The relationship between financial services liberalization, the regulatory framework and financial stability: an EU perspective

Olivier SALLES, EC, DG MARKT
Summary

- The 2008 crisis: a world effort to regulate
- The European path out of the crisis
- Regulation/Stability vs Liberalization/Development?
Two financial crises

**2007-08 financial shock**
- Made in USA: subprime market and complex securitisation
- Failure of monetary policy
- Regulatory gaps and inadequate supervision
- Weak corporate governance
- Conflicts of interest in credit rating agencies

**2010-11 sovereign weaknesses**
- Made in Europe, various causes in different Member States:
  - Poor government financial management
  - Debt overhang from the past
  - Real estate bubbles
- Negative feedback to financial sector via haircuts, reduced value of collateral, etc, then negative circle feeding financial instability
The 2008 crisis and its consequences

Economic effects of the crisis at a glance

EU27 debt to GDP evolution
Political response to the crisis:

- A world effort to regulate and stabilise Financial Markets and Global Economy

- Tackling financial issues at the global level (G20 agenda): more robust institutions, secure and transparent financial markets, reducing dependency on specific actors such as CRAs

- Economic growth as an answer to the financial crisis: jobs creation (esp. for the young) and improved public finances balances
Key objectives

• **Financial stability**
  - Financial institutions must be robust enough to resist shocks
  - Financial markets must be secure and transparent
  - Consumers must be protected
  - Sovereign debt problems must be stabilised

• **Growth in the real economy**
  - Need to create jobs, especially for the young
  - Growth helps public revenue and debt repayment
  - The financial sector must contribute to this
  - Regulatory policy can help
Europe's regulatory path out of the crisis

The European Union has followed the most ambitious regulatory agenda among G20 members:
- A comprehensive agenda that covers all aspects of financial services
- International coordination of regulatory reforms (G20, FSB, bilateral relations, i.e. regulatory dialogues)
- Quickest implementation of reforms to be achieved by 2013
- Integration in an overarching economic policy in favour of growth and jobs
Key milestones in the area of financial services last year

**March**
- Directive on Mortgage Credit (COM adoption)

**June**
- DGS (General approach in ECOFIN)

**July**
- CRD IV / CRR (COM adoption)

**October**
- MIFID II & Market Abuse Directive (COM adoption)
- Accounting Directives & Transparency Directive (COM adoption)
- Omnibus II (General approach in ECOFIN)

**November**
- Credit Rating Agencies III (COM adoption)
- Audit (COM adoption)
- Investor Compensation Scheme (General approach in ECOFIN)

**December**
- Venture capital & Social Investment Funds (COM adoption)

**2012**
- Bank resolution
The financial sector and stability

- Improve **supervision** – new structure of the European supervision (EBA, EIOPA, ESMA, ESRB)
- Strengthen **capital levels** of banks, insurers etc.
- Improve **corporate governance**, control **remuneration**
- Regulate previously **unregulated sectors** (rating agencies, hedge funds, in future also other areas of shadow banking)
- Control or sometimes ban the **riskiest transactions** (short-selling, naked sovereign Credit Default Swaps)
- Reduce the riskiness of **derivatives** (especially OTC)
- Improve functioning and **transparency** of markets (MiFID, MAD).
The financial sector and sovereign debt

- Latest **EBA recapitalisation exercise** for banks used «mark to market»
- **Restrictions on trading in naked sovereign CDSs**
- Special responsibility of the rating agencies requires **specific rules on sovereign rating**
- Global coordination on the **risk weighting** for sovereign exposures needed
- **Accounting rules** must be consistently applied on sovereign exposure
The financial sector and consumers

- Right to **basic bank account**
- Improvements to **deposit guarantee and investor compensation schemes**
- Better rules on design and selling of **retail investments**
- Better **protection for residential mortgage borrowers**
- **Single euro payments area** will be completed – and extended to e-payments
Europe's regulatory path out of the crisis: work in progress

- CRD IV
- Crisis resolution
- coming: EU Deposit Guarantee Scheme
- coming: EU Supervision on Cross border banks

⇒ Basis for possible Banking Union.

Future work streams: consumer package, Shadow banking, Liikanen Group
Regulation vs Liberalization

Overall, Europe regulated but did not departed from a liberal conception of financial markets functioning:

- Numerous and significant regulations aim at covering formerly out-of-scope activities but not putting unbearable constraints (e.g. shadow banking, derivatives, alternative investment) = proportionality.
- European reforms followed an international agenda decided and implemented by all G20 members aiming at creating a world-wide level playing field.
- Overall, very few practices have been forbidden. Several have been strictly regulated.
Regulation vs Liberalization

- Regulation + fiscal consolidation = key elements for predictability and stability.
- European regulatory agenda did not promote protectionism. On the contrary, Europe develops specific legal tools to facilitate international business (third country regime) and promote trade opportunities and agreements.
- Important consultations with stakeholders.
Conclusions:

- European regulatory reforms have been quite far reaching and will pursue in that way for the future: tough regulation is not opposed to liberal and smooth functioning of financial markets.

- Right balance between regulating and allowing financial actors to play their role.

- EU answer has been comprehensive and integrative, addressing different stakeholders.

  ➔ No evidence of contradiction between ambitious regulatory framework and liberalization/development.
Conclusions:

- No evidence it had so far a negative impact on international business and Trade. GATS rules provide stability and clarity.
- Financial carve-out has not been an obstacle.

- Still too early to draw some definitive conclusions. Very difficult to analyse the global impact (study from FSB).
- Need to futuro analyse and monitor.
THANK YOU

QUESTIONS ??