

**ADDRESSING THE FINANCIAL CRISIS:
THE EU'S INCOMPLETE REGULATORY RESPONSE**

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**ADDRESSING THE FINANCIAL CRISIS:
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RESPONSE**

Stijn VERHELST



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INTRODUCTION

The financial crisis revealed numerous shortcomings in the regulation and supervision of the financial sector. In order to avoid similar crises – or at least limit their magnitude – there has grown international consensus to increase public involvement in the financial sector.

Major international reports identified several gaps in the financial regulatory framework. In a nutshell, financial products have grown in complexity. Coupled with their opaque trading, this has resulted in an inadequate apprehension and spreading of risks. This was further aggravated by an overreliance on deficient risk assessment by others, notably credit rating agencies. Furthermore, financial institutions proved to have insufficient buffers in case things went wrong. Supervisors for their part were unable to detect or prevent the accumulation of risk. The public sector was also unable to avoid large-scale panic in the financial markets. In summary, the light regulatory approach was flawed¹.

Governments worldwide have started taking measures to tighten their grip on the financial sector. In addition to individual country efforts, initiatives have been taken on the regional and international level. In Europe, the European Union plays a key role in driving such initiatives.

The EU committed itself to an important reform of financial sector regulation. In its 2009 Communication entitled ‘*Driving European recovery*’² the European Commission lists five key objectives with regard to this reform, namely to:

1. build a more secure supervisory framework;
2. fill in gaps of European and national regulation;
3. improve confidence in the financial sector;
4. adjust risk management of the financial sector;
5. ensure more effective sanctions against market wrongdoing³.

These five objectives are required to achieve the Commission’s overarching final goal: a sound and secure financial system that operates in a single European market. The Commission has taken a wide range of regulatory initiatives to

1. For a more comprehensive overview, see: BRUNNERMEIER, M., CROCKETT, A. (e.a.), *The Fundamental Principles of Financial Regulation*, Centre for Economic Policy Research, 2009; Financial Services Authority, *The Turner Review: A regulatory response to the global banking crisis*, 2009; UNCTAD, *The Global Economic Crisis: Systemic Failures and Multilateral Remedies*, Report by the UNCTAD Secretariat Task Force on Systemic Issues and Economic Cooperation, 2009; Group of Thirty, *Financial Reform: A Framework for Financial Stability*, 2009 and G-20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency*, 2009.

2. European Commission, *Driving European recovery*, 4 March 2009, COM(2009) 114 final.

3. *Ibid.*, pp. 7-8.

meet this goal. The aim is to complete the legislative reforms by the end of 2011⁴.

In this paper we evaluate the European efforts to achieve a sound and secure financial system. In the first five chapters, we examine the work completed by European institutions to achieve each of the aforementioned objectives. As a way of concluding, we provide an overall evaluation by discussing whether or not efforts will lead to a secure financial system⁵.

Stijn VERHELST⁶

4. European Commission, Regulating Financial Services for Sustainable Growth, 2 June 2010, COM(2010) 301 final.

5. Work on this paper was finished on 5 November 2010.

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1. Supervision of the Financial Sector

Financial markets in the EU have become increasingly integrated. In contrast, financial supervision structures remained fragmented across Member States. This has resulted in a financial sector that had outgrown its supervisory framework. As a consequence, financial supervision was unable to effectively signal risks⁷. The bulk of European efforts in improving financial sector supervision consists of reforming the supervisory framework. In addition, the Commission wants to improve the supervision of financial conglomerates.

1.1. A New Supervisory Framework

The reform of the supervisory framework has been high on the European agenda for a long time. The de Larosière report⁸ has been of significant importance in the debate and largely influenced the final compromise reached by the Parliament and the Council in September 2010. The new supervision framework they agreed upon will enter into force on the 1st of January 2011⁹.

The new supervisory framework, dubbed the European System of Financial Supervision (ESFS), will include two levels of supervision. The first level deals with macro prudential supervision, with an objective of monitoring and assessing the overall stability of the financial system. This shall be carried out by a new European supervisory body called the European Systemic Risk Board (ESRB). The European Central Bank will play an important role in the ESRB, by providing administrative support and an important part of the data. Furthermore, central bankers will be well represented in the ESRB's decision-making bodies.

The second level of supervision is concerned with micro prudential issues, i.e. the individual financial institutions. In contrast to the macro level, micro prudential supervision will be carried out by a multitude of supervisors. On one side, Member States' supervisory authorities will carry out the day-to-day supervision of financial institutions. On the other, three European Supervisory Authorities (ESAs) are to coordinate national supervision. They will equally work towards a so-called single European rulebook, i.e. a single set of core rules, applied to all the relevant European financial institutions. These three ESAs are known as the European Banking Authority (EBA), the European Insurance and

7. DE LAROSIÈRE, J., et al., Report High-level Group on Financial Supervision in the EU, 25 February 2009.

8. Ibid.

9. See the annex for a list of legislation that puts in place the new supervisory framework.

Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). Each of them will deal with the corresponding segments of the financial industry. They will be created by reforming existing EU Committees and will thus not be entirely new¹⁰. In addition, a joint committee of ESAs is to deal with cross-sectoral matters.

This supervisory framework will considerably alter financial supervision in the EU. The EU bodies will have a more prominent role, although a distinction should be made between macro and micro prudential supervision. Micro level EU supervision, i.e. the ESAs will have substantial, binding powers to harmonise rules and supervisory practices, but they will not have a major role in actual supervision. At the macro level, the opposite is true. In this case, the ESRB will be the chief supervisor, while it will not have any coercive powers. At any rate, the work of the ESRB will be challenging, as it will have to warn policymakers against unsustainable growth. Despite the increased role of EU supervisors, it is clear that national supervisors will still remain crucially important, as they will still be charged with the majority of supervisory tasks.

1.2. Supervision of Conglomerates

In the margin of the major reform of the financial supervisory framework, the Commission also proposed to change the supervision of financial conglomerates¹¹. These large financial groups are already subject to supplementary supervision¹², but the Commission considers that these rules need to be improved. It seeks to obtain two main reforms. The first reform is to allow for simultaneous banking and insurance supervision of financial conglomerates' parent bodies. As of now, some Member States' legislation does not allow for such a combined supervision. A second reform is to allow for non-quantitative indicators to identify financial conglomerates, instead of the current exclusive focus on balance sheet figures. Such reform should allow supervisors to focus on those financial groups that pose the largest group risks. The Commission hopes to see reforms implemented in 2011.

10. These existing European Committees are: the European Banking Committee, the European Insurance and Pensions Committee and the European Securities Committee.

11. European Commission, Proposal for a Directive amending Directives 98/78/EC, 2002/87/EC and 2006/48/EC as regards the supplementary supervision of financial entities in a financial conglomerate, 16 August 2010, COM(2010) 433 final.

12. Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC, OJ L 35, 11.2.2003, p. 1-27.

