

"Does financial reform entail real change? For whom? By whom? And how?"

An EU Perspective"¹

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"[...] Saving banks at any cost, making the public pay the price, foregoing a firm commitment to reviewing and reforming the entire system, only reaffirms the absolute power of a financial system [...]. The financial crisis of 2007-08 provided an opportunity to develop a new economy, more attentive to ethical principles, and new ways of regulating speculative financial practices and virtual wealth. But the response to the crisis did not include rethinking the outdated criteria which continue to rule the world. [...] The problem of the real economy is not confronted with vigour, yet it is the real economy which [...] helps companies to function well, and enables small and medium businesses to develop and create employment. "

Pope Francis, Laudato Si', Encyclical letter, n. 189

"The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress [...]" From Article 3.3, Treaty on European Union

1. Introduction

The 2007/08 financial crisis represented a significant failure for the European Union, in particular when assessed against the standards embodied in the concept of a social market economy and in the EU's very favourable experience with the benefits of functioning markets. The financial crisis was also fuelled by important macroeconomic trends and imbalances, particularly in the Euro area. However, the state of regulation before the crisis was a major factor in creating it and in exacerbating its impact on the real economy, on jobs and unemployment. The crisis exposed major weaknesses of European financial sector legislation and the inadequacy of the governance of the institutions overseeing its regulation. In particular, while financial markets were fully liberalised and integrated on the European scale, their supervision had remained national. The European Union responded first in terms of crisis management with emergency measures to stabilise the financial sector. They included bank bail-outs which, for lack of other instruments, could only be achieved through use of public money. A meltdown of the financial system was thus averted, albeit at a high price, not least in terms of political acceptability and trust. The EU also moved to take measures correcting regulatory weaknesses and market failures to prevent future crises. The systematic overhaul of financial sector legislation/regulation and the new level of integration in the form of a Banking Union aimed to implement, one by one, the lessons from the crisis. The ultimate objective was to match the financial system's capacity to deliver with the aspirations of a social market economy.

This short paper provides a sketch (section 2) of key actions taken at European Union level in response to the crisis, discusses some persisting negative impacts and steps being taken to improve the prospects for the real economy (section 3). Section 4 hints at benefits and challenges of the Megatrend of digitisation also in the financial sector. Section 5 concludes.

2. Action at EU level to address the weaknesses and failures exposed by the financial crisis²

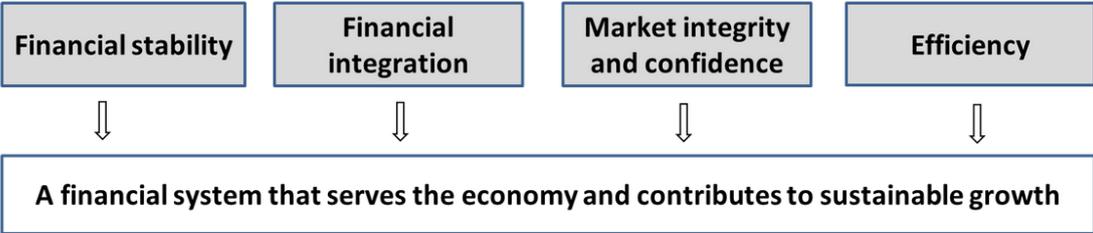
The weaknesses of the dysfunctional pre-crisis financial system were chiefly inadequate micro- and macro-prudential supervision and regulation; high leverage and a limited ability

¹ This paper reflects the personal views of the author and is not attributable to the European Commission.

² This section is based on [Commission Communication "A reformed financial sector for Europe" COM\(2014\)279 final](#) and [Staff Working Document SWD\(2014\)158 final](#).

to absorb losses and liquidity shocks; the absence of frameworks for the orderly winding down of financial institutions; the moral hazard of "too-big/interconnected/complex-to-fail" with its implicit subsidy for systemically relevant institutions; poor risk management frameworks; deficiencies in derivatives markets where volumes of trading in largely unregulated OTC derivatives ballooned; uncontrolled systemic risk stemming from shadow banking and inadequate regulation of credit rating agencies and audit firms impacting the independence and quality of their assessments, while giving them a central role in risk evaluation. These weaknesses compounded to incentivise inefficient and irresponsible behaviours by market participants. The key market failures at work were the effect of asymmetric information magnified by the unprecedented complexity of financial market products, services and transactions; externalities and perverse incentives arising e.g. from the systemic importance of individual financial institutions; as well as market power and market abuse.

