can be a significant source of institutional power. More specifically, a jurisdiction's regulatory capacity, as well as the institutional complementarity and compatibility of its domestic regulatory framework with the institutional framework of the global regulatory regime represent significant institutional resources that can prove valuable negotiating tools. Regulatory capacity involves regulatory expertise, (the ability to identify regulatory challenges, develop policy solutions, implement them, and provide comprehensive monitoring), coherence of regulatory authority in a policy domain and the statutory sanctioning authority of regulators. Institutional compatibility refers to the institutional correspondence of the structures of regulatory coordination at one level of aggregation (domestic or regional) with those at a higher level of aggregation (international). Thus, there is institutional compatibility in a jurisdiction when, for example, its regulatory infrastructure includes a private standard-setting body which can participate in international standard-setting negotiations in an issue-area where regulatory coordination is dominated by a private organisation. Institutional complementarity on the other hand, denotes the institutional fit between domestic and international regulatory structures, that is, the degree to which specific institutional characteristics of domestic arrangements (e.g. hierarchical organisation with a single authoritative agency representing the national position) allow the efficient and effective participation of domestic regulatory agents in global negotiations. The latter two features are particularly important for private and other transnational, soft-law regulatory arrangements such as those that dominate the international financial regulatory landscape.

"TO A LARGE DEGREE, EU DIFFICULTIES IN INFLUENCING INTERNATIONAL NEGOTIATIONS STEM FROM A LIMITED REGULATORY CAPACITY"

To a large degree, the EU's difficulties in influencing international regulatory negotiations stem from a lack of these institutional resources at the regional level. In most areas of finance, EU regulatory capacity is limited. This is because regulatory coherence is restricted as EU agencies must share regulatory authority with national regulators, which typically also retain implementation responsibility and sanctioning authority. The recently established European Supervisory Authorities (ESAs) are a case in point. The ESAs are part of a complex structural development in which a highly invasive regulatory approach is combined with a decentralised supervisory structure. The ESAs' legal status is less ambiguous than that of the Lamfalussy process, but still quite hazy. The three ESAs are independent advisory bodies acting as umbrella organisations in the financial supervision of banks, stock markets and insurance companies. They are endowed with legal personality[1] and dispose of administrative and financial autonomy. Their tasks include legally-binding mediation between national supervisors, the provision of high regulatory and supervisory standards as well as the oversight and coordination of colleges and networks of supervisors. Exceptionally, they may take binding decisions in relation to individual financial institutions and be given further tasks in EU financial market legislation. It is clear that while ESAs contribute to the improvement of EU legal and regulatory design, a good part of the regulatory tasks remain in the hands of the national regulators acting in networks.

1. On the basis of Article 114 TFEU.

This fragmentation has led to the emergence of a European financial regulatory landscape comprising numerous organisations and agencies, at both the national and supranational levels, characterised by institutional divergence and overlap. How does this situation affect the EU's regulatory capacity to act within its borders and vis-à-vis international fora? There are two main implications. First, in the majority of global standard-setting bodies, public or private, the leading role is played by the national supervisory authorities, but the status quo of the EU's external representation varies. The European Commission (or one of the new European agencies) is invited to either participate officially without voting rights, meaning that the final decision does not depend on the EU's consent, or it has only observer status, as is the case with the transnational regulatory network of the BCBS, or the International Organisation of Securities Commissions (IOSCO). Even when a supranational European agency enjoys full member status, this typically coincides with the separate representation of the national regulatory authorities of EU Member States; for example this is the case with the International Association of Insurance Supervisors (IAIS), and the FSB. This fragmentation of EU representation in the international arena leads EU Member States to approach international negotiations mainly with a national set of priorities.

Secondly, while EU administration has been developed with the aim of fostering financial cooperation between national authorities, the role of law enforcement agencies is still left to Member States' administrations. In this context, predominately national and regional preferences often generate weak political commitment on the part of EU Member States to financial convergence. Furthermore, decentralised European supervisory structures still based on national regulator networks complicate control over the implementation at the national level of regulatory standards designed at the global or European level.

Things become increasingly complicated with regard to the transnational organisations dominating various aspects of the global financial reform agenda: they are characterised by institutional differentiation and innovation and render most of the traditional national institutional channels obsolete. This situation in turn means that in most cases the EU lacks institutional compatibility and/or complementarity with international and/or transnational regulatory governance.

