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The New Financial Regulatory Paradigm: A transatlantic perspective

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Five years after the start of the financial crisis, the EU is further behind in re-engineering its regulatory regime than the US. Although it seemed two years ago that the two blocs were moving in tandem, it is now clear that the US is further advanced in re-regulation and implementation than the EU. The sovereign debt crisis in the eurozone is to some extent to blame, but there is more to the story than that. Bank supervisory issues do not appear to be moving off the policy agenda in the EU. On the contrary, with the exception of 'banking union', a valuable initiative taken in the EU to correct the shortcomings of earlier responses, other matters give grounds for concern. These include questions of compatibility between national responses to the crisis and EU initiatives, a Tobin tax in 11 member states under 'enhanced cooperation', the challenging implementation of the Liikaanen (2012) recommendations and further delays in the introduction of risk-based supervision for insurers and pensions funds. The outcome may be an even more fragmented European financial market, access to which for third-country institutions is highly problematic.

The G-20 set the end of 2012 as the target date for all members to have implemented their response to the financial crisis. The impressive financial sector re-regulation has been followed very carefully on both sides of the Atlantic: the US has concentrated its response in one piece of legislation, the Dodd-Frank Act, whereas the EU spread its response across several new directives and regulations. Overall, action has been taken on both sides to deal with the different elements of the G-20 agenda: rating agencies, hedge funds, OTC derivatives, capital standards, crisis management. But one must look carefully at the details in order to judge whether the approaches are comparable and whether the resulting market access is satisfactory.

On February 12th, the EU and the US agreed to start discussions on a Transatlantic Trade and Investment Partnership. The intention of the Partnership, which is not a Free Trade Agreement, is to eliminate existing barriers to trade and investment to further deepen economic integration. The intention is to also open the services sectors to at least the level achieved in other trade agreements. Financial services are not included in the scope of the transatlantic trade pact, which raises the question of how much market access will be in place post-crisis, given the degree of re-regulation and the huge change in the mindset of policy-makers.

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This policy brief reviews key aspects of the new financial paradigm in a transatlantic perspective. It then discusses the general approach in EU and US legislation in response to the financial crisis and the G-20 commitments and specifically as regards the extraterritorial implications. The institutional setting is discussed, before offering conclusions on what these changes mean in the context of the new Partnership agreement.

1. EU and US financial markets and institutions pre- and post-crisis

On both sides of the Atlantic, the crisis has made a big dent in the two trading blocs' share of global financial markets. The EU and the US have fallen back significantly on several accounts, in relative numbers and also sometimes in absolute numbers (see Table 1). The total level of bank assets of both blocs reached just about half of global assets by end 2011, whereas in 2006 Europe alone still had more than 50%. The same shift applies ceteris paribus for stock market capitalisation. Both blocs thus represent a much reduced share of the world's financial markets post-crisis.

Table 1. Change in overall size of EU and US financial markets and share of world total, 2006-2011

