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Commentary on the economy & regulatory policies affecting financial companies

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A Lawyer in Europe: A Review of the State of Financial Reform in the EU and UK*

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In 1880, Mark Twain wrote a travelogue entitled "A Tramp in Europe." Having just spent 48 hours in Brussels and London attending meetings with EU and UK officials on the status of financial reform, I offer you "A Lawyer in Europe: A Review of the State of Financial Reform in the EU and the UK." Admittedly, a newsletter article on financial policy is not as entertaining as Mr. Twain's work. However, I was able to download his book to my Kindle for just $1.00, so even the value of his work has diminished over the years. The first stop on this journey is a general introduction to EU governance.

Some Background on the EU

The economic and political union that constitutes the EU has its origins in a coal and steel agreement that was signed by Germany, France, Italy and the Benelux nations in 1951. The preamble to this "Treaty of Paris" makes it clear that the agreement was not just a step toward economic integration, but a step away from the military rivalries that had destroyed much of the continent in the first half of the 20th century:

> CONSIDERING that world peace can be safeguarded only by creative efforts commensurate with the dangers that threaten it . . .
>
> [We are] RESOLVED to substitute for age-old rivalries the merging of their essential interests; to create by establishing a common community, the basis for a broader and deeper community

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> among peoples long divided by bloody conflicts; and to lay the foundation for institutions which will give direction to destiny henceforth shared...

The Treaty of Paris has been followed by several other economic and political agreements, including the Treaty of Rome (1957), which created a more complete economic union and the Maastricht and Lisbon Treaties (1992 and 2007), which created a more complete political union. Today, 27 countries belong to the EU, and there is no doubt that this experiment in cooperation has contributed to economic growth and peace within the EU during the past 60 years.

Brussels is the capital of this unified political and economic system. It is seat of the EU executive department, and part-time seat of the EU Parliament. (The official seat of Parliament is Strasbourg, France, but most Parliament meetings are held in Brussels.) Some Europeans joke that Rome would have been a better site for EU policymakers, but it was feared that delegates would have too much fun there.

While many of the buildings in Brussels were constructed in medieval times, the governance structure that has evolved for the EU seems Byzantine. There are four major governing bodies in the EU. There is the European Council, which is not to be confused with the Council of the European Union. There is the European Commission, and the 736-member EU Parliament. To the uninitiated, the lines of authority between these bodies are difficult to appreciate.

The European Council sets general policy for the EU. It is composed of the heads of the 27 member states, and was formalized at the end of last year. Before that it operated as an informal body.

The European Commission operates as the executive branch of the government. The Commission proposes legislation and implements laws. Its 27 members are selected every 5 years, and each is responsible for a particular policy area. Most financial policies fall under the Commissioner for Internal Markets and Services.

The Council of the European Union and the Parliament are the legislative branches of the EU government. Like the House and Senate in the U.S., both of these bodies must approve a measure before it becomes a law. The

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members of Parliament are elected directly by the citizens of the member nations and serve 5 year terms. The Council is composed of ministers from the 27 member nations. The exact make-up of the Council varies from issue to issue. For example, on financial matters the Council is compromised of the finance ministers from each of the member nations.

Consensus is a key to this governance structure. While the 27 members of the EU have joined to make common economic and political policies, the members of the EU remain independent, sovereign nations. As our journey continues, you will see that recent efforts to arrive at a common EU response to the financial crisis illustrate the challenges to reaching consensus.

Financial Policy in the EU

In the aftermath of the financial crisis, public anger with the financial services industry is just as evident in the EU as in the U.S. As a result, many of the same policy responses to the crisis that we have seen in the U.S. are under consideration in the EU. Recent proposals by the EU Parliament to limit executive compensation for bankers are evidence of this.

Yet, with a need to satisfy 27 nation states, reaching a consensus on some issues has proven difficult. A deadlock between the Council of the European Union and the EU Parliament over how to regulate hedge funds is illustrative. The Council, reflecting concerns of its French and German members, is seeking some limits on cross border activities by non-EU firms. The Parliament (as well as the Commissioner for Internal Markets) favors a "passport" that would permit firms to operate throughout the Union. Efforts to revolve this impasse have been put off until the fall. Similarly, efforts to establish a common approach to a bank tax are floundering. While many EU countries may eventually enact such a tax, the design and purpose of the tax is likely to vary widely.

Agreement has been reached on some structural changes designed to enhance coordination between financial regulators. The EU is establishing a new set of financial supervisory authorities: the European Banking Authority, the European Insurance Authority, and the European Securities Authority. These new bodies will stand above existing banking, insurance and securities structures, and will, for the first time, have power to take reg-

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ulatory actions that apply throughout the EU. The pre-existing supervisory structures served largely as forums for banking, insurance and securities regulators from the various member states to discuss policies, but did not have the authority to take binding actions. Unified regulation of credit rating agencies will be one of the first items of business for these bodies.

