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European Financial Regulation and Governance

Professor Kern Alexander

Ist.alexander@rwi.uzh.ch

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Main areas

- Changing structure of EU financial markets
- Financial institution management & structure
- EU regulation and the European Commission proposals
- Which way forward for Europe?

Changing structure of financial markets



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- Globalisation
- Consolidation
- Conglomeration
- Convergence

Financial services industry has become more complex and the risks have changed. Global financial service firms have changed their structures and strategies in response to these changes.

Foreign-Owned assets in EU Banks (2004)

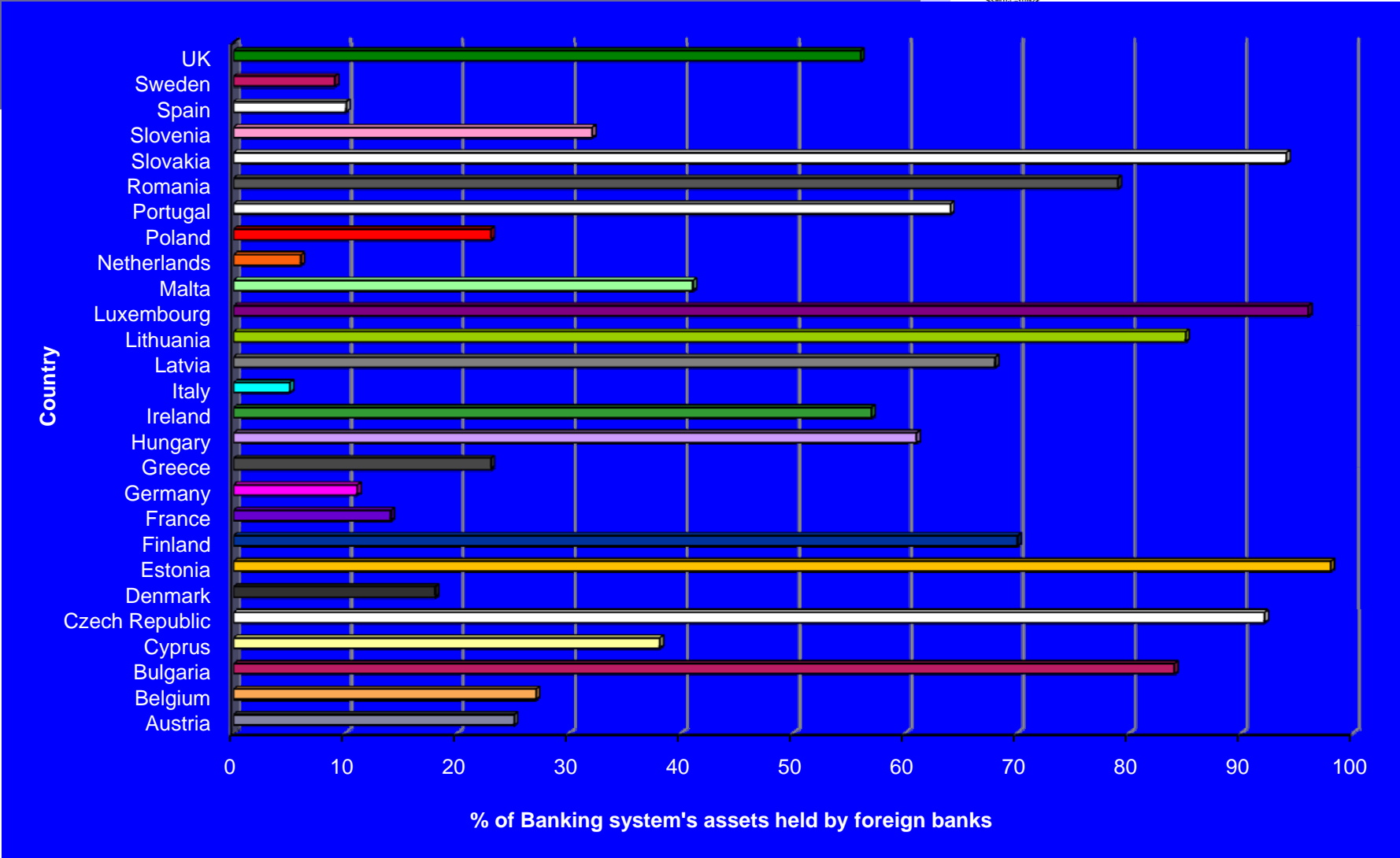


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Source: World Bank, Bank Regulation and Supervision Database 2003

