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Financial Supervisory and Regulatory Reform of the EU after the Global Financial Crisis

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Yoo-Duk Kang Research Fellow, Europe Team, Dept. of International Economy (ydkang@kiep.go.kr)
Kyun Tae Kim Senior Researcher, Europe Team, Dept. of International Economy (ktkim@kiep.go.kr)
Tae Hyun Oh Senior Researcher, Europe Team, Dept. of International Economy (asroc101@kiep.go.kr)
Cheol-Won Lee Senior Researcher, Europe Team, Dept. of International Economy (cwlee@kiep.go.kr)
Hyun Jean Lee Senior Researcher, Europe Team, Dept. of International Economy (hjeanlee @kiep.go.kr)
Hee-Yul Chai Professor, Kyonggi University (hycha @kyonggi.ac.kr)

History and Background of the EU's Financial Supervisory and Regulatory Reform

Financial Regulation and Supervision at the EU level has been implemented with the formation of the European Single Market. In the 1980s, there was a significant increase in the number of cross-border financial transactions as free capital movement within the EU territories, mutual recognition of regulation, and supervisory responsibility of the home country were established as the principles of the EU internal financial supervision. However, blind spots in financial supervision have been consistently pointed out as large banks have operated beyond one member country, resulting in a set of problems from mismatch among the financial activities taking place over integrated European Single Market and supervisory authority limited in national boundary.

The global financial crisis revealed institutional limit of the financial regulation and supervision in the EU. As a result, demands are increasing for reforms on financial supervision and regulation. In particular, new supervisory arrangements should concentrate not only on the prudential of individual financial firms but also on the macroprudential. Furthermore, there are increasing needs for a more integrated financial supervisory institute as the more efficient measure to supervise the integrated European financial markets.

Supervisory and Regulatory Reform at the EU Level

Following the recommendations of the De Larosière Report, the European Commission proposed the establishment of a new framework composed of (1) the European Systemic Risk Board (ESRB), a new body that will be responsible for the macroprudential supervision of the EU financial system with a secretariat function provided by the ECB; (2) the European System of Financial Supervisors, including the existing national supervisory authorities and the European Supervisory Authorities (EBAs) were established, which oversees such areas including banking, securities, and insurance and pension.

ESRB is the product of these considerations, as institution responsible for the macroprudential oversight of the financial system within the EU. In other words, even though financial supervision is still in the competence of member states' authorities, ESRB has rights to issue strong recommendations or alerts. In addition, ESRB can participate in the decision-making process in details of regulations at large.

In general, the current review shows that the policy reflections on the lessons learned from the global financial crisis are being translated into specific initiatives aimed at enhancing the efficiency and effectiveness of the supervisory structure. At the EU level, there is a consensus among member states on the need to enhance the current EU institutional structure for financial stability by establishing the EBAs. Moreover, the need to strengthen the capacity of the EU financial system to identify and address systemic risk will be enhanced with the establishment of the ESRB in which the EU central banks and the ECB in particular will play a major role

The perception that loose financial regulations had caused the global financial crisis has been widespread. Many countries moved toward reinforcing their financial regulations. The EU is also developing various methods for financial regulation at the EU level, in order to (i) regulate the credit-rating institutions, (ii) introduce an EU-wide financial transaction tax, and (iii) regulate the banking sector. First, the new rules to regulate credit rating agencies concentrates on reducing reliance on external ratings in line with the basic spirit, which is to make financial firms to do their own internal ratings. The EU commission addresses that credit rating agencies should not seek to influence national policies. Furthermore, the new rules require credit rating agencies to be more accountable for their actions.

Second, the European Union Financial Transaction Tax (EU FTT) enters into force in 2014. According to the EU FTT, financial transactions, including financial institutions within the EU territory (as of January 2013, for 11 eurozone countries), are taxed, charging 0.1% (or 10 basis points) against the exchange of securities, equities, and bonds, and 0.01% (1 basis point) across derivative contracts over all asset classes. As assessing that the levy could be raised as much as €35 bn a year, the EU commission thinks that the new taxation can prevent a repeat of the credit crunch by Reining in investment banks.

Figure 1. The Taxation of Transactions

Party/ counterparty	**EU** financial institution (Member State B)	**EU** citizens, companies and alike (Member State B)	**Non EU** financial institution	**Non EU** citizens, companies and alike
EU financial institution (Member State A)	Tb / Ta	- / Ta	Ta / Ta	- / Ta
EU citizens, companies and alike (Member State A)	Tb / -	- / -	Ta / -	- / -
Non EU financial institution	Tb / Tb	- / Tb	- / -	- / -
Non EU citizens, companies and alike	Tb / -	- / -	- / -	- / -

Note: Ta and Tb are tax of country A and B
Source: European Commission(2011), The Commission Proposal for a Council Directive on a Common System of FTT.