These weaknesses in financial sector regulation were largely global in nature and not specifically European. However, owing to vulnerabilities built up before the crisis in terms of excessive levels of debt and current account imbalances in several EU and Euro area Member States, the impact was more pronounced and persistent in Europe than elsewhere, particularly in the form of sovereign debt crises within the Euro area.



The systematic overhaul of EU financial regulation since 2008 aimed to re-establish a financial system at the service of the real economy and society at large by introducing legislation to re-establish financial stability, to enhance financial integration, to restore confidence and market integrity and to provide the rules needed for market efficiency. To do this, the reform agenda addressed, one by one, the lessons learned from the crisis.

With the re-establishment of financial stability being the most urgent need, action was taken to avert bank runs through strengthening the safety net for depositors and inserting depositor preference into the Bank Recovery and Resolution legislation (BRRD)³. In the same vein, the Capital Requirement Directive (CRD IV) increased loss-absorbing capacity and improved liquidity management. Other key objectives addressed through various new legislative instruments were checking the build-up of systemic risks and pro-cyclicality (monitoring through the European Systemic Risk Board, macro-prudential elements in CRD IV, increased disclosure requirements, regulations on credit rating agencies); the reduction of interconnectedness (CRD IV, BRRD, the quality of ratings; audit reform); ensuring resolvability and tackling the "too-big/interconnected/complex-to fail" problem (CRD IV, BRRD, Single Resolution Mechanism, the proposal on bank structural reform). The reform agenda went beyond the banking sector to cover the insurance sector, financial markets and infrastructures as well as shadow banking. The reforms also aimed at clearer incentives supporting ethical behaviour, including through internal governance and remuneration rules

³ See the Annex for a list of objectives and key measures taken on each of them.

for financial institutions going against short-termism and enhancing accountability and transparency (CRD IV, audit reform, sanctions regimes under CRD IV and in other legislation).

Overview of objective and key reform measures taken⁴

Objectives	Main reforms	Objectives	Main reforms
FINANCIAL STABILITY		MARKET INTEGRITY AND CONFIDENCE	
Banking sector			
Increasing loss absorbency	Capital Requirements Regulation and Directive IV (CRD IV package), Bank Resolution and Restructuring Directive (BRRD)	Countering market abuse	Market Abuse Regulation and Directive on Criminal Sanctions for Market Abuse (MAR/CSMAD), benchmark regulation
More adequate liquidity and maturity matching	CRD IV package	Consumer and investor protection	Deposit Guarantee Scheme (DGS) Directive, Mortgage Credit Directive (MCD), Packaged Retail and Insurance-based Investments Products (PRIIPS), Insurance mediation Directive (IMD), Undertakings for Collective Investment in Transferable Securities (UCITS) Directive V, MiFID II, Payment Services Directive (PSD) II, Payment Account Directive (PAD)
Reducing pro-cyclicality and systemic risk	CRD IV package, European System of Financial Supervisors (ESFS), structural reform	Improving the reliability of ratings and financial information	CRA regulations, accounting and transparency rules, audit market reforms
Improving risk management and governance	CRD III, CRD IV package, structural reform	EFFICIENCY	Single rulebook, CRD IV package, BRRD, structural reform, Banking Union, Solvency II, MiFID II, EMIR, CSDR, CRA regulations
Improving crisis management, recovery and resolution	BRRD, Single Resolution Mechanism (SRM), structural reform		
Correcting "too big to fail"	Structural reform, BRRD, CRD IV package		
Financial markets and infrastructures	Markets in Financial Instruments Directive II (MiFID II), European Market Infrastructure Regulation (EMIR), Central Securities Depositories Regulation (CSDR), Short-selling and CDS regulation, regulations on credit rating agencies (CRAs), Prospectus Directive, accounting reforms, audit market reforms, benchmark regulation, regulation on securities financing transactions (SFTs)		
Shadow banking	Alternative Investment Fund Managers Directive (AIFMD), Money Market Fund (MMF) regulation, SFT regulation (and other measures)		
Stability and resilience of the insurance sector	Solvency II, Omnibus II		
FINANCIAL INTEGRATION			
Enhancing the single market	All reforms, in particular the single rulebook, ESFS, European venture capital funds (EuVECAs), European social entrepreneurship funds (EuSEFs), European Long-term investment funds (EuLTIFs)		
Banking Union to improve the functioning of EMU	Single Supervisory Mechanism (SSM), SRM		