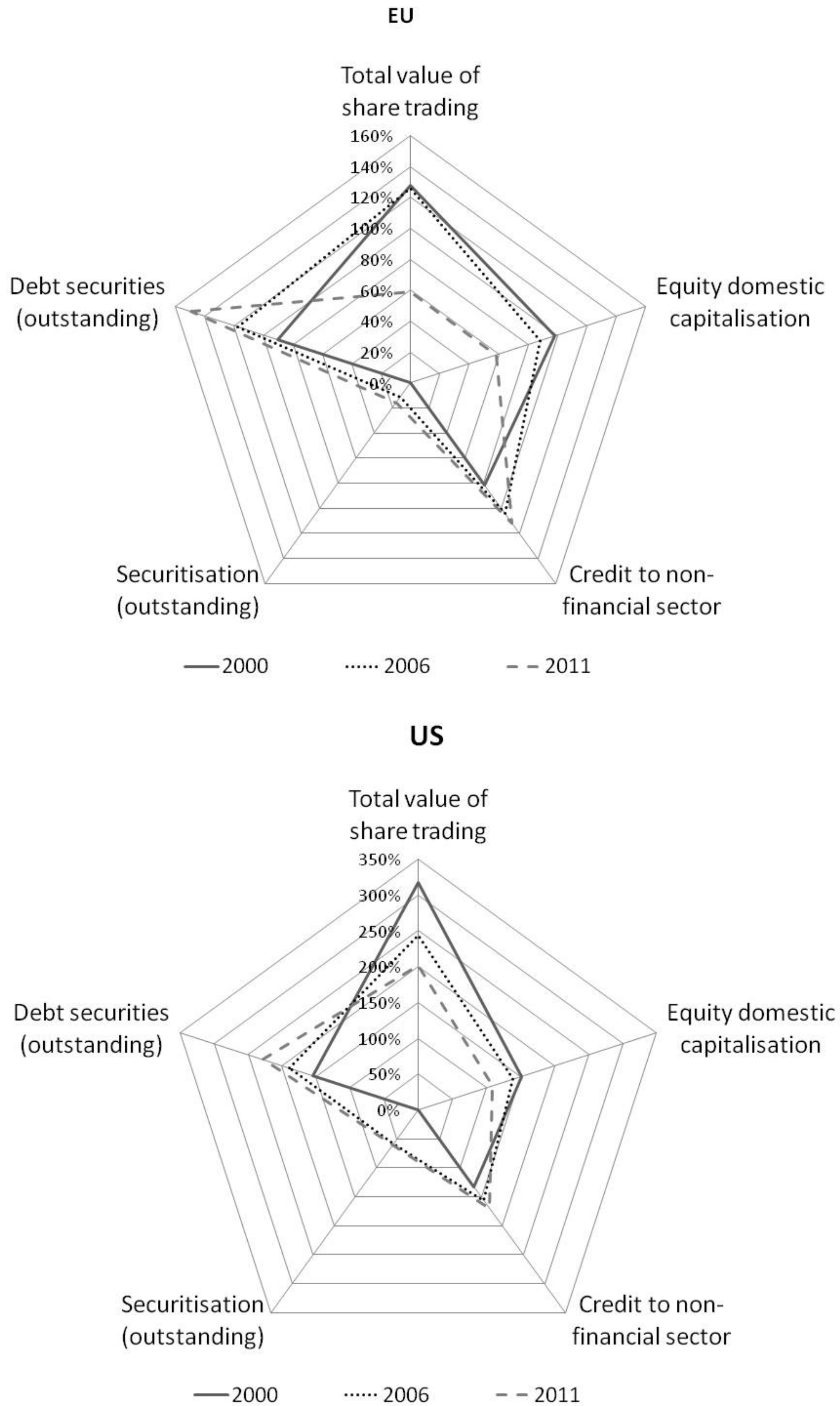
		World (€ bil.)	EU (€ bil.)	%	US (€ bil.)	%
GDP	2006	€37,596	€11,156	29.7%	€10,110	26.9%
	2011	€54,086	€13,583	25.1%	€11,586	21.4%
Gross national savings	2006	€8,701	€2,358	27.1%	€1,622	18.6%
	2011	€12,246	€2,342	19.1%	€1,355	11.1%
Bank assets	2006	€53,804	€27,822	51.7%	€7,748	14.4%
	011	€85,307	€32,593	38.2%	€11,311	13.3%
Stock market capitalisation	2006	€40,528	€10,285	25.4%	€14,750	36.4%
	2011	€36,157	€7,161	19.8%	€12,088	33.4%

Sources: IMF and World Bank.

An important global trend triggered by the financial crisis, and one that is very pronounced in both the EU and US, is the decline in cross-border capital flows, including lending, FDI and purchases of bonds and equities. Overall, these flows remain today at 60% below their pre-crisis peak. This decline is most pronounced in the UK and continental Europe, followed by the US, declining by 82, 67 and 60%, respectively (see McKinsey report – Lund et al., 2013, pp. 24-25). In the EU, much of the decline of cross-border capital flows happened intra-EU, as a result of the sovereign crisis and ongoing financial disintegration, with a strong decline in cross-border lending and sales of equities and bonds. Hence, whereas the US experienced just one setback with the financial crisis, the EU suffered a second one, with the sovereign crisis.