2. The Gaps in European and National Regulation

The decennia leading to the financial crisis have often been characterised by deregulation and self-regulation of the financial sector. Rules on complex financial products were for largely non-existent, with the underpinning idea that such instruments are for professionals who should be wise enough to make well considered decisions. Yet, as the financial crisis expanded it became evident that this regulatory paradigm was erroneous¹³.

The financial sector proved unable to correctly assess or protect itself against its risks. In order to fill the gaps in European and national regulation, the Commission made propositions in different areas, including financial products (derivatives), actors (alternative investment funds, credit rating agencies and auditing firms), capital and liquidity requirement rules and crisis management. Each of these propositions will be discussed in detail in this chapter.

2.1. Derivatives

Derivatives are in essence securities whose values are based on underlying assets¹⁴. This renders them rather complex financial products. Their complexity increased considerably in the years preceding the crisis. In addition, derivatives are mostly traded on a bilateral basis (called over-the-counter trade or OTC). Due to these characteristics, derivatives led to large-scale market uncertainty during the financial crisis, notably in the wake of the investment bank Lehman Brothers' default¹⁵.

In September 2010, the Commission – finally¹⁶ – published a legislative proposal on derivative trading¹⁷. The main element of the Proposal is the generalisation of central clearing. This implies that derivative trading should be done

13. UNCTAD, *The Global Economic Crisis: Systemic Failures and Multilateral Remedies*, Report by the UNCTAD Secretariat Task Force on Systemic Issues and Economic Cooperation, 2009.

14. The value of a derivative is thus determined by fluctuations in the underlying asset. Underlying assets include bonds, commodities, currencies, market indexes, interest rates and stocks. For a full definition, see: BANKS, E., *The Palgrave Macmillan dictionary of finance, investment and banking*, Basingstoke, Palgrave Macmillan, 2009, p. 150.

15. G20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency*, March 2009.

16. Already in October 2008 the Commission indicated that it sought to regulate derivative trading, see: MCCREEVY, C., *Time for regulators to get a better view of derivatives*. Statement on reviewing derivatives markets before the end of the year, 17 October 2008, SPEECH/08/538.

17. European Commission, *Proposal for a Regulation on OTC derivatives, central counterparties and trade repositories*, 15 September 2010, COM(2010) 484 final.

through a Central Counterparty (CCP). Such a CCP acts as an intermediate between sellers and buyer. In other words, it acts as a seller to every buyer and a buyer to every seller. By generalising central clearing, the Commission seeks to increase transparency and reduce counterparty risk.

Central clearing would be mandatory for all derivatives that are deemed eligible, i.e. sufficiently standardized. The Proposal does not detail however which derivatives are concerned. Instead, a number of broad criteria are listed in the Proposal, allowing the European Securities and Markets Authority (ESMA)¹⁸ to determine whether a derivative should be centrally cleared¹⁹. Derivatives that are not eligible for central clearing would not be prohibited, but their trade would be subjected to additional requirements, notably supplementary capital retention.

According to the Proposal, all derivative trading, be it centrally cleared or otherwise, would have to be reported to a (private) trade repository, which act as a central derivative trade data centre. These trade repositories would have to provide supervisors with specified information and publish aggregated data reports.

There will be a few exceptions to the aforementioned rules. First, certain public bodies would be exempted from obligations outlined in the regulation²⁰. Secondly, a special regime would be put in place for non-financial firms. They are in principle exempted from reporting and clearing obligations, unless their trading exceeds certain thresholds when used for purposes other than risk mitigation²¹.

It should be clear that Central Counterparties will play a systemically important role in future derivative trading. While these private firms are paramount in the efforts to reduce the risk of derivative trading, they actually could lead to the opposite if not well managed. The Commission Proposal sets out conditions for CCP's operation, including capital requirements and access to liquidity. With regard to the latter, CCPs would require access to central or commercial bank liquidity if needed. This is rather lenient compared to IMF recommendations²².

18. See *supra* (1.1. A New Supervisory Framework).

19. Determining the eligibility for central clearing would be based on criteria such as the systemic risk involved, pricing information and the ability of CCPs to deal with the derivatives.

20. Central banks and public bodies who manage public debt would be exempted.

21. These thresholds are to be determined by the Commission on proposal by the ESMA.

22. The IMF favours stricter rules as it argues that in emergencies CCPs should have access to central bank liquidity facilities, see: IMF, Global Financial Stability Report. Meeting New Challenges to Stability and Building a Safer System, April 2010, p. 111.

The proposed supervision of derivative trade seems somewhat incoherent. The ESMA would be empowered to supervise trade repositories, while CCPs would be supervised nationally. A main driver for the national supervision of CCPs is that their failure would be financially borne by the Member States. This national financial responsibility puts smaller Member States at a disadvantage, as it would be harder for them to bailout a CCP.

Third country CCPs and trade repositories would only be authorized to deal with the trade of derivatives by an EU trader if the third country's legal and supervisory framework is equivalent to that of the EU. Furthermore, an international agreement between the EU and the third country on the matter would be required.

The European Parliament and the Council need to strike an agreement on the matter. Rules are projected to apply at the end of 2012. The Regulation will need to be complemented by other EU legislation in order for it to be effective. Of notable importance are the revision of the Capital Requirements Directive²³ (setting out rules in bilateral derivative trade), MiFID²⁴ (to oblige the use of CCPs) and the Market Abuse Directive²⁵ (to include bilaterally traded derivatives). A complete set of rules governing derivative trade is thus far from imminent.

2.2. Alternative Investment Funds

A hotly debated issue concerns so-called Alternative Investment Funds (AIFs). These encompass a variety of funds, described as funds that are not harmonised by the UCITS Directive²⁶. These funds include private equity and hedge funds, but also for example commodity funds, real estate funds and trusts. Their common feature is the fact that they were previously subject to light regulation. EU-wide regulation thus constitutes a major change.

A major difficulty in regulating alternative investment funds is the fact that they are often located in offshore financial centres²⁷. Hence regulating funds located

23. See *infra* (2.5. Capital and Liquidity Requirements).

24. Directive 2004/39/EC on markets in financial instruments, 30 April 2004, OJ L 145, p. 1-44.

25. See *infra* (5.1. Market Abuse).

26. Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 375, 31.12.1985, p. 3-18.

27. A main reason is tax avoidance, while light regulation plays a role as well. See: FUNG, W., HSIEH, D., A primer on hedge funds, *Journal of Empirical Finance*, Volume 6, Issue 3, September 1999, pp. 309-331.

in Europe would only address a portion of funds operating in the EU. Alternative Investment Fund Managers (AIFMs) are on the contrary often located in onshore financial centres like the City of London. For this reason, the EU seeks to regulate the alternative investment funds managers rather than the funds themselves.

The Commission published a legislative Proposal in April 2009²⁸. After long debate both inside and between institutions, a compromise has been agreed upon²⁹. Under the future Directive, minimal harmonisation and mutual recognition will apply. Alternative investment fund managers will need an authorisation by the Member State where they are located, which will be subject to a number of requirements³⁰. If a fund's manager meets these requirements, he obtains a so-called European passport, allowing him to operate in all EU Member States. Fund managers that are located in the EU can benefit from such a European passport from 2013 onwards. Managers of small funds, with assets worth less than EUR 100 million (or EUR 500 million in case no leverage is used³¹) will be subject to less demanding rules. They are only obliged to register and are subject to a more simplified reporting process. Yet, they will not benefit from a European passport, unless they voluntarily comply with the obligations that apply to managers of larger funds.