Finally, even though there are still more procedures to finalize the banking regulation, High-level Expert Group on reforming the Structure of the EU banking sector, or the Liikanen Report, recommends a set of five reforms to address weaknesses, which can endanger financial system stability: (i) proprietary trading and other significant trading activities should be assigned to a separate legal entity if the activities to be separated amount to a significant share of a bank's business; (ii) banks need to draw up and maintain effective and realistic recovery and resolution plans; (iii) the use of designated bail-in instruments is necessary; (iv) more risk weights should be applied in the determination of minimum capital standards; (v) it is necessary to augment existing corporate governance reforms.

Recognizing the mixed interests among business categories and dissonance within the EU member states clearly shows that such financial reform is yet unfinished. However, the fact that the EU and member states have developed their agreed-upon financial regulation into a global agenda through G20 meetings should be emphasized.

Supervisory Reform at the National Level

At the EU and national levels, regulatory authorities are implementing or planning reforms of institutional arrangements for financial supervision. In spite of integrated supervision and regulation at the EU level, the EU member states still retain enforceable supervisory power. Recent developments in supervisory structures in the EU member states are as follows: (i) a tendency toward further enhancement of the role of national central banks in supervisory activities; (ii) a consolidation of information-related synergies between the central bank and the prudential supervisory function in the case of the single supervisory authority.

Supervisory reform aimed at enhancing specific elements of the supervisory framework was adopted before or immediately after the financial crisis. The EU member states have taken measures to improve the effectiveness and efficiency of certain part of supervision. The changes brought forward in Germany to clarify the interplay between the central bank and the supervisory authority.

At the national level, wide-ranging institutional changes were adopted or planned. A number of EU member states have announced or started to implement reforms of their national supervisory structure. In France, a new Prudential Control Authority was established in the first quarter of 2010, as the single licensing and supervisory authority for the banking, payment services, and investment services sector, as well as for the insurance sector. The German government has announced its intention to concentrate responsibility for banking supervision at the Deutsche Bundesbank. The UK government plans to legislate to create a new Prudential Regulation Authority (PRA), as a subsidiary of the Bank of England, to conduct prudential regulation of sectors, such as deposit-takers, insurers, and investment banks.

In the national context, changes aimed at specifically implementing macroprudential supervision. Some EU member states are undertaking initiatives to strengthen the capacity of their national supervisory system to address systemic risk. In France, a law provides for the establishment of a Financial Regulation and Systemic Risk Council. In addition to playing a coordinating role, this Council will be entrusted with tasks relating to macroprudential supervision and financial stability. The UK government also has announced that it will legislate to create a Financial Policy Committee (FPC) in the Bank of England, which will be placed in charge of macroprudential regulation.

Based on Table 1, the following considerations can be made: (i) the tendency to depart from the spectral model is confirmed;(ii) Some EU member states have adopted or plan to adopt the "twin peaks" model; (iii) the single supervisory authority is still the dominant model.

Table 1. Supervisory Structures in the EU Member States

EU member states	Sectoral model	"Twin Peaks" model	Single Supervisor model	No. of authorities responsible for supervision[1)]	The NCB has supervisory tasks or responsibilities[2)]	New responsibilities or powers to the NCB[6)]
Belgium	X →→→	→→→→→→	→→→→ X	1		
Belgium Planned		X ←←←←	←←←← X	(→2)	X(NCB, B, I)	Planned
Bulgaria	X			2	X(NCB, B)	
Czech	X →→→	→→→→→→	→→→→ X	1	X(NCB All)	
Denmark			X	1		
Germany	X →→→	→→→→→→	→→→→ X	1	X[3)]	
Germany Planned					X(NCB, B)	Planned
Estonia	X →→→	→→→→→→	→→→→ X	1		
Greece	X			3	X(NCB, B)	
Greece Planned	X			(→2)	X(NCB, B, I)	Planned
Spain	X			3	X	
France	X →→→	X				
Ireland	X →→→	→→→→→→	→→→→ X	1	X(NCB All)	X
Italy	X	X		4	X(NCB, B)	X
Cyprus	X			4	X(NCB, B)	
Latvia	X →→→	→→→→→→	→→→→ X	1		
Lituania	X			3	X(NCB, B)	
Lituania Planned	X →→→	→→→→→→	→→→→ X	(→1)	X(NCB All)	Planned
Luxemburg	X			2→3	X[4)](NCB All)	X
Hungary	X →→→	→→→→→→	→→→→ X	1		
Malta	X →→→	→→→→→→	→→→→ X	1		
Netherland	X →→→	X		2		
Austria	X →→→	→→→→→→	→→→→ X	1	X[5)](NCB All)	X
Poland	X →→→	→→→→→→	→→→→ X	1		
Portugal	X	X		3	X(NCB, B)	X
Portugal Planned	X →→→	X		(→2)	X(NCB All)	Planned
Romania	X			4	X(NCB All)	
Slovenia	X			3	X(NCB All)	
Slovakia	X		X	1	X(NCB All)	
Finland	X →→→	→→→→→→	→→→→ X	2→1		
Sweden			X	1		
UK	X →→→	→→→→→→	→→→→ X	1		X
UK Planned		X ←←←←	←←←← X	2	X(NCB, B, I)	Planned

Notes: The ordering and naming of the countries in the table follows the standard EU order. The column "'Twin peaks' model" includes countries in which prudential supervision and conduct of business regulation are attributed to two different authorities. For instance in the Netherlands prudential supervision of all financial sectors (banking, insurance and securities) is concentrated at the central bank, conduct of business regulation being attributed to the Netherlands Authority for the Financial Market. Italy and Portugal appear in both the "Sectoral model" and "'Twin peaks' model" columns since they have implemented a combination of the two models.

