1

Crisis-driven regulatory reform: where in the world is the EU going?*

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I: Introduction

Never waste several good crises . . .

On the surface at least, crises shake the status quo and provide space for new ideas to emerge.[1] Complacent assumptions are overturned, policy learning takes place and there is a sharpened focus on the concerns that demand a robust response. The issues acquire the degree of political salience that is needed to push through a reform agenda.

The international regulatory response to the global financial crisis of 2007–9 appears to support the idea of crisis as a game-changer. The world's leading economies have adopted an apparently ambitious agenda for international financial regulation and have put in place institutional changes designed to bolster implementation of international standards

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1 W. Mattli and N. Woods, "In Whose Benefit? Explaining Regulatory Change in Global Politics" in W. Mattli and N. Woods (eds.), *The Politics of Global Regulation* (Princeton University Press, 2009), pp. 1–43, p. 37. Or, perhaps, a resurgence of interest in old ideas that had been marginalized by other ideologies more in tune with prevailing economic conditions, as exemplified by the post-crisis renewed interest in Polanyi's ideas on the inherently destructive nature of free-market capitalism: K. Polanyi, *The Great Transformation (The Political and Economic Origins of Our Time)* (Boston: Beacon Press, 1944/2001).

and to reinforce surveillance. They have also been putting in place far-reaching reforms at national or regional level. The United States has passed a mammoth piece of legislation with a view to reforming Wall Street and reinvigorating financial regulation.[2] The European Union (EU) is being no less determined in the extent of its reform program, although it is proceeding on a measure-by-measure basis rather than attempting to deal with everything in a single instrument. A common feature of the reforms on both sides of the Atlantic is that implementation is dependent on the adoption of a large number of detailed rules, many of which are still under development at the time of writing (Spring 2012). The level of government intervention in markets that is involved in these financial reform packages is far removed from mainstream policy preferences of just a few years ago.[3] On the European side, moreover, the pace of both coordination between Member States and centralization at EU level has accelerated. Spillover effects from the reforms that are eventually put in place to resolve the euro area sovereign debt crisis could lead to a still further concentration of EU regulatory power with respect to the financial markets. Since an effective solution to the euro area crisis remains elusive at the time of writing, the possibility that the reforms that are eventually adopted could reverse the trend by triggering a reining in of EU regulatory authority and perhaps even a "repatriation" of powers to Member States must be acknowledged. However, this appears to be a less likely outcome than an expansion and reinforcement of the existing tendencies.

In contrast to those who view crises as major turning points, others suggest that the view that a crisis leads to radical change does not always hold up when it is subjected to close examination. Instead, the set of ideas most likely to triumph after a crisis may be the one which "represents the smallest step into the unknown."[4] A report published by the Organization for Economic Cooperation and Development (OECD) makes the point in this way: "the process of change is always at the margin. Groupthink implicit in economic and market paradigms, unfortunately, takes a long time to change."[5] The absence of a radical break

[2] Wall Street Reform and Consumer Protection Act of 2010 (also known as the "Dodd-Frank Act"). See further, J.C. Coffee, Jr., Chapter 4 below.
[3] R.C. Altman, "Globalization in Retreat," *Foreign Affairs*, 88 (2009), 2–7; R.D. Cudahy, "The Coming Demise of Deregulation II," *Administrative Law Review*, 61 (2009), 543–56.
[4] Mattli and Woods, "In Whose Benefit?," p. 39.
[5] OECD, *The Financial Crisis: Reform and Exit Strategies* (Paris: OECD, 2009), p. 22.

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with the past need not be a bad thing if it means that the ideas that are taken seriously and translated into law are relatively familiar ones that have been seriously and soberly debated over a period of time so that their most obvious flaws have already been identified and addressed, and which are designed to fit well with the existing body of regulation so as to enhance its effectiveness.[6] But a troubling aspect of these views is that they suggest that even public clamor for tough action following a crisis may not be an effective counterweight to more reactionary forces, such as powerful industry interest groups that stand to lose from sweeping public interest-oriented reform. Industry interest groups that are adept at exploiting opportunities in law reform processes, which tend to be complex and time-consuming even in the aftermath of a disaster, may succeed in whittling down bold proposals to something they find more palatable. In spite of harsh, business-unfriendly rhetoric, politicians may be complicit in this process, with their words merely serving as a cloak for “gesture politics.”