The EU also has taken steps to address systemic risk. A macro-financial stability board is being created in Frankfurt, which will be chaired by the President of the European Central Bank and include central bankers from the member states, the heads of the new financial supervisory authorities, and representatives of the EU Commission. This board will be tasked with monitoring risks and issuing recommendations to individual prudential regulators within the EU. Like the Financial Stability Oversight Council created in the Dodd-Frank bill, this board will have no independent legal power, but must rely upon public pressure for action.

Finally, in the wake of the Greek debt crisis, the EU is facing its own challenge on bank solvency. A commitment to subject 20 major banks to a stress test has been expanded to include over 100 banks. There is an ongoing debate over whether and how these tests will take into consideration a default on the debt of a member state, and whether to release results of the tests on individual banks. In the U.S., the stress tests helped the markets move beyond the crisis because the tests were rigorous and the results for each bank were released. If the EU is to move beyond solvency concerns, these stress tests should factor in debt default and the results should be made public. Individual governments also should make it clear, in advance, that they will step in to capitalize any bank that fails the test.

It is now time to catch the Eurostar and ride through the chunnel to London.

Financial Policy in the UK

One of the most comprehensive assessments of the financial crisis released by any financial regulatory authority was the report issued by the head of the UK's Financial Services Authority, Adair Turner. The Turner Report was critical not only of industry practices that contributed to the crisis, but the role of the FSA itself. Ironically, Lord Turner's reward for this analysis

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has been the dissolution of the FSA. The agency known for principles-based regulation and a light supervisory touch is being split into two parts.

Prudential supervision will be transferred back to the Bank of England, where it was before the creation of the FSA. Since the UK "rulebook" will remain in effect, this change does not spell the end of principles-based regulation, but it does appear that the light touch has ended. A new agency will assume responsibility for consumer protection and markets. This latter combination is an interesting mix. In the U.S., it would be like merging the new consumer financial protection bureau created in the Dodd-Frank bill with the SEC and the CFTC.

Under this structure, the Bank of England also will be given explicit responsibility for identifying and controlling systemic risks. Bank officials already are wringing their hands over how best to exercise this authority.

This regulatory "reset" in the UK was one of the demands made by the Liberal Democrats in forming the new coalition government. Yet, the structure of financial regulation made little difference in identifying and controlling risks in advance of the financial crisis. The financial crisis was not the result of any particular regulatory structure, but was due to a failure of regulators to use existing powers to rein-in poor underwriting and risk-management practices within the industry. With the dissolution of the FSA, the UK is adopting the so-called "twin peaks" model of financial regulation — a model that performed well in Australia, but fell short in the Netherlands.

The UK also is giving serious consideration to breaking up large universal banking firms. A commission has been established to review bank structure and is due to issue a report in November 2011. Public statements by several members of this commission suggest that a recommendation for splitting up the banks is possible. Whether or not such a policy is pursued may depend upon how the new coalition government performs during the course of the next year.

Capital was a topic of discussion in every meeting I attended in both the EU and UK. Therefore, this tour concludes with a couple of observations on the issue of capital.

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A Note on Capital

EU and UK regulators (as well as U.S. regulators) are actively engaged in rewriting bank capital standards and in devising a new international liquidity standard. This exercise has assumed the name "Basel III." EU and UK regulators also are entering the implementation phase of a new capital regime for insurance firms, commonly called "Solvency II." In the wake of the financial crisis, no one questions the need for reforming capital rules. However, both the proposed Basel III regime and the pending Solvency II regime pose some difficult questions.

The elephant in the room for Solvency II is the U.S. While the EU has been pursuing a new capital regime for insurers for several years, the U.S., under the auspices of the NAIC, has just begun to study the issue. This policy difference creates a significant problem for international insurers. Solvency II is based upon an equivalency standard. In other words, under Solvency II an insurer may operate in any country that has a capital regime equivalent to the Solvency II standards. Since the U.S. is far from adopting anything close to a Solvency II regime, the equivalency requirement may stand as an obstacle to international insurance operations. This suggests that either EU implementation of Solvency II may be slowed, or EU regulators must conclude (somehow) that U.S. capital standards satisfy the equivalency test.

The issue for Basel III is the impact of the proposal on economic growth. The Institute of International Finance has concluded that the pending proposals would have a significant negative impact on economic growth. Regulators in the EU and UK (and the U.S.) dispute this conclusion and are doing their own study. The best way to bridge this gap is for complete transparency on the models used by the IIF and regulators. A clear understanding of the assumptions used by both sides in this debate would help to facilitate the establishment of capital standards that properly address solvency concerns without imposing unnecessary constraints on economic growth.

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Next Stop — Seoul

I leave you at this point in the trip, but suggest that the next stop on the path to financial reform will be the G-20 meeting in Seoul. Many of the financial reforms being debated in the EU, UK, and the U.S. have been driven by the leaders of the G-20 nations. They meet again in Seoul in November. At that meeting, we may learn how far coordinated policies can be pursued.

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