One of the most contentious elements of the legislative discussions was third country access. In the end, non-EU fund managers will be able to benefit from a European passport, although only from 2015 onwards. In addition, they will only be able to benefit from such a European passport if they and their country of origin meet certain conditions. The fund managers will need to be subjected to legislation and supervision that are "*to the same effect*"³² as EU rules. Furthermore, their home country should apply the relevant international standards and exchange information with the EU, notably on tax issues.

28. European Commission, Proposal for a Directive on Alternative Investment Fund Managers, COM(2009), 30 April 2009, COM (2009) 207 final.

29. Council of the European Union, Proposal for a Directive on Alternative Investment Fund Managers – Council's position agreed by ECOFIN, 20 October 2010, 15053/10.

30. These concern, inter alia, the appointment of a depository for its financial instruments, capital requirements, risk management, reporting and disclosure rules.

31. In this case, a lock-in period of 5 years applies to investments made at the moment the alternative investment fund was constituted.

32. In its original proposal, the Commission required equivalent rules and supervision. This had prompted international protest, including by the US administration.

2.3. Credit Rating Agencies

The role of credit rating agencies is to assess the creditworthiness of financial products and actors. Credit ratings issued by these agencies are widely used by investors in assessing risks. Regulatory requirements in fact oblige financial institutions to take the ratings into account when determining their capital needed. Even public bodies, such as the ECB, rely on credit ratings³³. Yet, ratings were found to be anything but foolproof. In the run-up to the financial crisis, credit rating agencies did not adequately detect risks, especially with regard to complex financial products. While several products received top-notch ratings, they proved to entail high risks for investors³⁴.

In 2009, the EU adopted a Regulation on credit rating agencies that aims to tackle the sector's shortcomings³⁵. The regulation abandons the previous self-regulation approach. Instead, credit rating agencies are subjected to supervision and EU-wide rules. Credit rating agencies will only be allowed to operate in the EU if they meet certain requirements. These include:

- Transparency requirements, entailing an annual transparency report, methodology disclosure and specific notice when credit ratings concern complex financial products.
- Corporate governance requirements, including an internal quality review mechanism.
- Requirements that try to limit conflicts of interest. To this extent, a certain proportion of credit rating agencies' directors cannot receive incentives based on business performances and credit rating agencies are not allowed to provide advisory services.

The Regulation puts in place a particular regime for credit rating agencies that are located outside the EU. Their ratings can only be used under specific conditions. They need to be subjected to an equivalent system of regulation and supervision³⁶, or should have an affiliated credit rating agency in the EU that endorses their rating.

33. Credit ratings are an eligibility criterion for accepting collateral in the ECB's liquidity providing operations.

34. For an evaluation of the role of credit rating agencies in the financial crisis and its causes, see: G20 Working Group 1, op. cit.

35. Regulation (EC) No 1060/2009 of 16 September 2009 on credit rating agencies, OJ L 302, 17.11.2009, p. 1-31.

36. In this case, their ratings are not allowed to be used if they are of "*systemic importance to the financial stability or integrity of the financial markets of one or more Member States*" (Article 5(1)d of Regulation No 1060/2009). Although depending on the exact interpretation, this is likely to force credit rating agencies to have a registered office in the EU if they want to continue certain rating activities. For some this might prove too expensive, which could reduce competition between credit rating agencies in the EU.

In June 2010, the same month as the aforementioned Regulation fully entered into force, the Commission already proposed a revision of applicable rules³⁷. The Commission proposed supplementary disclosure rules for a financial instrument that results from securitisation operations³⁸. If the issuer of such an instrument commissions a rating from a credit rating agency, it would have to provide the necessary information not only to that agency, but also to every credit rating agency that requests so. These provisions seek to limit disadvantages associated with the issuer-pays model, i.e. rating agencies are contracted by the firm whose products they need to evaluate, which is common practice in the credit rating sector. Yet, it should be clear that these additional disclosure rules are far from universal given that they only apply to a specific type of complex financial instruments.

The June 2010 Proposal also included provisions concerning the supervision of credit rating agencies. According to the Proposal, the future European Securities and Markets Authority³⁹ (ESMA) would become solely responsible for the supervision of credit rating agencies. National authorities' only supervisory function would consist of overseeing the use of credit ratings for regulatory requirements (e.g. capital requirements), although the ESMA could delegate additional supervisory tasks to them. With regard to enforcement, the ESMA would be empowered to temporarily prohibit the issuing of credit ratings by a specific credit rating agency, or suspend the use of its ratings. The Commission would be able to impose pecuniary sanctions.

When combining the already adopted Regulation and the latest Commission Propositions, it's clear that progress is made in bringing credit rating agencies into the regulatory and supervisory scope. Some important issues remain open for improvement however. Firstly, the issuer-pays model is not thoroughly questioned. Secondly, credit ratings are still extensively used for regulatory purposes. Finally, the credit rating sector is said to lack competition⁴⁰. The Commission plans to propose yet another revision of the rules applicable to credit rating agencies in 2011, which should address these issues⁴¹.

37. European Commission, Proposal for a Regulation on amending Regulation (EC) No 1060/2009 on credit rating agencies, 2 June 2010, COM(2010) 289 final.

38. So-called rated structured finance instruments, for the full definition see: Article 4(36) of Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, OJ L 177, 30.6.2006, p. 201-255. For more information on securities, see footnote 49.

39. See *supra* (1.1. A New Supervisory Framework).

40. LANNON, K., What reforms for the credit rating industry? A European perspective, ECMI Policy Brief, No. 17, October 2010, pp. 5-6.

41. European Commission, Commission Work Programme 2011, Volume II, Annex I: Strategic initiatives scheduled for adoption in 2011, 27 October 2010, COM(2010) 623 final. A public consultation on the subject has been launched in November 2010, see: European Commission, Public Consultation on Credit Rating Agencies, 5 November 2010.

In light of the Greek debt crisis European heads of state and government floated the idea of creating a European credit rating agency as an additional measure to improve the credit rating sector⁴². The Commission did not reject this idea. It could introduce such a European credit rating agency in its 2011 Proposal. It is doubtful however whether a public rating agency would be able to prevent a sovereign debt crisis or significantly increase competition in the sector.

2.4. Auditing Firms

The role of auditing firms is to verify the accuracy of a company's financial statements. Such audits are required by European legislation⁴³. In a sense, auditing firms provide a service similar to credit rating agencies as their audits provide an important signal to regulators and stakeholders on the financial credentials of a firm. Yet, auditors approved the financial statements of some financial institutions that did not accurately reflect their true financial position. While these problems were far smaller than those related to credit rating agencies, the Commission seeks to reform the current legislation. In October 2010 it launched a public consultation, paving the way for a legislative proposition in 2011⁴⁴. The public consultation proposes measures in three main areas, similar to the measures with regard to credit rating agencies.

