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The European Union's Regulatory Response to the Financial Crisis

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Abstract

The current financial crisis spread fast throughout the globe with catastrophic consequences. It resulted in the collapse of several major financial institutions, the bailout of banks by national governments, downturns in stock markets and failure of numerous businesses. The EU's response to the financial crisis was swift and decisive. The European Commission appointed a high level committee to propose new regulation and supervisory frameworks to reduce the odds of another crisis in the future. Based on the committee's report, the Commission published a communication titled "Driving European Recovery," which listed five key objectives with regard to its regulatory response to the financial crisis. The Commission's first objective was to build a more secure supervisory framework. In September 2010, the EU's existing supervisory structure was replaced with a European system of financial supervisors. The second objective was to amend and fill gaps where European or national regulation was insufficient or incomplete. The Commission has taken important steps towards filling these gaps and has proposed and completed amendments in several areas, such as regulation of credit rating agencies, derivatives, auditing, capital requirements and crisis management. The third objective was to improve confidence in the financial sector. Multiple steps have been taken to address this issue, such as amending and/or proposing amendments to rules on deposit and insurance guarantee schemes, packaged retail investment products and responsible lending and borrowing. The fourth objective was to improve risk management in financial institutions and align pay incentives with sustainable performance. The fifth and final objective of the Commission was to ensure more effective sanctions against market wrongdoing. It has done so by proposing legislation to deal with issues related to short selling and credit default swaps and by revising the Market Abuse Directive. Most of the proposals to address the flaws exposed by the financial crisis are either already agreed upon or are on the table; the Commission plans to complete the regulatory reform by the end of 2011. Overall, the EU's regulatory response is quite comprehensive and has been adopted swiftly and decisively; it addresses failures in the key areas considered to have contributed to the financial crisis, and it has led to a noteworthy increase of the European financial regulatory integration.

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1 INTRODUCTION

The current global financial crisis is viewed by many as the worst financial crisis since the worldwide Great Depression of the 1930's.[1] The crisis, which is considered to have started in the United States, spread fast throughout the globe with catastrophic consequences. Globally, the financial crisis resulted in the collapse of several major financial institutions, the bailout of banks by national governments, downturns in stock markets and the failure of numerous businesses. Furthermore, the crisis has caused many housing markets to suffer, resulting in evictions and foreclosures and has increased unemployment rates.[2]

The European Union (the "EU") and its Member States were in no way exempt from this disaster. The financial crisis impacted the economy of the EU in every field, ranging from the labor market to governmental budgetary positions. Policy makers in the EU, both at the central and Member State levels, were taken by surprise by the severity of the crisis.[3] The EU's response to the financial crisis was, however, swift and decisive. On October 28, 2008, the European Commission (the "Commission") published a Communication titled "From Financial Crisis to Recovery: A Framework for Action" [4] to pave the way for a more detailed EU recovery plan that was set to be published a month later. In November 2008, the Commission adopted the European Economic Recovery Plan, which was swiftly approved by

[1] *See, e.g.,*, Larry Elliott, *A Financial Crisis Unmatched Since the Great Depression, Say Analysts*, The Guardian, Mar. 18, 2008 http://www.guardian.co.uk/business/2008/mar/18/creditcrunch.marketturmoil1; James Buckley & David Howarth, *Internal Market: Gesture Politics? Explaining the EU's Response to the Financial Crisis,* 48 Journal of Common Market Studies, 119 (2010), *available at* http://onlinelibrary.wiley.com/doi/10.1111/j.1468-5965.2010.02097.x/pdf

[2] *See, e.g.,* US Congressional Research Service, *The European Union's Response to the 2007-2009 Financial Crisis* (R41367 Aug. 13, 2010), by Walter W. Eubanks, *available at* http://www.fas.org/sgp/crs/row/R41367.pdf

[3] *See, e.g.,* European Economy, *Economic Crisis in Europe: Causes, Consequences and Responses*, European Commission: Directorate-Generale for Economic and Financial Affairs, 23-56, (July 2009) [hereinafter European Economy]

[4] *Commission Communication: From Financial Crisis to Recovery: A European framework for action,* COM (2008) 706 final (Oct. 29, 2008) [hereinafter A European Framework for Action].

the Council of the EU (the "Council") in December 2009.[5] The objective of the recovery plan was to drive a coordinated EU response to the economic crisis. The priority was to treat the symptoms of the economic crisis and protect jobs in the short-term while also investing in Europe's long-term economic health.[6]

In evaluating the causes of the financial crisis, failures in the regulatory framework were identified as a key factor in the build-up of the crisis. Thus, a new regulatory framework with enhanced prudential and supervisory policies was deemed essential. This determination led to the appointment of a high level committee, under the chairmanship of Jacques de Larosière, whose purpose was to propose new regulation and supervisory frameworks to reduce the odds of another crisis in the future.[7] Following the Larosière report, which was presented on February 25, 2009,[8] the Commission published a communication titled "Driving European Recovery" in March 2009, which listed five key objectives with regard to its regulatory response to the financial crisis. These objectives were to:

i. build a more secure supervisory framework;

ii. fill in gaps and amend the European and national regulation;

iii. improve confidence in the financial sector;

iv. adjust risk management of the financial sector; and

v. ensure more effective sanctions against market wrongdoing.[9]

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[5] *Communication from the Commission to the European Council: A European Economic Recovery Plan*, COM (2008) 800 final (Nov. 26, 2008).

[6] Press release, European Commission, The Commission Launches a Major Recovery Plan for Growth and Jobs, to Boost Demand and Restore Confidence in the European Economy (Nov. 26, 2008), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1771

[7] European Economy, *supra* note 3, at 56.

[8] Report, The High-Level Group on Financial Supervision in the EU (Feb. 25, 2009) [hereinafter The Larosiére Report] (chaired by Jacques de Larosiére).

[9] *Communication from the Commission for the Spring European Council: Driving European Recovery*, COM (2009) 114 final, 7 (Mar. 4, 2009) [hereinafter Driving European Recovery].

This paper will review and explore i) each of the above five objectives and ii) the steps the Commission has already taken or proposed as part of the regulatory reform in order to meet these objectives.

2 THE FINANCIAL CRISIS

The current financial crisis is assumed to have started in the United States during the second half of 2006 with a liquidity shortfall in the United States banking system. The liquidity shortfall was triggered when the United States housing bubble burst; this bubble had been growing steadily since 1982 due to decreased interest rates, backed by the U.S. Federal Reserve, and increased construction. As banks granted more loans to potential home owners, housing prices rose. After the bubble burst in 2006, the already rising default rates on "subprime" mortgages quickly increased. Once interest rates started rising in late 2006, housing prices started to drop significantly, resulting in an increased number of foreclosures. As part of the housing and credit booms, the number of investments in mortgage backed securities and collateralized debt obligations, financial agreements that derive their value from mortgage payments and housing prices, greatly increased. As housing prices declined, major global financial institutions that had borrowed and invested heavily in such instruments reported significant losses.[10]

A series of other factors, such as government policies like the U.S. Government's policy to deregulate and encourage business, increased the problems. This deregulation resulted in less oversight of activities and less disclosure of information about new activities undertaken by financial institutions. These institutions had assumed significant debt burdens while also providing loans to home owners and investors in mortgage backed securities.

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[10] *See, e.g.*, US Congressional Research Service, *Causes of the Financial Crisis*, (R40173 Apr. 9, 2010), by Mark Jickling, *available at* http://assets.opencrs.com/rpts/R40173_20100409.pdf; European Economy, *supra* note 3; The Larosiére Report, *supra* note 8, at 7-12.

