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Expanding EU Role in European Financial Regulation

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In its conclusions published on March 20, 2009, the European Council endorsed a greatly expanded European Union role in the regulation of the European financial system, as laid out in the report of the de Larosière Group published on February 25, 2009 (the "de Larosière Report") and the Commission's communication of March 4, 2009 (the "Commission Communication").[1] The EU program will form part of the discussions to be undertaken by G-20 members at their meeting in London on April 2, 2009. The European Council will take the first decisions to strengthen the regulation and supervision of the European financial sector at the June 2009 European Council meeting.

The Commission's program calls for the adoption of a wide range of regulatory reforms over the course of 2009 and 2010, complementing the regulatory initiatives already launched in response to the financial crisis. Specifically, the Commission proposes to establish a new European financial supervisory body to be operational by the end of 2010; to adopt a number of specific legislative measures to fill gaps in the existing financial regulatory structure; and to create a comprehensive legal framework for retail financial services. The Commission's proposals mirror thematically similar initiatives by Member State governments.

This Memorandum summarizes the initiatives proposed by the Commission to reshape the European financial regulatory system, together with related initiatives already launched by the European institutions in response to the financial crisis.

I. EUROPEAN SUPERVISORY FRAMEWORK

The Commission Communication noted that one of the major lessons of the financial crisis is that cross-border cooperation by Member State supervisory authorities within the existing regulatory framework is ineffective and unresponsive. Building on the de Larosière Report, the Commission will propose the establishment of a new Euro-

1 Presidency conclusions of the Brussels European Council of March 19-20, 2009 and Commission's communication for the Spring European Council – Driving the European recovery, March 4, 2009 ((COM)2009 114) are both available at: http://europa.eu/european-council/index_en.htm

pean body to oversee the stability of the European financial system, as well as the architecture of a new European financial supervisory system. This system would coordinate the activities of national supervisors, who would remain responsible for the day-to-day supervision of financial institutions.

The Commission plans to publish a package of measures to be considered at the European Council meeting in June 2009 and to follow up with specific legislative proposals in Autumn 2009. The Commission aims to have the new framework up and running by the end of 2010. The Commission will also publish a White Paper by June 2009 to address the limitations in the early intervention tools available to Member States during the financial crisis. The Commission noted in particular that cross-border arrangements need to be improved in view of the increasing integration of the EU financial sector.

Although the Commission Communication contains no details about the proposed structure, the de Larosière Report proposed a three-tier system:

- Under the de Larosière Report proposal, the new European financial supervisory system would be headed by a new European body, the European Systemic Risk Council (ESRC), under the auspices of the European Central Bank (ECB). The ESRC would be responsible for overall "macro-prudential" policy, employing risk warnings as inputs to EU supervisors and giving them direction based on comparisons across Member States. For instance, the ESRC would harmonize national regulations such as deposit guarantee schemes and their pre-funding, capital adequacy requirements and quality of the supervision standards.

- Under the ESRC would be a European System of Financial Supervisors (ESFS) made up of three European authorities: the European Banking Authority, the European Securities Authority, and the European Insurance Authority. These authorities would supersede the current "Level 3 Committees" (the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR)) and would have substantially greater powers. The European financial supervisors' responsibilities would include conducting legally binding mediation between national supervisors, adoption of binding supervisory standards, adoption of binding technical decisions applicable to individual institutions, oversight and coordination of colleges of supervisors, licensing and supervision of specific EU-wide institutions (*e.g.*, credit rating agencies and post-trading infrastructures) and cooperation with the ESRC.

- Finally, national regulators at the Member State level would remain responsible for the day-to-day supervision of financial firms.

II. REGULATORY REPAIR

The Commission Communication noted that the financial crisis has exposed shortcomings in the current EU and national regulatory frameworks. The Commission will present a number of specific initiatives in the course of 2009 to complement EU measures taken in recent months to shore up the EU financial regulatory system. Such measures include the European Economic Recovery Plan - the early signs of which the Commission Communication described as "positive, both in terms of the volume of the stimulus and the direction of reforms."[2]

A. TREATMENT OF IMPAIRED ASSETS

The European Council underlines the importance of the treatment of impaired banking assets for restoring the functioning of credit markets and facilitating the flow of lending to the real economy. It further calls on the Member States to act in a coordinated manner, in line with the guidelines set forth under the Commission communication of February 25, 2009 on the treatment of impaired assets in the EU banking sector. While allowing Member States to choose whether a "bad bank", an insurance scheme, a restructuring or even nationalization is most appropriate to their situation, the guidelines ensure that a level playing field is maintained among banks in the Single Market. Commission approval for asset relief measures (based on uniform assessment criteria) will be granted for periods of six months and will be conditional on Member States' commitment to present details of the valuation of the impaired assets, as well as a viability assessment and restructuring plan for each beneficiary institution within three months from its accession to the asset relief program.