Initial measures aim at to reducing potential conflicts of interests⁴⁵. The Commission suggests that, at least for the largest companies, supervisors could choose which auditing firm to contract or oblige firms to rotate their auditing firm on a regular basis.

Subsequent measures would need to increase competition in the market. As of now, the global auditing market is dominated by four firms⁴⁶, which according to the Commission can create systemic risks. The Commission proposes a European passport for auditing firms, so that a firm based in a Member State can operate across the EU. Additional measures to increase competition seem unlikely.

42. European Council, Statement of the Heads of State or Government of the Euro Area, 7 May 2010, PCE 86/10.

43. Directive 2006/43/EC of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, OJ L 157, p. 87-107.

44. European Commission, Green Paper on Audit Policy: Lessons from the Crisis, 13 October 2010, COM(2010) 561 final.

45. As for credit rating agencies, a major issue is whether or not it is harmful that auditing firms are contracted by the firms they audit. Another issue is the fact that auditing firms offer non-auditing services to the very same firms they audit.

46. These auditing firms are Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.

A final area where the Commission suggests legislative action is supervision. It notably seeks to increase the role of European supervisors, for example by creating a new European Supervisory Authority or empowering an existing one. If the idea of a European passport finds support, the European supervisor could issue them.

2.5. Capital and Liquidity Requirements

Banks are required to hold a certain level of capital in order to assure they have sufficient buffers in case problems arise. The applicable rules are laid down in the Capital Requirements Directive⁴⁷ (CRD). The existing requirements proved inadequate to prevent the financial crisis from occurring. Important shortfalls in capital requirements include the inadequate assessment of risks, their pro-cyclicality⁴⁸ and their lack of attention for liquidity buffers. Since the crisis erupted, the Commission has proposed three reforms.

The first reform has resulted in a Directive (Capital Requirements Directive II or CRD II) that was published in September 2009⁴⁹. Member States have to apply the rules of the Directive from 2011 onward. The Directive brings about the following changes:

- The supervision of cross-border banking groups is strengthened.
- Financial institutions that rely heavily on a single counterparty will be more closely supervised.
- Higher capital requirements will be imposed in case of securitisation practices, which were an important factor in the financial crisis⁵⁰. If these are traded, the financial institution from who originates the product will have to retain 5% of the traded risk.

Rules on liquidity requirements are introduced. Liquid asset reserves, liquidity stress tests and contingency planning need to prevent financial institutions from facing a liquidity crisis, as occurred during the financial crisis.

47. The Capital Requirements Directive actually comprises two Directives, namely Directive 2006/48/EC, *op. cit.* and Directive 2006/49/EC, *op. cit.*

48. A revision of accounting rules is also of vital important to reduce pro-cyclicality. Yet, these reforms are decided on the international level.

49. Directive 2009/111/EC amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management, 16 September 2009, OJ L 302, 17.11.2009, p. 97-119.

50. Securitisation is the process of repackaging assets, liabilities or cash flows into tradable securities. Securitisation enabled financial institutions to trade risks associated to loans (including inferior quality subprime loans). This led to spreading risks throughout the financial system and decreased the due diligence of financial institutions. See: KAPOOR, S., *The Financial Crisis – Causes & cures*, Friedrich-Ebert-Stiftung, Bertelsmannstiftung and ETUI, 2010, pp. 79-80.

Even before this Directive was adopted, the Commission already proposed a second set of changes to the Directives on capital requirements (CRD III)⁵¹. The European Parliament and the Council have reached an agreement on its content⁵². The goals of this Directive are similar to the ones of the aforementioned CRD II, but their scope is different. The Directive will increase capital requirements for re-securitisations⁵³ and for assets that banks hold in their trading book⁵⁴. Both will also be subject to more stringent disclosure rules. The overuse of the trading book will be further limited by increasing the required assessments of risks contained therein. The Directive furthermore sets out rules on remuneration⁵⁵. The capital requirements rules of the Directive should be implemented by 2012.

The third capital requirements reform (CRD IV) is still at an early stage. For now, the Commission has finished public consultations⁵⁶ and a hearing on seven potential action areas⁵⁷. Its outcome will depend heavily on the future reforms of the Basel capital framework. These reforms will lead to more stringent international rules on capital and liquidity requirements, including countercyclical buffers⁵⁸.

2.6. Crisis Management of Financial Institutions

The financial crisis has shown that previous mechanisms to deal with bank failures were largely insufficient, especially in cross-border situations. The Com-

51. European Commission, Amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, 13 July 2009, COM(2009) 362 final.

52. Council of the European Union, Directive 2010/.../EU of ... amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, 30 September 2010, PE-CONS 35/10.

53. Re-securitisations are securitisations that are composed of underlying securitisations.

54. A financial institutions' trading book is a portfolio of financial instruments that the institution regularly buys and sells. Financial instruments which are to be held until they mature are held in the banking book. Capital requirements for the trading book are traditionally less demanding than requirements for the banking book. For a definition, see: The Palgrave Macmillan dictionary of finance, investment and banking, *op. cit.*

55. See *infra* (4.1 Remuneration).

56. European Commission, Possible Further Changes to the Capital Requirements Directive, Consultation Document, 26 February 2010 and European Commission, Countercyclical Capital Buffer, Consultation Document, 22 October 2010.

57. The potential action areas are: liquidity standards, definition of capital, leverage ratio, counterparty credit risk, countercyclical measures, systemically important financial institutions and a single rule book in banking.

58. In September 2010 the Basel Committee on Banking Supervision reached an agreement on new capital rules (so-called Basel III rules). The rules are set to be endorsed at the G-20 meeting in November 2010. See: Basel Committee on Banking Supervision, Group of Governors and Heads of Supervision announces higher global minimum capital standards, 12 September 2010, retrievable on <http://www.bis.org/press/p100912.pdf>.

mission seeks to address the issue by creating a European crisis management framework. A proposal is expected in spring 2011, which is rather late. By delaying such a vital part of financial legislative reform, the window of opportunity for significant regulatory reform risks being closed.

In October 2010, the Commission published a Communication outlining its future proposal⁵⁹. The overarching aim of the Commission is to allow credit institutions to fail with minimal influence on financial stability and without bail-outs by public authorities. To achieve this aim, the Commission proposes harmonising rules in three subsequent parts of crisis prevention and management.

First of all, it seeks common rules for preparatory and preventive measures. This includes drawing up recovery and resolution plans for banks (so-called living wills). Furthermore, supervisors could request a bank to change its business operations and corporate structure. Such intrusion in the management of a bank might meet significant opposition by Member States.

Secondly, the Commission proposes to provide supervisors with early intervention powers if problems are detected. The Commission suggest allowing supervisors to intervene once a bank is likely to fail its capital requirements, although this trigger requires more precise definition⁶⁰. In such a case, supervisors would be able to prohibit the payment of dividends and could force a bank to abandon certain business activities. Furthermore, it would be authorised to replace managers or even appoint a temporary CEO.