Yet another line of analysis suggests that crisis situations can, indeed, propel far-reaching changes, but that these reforms are likely to turn out to have adverse longer-term consequences for both the particular field at which they are targeted and for other areas that suffer spillover effects. It is argued that crises can lead lawmakers into error because they act too quickly in circumstances of considerable uncertainty.[7] Knee-jerk overreaction can result in misplaced crude simplification of complex issues and faulty policy choices designed to pander to populist sentiments.[8] The general mood of hysteria and heightened political interest can allow popular but fundamentally flawed ideas, which would have been screened out in calmer times, to take hold. Even the most well-intentioned lawmakers can go astray when, in their eagerness to be seen to be doing something, they take up from policy entrepreneurs ideas that seem to be responsive to the topical problem but which, in reality, are

[6] Favoring incremental regulatory adjustments over sweeping regulatory revolution: L.A. Cunningham and D.T. Zaring, “The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response,” *George Washington Law Review*, 78 (2009), 39–113.

[7] R. Romano, “The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,” *Yale Law Journal*, 114 (2005), 1521–611, 1523–4; S.M. Bainbridge, “Dodd-Frank: Quack Federal Corporate Governance Round II,” *Minnesota Law Review*, 95 (2011), 1779–821.

[8] But see B. Thirkell-White, “Dealing with the Banks: Populism and the Public Interest in the Global Financial Crisis,” *International Affairs*, 85 (2009), 689–711 (identifying some benefits in populism).

simply repackaged versions of existing proposals that were formulated long before the crisis to treat a different mischief. If not operating within a system containing appropriate checks and balances, some officials may seek to pursue their own personal agenda rather than to aim at making unbiased choices in the public interest. Decisions about the content of regulation are always at risk of being distorted so as to fit the short-term political goals of those who control the lawmaking process.[9]

Taken in the round, these various arguments suggest that the chances for successful crisis-driven regulatory reform are low, and that they are likely to be very slim indeed in an area as complex and as vast as financial regulation. Furthermore, the concept of success in this context is elusive. The post-global financial crisis regulatory goal has been described in quite daunting terms as being to "restore strong, competitive, innovative financial markets to support global economic growth without once again risking a breakdown in market functioning so severe as to put the world economies at risk."[10] However, it asks too much of regulation to expect a permanent cure that eliminates financial crises forever more.

The speculative bubbles that precede crashes occur for many reasons, and not all of them can be controlled through regulation.[11] Andrew Lo has suggested that financial manias and panics may be "an unavoidable aspect of modern capitalism – a consequence of the interactions between hardwired human behavior and the unfettered ability to innovate, compete, and evolve."[12] "Black swan" events can happen.[13] Even the most insightful architects of well thought out regulatory reform cannot

[9] G.J. Stigler, "The Theory of Economic Regulation," *The Bell Journal of Economics and Management Science*, 2 (1971), 3–21.

[10] Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Washington DC: G30, 2009), p. 8.

[11] J.B. Taylor, "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong," National Bureau of Economic Research Working Paper 14631 (2009) (excesses in monetary policy); S.B. Wadhwani, "What Mix of Monetary Policy and Regulation is Best for Stabilising the Economy?" in A. Turner, A. Haldane, P. Woolley, S. Wadhwani, C. Goodhart, A. Smithers, A. Large, J. Kay, M. Wolf, P. Boone, S. Johnson and R. Layard, *The Future of Finance* (London: LSE, 2010), pp. 145–63 (monetary policy mistakes); R.J. Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do About It* (Princeton University Press, 2008) (irrational exuberance).

[12] A.W. Lo, "Regulatory Reform in the Wake of the Financial Crisis of 2007–2008," *Journal of Financial Economic Policy*, 1 (2009), 4–43, 5. That financial markets tend towards excess is not a new insight: Polanyi, *The Great Transformation*; H.P. Minsky, *Stabilizing an Unstable Economy* (New Haven: Yale University Press, 1986).

[13] N.N. Taleb, *The Black Swan: The Impact of the Highly Improbable* (New York: Random House, 2nd edn., 2010).

guarantee that regulatory shortcomings will not play a significant part in a future crisis. To imagine that regulatory change today could have such a rock-solid effect far into the future would be to conjure up a model that rests on dangerously naïve presuppositions about regulatory foresight.[14] Franklin Allen and Douglas Gale have noted that financial regulation has always involved an element of trial and error.[15] Charles Goodhart has also stressed its pragmatic character.[16]

In the face of inevitable crises and regulatory fallibility, perhaps the best we can hope for is that post-crisis regulatory changes will do as much as is feasible, based on the best current technical knowledge, to reduce the risks of new crises emerging and to anticipate and seek to mitigate at least some of the consequences of future failure, all the while doing as much as possible to avoid handicapping legitimate, economically worthwhile businesses with unnecessary additional costs. Even these are still quite lofty aspirations, and the reality is likely to fall short.