The Council will assess the effectiveness of the measures taken – as well as the overall stability and functioning of financial markets – and report back to the next European Council meeting in June 2009.

B. REGULATION OF HEDGE FUNDS AND PRIVATE EQUITY FIRMS

Although hedge funds and private equity firms do not appear to have played a major direct role in the onset of the financial crisis, the Commission will propose a comprehensive legislative instrument establishing regulatory and supervisory standards for such firms, as well as other systematically important market participants, by April 2009.

[2] The Commission Communication, p 8.

The Commission has already launched an investigation into the treatment of hedge funds and private equity firms. The Commission published on March 12, 2009 a summary of the responses to its recent public consultation on hedge funds and on the Conference on Hedge Funds and Private Equity, held in Brussels on February 26-27, 2009.[3] Sixty-two per cent of respondents believed that regulators need more information on hedge funds to monitor the systemic effect their activities may have on European and global markets.

The Commission's actions follow the Rasmussen and Lehne reports issued by the European Parliament in September 2008 and the creation of an IOSCO task force on unregulated financial entities.[4] In line with the European Parliament's recommendations, the regulatory framework applicable to hedge funds and private equity firms should contain minimum transparency rules on how investments are financed and on ownership structures, as well as rules on risk management, assessment methods, managers' qualifications, possible conflicts of interests, and registration of such hedge funds.

C. REGULATION OF CREDIT RATING AGENCIES

The role played by credit rating agencies ("CRAs") in the global economy has been under scrutiny since the onset of the credit crunch in the second half of 2007. The European Council calls for rapid agreement on the proposed regulatory framework set forth in the Commission proposal of November 12, 2008, which aims at ensuring that CRAs avoid and manage appropriately any conflict of interest and remain vigilant on the quality of ratings and rating methodologies, increasing CRAs' transparency and at ensuring there is an efficient registration and surveillance framework to prevent forum shopping and regulatory arbitrage.[5]

In particular, the Commission proposal prohibits CRAs from providing advisory services or rating financial instruments if they do not have sufficient quality information on which to base their ratings and requires CRAs to disclose the models, methodologies and key assumptions on which they base their ratings, to publish an annual transparency

3 http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm. Hedge funds and private equity managers are already subject to the same market abuse disciplines as other market participants and to similar transparency and consultation obligations when investing in public companies, and the exposure of the banking sector to hedge funds and private equity is subject to the Capital Requirements Directive.

4 European Parliament resolution of 23 September 2008 with recommendations to the Commission on hedge funds and private equity (2007/2238(INI)). Details on the IOSCO task force can be found at: http://www.isco.org.

5 The proposal can be found at http://ec.europa.eu/internal_merket/securities/agencies/index_en.htm. CRAs are currently subject to Community legislation to a limited extent under the Market Abuse Directive and the Capital Requirements Directive in the determination of risk weights of a firm's or bank's exposures which are relevant to capital requirements.

report and to create an internal function to review the quality of their ratings. CRAs will further be required to have at least three independent non-executive directors (one of them being an expert in securitization and structured finance), whose remuneration cannot depend on the business performance of the rating agency, who can only be dismissed in case of professional misconduct and who will be appointed for a single term of at most five years.

The European Parliament is expected to adopt its report on the European Commission's proposed regulation for CRAs in April 2009.

D. REVISION OF THE CAPITAL REQUIREMENTS DIRECTIVE

The Commission will propose a number of actions to reinforce capital requirements in connection with the ongoing revision of the Capital Requirements Directive (the "CRD").[6] Notably, by June 2009 the Commission will propose capital requirements for trading book activities, *i.e.*, the capital requirements related to assets that banks hold for short-term resale, and capital requirements for complex securitizations, both in the banking and the trading book. By Autumn 2009, the Commission will propose measures supplementary to risk-based requirements in the CRD, for example to address leverage and/or liquidity risk. By the end of 2009, the Commission will also present a report on ways to mitigate the effects of "excessive" procyclicality in the CRD (stemming in particular from the interaction of risk-sensitive capital requirements and the application of the mark-to-market principle in distressed market conditions), possibly by allowing banks to build up reserves during good times while reducing capital buffers during difficult times.

These suggestions supplement the Commission's proposal of October 1, 2008 to amend the CRD,[7] which already contemplated important changes in terms of:

(i) *Management of large exposures:* Banks will be restricted in lending beyond a certain limit to any one party. As a result, in the inter-bank market, banks will not be able to lend or place money with other banks beyond a certain amount, while borrowing banks will effectively be restricted in how much and from whom they can borrow;

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6 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions. For an overview of the Commission's initiatives see: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#consultation

7 Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (COM(2008) 602/3).