Unfortunately, such institutions did not have a financial cushion sufficient enough to absorb large loan defaults or their own losses in the securities market. These losses impacted the ability of financial institutions to lend, thereby slowing economic activity.[11] Questions regarding bank solvency, decreased credit availability and damaged investor confidence had a severe impact on global stock markets. Economies throughout the world slowed during this period as credit tightened and international trade declined. Critics argued both that credit rating agencies and investors failed to accurately price the risk involved with mortgage-related financial products and that governments did not adjust their regulatory practices to address the activities of modern financial markets.[12]

According to the International Monetary Fund (the "IMF") and the European Central Bank (the "ECB") many of the factors that led to the financial crisis in the United States created a similar crisis in Europe. As creditworthiness problems in the United States began surfacing in the subprime mortgage market in July 2007, the risk perception in European credit markets followed. The financial turmoil quickly spread to Europe, but European mortgages initially remained unaffected by the collapse in mortgage prices in the United States. Other factors that spread the financial turmoil to Europe were the links between national credit markets and the fact that international investors react to economic or financial shocks by rebalancing their portfolios in assets and markets that otherwise would seem to be unrelated. The rise in uncertainty and the drop in confidence that arose from this rebalancing action undermined the confidence in major European banks and disrupted the interbank market, making money center banks unable to finance large portfolios of securities in

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[11] *See, e.g.,* Robert Weissman, *Deregulation and the Financial Crisis*, The Huffington Post, Jan. 22, 2008, *available at* http://www.huffingtonpost.com/robert-weissman/deregulation-and-the-fina_b_82639.html

[12] *See, e.g.,* Commission Regulation 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, 2009 O.J. (L302) 1-31, at recital 10 [hereinafter The Credit Rating Agencies Regulation].

wholesale markets.[13] The increased international links between financial institutions and the spread of complex financial instruments meant that financial institutions in Europe and elsewhere had to rely more on short-term liquidity lines for their day to day operations. Such reliance made these institutions especially vulnerable to drawbacks in the interbank market.[14]

As a result, several financial institutions in the United States and the EU collapsed or were bailed out by national governments, causing a domino effect on stock, housing and labor markets. The consequences were catastrophic.

3 THE EUROPEAN UNION'S RESPONSE TO THE FINANCIAL CRISIS

3.1 The European Framework for Action

On October 29th, 2008, the Commission published a paper called "From Financial Crisis to Recovery: a European Framework for Action" to coordinate the actions of the 27 Member States of the EU to address the financial crisis.[15] The paper provides a three part approach to an overall EU recovery plan. The first part is a new financial market structure at the EU level, the second deals with the impact on the real economy and the third is a global response to the financial crisis. A key element of this short term plan is that it takes a step towards addressing the long term improvements of the financial system. After publishing this paper, the Commission announced that it would propose a more detailed EU recovery framework a month later. It also announced that it had mandated a high level group, chaired

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[13] *See, e.g.*, Int'l Monetary Fund, *Regional Economic Outlook: Europe Reassessing Risk* (Apr. 2008), *available at* http://www.imf.org/external/Pubs/FT/REO/2008/EUR/ENG/ereo0408.pdf; European Central Bank, *EU Banking Structures* (Oct. 2008), *available at* http://www.ecb.int/pub/pdf/other/eubankingstructures2008en.pdf

[14] *See, e.g.*, Nathaniel Frank, Brenda Gonzalez-Hermosillo & Heiko Hesse, *Transmission of Liquidity Shocks: Evidence from the 2007 Subprime Crisis* (IMF Working Paper WP/08/200, Aug. 2008), *available at* http://209.133.61.129/external/pubs/ft/wp/2008/wp08200.pdf

[15] A European Framework for Action, *supra* note 4.

by Mr. Jacques de Larosiére (the "Larosiére Group"), to propose recommendations for reform with particular focus on supervision.[16]

3.2 The Larosiére Group

As stated above the Commission mandated the Larosiére Group to propose recommendations for the regulatory reform in the financial sector. The Larosiére Group published its report on February 25, 2009, offering thirty-one recommendations for a comprehensive set of solutions for regulatory, supervisory and global repair action (the "Larosiére Report").[17] The Larosiére Report consists of four chapters: (i) causes of the financial crisis, (ii) policy and regulatory repair, (iii) EU supervisory repair and (iv) global repair. The Report emphasizes that an inconsistent set of rules across the EU, due to the closely guarded sovereignty of national financial regulators, led to a wide diversity of national regulations that reflect local traditions, legislation, and practices. The Larosiére Group further found that the regulatory response by the EU and its members was weakened by an inadequate crisis management infrastructure in the EU.[18]

3.3 The Driving European Recovery Report

In the "Driving European Recovery" report, the Commission announced that it would, over the course of 2009, propose ambitious reforms to the European financial system. The reforms will ensure that all relevant actors and all types of financial instruments will be subject to appropriate regulation and oversight. In the Commission's opinion, the Larosiére Group's thirty-one recommendations offer a comprehensive set of concrete solutions for regulatory, supervisory and global repair action. Building on the recommendations of the high

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[16] *Id*. at 2-4.
[17] The Larosiére Report, *supra* note 8.
[18] *Id*. at 12, 27.

level group, the Commission lists five key objectives to deliver responsible and reliable financial markets for the future. These objectives are to:

(i) build a more secure supervisory framework;

(ii) fill in caps and amend the European and national regulation;

(iii) improve confidence in the financial sector;

(iv) adjust risk management of the financial sector; and

(v) ensure more effective sanctions against market wrongdoing.[19]

The five objectives are required to achieve the Commission's overarching financial goal: to create a sound and secure financial system that operates in a single European market. The Commission has already initiated a wide range of regulatory reforms to meet this goal and aims to complete them before the end of 2011.[20]

3.3.1 Supervision of the Financial Sector

Despite the fact that financial markets in the EU and throughout the world have become more integrated, financial supervisory structures remain fragmented across the EU's Member States. Consequently, financial supervisors were unable to detect important signals in the market and react in time to prevent the drastic consequences of the current financial crisis. This flaw in financial supervision was, in hindsight, clear to the Larosiére Group.[21] One of the Commission's objectives with the reforms is to provide the EU with a supervisory framework suitable for complex international financial markets to detect potential risks early and deal with them effectively before causing significant damage.[22]

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[19] Driving European Recovery, *supra* note 9, at 4-8.

[20] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank: Regulating Financial Services for Sustainable Growth*, COM (2010) 301 final (Jun. 2, 2010), p. 8 [hereinafter Regulating Financial Services for Sustainable Growth].

[21] The Larosiére Report, *supra* note 8, at 39-42.

[22] Driving European Recovery, *supra* note 9, at 7.

The European Parliament and Council reached an agreement in September 2010 to replace the EU's existing supervisory framework with a European system of financial supervisors (the "ESFS") as suggested by the Larosiére Report.[23] The new supervisory framework was instituted on December 16, 2010 with Regulation EU No. 1092/2010 (the "ESRB Regulation").[24] The framework brings financial supervisors from both the national and EU level together to act as a network.[25] According to Paragraph 3 of Article 1 of the ESRB Regulation, the network is comprised of (i) the European Systemic Risk Board (the "ESRB"),[26] (ii) the European Banking authority,[27] the European Insurance and Occupational Pensions Authority[28] and the European Securities and Markets Authority[29] (collectively the "ESAs"),[30] (iii) the Joint Committee of the ESAs,[31] and (iv) the competent or supervisory authorities in the Member States.[32]

The ESFS will have two levels of supervision. The first level deals with macro prudential supervision where the objective is to monitor and assess the overall stability of the financial system. This objective will be carried out by the ESRB,[33] which shall be composed

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[23] Press Release, Council of the European Union, Council Approves Compromise with Parliament on Financial Supervision (Sep. 7, 2010), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/116303.pdf

[24] Commission Regulation 1092/2010, of the European Parliament and of the Council of 24 November 2010 on European Union Macro-Prudential Oversight of the Financial System and Establishing a European Systemic Risk Board, 2010 O.J. (L331) 1-11 [hereinafter the ESRB Regulation].

[25] *Id*. at recital 15.

[26] *See, e.g.*, ESRB Regulation, *supra* note 24, at art. 1. ¶ 1.

[27] *See, e.g.*, Commission Regulation 1093/2010, of the European Parliament and of the Council of 24 November 2010 Establishing a European Supervisory Authority (European Banking Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/78/EC, 2010 O.J. (L331) 12-47.