The final field in which the Commission proposes harmonised rules concerns the resolution of a bank. Such a resolution should only occur when there is no realistic prospect of recovery, although the Commission again still needs to define specific thresholds. During such a resolution phase, authorities would be able to sell a bank or parts thereof without the consent of shareholders. In addition, it would be empowered to write off shares and write down debt or convert it into equity⁶¹.

Besides harmonising rules, the Commission also seeks to improve cross-border cooperation in the preparation and management of bank crises. However, important actors will remain at the Member State level, with only voluntary cross-border coordination. The European Supervisory Authorities⁶² would only

59. European Commission, Communication on an EU Framework or Crisis Management in the Financial Sector, 20 October 2010, COM(2010) 579 final.

60. Currently, supervisors can only intervene when a bank is failing its capital requirements, which the Commission deems too late.

61. Such a conversion would constitute a so-called bail-in.

62. See supra (1.1. A New Supervisory Framework).

play a minor role. As their mediation and crisis management may not impinge on the financial responsibilities of a Member State, their role will be limited mainly to non-binding supervision and coordination. It is doubtful whether these provisions would prevent the lack of cross-border coordination we faced during the financial crisis⁶³.

To finance bank resolutions, the Commission has proposed a bank levy⁶⁴. Yet, it did not propose to set up a single European-wide fund for all Member States. Instead, a patchwork of national funds governed by a single set of EU-rules has been proposed. This seems likely to constitute a disadvantage for smaller Member States as they would proportionally need larger funds (in relation to their GDP) to finance the resolution of a given bank. The proposition is further criticised by Member States, as they want to use the bank levy for their general budget. The IMF has toned down the budgetary difference between the two approaches⁶⁵. Furthermore, bank resolution funds could, it is argued, lead to moral hazard as banks risk seeing the funds as an insurance premium. In any case, excluding the possibility of a public bail-out seems somewhat naive. The EU could instead work out ways to split the cost of such a bail-out among its Member States.

The aforementioned rules would only apply to credit institutions⁶⁶ and investment banks that are deemed to represent a systemic risk. Crisis management for other types of financial institutions would be regulated at a later stage. In addition, the Commission plans to harmonise national bank insolvency rules. Yet, according to the Commission's planning, legislation in both fields will most likely not be adopted in the coming years⁶⁷. By this stage, the momentum for reforms created by the financial crisis is likely to have faded away completely.

63. Notably the Fortis break-up.

64. European Commission, Communication on Bank Resolution Funds, 26 May 2010, COM(2010) 254 final.

65. In a report to the G-20, the IMF states that it “*makes no substantive difference to the public sector's financial position whether a levy accrues to general revenues or to a fund that invests in government securities*”. See: IMF, A Fair and Substantial Contribution by the Financial Sector – Interim Report for the G-20, 2010, p. 13.

66. A credit institution is an undertaking which both receives deposits from the public and grants credits. For the full definition, see: Article 4(1) of Directive 2006/48/EC, op. cit.

67. The Commission plans to publish a preliminary report by the end of 2011 on the resolution of other types of financial institutions. A report on harmonising bank insolvency rules is planned for end 2012.

3. Confidence in the Financial Sector

Confidence is vital to the banking system. People need to be confident that their deposits are safely managed. If not, they will withdraw their savings. Under the modern banking system, banks use fractional-reserve banking, which implies that they lend more money than they have obtained via deposits. Therefore, if a large number of depositors want to withdraw their deposits in a short time-frame, the bank could fail, as well as the banking system as a whole.

The financial crisis saw many losing confidence in the banking sector, with important consequences⁶⁸. The existing provisions proved unable to maintain confidence. The EU has taken multiple actions to address the issue. These cover retail investment, guarantee schemes, as well as lending and borrowing.

3.1. Packaged Retail Investment Products

Consumers or retail investors are what could be considered ‘non-professional investors’. The Commission believes that these investors benefit from a simple legislative framework and clear investment information. This is especially useful when more complex investment products are at stake. This includes packaged investment products, which are investment products that are composed of multiple underlying financial assets⁶⁹.

Packaged retail investment products are currently governed by sectoral directives and crosscutting legislation of which the MiFID⁷⁰ and the IMD⁷¹ are of particular importance. The Commission believes that the legislative framework is too fragmented. Furthermore, according to the Commission, the framework contains several holes. The complex and incomplete nature of this legislation is seen as harmful when it comes to instilling confidence in these products⁷². A legislative proposal on packaged retail investment products will be published in 2011⁷³.

68. Liquidity problems were a major issue in the crisis and were partly caused by deposit withdrawal.

69. For a complete definition, see: European Commission, Communication on Packaged retail investment products, 30 April 2009, COM(2009) 204 final.

70. Directive 2004/39/EC, op. cit.

71. Directive 2002/92/EC on insurance mediation, 15 January 2003, OJ L 9, p. 3-10.

72. European Commission, Communication on Packaged retail investment products, op. cit.

73. Letter by Commission President Barroso to the Members of the European Parliament, 7 September 2010, MEMO/10/393.

In April 2009, approximately two years before the expected legislative proposals, the Commission published a Communication on packaged retail investment products laying out its envisaged future proposition. The institution wants to establish a horizontal approach towards packaged retail investment products. Complexity would nevertheless remain, as two fields of action would be dealt with by separate acts. Initially, a set of rules on the information to be provided to retail investors would be developed using provisions of the UCITS Directive⁷⁴ as a benchmark. Secondly, the selling of Packaged Retail Investment Products would be submitted to a set of rules where MiFID would serve as a point of reference. The complex nature of such legislation is not necessarily a problem, as long it results in a coherent framework that provides clear and easily accessible information to retail investors.

3.2. Guarantee Schemes

Guarantee schemes aim at safeguarding the public against certain unforeseeable events, notably the failure of a financial institution. EU rules have been in place for over a decade for both Deposit Guarantee and Investor Compensation Schemes. Both will be revised. In addition, the Commission wishes to introduce EU rules on Insurance Guarantee Schemes.

Deposit Guarantee Schemes

A system of Deposit Guarantee Schemes serves to protect European depositors. If a financial institution fails, these schemes are to ensure that deposits can be redeemed up to a predetermined amount. The initial European rules on the matter were adopted in 1994⁷⁵. In the heat of the financial crisis, the system was amended by a new Directive⁷⁶.

This Directive, adopted in March 2009, was largely aimed at restoring short-term confidence in the financial system. It changes the rules applicable to Deposit Guarantee Schemes in the following fields:

- The minimum level of coverage is initially increased from EUR 20 000 to EUR 50 000. This will be further increased to EUR 100 000 at the end of 2010.
- The principle of co-insurance has been abandoned. Before, Member States

74. Council Directive 85/611/EEC, op. cit.

75. Directive 94/19/EC of 30 May 1994 on deposit-guarantee schemes, OJ L 135, 31.5.1994, p. 5-14.

76. Directive 2009/14/EC amending Directive 94/19/EC on Deposit-Guarantee Schemes as regards the coverage level and the payout delay, OJ L 68, 13.3.2009, p. 3-7.

could limit the coverage of deposits to 90%. Now full coverage (100%) is required.