The most ambitious element of the reform agenda was the creation of a Banking Union. Externalities arising from the coexistence of financial markets integrated at EU level and national regulatory and prudential oversight had been a major structural weakness of the EU financial system. Furthermore, the slump in confidence associated with the crisis had led to a severe re-fragmentation of EU financial markets along national lines and the bank-sovereign loop has continued to endanger financial stability and growth prospects. The Banking Union project aims to address these issues. It also enhances the EU's future capacity to prevent and, if needed, manage crises more effectively. Banking Union had already made significant progress with the coming into force of a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM). This agenda is ongoing. Only in November 2015 did

⁴ See [Staff Working Document SWD\(2014\)158 final](#), p. 51 f.

the Commission table a proposal for a European Deposit Insurance Scheme to complement SSM and SRM and to complete the Banking Union⁵.

3. What has changed? Have the European institutions delivered? Impacts on the real economy and growth?

The more than 40 laws put forward in the EU financial sector reform brought significant change in terms of the stability of the system overall, the resilience of banks, the incentives for bank managers, the transparency and reporting requirements, oversight over shadow banks, and consumer protection. The reforms have enabled supervisors to oversee markets that had been beyond their reach before. Combined with the leap forward in terms of integration represented by Banking Union, the likelihood of taxpayers bailing out banks ever again will have greatly diminished with the implementation of the relevant legislation. However, not all of the reforms proposed by the European Commission have already entered into force and European co-legislators still have not adopted the proposal on bank structural reform and on money market funds.

In 2014, the Commission undertook an extensive economic review of the financial regulation agenda⁶. One of the aspects analysed in this context was the impact on the flow of finance to the economy, in particular to small- and medium-sized enterprises (SMEs). In striking the balance between financial stability and a sufficient and sustainable flow of finance to the economy, the Commission has been mindful of potential costs of the reforms. In view of such considerations, the European Commission has 2015 come forward with a Capital Markets Union Action Plan whose objective it is to improve the financing of the real economy by complementing Europe's strong tradition of bank financing with measures facilitating market financing, in particular for SMEs⁷. The first concrete measures put forward are legislative proposals 1) to establish a framework for simple, transparent and standardised securitisation; 2) to make it easier for insurers to invest in infrastructure; 3) consultations regarding a European covered bond framework and venture capital; and 4) a call for evidence on the cumulative impact of financial sector reforms. In the latter, the European Commission aims at a comprehensive analysis of whether and to what extent current rules may affect the ability of the economy to finance itself and grow; whether there are unnecessary regulatory burdens; what are interactions, possible inconsistencies and gaps; and rules giving rise to possible other unintended consequences⁸. The attention to the need for financing of the real economy is also the motivation behind the European Fund for Strategic Investments launched already soon after the start of its mandate in 2014⁹.

4. The Megatrend of Digitisation and new regulatory challenges

"In the face of profound and epochal changes, world leaders are challenged to ensure that the coming "fourth industrial revolution", the result of robotics and scientific and technological innovations, does not lead to the destruction of the human person – to be replaced by a soulless machine – or to the transformation of our planet into an empty garden for the enjoyment of a chosen few."

Pope Francis, Message to the World Economic Forum, January 2016

⁵ The [European Deposit Insurance Scheme](#) was proposed on November 24, 2015.

⁶ See Footnote 2.

⁷ See [Commission Communication "Action Plan on Building a Capital Markets Union". COM\(2015\) 468 final.](#)

⁸ For the call for evidence see http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/index_en.htm.

⁹ For the European Fund for Strategic Investment see http://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan_en.