## 4. Strengthening EU bargaining power

To overcome these problems, this Policy Paper suggests that the EU builds on its experience in international accounting harmonisation. Divergent regulatory preferences and institutional legacies between the United States and Europe obstructed harmonisation in this issue-area despite more than three decades of efforts in a variety of international and transnational fora. The stalemate was resolved by the EU's decision to adopt the International Financial Reporting Standards (IFRSs), produced by the International Accounting Standards Board (IASB) – a private transnational organisation. The decision to adopt these standards was not a *chèque en blanc*; it was accompanied by the establishment of a new differentiated and innovative European accounting institutional framework, which allows the EU to participate in the workings of the IASB. Previously, the high regulatory capacity of the SEC, combined with the institutional compatibility between the private standard-setting process of the US Financial Accounting Standards Board (FASB) and the IASB, had allowed the US to play a dominant role in the shaping of the IASB's agenda and work. On the other hand, the EU's fragmented regulatory authority and lack of institutional compatibility with the IASB had effectively denied it any substantial role in negotiations over IFRSs. While the United States continues to disproportionately influence the work of the IASB, the EU's ability to participate in IASB workings and influence the standard-setting process has been upgraded substantially, as the new European governance structure includes the European Financial Reporting Advisory Group (EFRAG), a private sector organisation, which includes all interested parties (including standard setters) and provides the technical assessment of the proposed standards. Moreover, the new regulatory framework has given the EU the opportunity to employ new bargaining tools, such as the adoption of equivalency requirements for foreign jurisdictions (such as the United States).

The proposition put forward here is that the EU should turn this specific, ad hoc initiative into a full-blown strategy in all areas of financial regulation. The objectives of such a strategy would be: a) to strengthen regulatory authority and compliance within the EU, b) to improve information sharing and coordination among all relevant European actors, both public and private, and thus c) to ensure the EU's institutional compatibility and complementarity with transnational regulatory organisations in order to communicate effectively on agreed positions and strengthen its bargaining power at the global level. Obviously, this is not an easy task. A replication of the IASB strategy would necessitate the concentration of significant regulatory authority within European agencies, a prospect fiercely resisted by national authorities in the past. However, as a first step, the second and third objectives could be given priority; they could probably be achieved without substantial transfer of regulatory authority from the national to the European level.

More specifically, in order to strengthen the EU's regulatory capacity and ensure institutional compatibility and complementarity with global financial regulatory fora we propose:

- To improve the EU's regulatory coherence and external representation, by using the newly established ESAs as institutional platforms to coordinate and represent European views in global financial regulatory negotiations once a coherent position has been formed.

- To ensure that the design of the new European banking supervisory authority based at the European Central Bank (ECB) takes into account both the dimension of EU external representation in global banking regulation as well as the new agency's relation to the EBA, thus avoiding further fragmentation in the European financial regulatory landscape.

- To complement the ESAs, where needed, by establishing appropriate governance structures compatible with the global financial regime, which is composed of a variety of organisations often transcending the traditional public-private dichotomy.

On the same theme…

**Contributions to the TGAE series: "Promoting EU economic interests abroad"**

EUROPE'S TRADE STRATEGY: PROMISE OR PERIL?
Richard Youngs (Fride) and John Springford (CER), *Policy Paper No. 83, Notre Europe – Jacques Delors Institute*, March 2013

TOWARDS A TRANSATLANTIC MARKET
Paweł Świeboda (demosEUROPA), *Policy Paper No. 84, Notre Europe – Jacques Delors Institute*, March 2013

HOW CAN THE EU PROMOTE ITS ECONOMIC INTEREST WITH CHINA?
Jonas Parello-Plesner (ECFR) and Agatha Kratz (for ECFR), *Policy Paper No. 85, Notre Europe – Jacques Delors Institute*, March 2013

TOWARDS A COMMON EXTERNAL REPRESENTATION FOR THE EUROZONE?
Daniela Schwarzer (SWP), Federico Steinberg (Real Instituto Elcano) and Diego Valiante (CEPS), *Policy Paper No. 86, Notre Europe – Jacques Delors Institute*, March 2013

A STRATEGY FOR STRENGTHENING EU PRESENCE IN GLOBAL FINANCIAL REGULATION REFORM
Dimitros Katsikas (Eliamep), Filippa Chatzistavron (Eliamep) and Yiannis Tirkides (CCEIA), *Policy Paper No. 87, Notre Europe – Jacques Delors Institute*, March 2013





NOTRE EUROPE JACQUES DELORS INSTITUTE
info@notre-europe.eu
19 rue de Milan
75009 Paris - France
www.notre-europe.eu