That expectations as to likely effectiveness are best managed downwards, first because of our inability to predict the future and second because of distortions arising from the particularly messy way in which law reform processes tend to operate in the aftermath of a crisis, is a sobering thought with which to begin the task that this chapter undertakes: an examination of the EU's regulatory response to the global financial crisis, also taking account of the way in which that response has been influenced by the euro area sovereign debt crisis. At the same time, being clear-sighted about the inevitability of imperfections and shortcomings in post-crisis law reform also underscores the importance of starting to conduct careful appraisals of policy processes and outcomes while memories of the problems that the changes were supposed

[14] Leading texts giving the historical perspective on financial crises are: C.P. Kindleberger and R.Z. Aliber, *Manias, Panics and Crashes: A History of Financial Crises* (Hoboken, NJ: 5th edn., Wiley, 2005); C.M. Reinhart and K.S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009). Reinhart and Rogoff emphasize the dangers of assuming omniscience: "one would be wise not to push too far the conceit that we are smarter than our predecessors. A few years back many people would have said that improvements in financial engineering had done much to tame the business cycle and limit the risk of financial contagion": C.M. Reinhart and K.S. Rogoff, "The Aftermath of Financial Crises," *American Economic Review*, 99 (2009), 466–72, 472.

[15] F. Allen and D. Gale, *Understanding Financial Crises* (Oxford University Press, 2007), p. 190.

[16] C. Goodhart, "How Should We Regulate Bank Capital and Financial Products? What Role For 'Living Wills'?" in Turner *et al.*, *The Future of Finance*, pp. 165–86, p. 165.

to address are still relatively fresh. As time goes on, there will be opportunities to reconsider and make improvements to the post-crisis EU financial services regulatory system. To help ensure that those opportunities are fully exploited, the development of a deeper contextual understanding of the policy choices that were made in the immediate aftermath of turmoil is essential preparatory work. Even though the full impact of some of those policy choices may not be felt for many years, it is not premature to start the process of critical evaluation and audit.

Defining the scope of the chapter and explaining the approach

In 2005, having completed the Financial Services Action Plan (FSAP), a five-year plan launched in 1999 to accelerate progress towards a single EU financial market which had triggered an ambitiously far-reaching revamp of European financial services regulation, the European Commission envisaged a period of relative calm. The Commission thought that the main priorities for the next five years would be consolidating progress, completing unfinished business, enhancing supervisory cooperation and convergence, and removing the remaining economically significant barriers.[17] This was not to be. As a consequence of the global financial crisis, regulatory repair aimed at bolstering the safety, soundness and responsibility of the markets, rather than dismantling remaining barriers and tidying up loose ends, has become the new number one priority.[18] It has also been deemed necessary urgently to look again at the institutional architecture of supervision because existing arrangements – based on a home/host State distribution of responsibilities, pan-EU coordinating committees of national supervisors, and a reliance on gradual, incremental enhancements to promote convergence in national supervisory practices – have proved to be inadequate to prevent disorderly cross-border contagion.[19]

EU regulatory policy has now begun to stray into previously "no-go" zones that were jealously guarded by Member States – albeit rather

[17] European Commission, *White Paper on Financial Services Policy 2005–2010* (COM(2005) 629), p. 4.
[18] European Commission, *Driving European Recovery* (COM(2009) 114); European Commission, *Regulating Financial Services for Sustainable Growth* (COM(2010) 301).
[19] J. Faull, *Some Legal Challenges of Financial Regulation in the EU* (Slynn Foundation, 2011, online: www.slynn-foundation.org/UserFiles/File/Slynn%20Lecture.pdf).

cautiously in some areas – such as national sanctioning regimes[20] and financial sector crisis management arrangements,[21] but more boldly in others, such as the first steps towards direct supervision by EU bodies of financial market actors which have been taken with respect to the European Securities and Markets Authority (ESMA)[22] in relation to credit rating agencies (CRAs)[23] and trade repositories.[24] Furthermore, with the euro area sovereign debt crisis both intensifying some existing problems and adding new issues as well, there has been little sign of the tap of new regulatory reform proposals being closed off.