1) Supervisory authorities with overall responsibility for taking final decisions in their field of competence.

2) The column includes central banks entrusted by law with specific supervisory responsibilities and indicates the related sector of competence (B = banking, I = insurance, All = all sectors). In Estonia and Finland, supervision is carried out by independent bodies that constitute part of the legal personality of the respective central banks.

3) The Deutsche Bundesbank is entrusted by law with the ongoing monitoring of institutions.

4) The Banque centrale du Luxembourg is entrusted by law with the prudential supervision of liquidity of markets and market operators of all financial sectors.

5) The Finanzmarktaufsichtsbehörde and the Oesterreichische Nationalbank have joint responsibility for the supervision of banks.

6) In Portugal, the power and responsibilities of the Banco de Portugal in the supervision of conduct of business of credit institutions and financial companies were reinforced in January 2008. In Italy, the Financial Intelligence Unit was established as independent division within the Banca d'Italia in 2008. In Ireland, legislation to re-integrate financial regulation into a unitary central bank was enacted in July 2010.

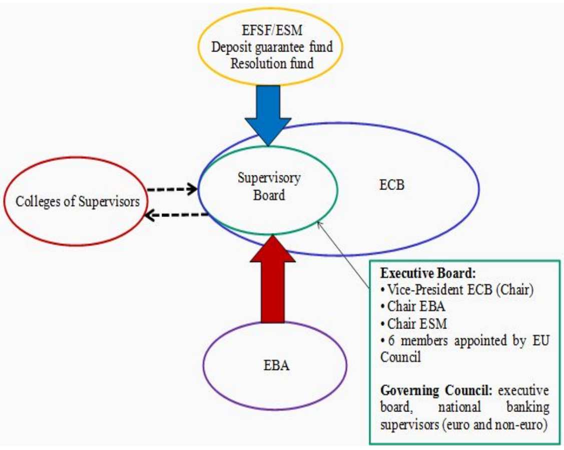
Source: European Central Bank(2010). Recent Developments in Supervisory Structures in the EU Member States (2007-10), p. 6.

However, no single model for an optimal supervisory structure seems to exist, and the institutional structures for financial supervision differ significantly across the EU member states. One thing is clear: the experience of the financial crisis has highlighted the information-related synergies between the central banking and the prudential supervisory function.

The Future of the EU Banking Union and Implications

The European sovereign crisis triggered the move toward a banking union. The "vicious circle" is identified, which shows that fiscal consolidation can be burdened by banking credit condition, and any actions need to be implemented to prevent further deterioration. In the European Council meeting of June 2012, European leaders agreed the creation of the banking union. Prior to the agreement, four major European institutions, including European Commission, European Central Bank, and Euro Group, declared "Towards a Genuine Economic and Monetary Union." This report presented four visions: banking union, fiscal union, the creation of a single supervisory mechanism, deposit insurance system and clearing system is an important move that will complete the creation of the European banking union.

Figure 2. The Institutional architecture of the European Banking Union



Source: Carmassi, Jacopo, Carmine Di Noia, and Stefano Micossi (2012)

The first step for a banking union is the establishment of the Single Supervisory Mechanism, or SSM, with a central role conferred on the ECB. The SSM is expected to do the important role watchdog as well as a mechanism for channeling capital into troubled banks. In last 2012, European leaders and the European Commission reached an agreement that the launch of the SSM will be completed with dealing with 300 large banks within the eurozone this year. However, important things remain to be answered. As mentioned, the SSM is not a final stage but the first step for the banking union and, furthermore, the Single Resolution Mechanism (SRM), which complements the SSM, and the Bank Recovery and Resolution (BRR) should be designed as soon as possible. Nevertheless, the SSM is expected to pave the way for preventing a recurrence of the same fiscal crisis as the European sovereign crisis in the future.

EU's financial reformation has the following implications for the Korean government. First, macroprudential supervisory activities and policies should be reinforced. Second, the supervisory authorities should strengthen their cooperation system. Moreover, Korea should search for a systematic framework to protect financial consumers. In terms of financial regulations, financial stability should be considered while maintaining flexibility in speed, and the level of adoption of the global trend in financial regulations. Considering that the EU's financial regulations tend to develop into a global agenda, Korean authorities should make their stance and insist on Korea's position through international financial consultative bodies, such as the G20 or the IMF. KIEP