- The payout period in case of problems has been significantly reduced. Deposit Guarantee Schemes had to compensate depositors within three months, with a possibility to increase the period to nine months in exceptional cases. This is reduced to twenty working days with a possibility to extend it to thirty working days in exceptional cases.

In July 2010, the Commission proposed a further revision of the rules on Deposit Guarantee Schemes⁷⁷. It should allow for a more profound and more concerted revision of the Directive. The Commission's Proposal would put in place fully harmonised rules that would replace the current minimum harmonisation. Yet, a pan-European Deposit Guarantee Scheme wouldn't be introduced, although the Commission will report on the matter by 2014. The Commission proposes four main changes.

First, the Commission proposes to set the coverage level at EUR 100 000 across the EU. Only specific exceptions would allow for greater coverage (for example real estate transactions). Second, deposit protection would apply to every type of company. This is in clear contrast with some Member States' current rules that exclude large companies from benefiting from such Schemes. Third, the payout period would be further shortened to seven calendar days.

Finally, the Commission proposes a system for financing Deposit Guarantee Schemes. A cascade financing system would be established. In first instances, schemes would be financed by ex-ante funds. If this proved inadequate, ex-post funds would be used. If these are also insufficient, a Deposit Guarantee Scheme could borrow from other Schemes. If all this still proved insufficient, alternatives means of funding would be used, although the Commission refrains from detailing this type of funding. Repayment might still prove difficult, despite these provisions. This is especially true if several Schemes need to repay deposits within a short time frame, as it would put stress on the entire system.

The Proposition has run into opposition from several Member States, most notably from the German and Swedish Parliaments. The financing of Deposit Guarantee Schemes is particular controversial⁷⁸. The changes to the Directive might thus prove to be significantly different than the Commission Proposal.

77. European commission, Proposal for a Directive .../.../EU on Deposit Guarantee Schemes [Recast], 12 July 2010, COM(2010)368 final.

78. The German Bundesrat and the Swedish Riksdagen both stated that the proposal runs against the principle of subsidiarity. See: Interparliamentary EU Information Exchange, Dossier COD/2010/0207, retrievable on http://www.ipex.eu/ipex/cms/home/Documents/dossier_COD20100207.

Investor Compensation Schemes

EU rules on Investor Compensation Schemes have been in place since 1997⁷⁹. The Schemes offer compensation in case an investment firm is unable to return assets that belong to investors due to, inter alia, fraud or negligence. It does not however protect against ordinary risks associated with investments (e.g. capital risk, liquidity risk, currency risk...).

In 2010, the Commission proposed to revise legislation governing Investor Compensation Schemes⁸⁰. The main proposed changes are:

- A compensation level fixed at EUR 50 000, thus excluding any compensation of higher value.
- Full coverage by the Schemes, thus excluding co-insurance.
- The adoption of funding arrangements, including the possibility of borrowing between Schemes if required.
- A reduction of the payout delay, although the Commission Proposal only requires partial compensation within nine months after a firm is declared unable to repay the investor.
- An extension of the schemes' coverage, e.g. to include UCITS products and the failure of third party custodians.

These changes are in line with those proposed for Deposit Guarantee Schemes. Rules would equally become more harmonised at the EU level, but no EU-wide scheme would be introduced.

Insurance Guarantee Schemes

Protection against insurance failure, i.e. in case an insurer is unable to fulfil its obligations, is not common practice in the EU. Only 11 out of 27 Member States offers such insurance⁸¹. In its related July 2010 White Paper, the Commission proposes EU rules that would render Insurance Guarantee Schemes mandatory. In contrast to the Deposit Guarantee and Investor Compensation Schemes, the EU rules would only require minimum harmonisation, thus refraining from setting maximum protection levels. Formal legislative proposals are to be published in 2011⁸².

79. Directive 97/9/EC of 3 March 1997 on investor-compensation schemes, OJ L 84, 26.3.1997, p. 22-31.

80. European Commission, Proposal for a Directive amending Directive 97/9/EC on investor compensation schemes, 12 July 2010, COM(2010) 371 final.

81. These countries are: Bulgaria, Denmark, France, Germany, Ireland, Latvia, Malta, Poland, Romania, Spain and the United Kingdom.

82. European Commission, White Paper on Insurance Guarantee Schemes, 12 July 2010, COM(2010) 370.

3.3. Lending and Borrowing

The subprime lending crisis in the US, which in many ways ignited the financial crisis, has shown that overly flexible lending facilities can be harmful to borrowers, lenders, as well as the economy at large. A consultation⁸³ and public hearing⁸⁴ on responsible lending and borrowing have been organised by the Commission. The goal is to devise a legislative proposal, which is set to be published in 2011⁸⁵. The Commission seeks to put in place rules on information to be provided by the borrower and lender. Furthermore, lenders would need to better take the reimbursing powers of borrowers into account. Parallel to these efforts, there has been an expert study group⁸⁶ and a consultation⁸⁷ on the access to and availability of consumer credit history. There seems to be a consensus among experts to work towards a harmonisation rather than a pan-European credit register.

83. European Commission, Public Consultation on Responsible Lending and Borrowing in the EU, 15 June 2009.

84. European Commission, Hearing of 3 September 2009 on responsible lending and borrowing, 7 October 2009.

85. European Commission, Commission Work Programme 2011, *op. cit.*

86. European Commission, Report of the Expert Group on Credit Histories, May 2009.

87. European Commission, Summary of responses to the public consultation on the report of the expert group on credit histories, 30 November 2009.

4. Risk Management in Financial Institutions

Excessive risk taking was a major cause of the financial crisis. As aforementioned, EU regulators try to reduce risks, for example by modifying capital requirements, enhancing regulation on products and reducing the dependency on credit rating agencies. Yet, the EU also seeks to modify the way financial institutions themselves manage their risk. To this extent, it seeks to alter remunerations policies and rules concerning corporate governance.

4.1. Remuneration

Financial institutions in the EU and elsewhere have been heavily criticised for their remuneration schemes. The high bonuses and golden parachutes in the financial sector are seen by some as inappropriate and even counterproductive⁸⁸. As the Commission states, the general aim of EU initiatives is to align remunerations with long-term objectives rather than short-term risk-taking⁸⁹. To this end, both soft and binding legislative initiatives have been adopted.

In terms of soft law, the Commission published two Recommendations on the matter. The first Recommendation deals with the remuneration of directors in general, including those of financial institutions⁹⁰. The second Recommendation specifically deals with remuneration in the financial sector⁹¹. However, the impact of both Recommendations would arguably be limited, as they are not legally binding.

These measures contrast with rules laid down in the aforementioned Capital Requirements Directive III⁹² that will have a greater impact, due to its binding nature. It contains rules on three important types of remuneration related rules. Firstly, it lays down rules regarding the governance of remuneration policies. The Directive notably requires independent control of remunerations in the

88. See for example: BRUNNERMEIER, M., CROCKETT, A. (e.a.), *The Fundamental Principles of Financial Regulation*, Centre for Economic Policy Research, 2009.