Early assessments of this response by some political scientists have recorded a sense of underachievement: much activity but relatively weak policy impact,[25] and not as far-reaching as might have been expected given the magnitude of the crisis.[26] From a legal perspective, however, it has been claimed that "[i]n the wake of the crisis, the EU's ascendancy over financial market regulation seems almost complete."[27] The space

20 European Commission, *Reinforcing Sanctioning Regimes in the Financial Services Sector* (COM(2010) 716). The proposal for the introduction of a Directive on criminal sanctions for market abuse violations marks a significant step forward in this regard: European Commission, *Proposal for a Directive on Criminal Sanctions for Insider Dealing and Market Manipulation* (COM(2011) 654).

21 European Commission, *An EU Framework for Crisis Management in the Financial Sector* (COM(2010) 579); European Commission, *Proposal for a Directive Establishing a framework for the Recovery and Resolution of Credit Institutions and Financial Firms* (COM (2012) 280) (Recovery and Resolution Directive (proposed)). Crisis management proposals are discussed further in Parts II–IV below.

22 Regulation (EU) No. 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) (ESMA Regulation), [2010] OJ L331/84. (Note, for convenience this chapter refers to specific provisions of the ESMA Regulation, but the same core content is also contained in the founding Regulations of the European Banking Authority (EBA) (Regulation (EU) No. 1093/2010, [2010] OJ L331/12) and European Insurance and Occupation Pensions Authority (EIOPA) (Regulation (EU) No. 1094/2010, [2010] OJ L331/48)).

23 Regulation (EC) No. 1060/2009 on Credit Rating Agencies, [2009] OJ L302/1 (CRA Regulation) (amended by Regulation (EU) No. 513/2011, [2011] OJ L145/30).

24 Regulation (EU) No. 648/2012 on OTC Derivative Transactions, Central Counterparties and Trade Repositories [2012] OJ L201/1 (EMIR).

25 J. Buckley and D. Howarth, "Internal Market: Gesture Politics? Explaining the EU's Response to the Financial Crisis," *Journal of Common Market Studies*, 48 (Special Issue Supplement), (2010), 119–41.

26 L. Quaglia, "'The 'Old' and 'New' Politics of Financial Services Regulation in the EU," (online: www.ose.be/files/publication/OSEPaperSeries/Quaglia_2010_OSEResearchPaper2_0410.pdf).

27 N. Moloney, "EU Financial Market Regulation After the Global Financial Crisis: 'More Europe' or More Risks?" *Common Market Law Review*, 47 (2010), 1317–84, 1381.

between these views serves as a jumping-off point for more detailed inquiry. However, to conduct a comprehensive review of the entire field of EU post-crisis financial services law reform and to assess its effectiveness would require a large team of researchers and a publisher willing to commit to what in all likelihood would turn out to be a multi-volume work written over an extended period in which it has been possible to monitor the resolution of considerable implementation challenges and to discern the practical impact of the intended and unintended consequences of the changes. A chapter such as this necessarily has to be more selective.

When detailed research into the impact of the new laws adopted by the EU in response to the global financial crisis and the euro area sovereign debt crisis eventually comes to be done, the scorecard is bound to be less than perfect for the reasons outlined above. The search for explanations as to why the EU has, or has not, managed to adopt effective reforms can be expected to lead back to the preferences and aims of the main actors and institutions that were involved in the lawmaking process. In anticipation of this, this chapter focuses on the factors driving the Member States and the EU institutions in drawing up the post-crisis regulatory agenda and in transforming policy ideas into legislation. Recognizing that EU financial services regulatory policymaking is a multi-level complex process involving both intergovernmental and supranational components and also that the crises have given rise to new tensions in the interaction between these various components, the chapter seeks to establish the location of significant sources of influence with respect to agenda-setting, to identify the preferences of the key opinion-formers, and to determine the extent to which such preferences have made it into law rather than being filtered out during the many rounds of negotiation and compromise that are part of the EU lawmaking process.

The focus is on public actors, but the extent to which industry preferences can play a part in shaping their views is not ignored. The evolution of EU financial services regulation up to the global financial crisis has been described as having been geared mostly towards serving the needs of large internationally active financial firms.[28] One of the

[28] "The creation of an integrated European financial market" has been "primarily to the benefit of a new European 'champions league' of financial services providers": D. Mügge, "Reordering the Marketplace: Competition Politics in European Finance," *Journal of Common Market Studies*, 44 (2006), 991–1022, 992. On how to lobby effectively in the EU: M Levitt, *Getting Brussels Right: "Best Practice" for City Firms in Handling EU Institutions* (London: Centre for the Study of Financial Innovation, 2011).