[28] *See, e.g.*, Commission Regulation 1094/2010, of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/79/EC, 2010 O.J. (L331) 48-83.

[29] *See, e.g.*, Commission Regulation 1095/2010, of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/77/EC. 2010 O.J. (L331) 84-119.

[30] The ESAs were created by reforming the already existing European Banking Committee, the European Insurance and Pension Committee and the European Securities Committee.

[31] Provided for by Article 54 of Regulation 1093/2010, Regulation 1094/2010 and Regulation 1095/2010.

[32] As specified in Regulation 1093/2010, Regulation 1094/2010 and Regulation 1095/2010.

[33] Stijn Verhelst, *Addressing the Financial Crisis: The EU's incomplete regulatory response*, The Egmont Institute, Dec. 29, 2010, *available at* http://www.egmontinstitute.be/paperegm/ep39.pdf

of the president of the ECB, vice president elected by the members of the ESRB, the central bank governors from the Member States, the vice president of the ECB, the chairpersons from the ESAs and a member of the Commission. In addition, each national central bank governor shall be accompanied by a representative of the relevant national supervisory authority.[34]

The ESRB will ensure that the voice of the EU is heard on issues relating to financial stability through close cooperation with the IMF, the Financial Stability Board, and the partners of the Group of Twenty (the "G-20").[35] The IMF and the Financial Stability Board are expected to provide early warnings of macro-prudential risks at the global level. The ESRB's task is to monitor and assess systemic risk in normal times for the purpose of mitigating the exposure of the system to the risk of failure of systemic components and enhancing the financial system's resilience to shocks. In that respect, the ESRB will contribute to ensuring financial stability and mitigating the negative impacts on the internal market and the real economy.[36] The ESRB will be responsible for conducting macro-prudential oversight at the EU level and will have no legal personality.[37] The ESRB will issue warnings and, where it deems necessary, recommendations of either a general or specific nature, addressed to i) the EU as a whole, ii) one or more Member States, iii) one or more of the ESAs, or iv) one or more of the national supervisory authorities with a specific timeline for the relevant policy response. The ESRB will also monitor compliance with its warnings and recommendations to ensure that each are effectively followed. Addressees of recommendations shall either act on them or provide an adequate justification for inaction. If

[34] ESRB Regulation, *supra* note 24, at art. 5-6.

[35] The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. It is comprised of the following 19 members: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Korea, Turkey, United Kingdom and the United States of America.

[36] ESRB Regulation, *supra* note 24, at art. 3.

[37] *Id* at recital 15.

the ESRB considers the reaction inadequate, it shall inform the addressees, the Council and, where appropriate, the applicable European supervisory authority.[38]

The second level of supervision concerns micro prudential issues, i.e. individual financial institutions. Member States' supervisory authorities will handle day-to-day supervision of financial institutions, and the ESAs will coordinate national supervision. Together, they will work on a single set of core rules applicable to all European financial institutions.[39]

The new supervisory framework will dramatically change financial supervision in the EU. EU authorities will be given a more prominent role at a micro level; the ESAs will have substantial binding powers to harmonize rules and supervisory practices, but they will not be in charge of the actual supervision. However, the opposite is true at the macro level as the ESRB will be the chief supervisor but will not have any coercive powers.[40]

According to the Commission's Work Programme for 2011, the Commission plans to assess the functioning of the new supervisory structures in the EU from 2012 to 2014.[41]

3.3.2 Gaps and faults in European and National Regulation

As discussed in Chapter 2 on the financial crisis, the increase of complex financial instruments and the deregulation of activities undertaken by financial institutions played a major role in the crisis. The second objective of the Commission's reform program, as set forth in the "Driving European Recovery" report, was to amend and fill gaps where European or national regulation is insufficient or incomplete.[42] The Commission has taken important steps towards filling these gaps and has proposed amendments in various areas. For example,

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[38] *Id*. at art. 16-18.

[39] Stijn Verhelst, *supra* note 33, at 5-6.

[40] *Id*. at p. 6.

[41] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of Regions, Commission Work Programme 2011,* COM (2010) 623 final (Oct. 27, 2010) 25 [hereinafter Commission Work Programme].

[42] Driving European Recovery, *supra* note 9, at 7.

the Commission has taken steps to regulate actors in the financial market and financial products, to impose capital requirements and to encourage crisis management plans. Each one of these areas will now be discussed.

3.3.2.1 Credit Rating Agencies

A credit rating agency is a company that rates both the credit of issuers of certain types of debt obligations and the underlying debt itself. Credit rating agencies play an important role in global securities and banking markets; investors, borrowers, issuers and governments use credit ratings to help make informed investment and financing decisions.[43]

The value of credit ratings has been widely questioned in the wake of the financial crisis. Many believe credit rating agencies failed i) to reflect worsening market conditions early enough in their credit ratings, and ii) to adjust their credit ratings in time following the market crisis.[44] The Commission responded in September 2009 by aiming to tackle the shortcomings of credit rating agencies in Regulation No. 1060/2009.[45] The Regulation introduced mandatory registration for all credit rating agencies operating in the EU and includes a number of rigorous requirements to ensure that proper oversight and regulatory standards apply, diminishing conflicts of interest. The Regulation further stipulates that credit ratings agencies located outside the EU can only be used in the EU if they are subject to an equivalent system of regulation and supervision or have been endorsed by an affiliated credit rating agency in the EU.[46]

It is a common view that the deficiencies in the current rating process have not yet been sufficiently addressed. The lack of competition amongst credit rating agencies is troublesome. The Commission is looking into possible solutions and has mentioned an

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[43] *See, e.g.*, The Credit Rating Agencies Regulation, *supra* note 12, at recital 1.
[44] *Id.* at recital 10.
[45] The Credit Rating Agencies Regulation, *supra* note 12.
[46] *Id.* at art. 5.

independent European credit rating agency as an option.[47] In June 2010, the Commission proposed a revision of the newly adopted Regulation. Under the proposed changes, the new European supervisory authority, the European Securities and Markets Authority (the "ESMA"), would be entrusted with exclusive supervisory powers over credit rating agencies registered in the EU. ESMA would have powers to request information, to launch investigations, and to perform on-site inspections. The ESMA's enforcement powers would include the ability to temporarily prohibit the issuing of credit ratings by a specific credit rating agency or suspend the use of the agency's ratings.[48]

These proposed changes mean that credit rating agencies would operate in a much simpler supervisory environment than the existing varied national environments and that they would have easier access to necessary information. Another result of centralizing EU supervision of all credit rating agencies and increasing competition among agencies is that users of ratings would also be better protected. The proposal has been passed to the Council and the European Parliament for consideration. At present, the proposal has not been adopted, but the new rules were originally expected to be instituted during the second quarter of 2011 following adoption.[49]

The steps taken by the Commission to bring credit rating agencies into regulatory and supervisory scope are extremely important. However, some important issues remain open for improvement. For example, critics point to several issues that have yet to be properly addressed, including the fact that: i) the issuer still pays for the rating, ii) credit ratings are still extensively used for regulatory purposes, and iii) the credit rating sector still lacks

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[47] Regulating Financial Services for Sustainable Growth, *supra* note 20, at 5.

[48] *Proposal for a Regulation of the European Parliament and of the Council on Amending Regulation 1060/2009 (EC) on credit rating agencies,* COM (2010) 289 final (Jun. 2, 2010).

[49] Press Release, European Commission, Commission Proposes Improved EU Supervision of Credit Rating Agencies and Launches Debate on Corporate Governance in Financial Institutions (Jun. 2, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/656&format=HTML&aged=0&language=EN&guiLanguage=en

competition.[50] Consequently, the Commission plans to address these issues by proposing yet another revision of the rules applicable to credit rating agencies in 2011.