89. European Commission, Recommendation on remuneration policies in the financial services sector, 30 April 2009, C(2009) 3159, p. 3.

90. European Commission, Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, 30 April 2009, C(2009) 3177.

91. European Commission, Recommendation on Remuneration policies in the financial services sector, 30 April 2009, C(2009) 3159.

92. Council of the European Union, Directive 2010/.../EU of ... amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, PE-CONS 35/10.

financial institutions and the set-up of a remuneration committee. Secondly, transparency rules are introduced that oblige financial institutions to annually publish information on their remuneration policies and practices.

The most far-reaching element of the Directive is its limits to variable remunerations, i.e. bonuses. These rules apply to staff that has a material impact on the risk profile of the financial institution. They stipulate the following:

- At least half of such staff's variable remunerations is to consist of ownership entitlements (e.g. shares) or instruments that can be converted to ownership entitlements in case of contingency.
- At least 40% of their variable remuneration (60% in case of high amounts) is to be deferred for at least 3 years.
- More strict rules apply to financial institutions that have benefited from state aid. For example, variable remunerations for senior management of such institutions require justification.

The Directive's rules pertaining to remuneration should take effect in January 2011. Many of the rules need further detailing from the Committee of European Banking Supervisors⁹³, for example by stipulating the required balance between variable and fixed remunerations and defining 'high' amounts of variable remunerations.

4.2. Corporate Governance

Besides rules on the remuneration policy in financial institutions, the Commission plans to propose measures vis-à-vis corporate governance in financial firms. In June 2010, it launched a Green Paper and public consultation on the topic⁹⁴. The Commission proposes measures, inter alia, to address the supervisory role of senior management, remuneration policies and the involvement of shareholders, financial supervisors and external auditors.

Some of the propositions are quite far-reaching, such as limiting the number of boards on which a director may sit, demanding a level of diversity amongst the board of directors in terms of gender and background, disclosure of institutional investors' voting practices and reinforcing civil and criminal liability of directors. The Commission plans to propose measures in 2011. It is not yet known to what extent these would include binding legislation.

93. In 2011 this Committee will be replaced by the European Banking Authority, see *supra* (1.1. A New Supervisory Framework).

94. See: European Commission, Green Paper on Corporate governance in financial institutions and remuneration policies, 2 June 2010, COM(2010) 284 final.

5. Market Wrongdoing

Governments prohibit certain ways of conduct deemed abusive, in order to allow financial markets to function properly. In the EU, rules have been grouped in the Market Abuse Directive. Since the financial crisis erupted, there have been calls to revise this Directive and to limit additional forms of market behaviour, especially with regard to short selling and credit default swaps. In contrast to other regulatory proposals in the field of financial regulation, there seems to be less of a consensus on the need of actions in case of market wrongdoing.

5.1. Market Abuse

The original Market Abuse Directive (MAD) was adopted in 2003⁹⁵. The Directive covers rules on insider dealing and market manipulation. The financial crisis did apparently not lead to a significant increase of these types of market wrongdoings⁹⁶. Yet, the de Larosière report found sanctioning weak and heterogeneous⁹⁷. The Commission therefore plans to review the Directive. A Commission proposal on the matter is expected in 2011⁹⁸. The latter will have three main objectives. Firstly, enlarge the scope of the Market Abuse Directive in order to cover new markets and instruments. Secondly, increase the supervision and enforcement mechanisms⁹⁹. Finally, the Commission wants to better harmonise rules by limiting the options and discretions of Member States. Common EU rules are not envisaged. If the European Parliament and the Council reach a timely consensus, rules would apply from July 2012 onwards.

5.2. Short Selling and Credit Default Swaps

Short selling and credit default swaps (CDS) have been regularly subject to the mistrust of policymakers, notably during recent periods of market turmoil. This is not very surprising as both of them are used for speculating on negative market evolutions. Although, the Commission states that short selling and credit default swaps as such do not constitute market abuse, it finds them potentially

95. Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ L 96, 12.4.2003, p. 16-25.

96. European Commission, Public Consultation on a Revision of the Market Abuse Directive (MAD), 25 June 2010, p. 2.

97. DE LAROSIÈRE, J., *op. cit.*, p. 23.

98. European Commission, Commission Work Programme 2011, *op. cit.*

99. The Commission envisages publishing a specific Communication on sanctions in the financial services sector along with its proposal to revise the Market Abuse Directive.

harmful in periods of market stress¹⁰⁰. As a result, it proposed in September 2010 legislation dealing with both short selling and credit default swaps¹⁰¹.

Short Selling

Short selling is a market strategy that aims to profit from a decrease in a security's value. It consists of selling a security that the seller does not own at the time of the transaction¹⁰². The seller may have arranged to acquire the security he sells (e.g. he can have borrowed it or taken measures to do so) which is called 'covered' short selling. In contrast to 'covered' short selling, the seller can also agree to short sell a security within a certain timeframe, without having made prior arrangements to acquire it. This is called 'uncovered' or 'naked' short selling. It entails higher risks than covered short selling as the seller is not guaranteed to obtain the security.

With its proposal, the Commission seeks to achieve the following goals:

- Increase transparency in short selling practices. When a market participant is engaged in a number of short sell operations of a share that exceeds a certain threshold¹⁰³ he has to notify the regulator of his short sell position. If the market participant exceeds a higher threshold¹⁰⁴, he has to make his position public. In addition, share sell orders in a trading venue that involve short selling have to be marked (also referred to as flagging). Different rules apply to short selling of sovereign bonds. In that case a market participant would not be obliged to make its short sell position public and no marking obligations would apply.
- Harmonise rules on temporarily restricting or banning short selling. National regulators would be able to do so if there is a serious threat to market stability or market confidence. If a national regulator does not adequately address a threat, the European supervisor (ESMA)¹⁰⁵ would be allowed to take measures. These measures would furthermore override the actions taken by national regulators. Under the Commission Proposal, the ESMA would however not be able to undo a ban on short selling imposed by a national regulator.

100. There is, however, far from a consensus on the matter. See for example: IMF, Staff Comments on EU Commission Consultation on Short Selling, August 5 2010, 17 p., <http://www.imf.org/external/np/eur/2010/pdf/080510.pdf> and FOTAK, V., RAMAN, V., YADAV, P., Naked Short Selling: The Emperor's New Clothes?, Working Paper Series, University of Oklahoma, 2009, 55 p.

101. European Commission, Proposal for a regulation on Short Selling and certain aspects of Credit Default Swaps, 15 September 2010, COM(2010) 482.

102. A similar strategy which bets on an increase in the value of a security is called long selling.

103. A net short position of 0.2% of issued share capital.

104. A net short position of 0.5% of issued share capital.

105. See *supra* (1.1. A New Supervisory Framework).

- Limit uncovered short selling. According to the Proposal, a market participant would only be able to short-sell a security if he has taken the appropriate measures to acquire it¹⁰⁶. Plain uncovered short selling would thus be prohibited.