Foreign-Owned assets in EU Banks (2008)

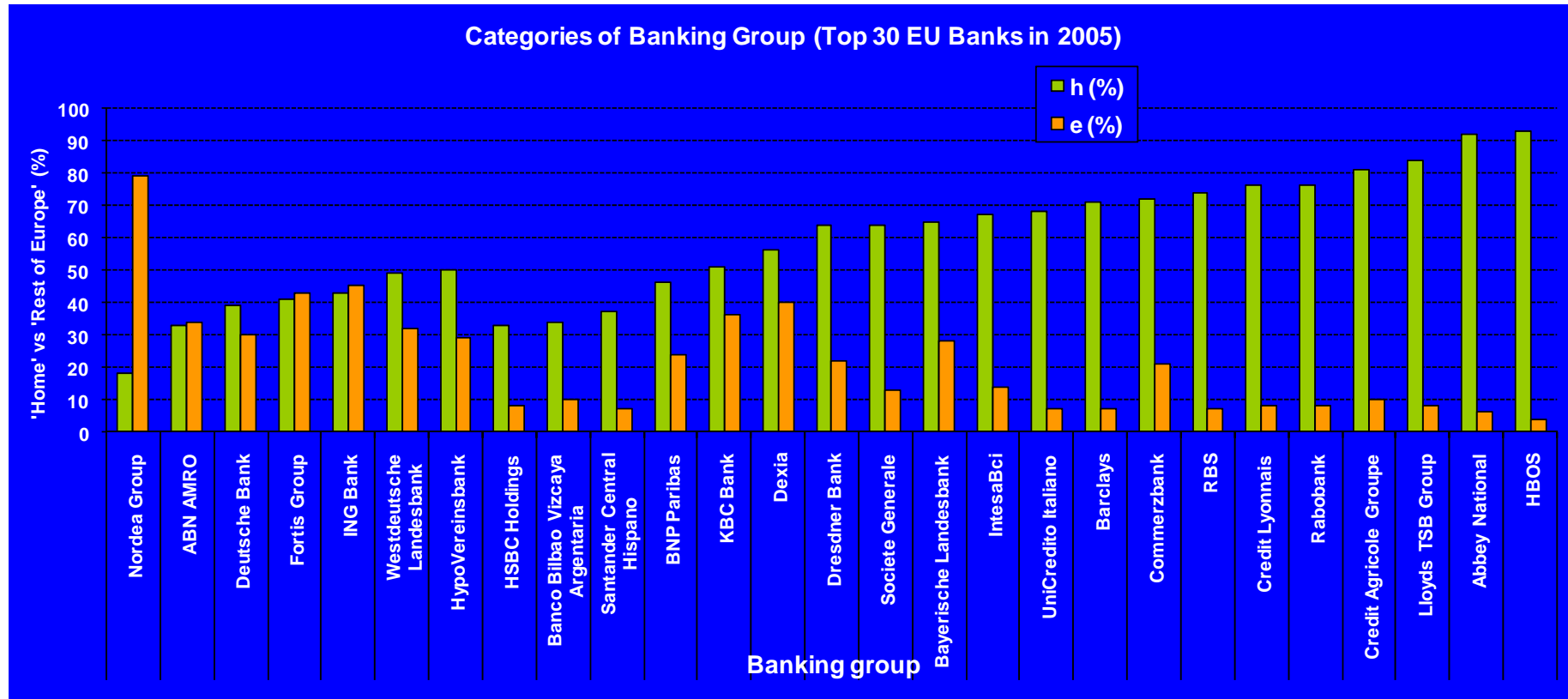


Source: ECB, 2009

Categories of EU Banking Groups (Top 30 EU banks in 2005)