Also the composition of how the economy is funded has been changing, with outstanding debt and securitisation instruments growing both in Europe and the US in the last decade. Equity trading and market capitalisation, however, have dropped more in Europe than in the US, further strengthening the former's overreliance on traditional banking models (see Figure 1).

Figure 1. EU-US domestic financial markets (% nominal GDP)



Note: Data on securitisation only available from 2007.
Source: ECMI Statistical Package (2012).

On both sides, central banks played an important role during the crisis in replacing the markets through a series of unconventional measures. The balance sheets of the Federal Reserve, the ECB and the Bank of England more than doubled in the period 2008-12. But a simple comparison of balance sheets may obscure the methods used. Whereas the Federal Reserve (and the Bank of England) reacted through 'quantitative easing' by directly buying securities in the markets, the ECB reacted through 'credit easing', by supplying credit against a broader range of collateral, often at significant haircut levels. The ECB furthermore had to react to growing disintegration in the eurozone by buying securities directly in the markets, with super seniority conditions (see Gros et al., 2012). In both cases, the ECB was more protective of its asset base, thereby delaying the recovery, whereas the Fed took over the credit risk. It is only with the Outright Monetary Transactions (OMT), announced in August 2012, that the ECB changed this stance, but it has not yet been used.

2. The EU-US crisis response, a comparative perspective

Both jurisdictions, the EU and the US, attached great importance to the follow-up of the commitments taken in the G-20 context. In the US, mostly one piece of legislation (the June 2010 Dodd-Frank Act) and discretionary powers of the supervisory authorities (e.g. for implementing Basel III) have been used to translate G-20 commitments into real actions. In the EU, commitments have to be implemented in multiple EU legislative acts, i.e. regulations or directives to ensure the application in all member states. The crisis also led recently to a series of institutional changes, most importantly with the 'banking union' proposals, which have revealed significant divergences between eurozone and non-eurozone countries. Box 1 gives an overview of the G-20 commitments by subject and their follow-up in the EU and the US.

Box 1. G-20 follow-up legislation in the US and the EU

Subject	Dodd-Frank (US)	EU legislation
Credit Rating Agencies	Upgrade of NRSRO regime (Title IX, Subtitle C)	Credit Rating Agencies Regulation (CRA 1, 2, 3)
Hedge funds	Title IV, amending 1940 Investment Advisors Act (exemptions remain)	Alternative Investment Fund Managers Directive (AIFMD)
OTC (over-the-counter) derivatives on CCPs (central counterparties), trade repositories	Title VII mandates central clearing and exchange trading of most OTC derivatives	Similar rules in EU Market Infrastructure Regulation (EMIR)
Price transparency of derivatives, commodities	Idem	Rules in draft MiFID II and MiFIR (Markets in Financial Instruments Directive and Regulation)
Short selling	-	Short selling regulation
Basel III	Consultation on implementation ongoing	Implemented in CRD II, III, (IV) (Capital Requirements Directive)
Bank structure	Volcker rule	Liikaanen report, Vickers, member states rules
Bank tax	Initially proposed, but scrapped	Financial transaction tax (FTT) in individual member states and through 'enhanced cooperation'
Remuneration rules	Enhanced disclosure	CRD III and IV, AIFMD, CRA 1
Bank resolution	Broader powers for the FDIC through the Orderly Liquidation Authority	Draft Directive on Resolution and Recovery (RRD)
Institutional aspects	Financial Services Oversight Council (FSOC) Enhanced powers for the Federal Reserve Consumer Financial Protection Bureau (CFPB) Federal Insurance Office	European Systemic Risk Board (ESRB) European Supervisory Authorities (ESAs: EBA, ESMA, EIOPA) Single Supervisory Mechanism (SSM)