major consequences of the financial crisis and subsequent events is that relations between the official sector and the finance industry have seemingly become much more antagonistic. Politicians and public officials have learnt that being home to vibrant financial markets can be very risky business, and that the potential for competitive gain has to be set against the threat that large financial firms, especially those that have become, in effect, "too-big-to-save," may pose to the public interest.[29] The re-setting of public policy to adapt to this new learning may make it less easy in future to characterize EU financial services regulation as a system built largely around the needs and preferences of international financial firms. However, given how pervasive such influences have been in the past and also the strong imperative to bolster financial competitiveness that remains entrenched in the public policies of developed economies, it seems prudent to have low expectations with respect to the likely extent of this recalibration. This chapter is therefore predicated on an assumption that European (EU and Member States') economic prosperity is too intricately tied up with, and dependent on, the prosperity of major actors within the financial system for industry views, and especially those advocated by the biggest internationally-oriented firms, not still to exert considerable influence in policy circles.

Whilst the exercise conducted in this chapter involves some selective examination of the content of new laws, the emphasis is more on the process of institutional decision-making within the legislative bodies and on the use of EU law as a policy instrument than on its substantive doctrinal content. As to what this policy is, in broad terms post-crisis EU financial regulation has been said to be all about producing "a safer, sounder, more transparent and more responsible financial system, working for the economy and society as a whole and able to finance the real economy."[30] The purpose of financial regulation has been said to be to ensure that the financial system provides the "backbone" for the real economy to flourish.[31] These quotations are from a European Commission publication but phrased at such a high level of generality that there is nothing in them to

[29] A. Demirgüç-Kunt and H. Huizinga, "Are Banks Too Big to Fail or Too Big to Save? International Evidence from Equity Prices and CDs Spreads," Centre for Economic Policy Research Discussion Paper No. DP7903 (2010); E.H.G. Hüpkes, "'Too Big to Save' – Towards a Functional Approach to Resolving Crises in Global Financial Institutions," in D.D. Evanoff and G.G. Kaufman (eds.), *Systemic Financial Crisis: Resolving Large Bank Insolvencies* (Hackensack, NJ: World Scientific Publishing, 2005), pp. 193–215.

[30] European Commission, *Regulating Financial Services for Sustainable Growth*, p. 2.

[31] Ibid., p. 3.

which any of the main European actors and institutions (which are, in any case, committed to the overall Europe 2020 strategy, which is aimed at making the EU a smart, sustainable and inclusive economy) would be likely to object. They reflect, moreover, current international policy aspirations, as reiterated by the political leaders of the leading economies at successive G20 meetings.[32] Mainstream policymaking is no longer to be built around the notion that the unrestrained growth of immense, interconnected financial markets and hyper-intense constant financial innovation are inherently desirable from a social perspective. Public policy has gone back to basics in recalling that the core functions of financial institutions are to provide payment mechanisms and deposit-taking facilities, and to channel resources to where they are most needed: financial services should support the real economy.[33]

As well as its explanatory force with respect to the reforms adopted in the immediate aftermath of recent turmoil, there is also a forward-looking dimension to the exercise conducted in this chapter. The Commission has said that the new approach involves putting in place "stringent, efficient and harmonized rules for all operators, coupled with an effective supervisory framework, strong, dissuasive sanctions and clear enforcement mechanisms."[34] But when and where does harmonized EU financial regulation reach its limits? Is the supranational approach now becoming all-embracing? With respect to the content of new laws, will considerations of "stringency" prevail over those of "efficiency" in the drafting of an ever-more prescriptive and lengthy harmonized rulebook? Will the urge to dissuade and deter leave no room to entertain the possibility that providing incentives to comply could produce better results? Will the emphasis on achieving pan-European uniformity in supervision mean that calls for rigid rules trump arguments that favor leaving room for the operation of a judgment-based approach?[35] Where

[32] e.g. G20, *Framework for Strong, Sustainable, and Balanced Growth* (Pittsburgh: G20, September 2009).

[33] M. Barnier, "Mettre les Marchés Financiers au Service de l'économie Réelle" (speech, June 11, 2011, online: http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/11/449&format=HTML&aged=0&language=FR&guiLanguage=fr). A. Turner, "What Do Banks Do? Why Do Credit Booms and Busts Occur and What Can Public Policy Do About It?" in Turner *et al.*, *The Future of Finance*, pp. 5–86.

[34] European Commission, *Regulating Financial Services for Sustainable Growth*, p. 3.

[35] Flagging up the need for the EU policy framework to leave scope for supervisors to make informed judgments: Bank of England and FSA, *The Bank of England, Prudential Regulation Authority: Our Approach to Banking Supervision* (London: Bank of England & FSA, 2011), p. 20.