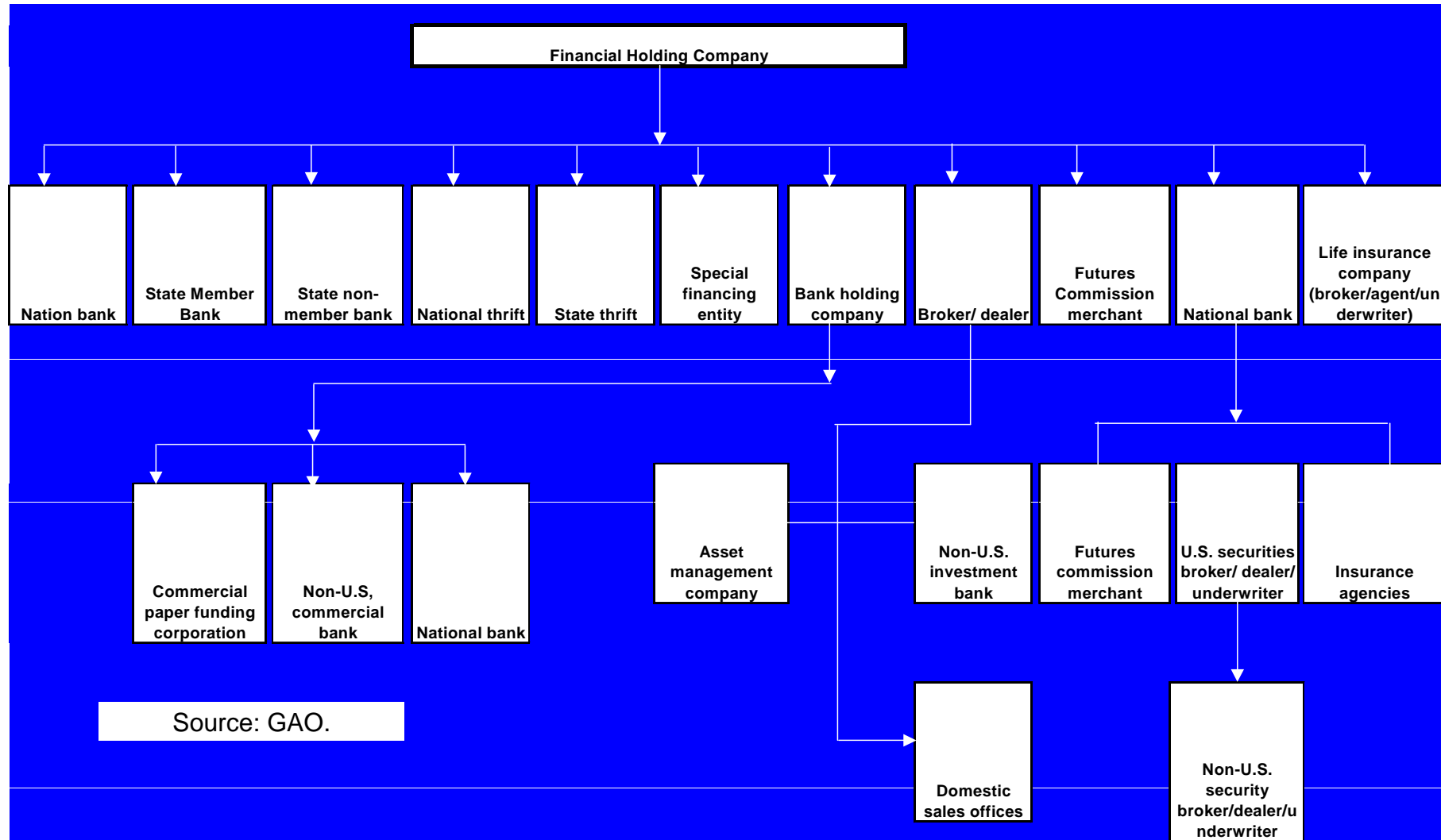


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Source: (Slager, 2005)

Structure of a Hypothetical Global Financial Firm



Source: GAO.

