For a Political View of Financial Regulation

Jean-Pierre JOUYET

The economic crisis is deep and structural. We must end the cycle of excessive financialization of our economies that began at the end of the eighties, without going into recession. For 30 years now, the economies of developed countries have shown diminishing returns, with the exception of market players who have benefited from ever increasing and exceptional returns. We are now aware that they involved high risks and, more serious still, they compromised sustainable economic development, due to the consubstantial instability of their nature. Market volatility and high debt levels amongst States, households and businesses went hand in hand in our economies which abused leverage, starting with public authorities, to the detriment of potential growth and true competitiveness.

Begun in 2007 through the massive debts and poor management of liquidities by American investment banks, the crisis has moved over the past two years to European sovereign bonds. Whereas in 2008, States, notably European States, supported the banking system, it is now the financial markets that are targeting too highly indebted States, distrusting a euro zone that they believe to be poorly governed. This defiance has resulted in a considerable reduction in the margin for manoeuvre available to States.

This crisis demands far-reaching reform of financial regulations and market organisation for an improved financing of the economy and a return to growth in the medium term. For we Europeans it also calls for in-depth thought about how the euro zone works, its governance, as well as a reflection on the European Union as a whole.

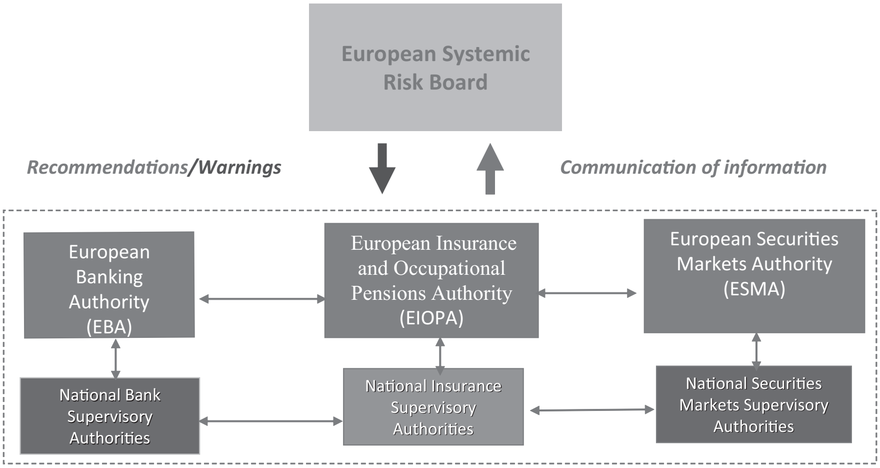
Re-working the regulations governing financial markets

The financial crisis calls for a change of paradigm. Financial regulations must be re-worked.

Important progress has been made under the effect of the crisis …

The first and most important feature of this progress is the re-appropriation of the theme of financial regulation by the political and public sphere. The creation of the G20, at France’s initiative, and the placing on its agenda of financial regulation subjects, have

The New European Financial Supervisory System



The European Regulatory Authorities are mainly repsonsible for setting out a joint rule book for the entire European internal market .
They act as part of the task set by the Parliament and the Council included in the sectoral legiislative acts.
They report to the Parliament and the Counciil.
They have a power of arbitration in the event ot litigation between the national authorities regarding the implementation of European legislation.
They have the power to take emergency measures which are necessary with regard to the national authorities . They can decide on individual , binding meaures against regulated entities if their national supervisory authorities do not implement European decisions.
The ESMA also has direct supervisory power over the c redit ratings agencies .

P. Starkman - AMF

had a determining effect. Financial regulation, a job for specialists, has now become a subject for political debate, addressed by both parliamentary commissions and journalists alike. The politicians are right to have addressed the matter; they must ensure that the file remains open until things are done differently and better. The key to success in market reform is the appropriation of financial regulation by politicians and public opinion; it should not be a matter for financiers alone.

Since the start of the crisis and the G20 meeting in Pittsburgh, much has been done in terms of regulatory reforms. Major reforms have been implemented in both Europe and the United States. Provisions governing ratings agencies and hedge funds have been adopted. Implementation of the Basel 3 agreements provides for major reinforcement of banks' equity and will help to redirect banking finance towards the real economy, making the most speculative activities more expensive. The regulation of OTC derivatives markets, with the requirement to register and compensate transactions, is also heading in the right direction. More recently still, in Europe an agreement has been reached on the regulation of short selling with, in particular, a ban on holding naked CDS involving sovereign debts, without also holding the debts themselves.