3.3.2.2 Auditing Firms

An audit is aimed at providing an accurate reflection of the correctness of a company's financial statements. Auditing firms serve a similar role as credit rating agencies as their audits provide an important signal to regulators and investors on the financial status of companies. However, the financial crisis highlighted some weaknesses in the system. Although audits of some large financial institutions just before or during the crisis resulted in "clean" audit reports, there remained serious weaknesses in the financial health of the institutions that had been audited.[51]

In October 2010, the Commission launched a Green Paper on audit policy to explore possible ways to improve rules governing audit firms.[52] The Green Paper focuses on the independence of auditors and conflicts of interest. The Commission suggests that, for larger companies, audit firms could be chosen by supervisory authorities or companies could be obligated to rotate their auditing firm on a regular basis. The Commission is concerned about the high level of concentration in the field as the global auditing market is currently dominated by only four firms.[53] The Commission believes that such a concentration can create systemic risks. A minor step towards addressing this problem is establishing a European passport for auditing firms such that a firm based in any Member State can operate across the EU. The Commission further suggests increased supervision by enhancing the role of European supervisors.[54]

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[50] *See, e.g.,*, Stijn Verhelst, *supra* note 33, at 12.

[51] Press Release, European Commission Green Paper on Audit Policy (Oct. 13, 2010) *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/487&type=HTML

[52] *Green Paper on Audit Policy: Lessons from the Crisis*, COM (2010) 561 final (Oct. 13, 2010) [hereinafter Green Paper on Audit Policy].

[53] These firms are: KPMG, PricewaterhouseCoopers, Deloitte and Ernst & Young.

[54] Green Paper on Audit Policy *supra* note 53.

It has been questioned whether action at a European level is really necessary. The Commission has responded by stating that, "while robust supervision within Member States is key, certain matters can be best dealt with at the European level, for example the potential future European passport allowing auditors, individual and firms, registered in one Member State to provide audit services in other Member States without further registration. Moreover, if the concentration of the audit market raises systemic risk issues, these would relate to the EU as a whole and not just to any one Member State, especially given the global reach of auditors."[55]

On February 10, 2011, the Commission held a high-level conference in Brussels to give stakeholders an opportunity to explore and discuss the Green Paper and the policy options for the future of the EU audit market. The conference was well attended with over 500 participants, including investors, lenders, regulators, accountants, auditors and policy makers.[56] Currently, nothing has been made public about the next steps in regulatory changes in this field.

3.3.2.1 Derivatives

A derivative is a financial instrument that has a value based on the expected future price movements of the asset to which it is linked, called the underlying asset. The underlying asset is often a share, currency or commodity. There are many kinds of derivatives, the most common of which are swaps, futures and options. Over-the-counter derivatives ("OTC derivatives") are contracts that are traded and privately negotiated directly between two parties and do not go through an exchange or other intermediary. The OTC derivative market

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[55] Press Release, European Commission Green Paper on Audit Policy (Oct. 13, 2010) *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/487&type=HTML

[56] EU Audit Policy Information Letter (Spring 2011), *available at* http://ec.europa.eu/internal_market/auditing/docs/info-letter/2011_05_en.pdf

is largely unregulated with respect to disclosure of information between parties.[57] OTC derivatives lack transparency as they are privately negotiated contracts, and any information concerning them is usually only available to the contracting parties. They create a complex web of interdependence, which can make it difficult to identify the nature and level of risks involved. The financial crisis has demonstrated that such characteristics increase uncertainty in times of market stress and, accordingly, pose risks to financial stability. The financial crisis brought OTC derivatives to the forefront of regulatory attention. The near-collapse of Bear Sterns in March 2008, the default of Lehman Brothers on September 15, 2008 and the bail-out of AIG the following day highlighted the shortcomings in the functioning of the OTC derivatives market.[58]

On July 3, 2009, the Commission adopted a first Communication that specifically examined the role played by derivatives in the financial crisis and looked at the benefits and risks of derivatives markets.[59] On October 20, 2009, the Commission adopted a second Communication that set out future policy actions the Commission intended to institute in order to increase transparency of the derivatives market, reduce counterparty and operational risk in trading and enhance market integrity and oversight.[60] That Communication also announced the Commission's intention to set forth legislative proposals in the year 2010. During this process, the Commission established the Derivatives Working Group and held several meetings with major stakeholders in the derivatives market. It further formed a Member States Expert Working Group on Derivatives and Market Infrastructures.[61]

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[57] Stijn Verhelst, *supra* note 33, at 7.

[58] *Proposal for a Regulation on OTC Derivatives, Central Counterparties and Trade Repositories*, COM (2010) 484 Final (Sep. 15, 2010) [hereinafter Proposal for Regulation on OTC derivatives].

[59] *Communication from the Commission, Ensuring Efficient, Safe and Sound Derivatives Markets,* COM (2009) 332 final (Jul. 2, 2009).

[60] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank, Ensuring Efficient, Safe and Sound Derivatives Markets: Future Policy Actions*, COM (2009) 563 final (Oct. 20, 2009).

[61] Proposal for Regulation on OTC derivatives, *supra* note 59, at 3-4.

The work of the Commission is part of an international effort to increase the stability of the financial system in general and the OTC derivatives market in particular. Given the global nature of the OTC derivatives market, an internationally coordinated approach is crucial. The G-20 leaders agreed in September 2009 that OTC derivatives contracts should be traded on exchanges and cleared through central counterparties by the end of 2012 at the latest. The G-20 leaders reaffirmed this commitment in June 2010 and further decided to accelerate the implementation of measures to improve transparency and regulatory oversight of OTC derivatives. The Commission is fully committed to this global effort and has engaged in frequent dialogue with non-EU authorities like the US government.[62]

As planned, the Commission published a legislative proposal on derivative trading in September 2010.[63] The objectives of the proposal are threefold: (i) to reduce counterparty risk, (ii) to increase transparency and (iii) to reduce operational risk.[64] The most important aspect of the proposal is that derivative trading should be done through a central counterparty that acts as an intermediary between a seller and buyer. The purpose of the central counterparty is to increase transparency and reduce counterparty risk. Central clearing would only be mandatory for derivatives that are sufficiently standardized. Determination of which derivatives are eligible for clearing cannot be left up to the Member States as that would give rise to different and inconsistent application of the clearing obligation throughout the EU. A uniform process is needed at the EU level to determine which OTC derivatives are eligible for mandatory clearing. Therefore, a number of broad criteria are listed in the proposal, allowing ESMA to determine whether a derivative should be centrally cleared or not. Derivatives that are not eligible for central clearing would not be prohibited, but their trade would be subject to

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[62] *See id.* (The Commission has mainly kept a dialogue with the Commodities Futures Trading Commission and the Securities and Exchange Commission).

[63] Proposal for Regulation on OTC derivatives, *supra* note 59.

[64] Press Release, European Commission, Making Derivatives Markets in Europe Safer and More Transparent (Sep. 15, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1125&format=HTML&aged=0&language=EN&guiLanguage=en

additional requirements, such as supplementary capital retention. The central clearing would be subject to national supervision.[65]

According to the proposal, all derivative trading would have to be reported to a trade repository, which acts as a central derivative trade data center and is supervised by the ESMA. These trade repositories would have to provide supervisors with specified information and publish aggregated data reports. Non-Member country central clearing parties and trade repositories would only be authorized to deal with the trade of derivatives by an EU trader if such country's legal and supervisory framework is equivalent to that of the EU. Furthermore, an international agreement between the EU and the Non-Member country on the matter would be required. It should be clear that central counterparties will play a systemically important role in future derivative trading. While these private firms are paramount in the efforts to reduce the risk of derivative trading, they could actually lead to the opposite if not well managed. Therefore, the Commission's proposal sets out conditions for a central clearing party's operation, including capital requirements and access to liquidity.[66]

Rules are projected to apply at the end of 2012. The Regulation will need to be complemented by other EU legislation in order for it to be effective. The most important sets of legislation are: i) the revision of the Capital Requirements Directive, which sets out rules in bilateral derivative trade[67], ii) MiFID, which obliges the use of central clearing parties,[68] and iii) the Market Abuse Directive[69], which includes bilaterally traded derivatives.[70]

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[65] Stijn Verhelst, *supra* note 33, at 7-8.