Changing structure of global financial firms



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- Centralisation of key management functions at Group level to achieve synergies (Joint Forum, 2003)

risk control, asset management,
treasury operations, compliance &
auditing

Changing structure of global financial firms



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- ‘Hub and spoke’ model (Kuritzkes et al., 2003)
- Hub: centralised oversight of risk, capital structure, methodology for economic/ regulatory capital, funding practices, target debt rating, liaising with regulators/rating agencies
- Spoke: risk management for business lines – credit function w/in bank; actuarial function in a insurance subsidiary; funding and account reporting for the subsidiary

Global financial firms' compliance and risk strategies



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- Growing differences between operational and legal structure of the conglomerate
- Home/host regulatory compliance issues
- More difficult for supervisor to attribute risk to the legal entity (ie., subsidiary)
- This complicates supervision b/c supervision based on statutory powers to supervise legal entities and this not correspond to where risk decisions are made. (Kremers et al., 2003) (Dermine 2003)

Modern financial management & regulation - an interactive process (Alexander et al., 2006)



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- **International**

- Basel II - (I) devise a process to measure financial risk for home approval, and (II) devise corporate governance structure to meet home/host regulatory approval

- **Europe**

- Home country control, mutual recognition, minimum standards – *However, a trend towards interactive regulation (ie., MIFID)*

Regulation has become a source of innovation and competitive advantage

EU financial legislation & policy



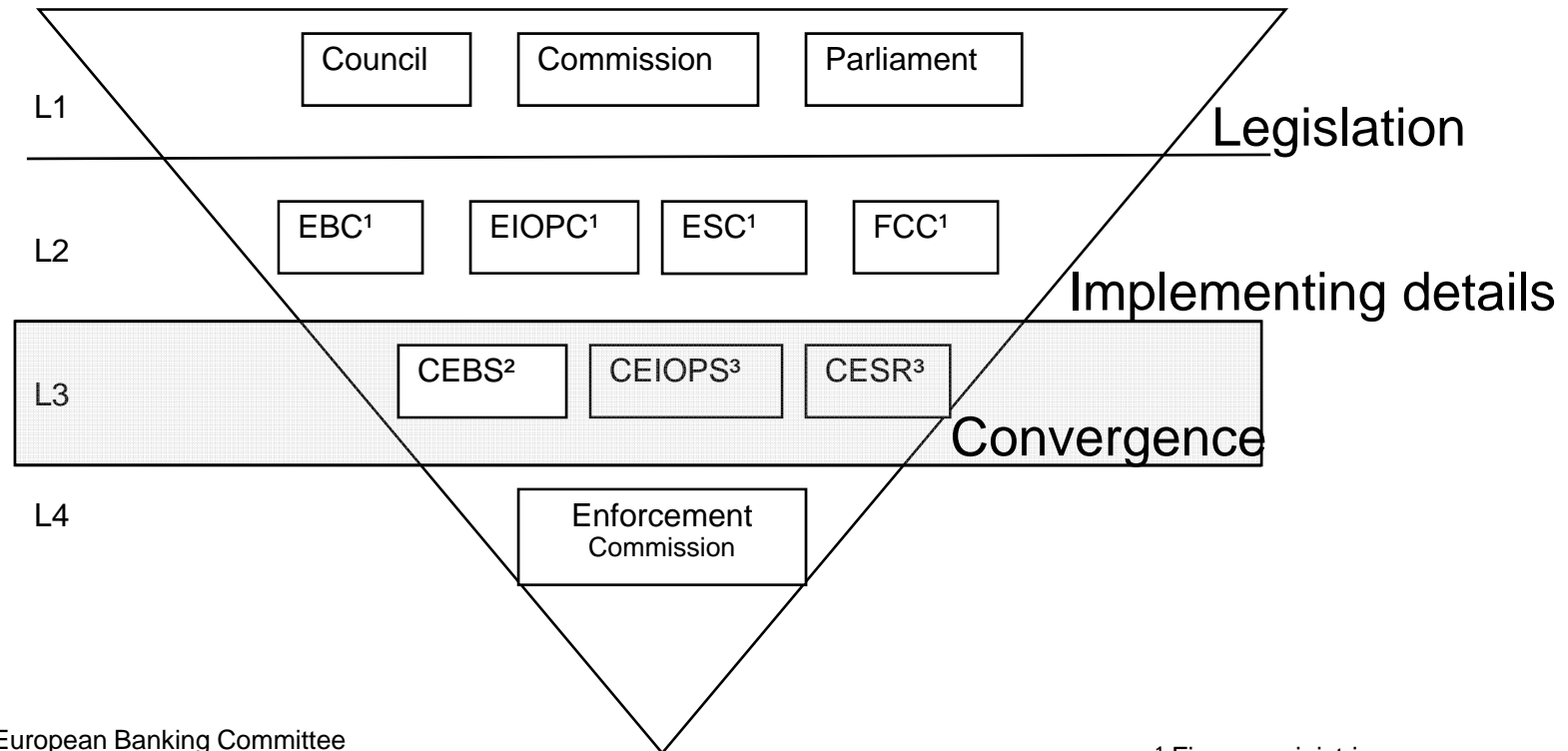
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- Pre-1986 – unsuccessful efforts to approximate and make equivalent financial law and regulation across EU states
- 1985 White paper and 1986 Single European Act
Home country control, mutual recognition based on minimum standards – the EC passport
- EU legislation is a tool for liberalisation with little oversight of member state regulatory practices
- Lisbon Council Decision (post 2001)– FSAP & Lamfalussy: Harmonisation of laws and coordinated regulatory practices based on market-based models (McCreevy era)