The heart of the matter has yet to be reviewed, that is to say regulation of the financial instruments markets. In Europe the work is still ahead of us, but the project is already on the table. The European Commission has presented a draft review of the directive. The first version of this text introduced greater competition between stock markets, with the aim of breaking the monopoly of traditional stock markets and thus reduce transaction costs. It also had less positive collateral effects, specifically the emergence of *dark pools* (opaque negotiation platforms where orders are not made public). It is also this text that has contributed to the fragmentation of the markets and, combined with the effect of technological progress, involuntarily contributed to the development of high frequency trading. Finally, the text also exempted from regulation players involved on the raw materials markets. Revision of this text should therefore remedy the current defects of the markets and improve their transparency and organisation. Expectations are high, commensurate with the challenges before us. There again it is important to look carefully at the developments happening in the United States in order to achieve a similar approach within the context of world regulation bodies.

Despite limitations yet to be overcome ….

Although the overview of regulatory activity is positive, two elements temper the results.

Results are not always tangible. Time required by reflection, negotiation and democracy is not the same time as that of the markets. Five years can pass between initial European considerations and the coming into force of a text after transposition into each of the Member States. Thus, the three big ratings agencies, Moody's, S&P and Fitch, have only been entirely regulated since 31st October, the date on which their registration process with the European Financial Markets Authority (ESMA-AEMF) was finalised. The obligations to register hedge funds will come into effect only as from 2013. The Basel 3 agreements are set to come into force gradually between now and the end of the decade, although pressure from the markets should lead to the application of certain provisions, particularly in terms of the amount of equity, as from next year. The United States is suffering a delay in the technical implementation of the Dodd-Franck law by regulatory authorities, notably due to a lack of resources, whereas it was adopted at top speed in response to the crisis.

However, the complexity of the markets and the considerable developments seen in finance and its uses, require us to go further, to re-work things more profoundly, reducing the opacity and fragmentation of the markets, setting up public regulation structures with forceful execution powers at international and European level.

Reinforcing economic and financial governance in Europe

Completion of the single market for financial services and the increase in the power of world financial institutions or at least those that are pan-European, should lead to the establishment of more integrated supervision.

On 1st January 2011 three European authorities were created for the regulation of banks, insurance companies and financial markets. The main task of these three authorities, the creation of which was inspired very directly by the report drawn up by Jacques de Larosière, is to encourage convergence by creating joint technical rules in application of the directives. They also have specific competence to take more direct action on those involved, particularly in case of emergency or when arbitrating. To begin with these authorities have not been given direct powers over market players, with the exception of the European Financial Markets Authority with regard to ratings agencies.

A European Systemic Risk Board has also been created. This Board brings together regulators from the three sectors as well as the central banks; it is chaired by the President of the European Central Bank (ECB). It is an extremely important forum for discussion, particularly in view of the current circumstances. It has its own resources and also works closely with the ECB.

Although it is too early to report on these authorities, it would appear however, and in the light of the challenges which the markets are facing, that greater integration will be necessary. Their power must be developed as the review of the directives progresses and they must be given the means by which to establish their authority. This summer, and in the absence of any sufficiently strong provisions in European texts, the new European Financial Markets Authority was barely able to go beyond concertation, and no decision was reached regarding joint action, particularly in terms of dealing with short selling or the treatment of sovereign debt in banks' balance sheets. Moreover, and in view of integration of the markets, these authorities should be called on to play a pivotal role in data gathering and the implementation of European supervision tools.

Finally, and more fundamentally, whereas the euro is the most visible and most undeniable asset in the construction of Europe, management of the single currency shared by 17 States is being challenged by private or institutional investors. Although the United States, downgraded in August 2011, can place their State bonds at very low interest rates, the same is not true for States in the euro zone, with the notable exception of Germany.

To reduce this asymmetry, which could be fatal to the joint work being undertaken, we must, everyone is agreed, show proof of more discipline, preserve our solidarity and provide ourselves with more efficient crisis management and financial regulation tools. In these unstable times, governance of the zone must be simultaneously simpler, more visible, more reactive and more democratic. This is a vast programme that cannot be achieved in just one day, but the direction towards economic, budgetary and financial federalism, which respects our democratic traditions, must be indicated quickly and firmly. If not we will spend our time running after the markets, living with the obsession of down-grading, creating despair amongst our Asian, American or Middle-Eastern partners who, paradoxically, are asking us to get better organised and to defend ourselves more forcefully in order to be worthy of the trust that has been placed in the euro. To some extent they are asking us to trust ourselves.

***

The crisis has put the European Union's back to the wall. It must, even at the price of institutional adaptations or unconventional measures, affirm a more political vision of financial regulation, bring the markets back to serving the economy and the economy to serving people. Europe, and first and foremost the euro zone, must have faith in its assets, show proof of daring. Sure of itself, it will have the means by which to impose its model and remain a reference market.