[66] Proposal for Regulation on OTC derivatives, *supra* note 59.

[67] Comprised of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 Relating to the Taking Up and Pursuit of the Business of Credit Institutions (recast), 2006 O.J. (L177) 1-200; Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the Capital Adequacy of Investment Firms and Credit Institutions (recast), 2006 O.J. (L 177) 201-255 [hereinafter the Capital Requirements Directive].

[68] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC, 93/6/EEC, and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, 2004 O.J. (L 145) 1-61 [hereinafter MiFID Directive].

[69] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation, 2003 O.J. (L96) 16-25 [hereinafter Market Abuse Directive].

The Commission's proposal has, however, met some criticism. A main driver for the national supervision of central clearing counterparties is that their failure would be financially borne by the relevant Member States. This national financial responsibility puts smaller Member States at a disadvantage, as it would be harder for them to bailout a central clearing counterparty. [71] The Commission has not officially responded to this criticism.

3.3.2.2 Capital and liquidity requirements

Banks are required to hold a certain level of capital in order to assure that they have sufficient buffers in the event that problems arise.[72] The existing requirements, as set forth in the Capital Requirements Directive,[73] were clearly insufficient to prevent the financial crisis from occurring. The Commission has responded with three reform proposals to the capital requirements rules.

The first reform resulted in the Capital Requirements Directive II in the winter of 2009.[74] The Directive strengthens the supervision of cross-border banking groups, increases supervision of financial institutions that rely heavily on a single counterparty and imposes higher capital requirements for securitization practices,[75] which were assumed to be an important factor in the financial crisis. The Directive further introduces rules on liquidity requirements and liquidity stress tests.

[70] Stijn Verhelst, *supra* note 33, at 9.
[71] *Id.*
[72] *See, e.g.,, id. at 14.*
[73] The Capital Requirements Directive, *supra* note 68.
[74] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards Banks Affiliated to Central Institutions, Certain Own Funds Items, Large Exposures, Supervisory Arrangements and Crisis Management, 2009 O.J. (L302) 97-119.
[75] *See, e.g.,,* Investopedia.com, http://www.investopedia.com/terms/s/securitization.asp (defines securitization as the process through which an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors. The process can encompass any type of financial asset and promotes liquidity in the marketplace)

The second reform resulted in the Capital Requirements Directive III in November 2010.[76] The Directive increases capital requirements for re-securitizations[77] and for assets that banks hold in their trading book.[78] Both types of assets will be subject to more stringent disclosure rules. Furthermore, the Directive sets out rules to tackle perverse pay incentives by requiring banks and investment firms to have sound remuneration policies that do not encourage or reward excessive risk-taking. Banking supervisors are given the power to sanction banks with remuneration policies that do not comply with the new requirements. Member States were required to implement the remuneration provisions by January 1, 2011 and the capital requirements provisions by December 31, 2011.

The third capital requirements reform, Capital Requirements Directive IV,[79] is still at an early stage. The objective of the third amendment is to render the regulatory framework even more responsive to market conditions by enhancing financial stability, safeguarding the interests of creditors, and securing a level playing field throughout the globe. The amendment also aims to ensure international competitiveness of the EU banking sector and to promote the integration of the internal market. These reforms will lead to stricter international rules on capital and liquidity requirements.[80] For now, the Commission has finished public consultations and a hearing on seven potential action areas.[81] According to the Commission's

[76] Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards Capital Requirements for the Trading Book and for Re-Securitization and the Supervisory Review of Remuneration Policies, 2010 O.J. (L329) 3-35.

[77] Re-securitizations are securitizations that are composed of underlying securitizations.

[78] *See, e.g.,*, Investopedia.com, http://www.investopedia.com/terms/t/tradingbook.asp (defines a trading book as a portfolio of financial instruments held by a brokerage or bank. The financial instruments in the trading book are purchased or sold to facilitate trading for their customers, to profit from spreads between the bid/ask spread, or to hedge against various types of risk).

[79] Press Release, European Commission, Financial Crisis Response: Commission Asks Stakeholders for Views on Further Possible Changes to Capital Requirements Directive ('CRD IV') (Feb. 26, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/197&type=HTML

[80] Stijn Verhelst, *supra* note 33, at 15.

[81] These areas are liquidity standards, definition of capital, leverage ratio, counterparty credit risk, countercyclical measures, systemically important financial institutions and a single rule book in banking.

Working Program for 2011, the amendment is expected to be adopted sometime in the 2nd quarter of 2011.[82]

3.3.2.3 Crisis Management of Financial Institutions

The financial crisis has shown that mechanisms to deal with a crisis in the financial sector were non-existent or, at best, extremely insufficient. It was clear that banks and other systemic financial institutions could not be allowed to fail. A bank cannot provide essential banking functions during insolvency proceedings. Indeed, if a bank is allowed to fail, then those functions would be shut down completely, causing significant systemic damage. The governments of the Member States took various action to prevent damage to the system, such as capital injections, asset relief measures, guarantees on assets and liabilities and liquidity support. Many of those actions were successful and helped stabilize the financial system. However, they also propped up failing institutions and supported creditors at huge costs to public finances. These public interventions have had a significant impact on balancing the playing field within the internal market. According to the Commission, there is a consensus that such negative interventions must never happen again. Banks must be allowed to fail, like any other business, and authorities must be equipped with tools that enable them to prevent the systemic damage caused by disorderly failure of such institutions; all this must be accomplished without unnecessarily exposing taxpayers to risk of loss and causing wider economic damage.[83]

The Commission intends to address the issue by creating a European crisis management framework. In October 2010, the Commission published a Communication

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[82] Commission Work Programme, *supra* note 41, at 2.

[83] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank, An EU Framework for Crisis Management in the Financial sector*, COM (2010) 579 final (Oct. 20, 2010) 2-3 [hereinafter An EU Framework for Crisis].

outlining the proposal for regulatory reform which was expected in Spring 2011.[84] The proposal has yet to be set forth. The goal is to allow banks and other financial undertakings to fail without causing major disruption to financial stability and without local governments needing to step in and bailout the failing entities.[85]

The crisis management framework is comprised of three elements. First, it seeks common rules for preparatory and preventive measures. This includes drawing up recovery and resolution plans for banks, which will allow supervisors to request that banks change their business operations and corporate structure if needed. Such intervention in the management of a bank might meet significant opposition.[86]

Second, the Commission proposes to provide supervisors with early intervention powers if problems are detected. The Commission suggests that supervisors should be allowed to intervene once a bank is likely to fail to meet its capital requirements by prohibiting payment of dividends or requiring the bank to abandon certain business activities. Furthermore, the Commission would authorize supervisors to replace managers or even appoint a temporary chief executive officer.[87] To finance bank resolutions, the Commission has proposed a bank levy.[88] The Commission has been criticized for not proposing a single European fund for all Member States; instead, the Commission proposed an accumulation of national funds governed by a single set of EU rules. This is likely to cause a disadvantage for smaller Member States as they would proportionally need larger funds (in relation to their GDP) to finance the resolution of a bank. Moreover, bank resolution funds could, it is argued, lead to moral hazard as banks risk seeing the funds as an insurance premium.[89]

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84 *Id.*
85 Stijn Verhelst, *supra* note 33, at 16.
86 An EU Framework for Crisis, *supra* note 84, at 5-6.
87 *Id*. at 8.
88 *Communication from Commission on Bank Resolution Funds*, COM (2010) 254 final (May 26, 2010).
89 Stijn Verhelst, *supra* note 33, at 17.

Finally, the Commission proposes harmonized rules for the resolution of a bank when it is clear that there is no realistic prospect of recovery. During the resolution, authorities would be able to i) sell the bank, or parts thereof without the consent of shareholders, ii) write off shares and iii) write down debt or convert it into equity. Some of these tools already exist in some Member States, and, consequently, it will be necessary to ensure a smooth transition between the current national arrangements and the new crisis management framework.[90] It is doubtful that these provisions would prevent the lack of cross-border coordination the EU faced during the financial crisis. [91]

In addition to implementing harmonized rules throughout the EU, the Commission seeks to improve cross-border cooperation in the preparation and management of bank crises.