The Commission Proposal contains some exemptions to the aforementioned rules. These exemptions would apply in case a share's principal market is outside the EU or in case actions are deemed non-detrimental¹⁰⁷.

Credit Default Swaps

In contrast to short selling, a credit default swap is a derivative (thus a financial instrument), not an investment strategy. The buyer of a CDS pays a fee to the seller. In return, the seller of the CDS commits to compensate the buyer in case a credit instrument (loan or bond) fails to meet its debt obligations.

One of the most commonsense uses of a CDS is for a bondholder to protect himself against the default of that bond. However, it is also possible to buy a CDS 'naked' (or 'uncovered'). In this case, the buyer of the CDS does not own the credit instrument that the CDS protects against failure. A main reason for buying uncovered CDS is speculating on an increase of the probability of a default. During the eurozone sovereign debt crisis policymakers distrusted such actions, as they added to doubts on the creditworthiness of sovereign debt.

The Commission Proposal would require notifying the regulators of an uncovered position of Member State debt CDS that exceeds a certain threshold¹⁰⁸. Regulators would also be able to demand additional information on CDS transactions. Finally, a national regulator would be able to restrict both covered and uncovered CDS transactions. The competences of national regulators and the ESMA in restricting CDS transactions would be similar to those in case of short selling.

106. This can be done by borrowing it, entering into an agreement to borrow or having a third party reserve the security.

107. Namely so-called market making and primary market operations.

108. To be determined by the Commission.

CONCLUSION: IS IT ENOUGH?

A simple, but crucial question lingers after highlighting EU regulatory actions taken in response to the financial crisis: will it lead to a sound and secure financial system? The question cannot be answered easily.

In terms of scope, the European response is rather comprehensive. The EU has undertaken steps in a wide range of areas, notably supervision, regulation of financial institutions, markets and products and risk and crisis management. In this sense, the EU addresses the primary failings of financial regulation as identified by international reports.

Despite the ample scope, EU initiatives stop short of a radical overhaul of the financial sector. The EU initiatives aim at moderate changes. Legislative stumbling blocks are often similar, such as the level of EU integration and conditions for third country access. However, in some areas the EU response seems to be particularly feeble, even when taking into account its rather moderate nature. Two noteworthy examples are consumer protection and the systemic importance of financial institutions. In these areas, the United States' actions are much more far-reaching, respectively by creating a consumer protection agency and curbing the size of financial institutions. Such initiatives are absent in the EU.

Furthermore, the focus of EU actions can be improved. In some cases, the priorities of the Commission seem to be guided by popular purposes, rather than genuine needs. Illustrative to this is the fact that it takes years to propose legislation on an issue as crucial as crisis management, while rules on short selling – a secondary issue for many – were speedily proposed. Complexity alone does not explain the difference. A lack of focus, combined with the EU's lengthy legislative process, can have harmful consequences. Momentum for decisive action risks grinding to a halt by the time crucial decisions need to be taken. This would no-doubt result in a less secure financial system.

Even if momentum for reforms would fade away in the future, it would not change the fact that the EU's response to the financial crisis has led to a considerable increase of European financial regulatory integration. Some fields of the financial sector will be covered by EU regulation for the first time, while other fields face strengthened EU rules. In addition, the role of EU actors – notably EU supervisors – will be enhanced. Yet, the strengthening of the EU level should not be exaggerated. Member States remain crucial actors, both in terms of regulation and supervision. The stability of the financial system continues to rely on their willingness to coordinate national supervision, implement EU-rules and

adopt national legislation where required. Without such willingness, EU financial regulation is destined to fail.

Both national and EU measures can however not solve all the shortcomings of financial regulation. A globalised financial sector requires an international approach. Global cross-border cooperation and meaningful international standards are vital conditions for the safety of our European financial system. If not achieved, regulatory arbitrage could lead to the same shortcomings that caused the financial crisis. Nevertheless, this need for international cooperation does not render EU actions irrelevant. They do have an impact and may moreover facilitate a global agreement.

In summary, the EU's regulatory response to the financial crisis is incomplete. Its work to secure the financial system needs to be continued. However, new financial regulation will not remove all risk from the financial sector and nor should it aim to do so. Inevitably, a difficult balance needs to be struck between securing our financial system and allowing it to support economic growth. Some risk is inevitable. Yet, firmer regulation must prevent the financial sector from repeating the mistakes made in the past. Inevitably, misplaced financial euphoria and the resulting recklessness will reoccur in the future. It will be up to policy-makers to prevent, detect and deal with these problems. Now is the time to develop the appropriate instruments. The lessons of the financial crisis mustn't go to waste.

ANNEX 1: TABLE OF INITIATIVES TAKEN

	Subject	Action taken	Next steps
Supervision	Supervisory Framework	Agreement between EP and CoM	Implementation
	Conglomerates	Legislative proposal	Agreement between EP and CoM
Regulatory Gaps	Derivatives	Legislative proposal	Agreement between EP and CoM
	Alternative Investment Funds	Agreement between EP and CoM	Implementation
	Credit Rating Agencies	Regulation adopted; Legislative proposal	Agreement between EP and CoM; Legislative proposal
	Auditing Firms	Public Consultation	Legislative proposal
	Capital and Liquidity Requirements	Directive adopted; Directive proposed; Communication	Implementation; Legislative proposal
	Crisis Management	EC Communication	Legislative proposal
Confidence	Packaged Retail Investment Products	EC Communication	Legislative proposal
	Guarantee Schemes	Directive adopted; Legislative proposals	Agreement between EP and CoM
	Lending and Borrowing	Public consultation and hearing	Legislative proposal
Risk Management	Remuneration	EC Recommendations; Directive adopted	Implementation
	Corporate Governance	EC Green Paper	Legislative proposal
Market Wrong-doing	Market Abuse	Public consultation	Legislative proposal
	Short Selling & Credit Default Swaps	Legislative proposal	Agreement between EP and CoM

EC: European Commission; EP: European Parliament; CoM: Council of Ministers

ANNEX 2: OVERVIEW OF RELEVANT DOCUMENTS

General

- European Commission, Driving European recovery, 4 March 2009, COM(2009) 114 final
- European Commission, Regulating Financial Services for Sustainable Growth, 2 June 2010, COM(2010) 301 final
- European Commission, Commission Work Programme 2011, Volume I and II, 27 October 2010, COM(2010) 623 final

New Supervisory framework

- de Larosière, J., et al., Report of the high-level group on financial supervision in the EU, 25 February 2009
- European Commission, Communication on European financial supervision of 27 May 2009, COM(2009) 252 final
- Council of the European Union, Proposal for a Council Regulation entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board, 13 September 2010, 13401/1/10 REV 1
- European Parliament, Position adopted at first reading with a view to the adoption of Regulation (EU) No .../2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, 22 September 2010, P7_TC1-COD(2009)0140
- European Parliament, Position adopted at first reading with a view to the adoption of Regulation (EU) No .../2010 establishing a European Supervisory Authority (European Banking Authority), 22 September 2010, P7_TC1-COD(2009)0142
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