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After the Financial Crisis are we Heading Towards a Renewed European Economic Model?

Reform of Financial Capitalism: What are the Opportunities for European Leadership?

Jean-Pierre JOUYET

Transformation of the national and international regulatory framework is ongoing. Never before in the history of world finance had we seen regulation make such a strong comeback. This is the case in the United States, as it is in Europe. The Americans responded quickly and vigorously but today their slow and complex internal decision-making process is delaying progress. The vast reform project, adopted on 11th December 2009 by the US House of Representatives, must be brought closer to the one being worked on by the Senate. In the heart of the crisis the Europeans may have given the impression that they did not come to agreement quickly enough on all subjects (even if the European Union presented a united front on essential matters), but it is now making progress in defining the guiding principles of an ambitious agenda, adopted at the European Council meeting of June 2009, drawing on proposals by Jacques de Larosière.

At the dawn of this aggiornamento of the European and global financial regulation, can and should the European Union affirm its leadership on these matters? And if so, under what conditions and to defend which regulation model?

The EU Must Affirm its Leadership

It is imperative that the European Union affirm this leadership for two reasons.

The first is that effective international regulation is based on convergence and mutual recognition. Such an approach, however, features less in the US tradition than in the European one. The United States, following domestic imperatives that happen to be totally understandable (they want to supervise better), focus on the reinforcement of the powers of their supervisory authorities with regard to the supervision of foreign entities developing an activity in the US or with American counterparts. This brings them to demand an increasing amount of reporting, communication of confidential data and the possibility of on-site inspection of the entities concerned, for all transborder relations or those considered as such.

As an example, concerning the credit derivatives market, the US, which is a step ahead of the European Union, is seeking to impose both its standards and its infrastructure. The Securities and Exchange Commission (SEC) is today demanding the right to obtain information directly and to make on-site inspections of the European clearing houses that would like to clear the operations of US establishments. The goods market offers another example. The Commodity Futures Trading Commission (CFTC), the US regulator with remit for these markets, demands that the major European players give information on the operations that would have a greater or lesser connection with the operations negotiated on the US markets.

The European Union, for its part, left matters for too long up to the good will of the Americans and to the laissez-faire of Member States. Within the framework of financial directives, relations with third countries are most often left to the discretion of Member States and their regulatory authorities, which ends up preventing coordinated and coherent dialogue. As, in addition, national authorities are sensitive to the competitiveness of their financial market, some of them come to conditions, which are at times excessive, to encourage the development of transatlantic activities.

If convergence takes place in one direction only, by alignment with the US standard, what then of European independence and the assertion of the European standard? For these European standards must be defended at international level. The European Union has technical standards and a European industry and it should therefore learn to negotiate on these issues, on the basis of reciprocity. That is why we must develop more balanced relations between the European Union and third countries (not just the US) to ensure a process of mutual recognition of the reciprocal quality of our regulations and of our supervisory models. These negotiations must be led at European level. This is the only way that we will preserve a coherent internal market that is competitive at international level.

The second reason is that what works in the US may not work in the European Union. Hence the importance of negotiations on the level of recapitalisation of banks and financial institutions and of debate on the leverage ratio that the Americans would like to impose. This purely quantitative ratio relates a bank's assets to its capital and does not take the quality of these assets into account. As it happens, a bank focusing on traditional credit activities does not take the same risks as an investment bank and does not remunerate its capital at the same level. The need for equity must therefore correspond to the risks incurred and take account of the economic models of those involved. In reality, behind this American proposal, it is the European universal bank model that is at issue, and with it, the principle of financing European companies through bank intermediation. Everyone knows that European companies, compared to US companies, are financed more by bank loans than by markets (two-thirds of the European economy is financed by credit, two-thirds of the US economy is financed by the markets). The leverage ratio would therefore be much more disadvantageous for economies that are mainly financed by banks, such as the European economies.

Under What Conditions can the European Union Affirm its Leadership?

If there is therefore no doubt that the European Union must assume its responsibilities in this reform of global capitalism, under what conditions can it affirm its leadership?

It must organise itself so that its partners can face counterparts who speak with a single voice and with indisputable authority. The construction of a new European regulation architecture at macro and micro-prudential levels, which responds first of all to a need that was clearly identified during the crisis, for better supervision of systemic risks, thus equips the European Union in this necessary dialogue with non-EU G20 countries.

The official creation of a European Systemic Risk Council, similar to the US Financial Services Systematic Risk Oversight Council, will allow us to detect risks better, to make information circulate more freely and to coordinate better our regulation policies.

At micro-prudential level, the European Union is creating three agencies, one for banks, one for insurance companies and the third one for financial markets, in order to bring European regulation and supervision up to the level of integration of the single market. Concerning markets, the European Securities and Markets Authority (ESMA), which will replace the Committee of European Securities Regulators (CESR, the informal committee of European regulators that had neither the means nor the authority to smooth out difficulties between Member States), should be able to supervise pan-European entities by nature (such as rating agencies), efficiently coordinate the supervision and treatment of systemic market risks, harmonise rules applying to players, structures and practices whenever necessary and lastly, ensure a homogenous level of protection for consumers of financial products and services. To this end, it is foreseen that ESMA will set the common rule, be able to take technical measures of a binding nature as well as coordination measures imposed in an emergency and act as a mediator in case of difficulties between Member States.