As the box above suggests, the EU and the US have followed up closely on the G-20 commitments. Both blocs now have legislation in place or are advancing to legislate on rating agents, hedge funds, OTC derivatives and bank capital. The rules differ a lot in their details, however, since they emerged in different political and economic contexts. Comparing the effectiveness of the rules is a difficult exercise because other objectives were added to the G-20 commitments. Overall, however, the rating agencies and hedge fund rules go further in the EU, with more detailed rules as they also relate to the introduction of a single passport regime. This has not prevented the US from taking very tough actions recently against both rating agencies and hedge funds. A common element regarding rating agencies on both sides is the reduction of the regulatory reliance on ratings, but it seems that the groundwork on both sides has only started. On OTC derivatives, the US is more advanced in putting in place a regulatory framework, even though the EU was the first to announce its intention to regulate OTC derivatives in 2009. However, divergences are emerging in the treatment of non-domestic financial infrastructures (e.g. CCPs) in cross-border transactions, and most importantly no agreement has been reached to set global standards for non-centrally cleared derivatives. The US has a specialist supervisor, the CFTC, apart from the SEC, while Europe has still to clarify the role of ESMA (and perhaps the ECB) in supervising these markets. The US is more advanced with trade repositories, where the DTCC has been acting as a repository for CDS since the beginning of the financial crisis, even though the EU is gradually coming out with multiple competing repositories in different asset classes.

The most contentious issue at this stage is the implementation of the Basel III capital rules for banks, where each bloc is criticising the other for not implementing, or incorrectly implementing what has been agreed by the Basel Committee. In its latest findings published in October 2012, the latter found shortcomings in the EU's compliance on the definition of capital and the internal ratings-based approach (because of the partial exemption), and on the part of the US on the securitisation framework (BIS, 2012). In the near-final EU draft agreed March 5th, these issues remain, in addition to the leverage ratio, which is not binding, but the final assessment is with the Basel Committee. A broader issue with capital measurement is accounting standards, where both blocs continue to be miles away from each other.

The differences in approach are especially pronounced in the following four areas:

- **Bank taxation**: A form of bank balance sheet tax was initially proposed in the Dodd-Frank Act, but later withdrawn. In Europe, further to the February 2013 Ecofin Council agreement, 11 member states will under the enhanced cooperation procedure introduce a financial transaction tax (FTT), which some have already under national law. In practice, this means that there will be a transaction tax of 0.1% of the value of secondary market equity and bond transactions, and of 0.01% on derivatives. This tax will only have a limited impact on banks' proprietary trading, while the tax for clients' investments will be directly borne by final investors. Since this falls under the procedure of 'enhanced cooperation', it is difficult to foretell if the Commission's new proposal will be implemented in full, but the tax will be damaging to the single market and to capital market development since it raises tax barriers in an already difficult cross-border financial environment. On the other hand, its effects should not be exaggerated, as 11 member states have introduced a form of FTT today, such as the UK with the stamp duty, only four of which will participate in the EU FTT.

- **Bank structure**: Implementation of the Volcker rule in Dodd-Frank, which limits the trading on own account by commercial banks, started in July 2012. In the EU, the Liikaanen (2012) report proposed to enact in EU law a Chinese wall between investment and commercial banking from a given threshold, but some member states have adopted their own provisions in the meantime, such as the Vickers proposal for retail ring-fencing in the UK and the recent changes in French and German law towards some degree of separation of trading departments in banking. The regrettable element of the latter proposals is, as with the FTT, their negative impact on the single market.

- **Remuneration rules** have become fairly common in EU legislation as a result of the crisis, covering banks, fund managers and rating agents. For banks, they are set in the CRDs III and IV, for hedge fund managers, rules under the AIFMD, and for rating agents, rules under the CRA I. Some member states are also legislating shareholder approval for executive pay, along the lines recently enacted by Switzerland. A limited focus has been given to organisational structure and governance rules both in Europe and the US. Recent wrongdoings by traders and broader market manipulation cases are cases in point.
- **Short-selling**: A common definition already existed in the US, but in order to deal with the wide diversity of practices followed in the EU, a regulation had to be adopted to introduce a single definition. The EU regulation prohibits uncovered short sales in shares and sovereign debt securities. This Regulation also covers uncovered short sales of CDS on sovereigns. The US is less strict on uncovered short sales, but it depends on the interpretation given by the Securities and Exchange Commission (SEC). In 2008, the SEC also restricted aggressive short-selling of 19 banking stocks.