(ii) *Supervision of cross-border banking groups:* "Colleges of supervisors" will be established for banking groups that operate in multiple EU countries. The rights and responsibilities of the respective national supervisory authorities will be made clearer and their cooperation will become more effective;

(iii) *Quality of banks' capital:* There will be clear EU-wide criteria for assessing whether "hybrid" capital is eligible to be counted as part of a bank's overall capital;

(iv) *Liquidity risk management:* The liquidity risk management of banking groups that operate in multiple EU countries – *i.e.*, how they fund their operations on a day-to-day basis – will also be discussed and coordinated within the "colleges of supervisors." These provisions reflect the on-going work at the Basel Committee on Banking Supervision and the CEBS; and

(v) *Risk management for securitized products:* Rules on securitized debt will be tightened. Originators will be required to retain some risk exposure to securitized products, while firms that invest in them will be allowed to make their decisions only after conducting comprehensive due diligence. If they fail to do so, they will be subject to heavy capital penalties.

The Commission's on-going review of the CRD will also be influenced by (i) the interim report on banks' liquidity buffers and survival periods issued by the CEBS on March 18, 2009,[8] (ii) the Basel Committee proposals to strengthen the Basel II capital framework published on March 12, 2009,[9] (iii) the ECB opinion of March 5, 2009, on the Commission's proposed amendments,[10] and (iv) the good practice guidelines for securitization disclosure requirements under Pillar 3 of the CRD, published by the London Investment Banking Association, in conjunction with the European Banking Federation, the European Savings Banks Group and the European Association of Public Banks and Funding Agencies, on January 15, 2009.[11]

8 The CEBS interim report is available at: http://www.c-ebs.org/News--Communications/Latest-news/CEBS-is-today-publishing-an-interim-report-on-liqu.aspx

9 A press release on the Basel Committee proposal is available at: http://www.bis.org/press/p090312.htm

10 The ECB opinion is available at: http://www.ecb.int/ecb/legal/pdf/en_con_2008_84_eu_e-money_directive.pdf

11 These guidelines are available at: http://www.liba.org.uk/issues/2008/Dec%2008/D2499A-Good%20practice%20guidelines%20on%20P3-4%20Dec%202008.pdf

E. SOLVENCY II DIRECTIVE FOR INSURANCE GROUPS

The European Council further advocates the rapid adoption of the Solvency II Directive, introducing more sophisticated solvency requirements and a new supervision framework for insurers, re-insurers and insurance groups. The implementation of the Directive has been delayed by discussion by Member States, the European Parliament and the European Commission.[12]

Under the Commission's proposal of February 26, 2008,[13] insurance groups would be supervised through a "group supervisor" in the home country that would have specific responsibilities to be exercised in close cooperation with other relevant national supervisors. The introduction of group supervisors would ensure that group-wide risks are not overlooked and would enable groups to operate more efficiently, while providing policyholders with a higher level of protection. Groups that are sufficiently diversified may also be allowed to lower their capital requirements under certain conditions.

F. COMPLEX FINANCIAL PRODUCTS

The Commission will make a proposal to ensure that financial firms use central counterparty clearing for complex financial products. On February 19, 2009, financial industry participants committed themselves to using EU-based central clearing for eligible EU credit default swaps contracts by mid-July 2009.[14]

The Commission is also working on a report on derivatives and other complex structured products to be issued around June 2009. This report will serve as a basis for recommending appropriate measures to increase the transparency and ensure the financial stability of the derivatives market. As suggested by the de Larosière Group, these should notably aim at the simplification and standardization of over-the-counter derivatives.

G. SECURITIES HOLDING

By the end of 2009, the Commission will introduce proposals to simplify and harmonize the national rules regarding holding of securities and securities transactions. The Commission noted that particular attention will be paid to money market funds and the lessons from the Madoff fraud.

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12 Political agreement has since been reached on the contents of the Solvency II Directive (http://europa.eu/press_room/index_en.htm). Final approval is expected in April 2009.

13 Commission Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (COM (2008) 119).

14 The press release is available on the website of the International Swaps and Derivatives Association, Inc. at http://www.isda.org/index.html

The de Larosière Report highlights the need for a common definition of money market funds and a stricter codification of the assets in which these funds can invest in order to limit exposure to credit, market and liquidity risks. The Madoff case has further illustrated the importance of better controlling the quality of processes, functions and delegations of responsibilities within funds (or funds of funds).

H. ACCOUNTING

Building on the recommendations set forth in the de Larosière Report, the European Council believes that new EU financial regulation should be complemented with a strong EU initiative to review international accounting standards.