The EU Lamfalussy structure



EBC = European Banking Committee

EIOPC = European Insurance and Occupational Pensions Committee

ESC = European Securities Committee

FCC = Financial Conglomerates Committee

CEIOPS = Committee of European Insurance and Occupational Pensions Supervisors

CESR = Committee of European Securities Regulators

¹ Finance ministries

² Supervisors and Central Banks

³ Supervisors



EU FSAP - weaknesses

- *Level playing field and competition concerns*
Greater consistency between directives, flexible legislation that adapts to markets, linguistic issues for implementation, EU regulations v. directives, avoid unintended consequences and not undermined by subsequently adopted national laws (Lord Woolf, June 2005).
- **Greater uniformity** needed in application and implementation of EC financial law

Van den Burg and Daianu report – EP 2008



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- Strengthen and clarify status of Lamfalussy 3 Level 3 committees.
- Promote supervisory convergence and level playing field
- 3 Level 3 committees should be able to take decisions based on QMV and adopt common rulebook
- Oversee supervisory colleges and interface with international bodies
- EU supervisory system with legal competence to monitor cross-border banks and link micro & macro supervision
- Commission to propose regulations by late 2009

The future of EU financial supervision



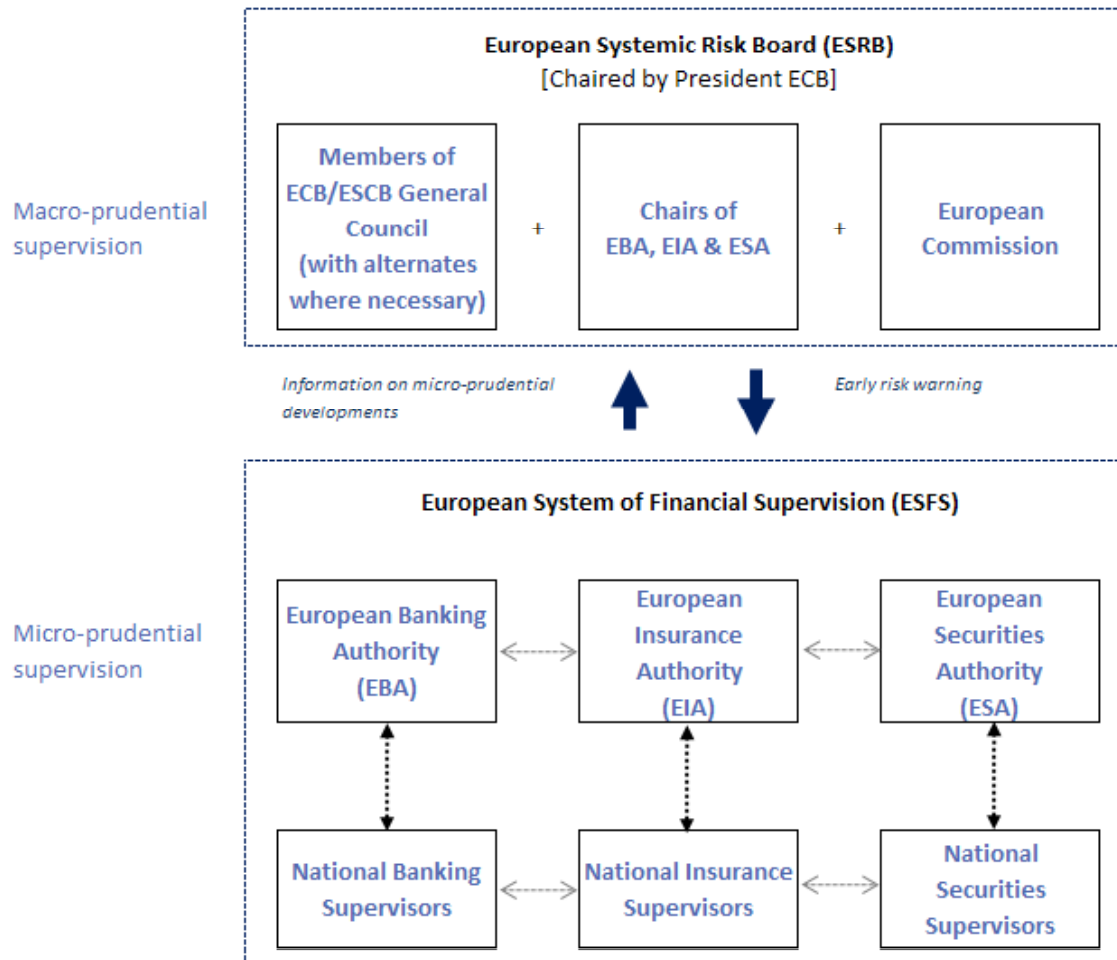
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- From De Larosière Report (Feb 2009) to the EU Commission's proposed Regulations (Sept 2009)
- On the microprudential: the European System of Financial Supervisors (ESFS).
 - It will consist in the current Level 3 Committees of supervisors, which will be transformed into new European Supervisory Authorities (ESAs) responsible for banking, insurance and securities respectively.
- On the macroprudential side, a European Systemic Risk Board (ESRB) will be established.
 - It will be composed of EU central bank governors, including the ECB President, the chairpersons of the ESAs, a representative the European Commission, as well as representatives of national supervisory authorities and the Chair of the EFC (the latter two without voting rights).