3.3.3 Confidence in the Financial Sector

The third objective of the Commission in the Driving European Recovery Report was to improve confidence in the financial sector. In general banking operations, banks lend more money than they have in actual deposits. Therefore, it is vital that people are confident that their deposits are being safely managed by the banks so that they will not withdraw their savings. If a large number of depositors withdraw their deposits in a short timeframe, then both individual banks and the banking system as a whole could fail. Liquidity problems were a major issue in the crisis and were partly caused by deposit withdrawal. Thus, existing regulations proved unable to maintain confidence in the banking system.

The EU has taken multiple actions to address the issue, including improving the framework on guarantee schemes, lending and borrowing, and implementing provisions on retail investment.[92]

[90] An EU Framework for Crisis, *supra* note 84, at 8-10.
[91] Stijn Verhelst, *supra* note 33, at 17.
[92] *Id*. at 19.

3.3.3.1 Guarantee schemes

The purpose of guarantee schemes is mainly to protect the public from the failure of financial institutions. The current EU rules on guarantee schemes have already been amended, and further amendments and innovations are in the works.

a) Deposit Guarantee Schemes

Deposit guarantee schemes ensure that if a financial institution fails, then depositors can redeem their deposits up to a certain amount.[93] The initial European rules on deposit guarantee schemes were adopted in 1994.[94] In the midst of the financial crisis, in March 2009, the relevant Directive was amended. This amendment was largely aimed at restoring short-term confidence in the financial system; the amendment i) increased the minimum level of coverage from EUR 20,000 to EUR 50,000, ii) reduced the payout period from three months to twenty working days, with a possibility to extend it to thirty working days in exceptional cases, and iii) abandoned the principle of co-insurance. Prior to the amendment, Member States could limit the coverage of deposits to 90 percent, but now full coverage is required.[95]

The Commission proposed further revisions to the rules in July 2010.[96] The Commission proposes four main changes. First, the Commission proposes to set the coverage level at EUR 100,000 across the EU. Second, the proposal would apply deposit protection to all depositor companies, regardless of their type or size. As such, the Member States' option to exclude large companies from the protection would be abandoned. Third, the proposal would further shorten the payout period to seven calendar days. Finally, the Commission

[93] Memorandum from the European Commission on Frequently Asked Questions about Deposit Guarantee Schemes (Jul. 12, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/318&type=HTML.

[94] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on Deposit Guarantee Schemes, 1994 O.J. (L135) 5-14.

[95] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on Deposit Guarantee Schemes as Regards the Coverage Level and the Payout Delay, 2009 O.J. (L68) 3-7.

[96] *Proposal for Directive ../../EU on Deposit Guarantee Schemes [Recast]*, COM (2010) 368 final (Jul.12, 2010).

proposes a cascade system to finance deposit guarantee schemes. Initially, schemes would be financed by ex-ante funds. If that proved inadequate, then ex-post funds would be used. If these are also insufficient, then a deposit guarantee scheme could borrow from other schemes. If all of these measures still proved insufficient, then alternative means of funding would be used. The proposal has run into opposition from several Member States. For instance, the financing of deposit guarantee schemes is particularly controversial. Both Germany and Sweden have claimed that the proposal runs against the principal of subsidiarity.[97]

b) *Investor Compensation Schemes*

Investor compensation schemes play a similar role as deposit guarantee schemes. Investor compensation schemes provide compensation in the event that an investment firm is unable to return assets that belong to investors due to fraud or negligence.[98] EU rules on investor compensation schemes have been in place since 1997.[99] The Commission proposed amendments to the rules in July 2010.[100] The main proposed changes include fixing the compensation level to EUR 50,000, abandoning co-insurance, reducing payout delay, adopting funding arrangements and extending the schemes' coverage to include things like UCITS products and failure of third party custodians.

c) *Insurance Guarantee Schemes*

In its July 2010 White Paper, the Commission proposed EU rules that would render insurance guarantee schemes mandatory.[101] These schemes would provide protection against

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[97] Interparliamentary Information Exchange, Dossier COD/2010/0207.

[98] Memorandum from the European Commission on Frequently Asked Questions about Insurance Guarantee Schemes (Jul. 12, 2010) *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/320&format=HTML&aged=0&language=EN&guiLanguage=en

[99] Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on Investor-Compensation Schemes, 1997 O.J. (L84) 22-31.

[100] *Proposal for a Directive of the European Parliament and of the Council amending Directive 97/9/EC on Investor Compensation Schemes*, COM (2010) 371 final (Jul, 12, 2010).

[101] *Commission White Paper on Insurance Guarantee Schemes*, COM (2010) 370 (Jul, 12, 2010).

insurance failure. For instance, it would provide protection if an insurer is unable to fulfill its obligations.[102] The White Paper sets out different options to ensure a fair and comprehensive level of consumer protection in the EU while also making sure that tax payers will not suffer in the event that an insurance company collapses. The White Paper proposes a directive to ensure that insurance guarantee schemes exist in all Member States that comply with a minimum set of requirements. The Commission requested comments from all interested parties to be submitted by November 30, 2010 and aims to propose rules in 2011.[103]

3.3.3.2 Lending and Borrowing

The subprime lending crisis in the US, which in many ways ignited the financial crisis, has shown that overly flexible lending facilities can be harmful to borrowers and lenders, as well as the economy as a whole.[104] On June 15, 2009, the Commission launched a public consultation on responsible lending and borrowing in an attempt to provide a framework which would ensure the provision of credit products specifically tailored to individual customer needs and ability to repay.[105] In the consultation, the Commission notes that regardless of current EU regulation, such as the provisions of the Credit Directive[106] and the Capital Requirements Directive,[107] evidence from the current economic crisis has shown, that there is still significant room for irresponsible lending and borrowing to take place.[108]

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[102] Memorandum by European Commission on Frequently Asked Questions about Insurance Guarantee Schemes (Jul. 12, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/320&format=HTML&aged=0&language=EN&guiLanguage=en

[103] Press Release, Commission Proposes Package to Boost Consumer Protection and Confidence in Financial Sector (Jul. 12, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/918&format=HTML&aged=0&language=EN&guiLanguage=en

[104] Stijn Verhelst, *supra* note 33, at 23.

[105] European Commission, Public Consultation on Responsible Lending and Borrowing in the EU, (Jun. 15, 2009), *available at* http://ec.europa.eu/internal_market/consultations/docs/2009/responsible_lending/consultation_en.pdf [hereinafter Consultation on Responsible Lending and Borrowing].

[106] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on Credit Agreements for Consumers and Repealing Council Directive 87/102/EEC, 2008, O.J. (L 133) 66.

[107] The Capital Requirements Directive, *supra* note 68.

[108] Consultation on Responsible Lending and Borrowing, *supra* note 106, at 3.

The Commission will attempt to use the consultation to cover, amongst other things, proper advertising and marketing of credit products and creation of measures to ensure the provision of accurate information of households' financial situation. While looking into issues such as pre-contractual information, advice standards and potential risk guidelines, the consultation also seeks to support the Commission in its creation of an appropriate framework for credit intermediaries. The Commission is now looking into issues such as information disclosure, registration, licensing and supervision of credit intermediaries.[109] The consultation was open until August 31, 2009 and was followed by a public hearing on September 3, 2009.

On March 31, 2011 the Commission set forth a proposal for a directive on credit agreements relating to residential property. The proposal deals with proper advertising of mortgage loans while also setting stringent rules for both information disclosure to borrowers and the rights of borrowers to prepay their loans. Furthermore, the proposal provides rules on credit intermediation. Credit intermediaries will be obligated to register and apply for an EU passport, allowing them to conduct their business anywhere within the EU area.[110]

3.3.3.3 Packaged Retail Investment Products

The market for packaged retail investment products is very large; it was estimated to have been worth up to EUR 8 trillion by the end of 2008. These products can offer considerable benefits to retail investors. However, they are often complex and difficult for investors to fully understand, particularly with regard to their risks and costs. Packaged retail investment products are currently governed by fragmented legislation, namely MiFID[111] and IMD.[112] The Commission believes that the legislative framework is too fragmented and that it

[109] *Id*. at 4-6.