The EU initiatives aimed at bringing risk-based supervision to insurers, including life insurers, and defined benefit pensions funds (Solvency II and IORP II) also deserve mention. Delayed for over 10 years, the introduction of Solvency II has now become quite urgent in order to mitigate prudential risks. The experience of Japan in the 1990s, where seven life insurers failed after a prolonged period of low interest rates, illustrates the risk of inaction. Unlike Basel III, Solvency II is not linked to a global regulatory process, although it is taken as a benchmark.

At the institutional level, both blocs have strengthened the setting, with the creation of a macro-prudential authority, reinforced cooperation among supervisors and enhanced powers for the central bank. Although the EU is taking more time in handing over supervision to the ECB (with a chance that this might be done only by eurozone countries), it could be argued that the EU structure may be in the end more streamlined than in the US, where powers between federal supervisory and state supervisory authorities often overlap. In the eurozone, the ECB will become the unique supervisors for medium-sized and large banks, with a balance sheet over €20 billion, according to the proposals for the SSM on the table. In the US, although the Federal Reserve's powers have been enhanced in Dodd Frank for all banks with a balance sheet over $50 billion (just under €39 billion), there remains a duplication of duties between the Office of the Controller of the Currency (OCC) in the US Department of the Treasury and state supervisors.

3. Third-country provisions in EU and US rules

Both blocs have restricted market access as a result of the crisis. The EU sets elaborate provisions for 'equivalence' of the rules of third-country providers as a pre-condition for market access, and the US applies its rules extra-territorially, i.e. foreign firms have to register with US authorities and respect some local rules. Before the crisis, both blocs seemed to be moving towards a form of mutual recognition, most markedly in the US with the 'substituted compliance' regime. The fact that financial services are not included in the mandate for the recently launched Partnership Agreement talks between the EU and US indicates that the financial crisis will continue to reverberate for some time to come.

From an EU perspective, the new post-crisis rule is 'equivalence' and the need for equivalence decisions of third-country regulatory regimes. Before the crisis, the expression was 'not more favourable treatment' of third-country service providers, with a tendency towards mutual recognition. Post-crisis legislation insists on detailed equivalence examinations in the different areas of legislation, subject to Commission implementing acts. A first set of decisions regarding the equivalence of the supervisory regimes of other countries' rating agencies was taken by the EU regarding the US, Canada and Australia, and published in October 2012. As regards the US, it decided that "the US framework provides for equivalent protection in terms of integrity, transparency, good governance of credit rating agencies and reliability of the credit rating activities".

Box 2 provides an overview of EU market access for third-country firms for the G-20 issues. This

was extensively debated in the context of the hedge funds Directive (AIFMD), where EU rules would favour third-country jurisdictions, and lead to a flight from EU financial centres, i.e. London. However, early evidence demonstrates that hedge funds are relocating to the EU. Under the new rules, firms can also choose to get a single license for the EU market, an option that was not available before. The same applies to rating agents and central counterparties, as there were no EU-wide rules, but mostly local rules, or no licensing requirements at all.

The US market access rule that has been most discussed concerns derivatives traders. According to implementing provisions of Dodd-Frank (Title VII), non-US banks trading with US counterparties must register in the US as swap dealers and abide by CFTC rules on capital requirements and risk management. However, non-US swap dealers responded that the legal risks of such a requirement may act as a huge disincentive to continue to deal with US counterparts. The EU can certainly be expected to react to such provisions. In the equivalence decision regarding CRAs, the EU stated: "the regulatory regime in the third country must prevent interference by the supervisory authorities and other public authorities of that third country (…). In this respect, the SEC and any other public authority in the USA are prohibited by law from interfering (…)."[1]

By reacting at global level to the crisis, the G-20 commitments were intended to ensure that all jurisdictions had similar rules in place and that trade relations would continue amongst the members. By imposing additional conditions, for example ring-fencing, the effect may be a duplication of requirements, more costs, probably less effective supervision and less cross-border trade.