The future EU financial architecture



European Supervisory Authorities



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- Ensuring that a single set of harmonised rules and consistent supervisory practices are applied by national supervisors;
- Ensuring a common supervisory culture and consistent supervisory practices;
- Collecting micro-prudential information;
- Ensuring consistent application of EU rules, and resolving disputes in cases such as the manifest breach of EU law or ESA standards and disagreement between national supervisors or within a college of supervisors.



- Article 114 (TFEU) as the legal basis for the establishment of bodies that are vested with responsibilities for contributing to the harmonisation process and facilitating uniform implementation by MSs (Case C-66/04, C-217/04)
- Actually and objectively apparent from the legal act creating the body in question that its purpose is to improve the conditions for the establishment and functioning of the internal market
- Tasks conferred on such a body must be closely linked to the subject-matter of the relevant harmonizing legislation

Summary - analysis of EU financial regulation



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- Increasingly integrated EU financial markets
- Centralised governance structure of largest 50 or so EU financial institutions
- Is the existing home/host/Lamfalussy adequate?
- Or do we need more institutional consolidation? What about a EU single supervisor?
- Far reaching re-appraisal of the role of EU financial regulation in controlling 'externalities' and development of uniform rules, technical standards and guidelines to enhance the implementation of EU financial services legislation.

Further readings – EP Parliament Reports



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- Alexander, K. 'Which future model for Europe?' (Feb 2010, IPA CRIS)
- Alexander, J. Eatwell, A. Persaud & R. Reoch
<http://www.europarl.europa.eu/activities/committees/studies/download.do?language=en&file=26588>
- '*Clearing and Settlement in the EU*' K. Alexander, J. Eatwell, A. Persaud and R. Reoch (Sept. 2009) IPA ECON 2009/001.
<http://www.europarl.europa.eu/activities/committees/studies/searchPerform.do?page=2&language=EN>