[110] *Proposal for a Directive of the European Parliament and of the Council on Credit Agreements Relating to Residential Property*, COM (2011) 142 final (Mar, 31, 2011).

[111] The MiFID Directive, *supra* note 69.

[112] Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on Insurance Mediation, 2003 O.J. (L 9) 3-10.

is incomplete. The complex and incomplete nature of this legislation is seen as harmful when it comes to instilling confidence in these products.[113]

In the Commission's April 2009 communication on packaged retail investment products, the Commission stated that it was committed to delivering important improvements to investor protection measures for the main investment products bought by retail investors. Inconsistencies in existing standards can be detrimental to investors and can lead to competitive distortions in the retail investment market. The Commission's conclusions are that product information requirements and rules on product sales need to be improved and made more coherent.[114]

The Commission launched a public consultation on the matter between November 2010 and January 31, 2010. The Commission plans to publish a legislative proposal on packaged retail investment products in 2011.[115]

3.3.4 Risk Management in Financial Institutions

The fourth objective of the Commission in the Driving European Recovery Report was to improve risk management in financial institutions and align pay incentives with sustainable performance. Excessive risk taking is presumed to have been a major cause of the financial crisis. As described above, the Commission has already taken several steps to reduce risks, including: i) modifying rules on capital requirements, ii) enhancing regulation on products, and iii) reducing the dependency on credit rating agencies. Additionally, the EU has initiated action to effectuate risk management within financial institutions by proposing rules to alter remunerations and corporate governance policies.

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[113] *Communication from the Commission to the European Parliament and the Council, Packaged Retail Investment Products.* COM (2009) 204 final (Apr. 30, 2009).

[114] Press Release, Financial Services: Commission Proposes Better Investor Protection Measures for Packaged Retail Investment Products (Apr. 29, 2009), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/666

[115] Regulating Financial Services for Sustainable Growth, *supra* note 20, at 10.

3.3.4.1 Corporate Governance

In June 2010, the Commission launched a Green Paper and public consultation on corporate governance in financial institutions.[116] The Green Paper describes measures to improve i) the supervisory role of senior management, ii) remuneration policies, and iii) the involvement of shareholders, financial supervisors and external auditors. The Commission also suggests i) limiting the number of boards on which a director may sit, ii) demanding a level of diversity amongst the board of directors in terms of gender and background, iii) disclosing institutional investors' voting practices, and iv) reinforcing civil and criminal liability of directors. The Commission plans to propose regulatory measures in 2011.[117]

3.3.4.2 Remuneration

Financial institutions in the EU and elsewhere have been heavily criticized for their excessive remuneration policies. The Commission has published two recommendations on the matter. The first recommendation deals with the remuneration of directors in general, including those of financial institutions,[118] but the second recommendation specifically deals with remuneration in the financial sector.[119] The general aim of EU initiatives is to align remunerations with long-term objectives, rather than short-term risk-taking.[120]

As discussed in chapter 3.3.2.2, the Commission has already taken steps to address remuneration policies in the Capital Requirements Directive III, which was instituted in January 2011.[121] The Directive contains three important types of remuneration related rules. First, it lays down rules regarding the governance of remuneration policies. The Directive

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[116] *Paper on Corporate governance in financial institutions and remuneration policies*, COM (2010) 284 final (Jun. 2, 2010) [hereinafter Paper on Corporate governance in financial institutions and remuneration policies].

[117] Regulating Financial Services for sustainable growth, *supra* note 20, 10.

[118] *Commission Recommendation Complementing Recommendations 2004/913/EC and 2005/162/EC as Regards Regime for the Remuneration of Directors of Listed Companies*, 2009 O.J. (L 120).

[119] *Commission Recommendation on Remuneration Policies in the Financial Sector,* COM (2009) 3159 (Apr. 30, 2009).

[120] Stijn Verhelst, *supra* note 33, at 25.

[121] The Capital Requirements Directive, *supra* note 68.

requires independent control of remunerations in financial institutions and creation of remuneration committees. Second, the Directive introduces transparency rules that oblige financial institutions to publish annual information on their remuneration policies and practices. Finally, the most stringent element of the Directive is its limits to variable remunerations, i.e. bonuses. The rules stipulate that at least half of the relevant employee's variable remunerations shall consist of ownership entitlements, namely, shares or instruments that can be converted to ownership entitlements in case of contingency. In addition, at least 40 percent of the relevant employee's variable remuneration is to be deferred for at least 3 years. These limitations apply to employees that have a material impact on the risk profile of the financial institution.[122]

3.3.5 Market Wrongdoing

The fifth and final objective of the Commission in the "Driving European Recovery" report was to ensure more effective sanctions against market wrongdoing. The current EU legislation on market wrongdoing is the Market Abuse Directive, adopted in 2003, under which certain conduct is deemed abusive.[123] Since the financial crisis erupted, there have been calls to revise this Directive and to limit additional forms of market behavior, especially with regard to short selling and credit default swaps. In contrast to other regulatory proposals in the field of financial regulation, there seems to be less of a consensus on the need for actions against market wrongdoing.[124]

3.3.5.1 Market Abuse

The Market Abuse Directive[125] covers rules on insider dealing and market manipulation. Although the financial crisis did not lead to a significant increase of these types

[122] Stricter rules apply to financial institutions that have received state aid.
[123] Market Abuse Directive, *supra* note 70.
[124] Stijn Verhelst, *supra* note 33, at 27.
[125] Market Abuse Directive, *supra* note 70.

of market wrongdoings,[126] the Larosière Report found sanctioning weak and disharmonious as sanctions for insider trading range from a few thousand Euros in one Member State to millions of Euros or jail in another; the Larosière Report suggested that this range could induce regulatory arbitrage in a single market. As a result, the Report recommended the urgent strengthening and harmonization of sanctions.[127]

The Commission launched a public consultation on the matter in June 2010 and a proposal for the revision of the Directive is expected in 2011.[128] The revision will have three main objectives: i) enlarge the scope of the Directive to include new markets and instruments, ii) increase the supervision and enforcement mechanisms, and iii) harmonize rules by limiting the options and discretions of Member States.[129]

3.3.5.2 Short Selling

Short selling is defined as either: i) the sale of a security that the seller does not own at the time of the transaction, or ii) any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock back at a lower amount than the price at which they initially sold it. The aim is to profit from a decrease in a security's value.[130]

Short selling can, in some situations, be viewed as giving rise to a number of potential risks. For example, in extreme market conditions there is a risk that short selling can lead to an excessive downward spiral in prices, which then leads to a disorderly market and possible systemic risks. Moreover, if there is insufficient transparency about short positions, then it can be difficult for regulators to monitor the implications upon market orderliness or monitor the use in connection with abusive strategies. In addition, lack of transparency may lead to

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[126] European Commission, Public Consultation on a Revision of the Market Abuse Directive (25 June 2010), 2.
[127] The Larosiére Report, *supra* note 8, at 23.
[128] Commission Work Programme, *supra* note 41, at 2.
[129] Stijn Verhelst, *supra* note 33, at 27.
[130] As defined by Investopedia.com, http://www.investopedia.com/terms/s/shortselling.asp

information asymmetries if other market participants are not adequately informed about the extent to which short selling is affecting prices. However, most studies conclude that short selling contributes to the efficiency of markets; it increases market liquidity as the short seller sells securities and then later purchases the identical securities to cover the short sale. What is more, allowing investors to act when they believe a security is overvalued leads to more efficient pricing of securities, mitigates price bubbles, and acts as an early indicator of underlying problems relating to an issuer. It is also an important tool that is used for hedging and other risk management activities and market-making.[131]

At the height of the financial crisis in September 2008, authorities in several EU Member States and the US adopted emergency measures to restrict or ban short selling in some or all securities. They acted based on concerns that at a time of considerable financial instability, short selling may aggravate the downward spiral in the prices of shares, notably in financial institutions, in a way that could ultimately threaten their viability and create systemic risks. The measures adopted by Member States were divergent as the EU lacks a specific legislative framework for dealing with short selling issues.[132]

In September 2010, the Commission proposed legislation to deal with issues related to short selling. The proposal seeks to increase transparency in short selling practices. To that end, the Commission has proposed that if a market participant is engaged in a number of short sell operations of a share that exceeds a certain threshold, then he has to notify a regulator of his short sell position. Furthermore, if the market participant exceeds a higher threshold, then he shall make his position publicly known. In addition, the Commission proposes that share sell orders in a trading venue that involve short selling should be marked. The Commission further proposes to harmonize rules on temporarily restricting or banning short selling.