The digital revolution is in full swing. It represents an unstoppable, global development that will encompass all areas of economy and society to which digitisation can be applied in a meaningful fashion. As other industrial revolutions before it, it will bring huge structural changes to our economies, including through new productivity dynamics and a tendency for monopoly formation. The role of digital platforms will be crucial in many sectors. These developments pose significant regulatory and competition policy challenges, some already known, many not yet. Digitisation will also impact labour markets and work organisation. Given its inevitability, European trade unions tend to advocate an approach of facing digitisation proactively and positively, aiming to embrace and shape it while guarding against its risks¹⁰. Digital skills are important both at the level of experts as well as for every citizen. Digitisation holds huge positive potential in terms of overall economic welfare and quality of life improvements, particularly in Europe's ageing societies, but also potentially important positive impacts for the environment. Examples are applications in education, health and energy sectors, but also in the context of smart homes and smart cities.

Digitisation will disrupt existing business models across all sectors of the economy, including the financial sector. Currently, the so-called "Fintechs", new financial companies making use of digital technology, provide innovations in their respective niches, often placing their services at the tip of the value chain between banks and their customers¹¹. Fintechs tend to focus on activities performed by banks, but to avoid activities requiring a banking license in order to stay clear of the compliance costs associated with financial sector regulation. Apart from the generally new and often small Fintechs, established large digital platforms are also moving into financial services, exploiting their considerable customer knowledge represented in the data they collect. Regulation concerning data protection, data security and privacy applying to financial institutions and other players differs significantly. This raises the question of a level playing field in the sector between different players. One way for established financial firms to deal with the situation is to innovate by cooperation with or takeover of Fintechs. Another approach for such companies is adopting a platform-like approach, e.g. by hosting other service providers and establishing the necessary interfaces. Established banks might be able to exploit a business model focused on trust and on a more "conservative" approach to data use to distinguish themselves from digital platforms. The situation is in flux. The European Commission is currently inter alia looking into assessing potential regulatory issues associated with platforms¹².

5. Conclusion

The financial crisis of 2007/08 caused the European Union to launch a profound overhaul of its financial sector legislation linked to the G20 agenda at the international level. Within a comparatively short time frame, the European Commission proposed more than 40 pieces of legislation covering all areas of the financial system and systematically addressing all regulatory weaknesses and market failures identified in the wake of the crisis. While the Commission has been mindful of the need for balance between re-establishing financial stability and the financial sector's capacity to finance the real economy, the necessary de-leveraging both in the banking sector as well as in the public finances of many Member States put a break on the availability of financing and growth. In response to the effective re-fragmentation of financial markets along national lines in the wake of the crisis, the

¹⁰ See the [positioning of the European Trade Union industriAll on the digitisation of manufacturing](#).

¹¹ See Dapp, Thomas F.: "Fintech reloaded – Die Bank als digitales Ökosystem". Deutsche Bank Research 2015.

¹² See [list of public consultation conducted by the European Commission in the digital area](#).

European co-legislators put in place elements of a Banking Union that is currently in the process of being completed. The financial crisis has thus challenged the European Union and the response was a significant deepening of integration well beyond what was politically imaginable only a few years ago.

The need to improve the financing of the real economy and to spur growth without incurring new public debt, the European Commission launched the European Fund for Strategic Investment. Its Action Plan for a Capital Markets Union aims to complement bank financing through market financing and to facilitate access to such financing in particular for SMEs. The global Mega-Trend of digitisation holds huge positive potential, including in the financial sector. Sector-specific regulatory needs in this regard are being addressed through the EU's Digital Single Market Strategy¹³. Issues such as the ownership and use of data require further analysis.

For the European Union, the Treaty principle of a social market economy is a meaningful reference point for policy making. In the history of the Union well-regulated, functioning markets and market integration has been an instrument not only of growing prosperity and social cohesion but of peace. The financial crisis undermined prosperity and social cohesion. The importance of this challenge to principles and core objectives of the Union has been understood. This understanding is reflected in the policy actions taken since 2008 and in the political guidelines of the current Commission President as well as in the Commission's work programme¹⁴.

¹³ On 6 May 2015, the European Commission presented its [Digital Single Market Strategy for Europe](#).

¹⁴ Jean-Claude Juncker: [A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change Political Guidelines for the next European Commission](#). Strasbourg 2014.