The ECOFIN Council meeting of 2nd December 2009, which validated the creation of these agencies, granted them globally satisfactory operating rules. But the European Parliament, which has taken over, could still make improvements, particularly to increase the responsiveness of ESMA and establish better its independence which ensures its efficiency and its credit in the eyes of the industry.

Insofar as positive discussion is taking place between these macro and micro-prudential levels of supervision, thanks to good information exchange in both directions, as hoped for by Tommaso Padoa Schioppa, we will have on one hand an authority with a global and instantaneous vision of the risks incurred by the fifteen or twenty major European financial institutions, and, on the other, more homogenous regulation of the financial markets. Our non-EU partners will no longer take advantage of regulatory incoherencies from one country to another as well as our absence of unity, by choosing the lowest regulatory level.

Which Priorities for Which Leadership?

The European Union now has the means for its ambitions. But what should its priorities be in the field of regulation, in the Union itself and in relation to its partners, in order to establish its leadership? I will distinguish two.

Firstly, it must steadily pursue the implementation of G20 recommendations, so that, insofar as is possible, its ideas continue to inspire the global harmonised regulation framework towards which we wish to head.

Hence the importance of debate on credit derivatives, where we have fallen behind in relation to the Americans. In this context, the ambitious communication of the European Commission issued on 21st October 2009 is particularly welcome. It makes it a necessity to standardise credit derivatives, to record them in a central database and to clear them. The new Commission could tackle this question without delay (France had been asking the Commission to examine the regulation of OTC markets for five years). In this way we will have discussion with our non-EU partners on a much more balanced basis, by basing ourselves on the European *acquis*. It will also be necessary to determine these regulatory reforms at industrial level and to accelerate the project to create a clearing house in the Euro zone, because the European Central Bank (ECB) is the lender of last resort. This project has an obvious strategic dimension to affirm European independence.

Hence also the importance of negotiation during work in progress on the draft directive on hedge funds (AIFM Directive). Here, once again, we will only be credible if we can claim a European standard as an argument, especially if we want it to serve as a possible model that is likely to inspire other geographic entities.

And finally, hence the importance of negotiations (which are getting bogged down) on accounting standards. One of the major issues on this point is the reinforcement of EU presence within the International Accounting Standards Board (IASB), in charge of drafting international accounting standards, for the method that it has followed up to now and its delays are placing Europe in a difficult situation. Behind the apparently technical issues of this debate, it is the competitiveness of European banks and insurance companies that could pay for this procrastination.

Second priority, the European Union must question itself on the reasons for which potential investors have not yet come back to long-term saving, the only way of reviving the economic machine, of financing our pensions and of adapting our production system to limit greenhouse gas emissions. We can only do this if they have confidence and we must progressively rebuild this confidence, but how?

It seems to me that the regulator should show savers that he is extremely vigilant regarding the way in which financial products are distributed. The Commission could draw inspiration from the most conclusive national experiences in order to boost harmonisation of protection for European savers, who, when they invest their money, are entitled to expect protection similar to that which they receive on buying a toy or some medicine, which is not the case today. Let us hope that the American project to create a consumer protection agency in charge of regulating financial products considered as too risky, will spur on the Commission.

Above all, investors long to see the financial markets once again fulfil their purpose, that of financing the economy. Good financial regulation should efficiently contribute to financing the real economy and channel and optimise saving. For this to happen, European markets must once again become the meeting point between the issuer and the investor, which means that we must fight against the increasing fragmentation of stock markets that are ever more opaque and do not allow comparison in satisfactory conditions between supply and demand. We know that the Markets in Financial Instruments Directive (MiFiD) has contributed to this growing fragmentation of transaction flows through the appearance of competitive negotiation platforms from the order books of historical markets. A review of this MiFiD in 2010 should be the opportunity to review the organisation of our markets and their transparency thoroughly. Our work will interest our non-EU partners who, for different reasons, are facing the same difficulties.

This reflection should result in the awareness of the impact of new technologies on the operation of markets. There is real disproportion between the means invested in this race for new technologies and the gains in terms of market efficiency (not to mention gains for the real economy). In addition, a regulator who is not up to speed with these technologies cannot efficiently supervise the integrity of markets, at the risk of altering investors' confidence.

We also need to think about new markets. In the future we will have CO_2 markets, energy derivatives markets and food markets that are more globalized than they are today. These are markets that will have to be either created *ex nihilo* – without leaving their monopoly to a continent or a country – or better organised if they already exist, to avoid speculation or tax fraud. The European Union, here again, must play its part, especially to organise the carbon market given the leadership we have gained in climate negotiations and in the construction of an operational emissions quotas market.

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We can see that the European Union has a card to play to establish its regulation model and to continue to guide the work of the G20, as it has done until now. It will be all the more credible if it has convinced all the Member States of their individual interest of a financial market is to accept more binding rules, provided that they are the same for everyone. It will thus show the rest of the world that it has not chosen security to the detriment of competitiveness but rather both, as they go hand in hand. Without naivety it can plead even more forcefully before the G20 for convergence of the standard – beginning with remunerations – the only way to end regulatory dumping that has cost us so much in the past.