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[131] *Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps*, COM (2010) 482 final (Sep.15, 2010) 2-4 [hereinafter Proposal for Short Selling Regulation].

[132] *Id*. at 12-13.

National regulators would be able to do so if there is a serious threat to market stability or market confidence. If a national regulator does not adequately address a threat, then ESMA would be allowed to take measures that would override the actions taken by national regulators. However, under the proposal, the ESMA would not be able to undo a ban on short selling imposed by a national regulator.[133]

3.3.5.3 Credit Default Swaps

A credit default swap is a type of derivative instrument. The buyer of a credit default swap pays a fee to the seller. In return, the seller of the credit default swap commits to compensate the buyer in the event that a credit instrument—namely, a loan or bond—fails to meet its debt obligations. It is also possible to buy a naked credit default swap where the buyer is not the actual owner of the underlying credit instrument for which the credit default swap protects against failure. The main reason for buying this type of credit default swap is to speculate on an increase of the probability of default.[134]

The above mentioned proposal on short selling also deals with credit default swaps. The proposal requires notifying the regulators of an uncovered position of a Member State government debt credit default swap that exceeds a certain threshold and authorizes regulators to restrict credit default swap transactions. The competencies of national regulators and the ESMA in restricting credit default swap transactions would be similar to those required in the case of short selling.[135]

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[133] Proposal for Short Selling Regulation, *supra* note 132.
[134] *Id*. at 3.
[135] *Id.*

4 CONCLUSION

This paper has provided a brief overview of the several ambitious regulatory actions taken by the EU in the past couple of years to meet the five key objectives of the Commission's reform of the European financial system.

The Commission's first objective was to build a more secure supervisory framework. In September 2010, the European Parliament and Council reached an agreement on replacing the EU's existing supervisory structure with a European system of financial supervisors.[136] The new supervisory framework will dramatically change the financial supervision in the EU as it brings together financial supervisors at both the national and EU level to act as a network. At present, no further actions are contemplated by the Commission in this respect and an assessment of the functions of the new supervisory structures is on the Commission's agenda from 2012 to 2014.[137]

The second objective of the Commission's reform program was to amend and fill gaps where European or national regulation is insufficient or incomplete. The Commission has taken important steps towards filling these gaps and has proposed and completed amendments in several areas. Regulation No. 1060/2009 on credit rating agencies was adopted in September 2009. The Council and the European Parliament are currently considering amendments to the Regulation, which were expected to come into force during the second quarter of 2011.[138] The Commission plans to propose yet another revision of the rules applicable to credit rating agencies in 2011.[139] The Commission has published an important legislative proposal on derivative trading that is expected to apply at the end of 2012, and it is also exploring possible ways to improve rules governing audit firms.[140] At the same time, the

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[136] *Supra* note 23.
[137] Commission Work Programme, *supra* note 41, at 25.
[138] *Supra* note 49.
[139] *See, e.g.*,, Commission Work Programme, *supra* note 41, at 2.
[140] Green Paper on Audit Policy, *supra* note 53.

Commission is working on its third capital requirements reform[141], which is expected to be adopted in the 2nd quarter of 2011.[142] Finally, a proposal for a regulatory reform of crisis management was expected in Spring 2011, but it has not yet been set forth.[143]

The third objective of the Commission in the Driving European Recovery Report was to improve confidence in the financial sector. The EU has taken multiple actions to address this issue. In March 2009, the Commission amended the Directive on deposit guarantee schemes[144] and proposed further revisions to the rules in July 2010.[145] Unfortunately, the proposal ran into opposition from several Member States due to the suggested financing of deposit guarantee schemes, bringing amendments to a halt.[146] The Commission aims to propose rules on insurance guarantee schemes in 2011.[147] On June 15, 2009, the Commission launched a public consultation on responsible lending and borrowing in an attempt to provide a framework which would ensure the provision of credit products specifically tailored to individual customer needs and ability to repay.[148] On March 31, 2011, the Commission set forth a proposal for a directive on credit agreements relating to residential property that would significantly improve borrower's rights.[149]

Finally, the Commission plans to publish a legislative proposal on packaged retail investment products to improve investor protection in 2011.[150]

The fourth objective of the Commission in the Driving European Recovery Report was to improve risk management in financial institutions and align pay incentives with sustainable performance. To that end, the Commission launched a Green Paper and public consultation on

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141 *Supra* note 80.
142 Commission Work Programme, *supra* note 41, at 2.
143 An EU Framework for Crisis, *supra* note 84.
144 Consultation on Responsible Lending and Borrowing, s*upra* note 106.
145 *Id*.
146 Supra note 98.
147 *Supra* note 104.
148 Consultation on Responsible Lending and Borrowing, *supra* note 106.
149 *Supra* note 102.
150 Regulating Financial Services for Sustainable Growth, *supra* note 20, at 10.

corporate governance in financial institutions in June 2010[151] and plans to propose regulatory measures in 2011.[152] In addition to the remuneration provisions of the Capital Requirement Directive, the Commission has published two recommendations[153] on the matter in an attempt to align remunerations policies with long-term objectives, rather than short-term risk-taking.[154]

The fifth and final objective of the Commission in the Driving European Recovery Report was to ensure more effective sanctions against market wrongdoing. A Commission proposal for the revision of the Market Abuse Directive is expected in 2011[155]. The Commission also proposed legislation to deal with issues related to short selling and credit default swaps in September 2010.[156]

A comprehensive timeline for delivery of proposals to complete the EU's financial reform, which was introduced with the Commission's Communication titled "Driving European Recovery," was presented by the Commission in June 2010.[157] As outlined above, most of the proposals to address the flaws exposed by the financial crisis are either already agreed upon or on the table. According to the timeline, the Commission will have proposed all the necessary elements for a fundamental improvement of the way Europe's financial markets are regulated and supervised by the end of 2011.

Overall, the EU's regulatory response is quite comprehensive and has been adopted swiftly and decisively. It addresses failures in key areas which are considered to have contributed to the financial crisis and has led to a noteworthy increase of the European financial regulatory integration. It should, however, be acknowledged that had a clear EU framework for coordination of financial crisis policies been available beforehand, rather than

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[151] Paper on Corporate governance in financial institutions and remuneration policies, *supra* note 117.
[152] Regulating Financial Services for sustainable growth, *supra* note 20, at 10.
[153] *See, e.g.,*, *supra* notes 119 and 120.
[154] Stijn Verhelst, *supra* note 33, at 25.
[155] Commission Work Programme, *supra* note 41, Annex at 2.
[156] Proposal for Short Selling Regulation, *supra* note 132.
[157] *Supra* note 4.

being set up under extreme time pressure when financial meltdown was a genuine risk, coordinated action could have been implemented sooner and the social cost would have been lower.

At this point, it is impossible to answer whether the EU’s response to the financial crisis is sufficient and whether it has managed to secure a European financial system that is stable enough to prevent another economic disaster from occurring. It is important to keep in mind that the financial crisis is far from resolved, and, therefore, continued work on the financial regulatory reform is crucial. In that respect, ongoing co-ordination with the EU's major international partners, such as the G-20 and the U.S. government, is essential for success.