4. Implications of the transatlantic Partnership agreement

Against the background of tighter rules for market access for financial services providers, the announcement of a formal start of talks on a Transatlantic Trade and Investment Partnership on February 12th comes as a surprise. Although the announcement emphasises the importance of transatlantic trade in goods and services, financial services, where both blocs continue to dominate globally, are only partially included (if they do not have systemic implications). The exclusion indicates that financial stability concerns will continue to dominate the approach to financial services for some time to come, and is not supportive of a transatlantic financial market – this in the context of an ongoing consolidation process among US and EU financial institutions and market infrastructures. Market access should be ensured, meaning that local rules and its reach to third-country providers, as discussed above, have to be respected.

The announcement of the Transatlantic Partnership is certainly ambitious. Although clearly less ambitious than a Free Trade Agreement (FTA), it aims to expand transatlantic trade and investment by reducing tariff and non-tariff barriers for goods and services, and to enhance the compatibility of regulations and standards. For some observers, the announcement meant that a new multilateral trade deal is definitely off the agenda for the time being, although only two days later the European Commission stated its intention to open multilateral trade negotiations on services, including financial services, with 21 WTO members, including the US. This agreement will be compatible with the General Agreement on Trade in Services (GATS). Thus, in light of the forthcoming multilateral services round, one should not be too pessimistic about the prospects for financial services, despite the limited scope of the Partnership Agreement.

5. Concluding remarks

The G-20 rules, the Partnership Agreement and a new GATS round mean for the time being a continuation of the status quo, or a more extensive use of the 'prudential carve-out', as we know it from the GATS. The recent financial crisis will keep supervisors alert to prudential concerns when dealing with third-country service providers. It is only once the new framework is thoroughly implemented on both sides that an open transatlantic financial market could be put back on the agenda.

[1] Ibid., p. 2.

Box 2. Regime for third-country firms under the EU's post-crisis financial services rules

Measure	Regime for third-country providers
Credit Rating Agencies	• Commission to adopt equivalence decision of CRA regime • Local endorsement of ratings of EU importance produced outside the EU • Cooperation arrangements between supervisors
AIFMD (non-UCITS managers/funds)	• 2013: Access at national level (compliance with transparency and reporting obligations in AIFMD) • From 2016: Introduction of passport for non-EU providers who comply in full with AIFMD (with exceptions) • Later on (final date based on review of directive): Access at national level to be phased out
EMIR (CCPs)	• Equivalence of regime, subject to Commission implementing Act • Third-country CCP to be recognised by ESMA (after equivalence) • Cooperation arrangements between supervisors
CRD IV draft (Basel III)	• Not more favourable treatment of branches • EU may conclude agreements for identical treatment
MiFID II (investment firms)	• Commission to adopt equivalence assessment for provision of investment services • ESMA to register third-country firms (from equivalent jurisdictions) • ESMA to establish cooperation arrangements

There is, however, a potential game changer in the wings: the Single Supervisory Mechanism (SSM). By transferring key bank supervisory tasks to the federal level (whether it will be the eurozone or EU level is still unclear), the EU is giving a signal to the US and the world at large: Europe will (finally) supervise its banks. With the ECB in the driver's seat, the job will be seriously done, above all for the large and global players. The eurozone will become the home market. The messy and byzantine structures for the supervision of large European banks should be a thing of the past. The ECB will directly deal with its counterparts in other jurisdictions for the supervision of large groups, most importantly the Federal Reserve and the Bank of England, and thus greatly improve supervisory efficiency and trust in the European financial system.

The fact that no eurozone-wide resolution framework or deposit guarantee scheme is in place should not be a cause for immediate concern, but it should be recognised that they are essential elements for building a real banking union over time. The EU's competition policy authority has been exercising the role of resolution authority by default since the beginning of the financial crisis. Hence, where the resolution authority in the US is the Federal Deposit Insurance Corporation (FDIC), in the eurozone (plus) this role is performed jointly by the ECB as supervisor, the Commission's competition authority (DG COMP) and, in last resort, the European Stability Mechanism (ESM) for large cross-border banks or in the event of a large domestic systemic banking crisis to impose additional requirements. The resolution of the Spanish savings banks, in which senior debt holders were bailed-in, should be an indication how such a crisis may be potentially resolved.

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