In the Commission Communication, the Commission called for reflection on the mark-to-market principle and in particular recommended that expeditious solutions be found to accounting issues such as the treatment of complex structured products, the valuation of assets in illiquid markets where mark-to market cannot be applied, and the pro-cyclical and short-term approach promoted by current accounting standards.

I. CORPORATE GOVERNANCE STANDARDS

The European Council stressed that action must be taken on remuneration structures to avoid excessive risk-taking and short-termism to the detriment of long-term performance and restore trust and confidence of European investors and businesses in financial institutions. In addition to the implementation of multi-year setting of bonus standards, the de Larosière report recommends stronger roles for chief risk officers and greater transparency requirements.

As part of its proposed directive on hedge funds and private equity firms (see B above), the Commission will propose standards for remuneration on or around April 21, 2009. The Commission has indicated that this will involve an element of supervisory review for both publicly and privately held institutions. In addition, the Commission plans to update its December 2004 recommendations on the remuneration of directors of listed companies.

J. "ROLLING" SUPERVISORY RULE REFORM

More generally, the Commission proposes to review differences in national legislation stemming from exceptions, derogations, and additions in national legislation and/or ambiguities in current directives. These will be removed through the adoption of harmonized standards at the EU level.

In particular, the Commission Communication points out the often weak and heterogeneous sanction regimes in the Member States. By Autumn 2009, the Commission is expected to review the Market Abuse Directive and make proposals on how sanctions could be strengthened in a harmonized manner and better enforced.

III. RETAIL FINANCIAL SERVICES

The financial crisis has highlighted the importance of investors', consumers' and SMEs' confidence about their savings and access to credit. In this context, the Council and the EU Parliament enacted Directive 2009/14/EC of March 11, 2009, amending Directive 94/19/EC on deposit-guarantee schemes as regards coverage levels and payout delays.

The main changes under Directive 2009/14/EC – which will be implemented in Member States' national legislation by June 30, 2009 – are as follows:

(i) *Level of coverage for deposits:* Member States are required to increase the coverage level to at least €50,000 and within a further year to at least €100,000 (against a minimum coverage of at least €20,000 under the previous regime), which shall increase the level of protection of eligible deposits to an estimated 80% (with coverage of €50,000) to 90% (with coverage of €100,000) of deposits (against 65% under the previous regime);

(ii) *Co-insurance (i.e., where the depositor bears part of the losses) is abandoned:* Member States must ensure that deposits are reimbursed up to the coverage level, while the previous regime allows Member States to limit the deposit guarantee to 90% of savings; and

(iii) *Reduction of the payout period:* The time allowed for the deposit guarantee scheme to pay depositors in the event of a bank failure is reduced to twenty working days and can only be extended with the approval of the competent authority under exceptional circumstances, by a period that does not exceed ten working days (against three to nine months under the previous regime).

The Commission has also recently launched a consultation to review the Investor Compensation Scheme Directive,[15] with a view to better protecting investors against the

15 Directive 97/9/EC of the European Parliament and of the Council of March 3, 1997 on investor-compensation schemes (OJ L-84)

risk of losses resulting from the inability of an investment firm to repay money or return assets to them.[16]

The Commission has further been requested to revert, by April 2009, with a communication on retail investment products, which will set out legislative actions that the Commission intends to propose to strengthen the effectiveness of safeguards to be respected when financial institutions market, sell or recommend investment products to retail investors. The Commission will organize a public hearing on responsible lending and borrowing (including on credit intermediation) in July 2009 and present follow-up measures by Autumn 2009.

IV. CONCLUSION

The economic crisis has produced a bewildering array of regulatory and economic responses at all levels of government. It is difficult, if not impossible, to have a complete overview of all these responses. A pattern that has emerged in European responses to the crisis, however, is the increased role the EU plays in laying down common guidelines for Member State actions and in identifying and attempting to remedy shortcomings in the regulation of banks and other market participants.

Based on the Commission Communication and the conclusions of the Spring European Council, the EU role in the European financial regulatory system will be further enhanced. If the European institutions adhere to the Commission Communication timetable, a new European supervisory framework will be created by the end of this year and operational in 2010, and an ambitious program of new and amended legislation will be in place to strengthen and harmonize the regulation not only of banks and investment banks, but also of hitherto largely unregulated entities such as hedge funds, private equity firms and CRAs.

As the EU and the U.S. agendas for regulatory reform in response to the financial crisis take more concrete shape, the question arises what scope will remain for the global coordination through the IMF and the Financial Stability Forum, to be discussed in the G-20 meeting in London on April 2, 2009.

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16 Further details can be found at: http://ec.europa.eu/internal_market/consultations/2009/investor_compensation_en.htm

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For additional information on issues regarding the financial crisis, please visit Cleary Gottlieb's Financial Crisis Resource Center at: http://www.cgsh.com/financial_crisis_resource_center/eu_resources/.

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