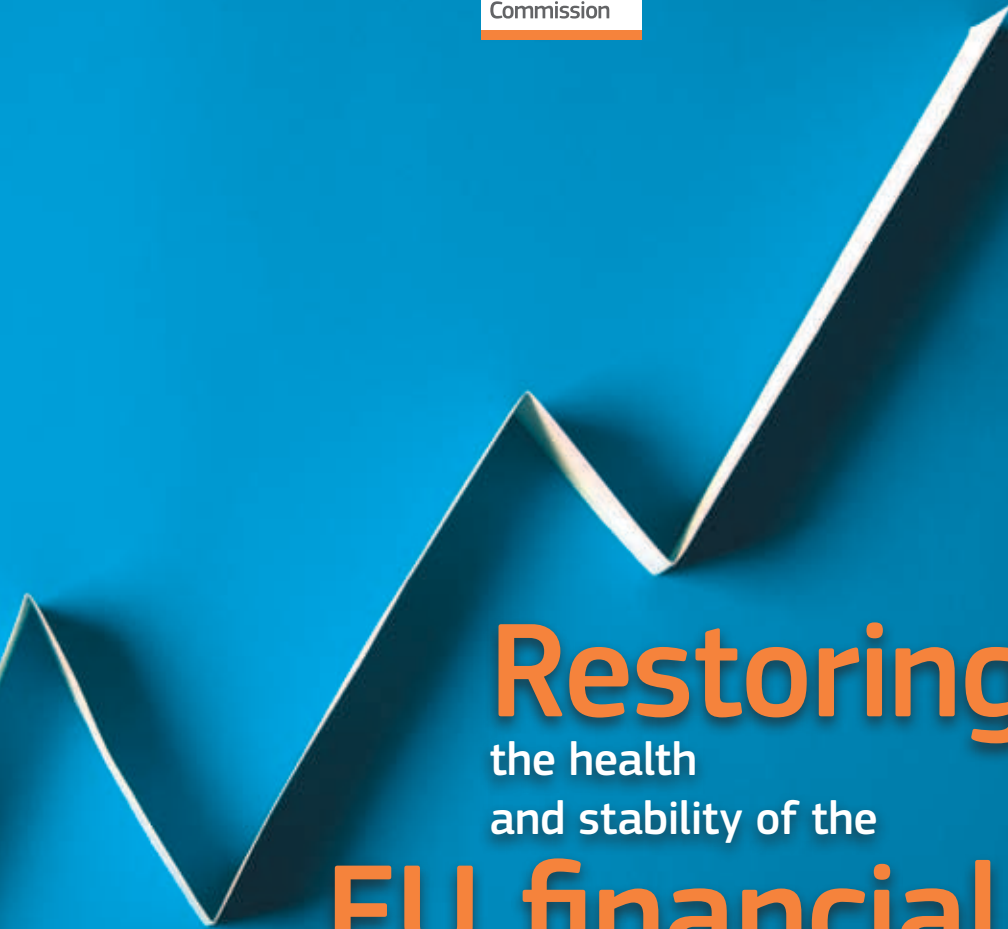




European
Commission



Restoring
the health
and stability of the
**EU financial
sector**

*Internal Market
and Services*

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We are all suffering the effects of the ongoing financial crisis. It began in the banking sector and has spread to public finances. It has led to necessary austerity programmes and impacted hard on the real economy.

Financial reform has a key role to play in stabilising the financial sector, removing the inadequacies and abuses which existed, and preventing or mitigating future crises.

The EU is in the end phase of its biggest ever programme for financial services reforms. Around thirty measures have been proposed or adopted, including almost all the key ones agreed at the G20. My goal is for all new legislation to be in force by 2013. It is an achievable goal.

But financial reform is about more than prevention of the next crisis. It can also play a role in remedying the present crisis, by favouring growth.

This booklet explains our reforms, how they will contribute to stability and growth and how they help to re-establish a prosperous Europe.

Michel BARNIER
Member of the European Commission in charge
of Internal Market and Services

Introduction

The financial crisis that started in 2007 is the worst Europe has faced since the 1930s. Originating primarily in the US subprime mortgage market, it proved to be highly contagious, spreading rapidly via the use of complex financial products.

The 2011 sovereign debt crisis is partly linked to the banking crisis but also has its own origins. It risks aggravating the position of the financial sector further. Financial institutions face funding difficulties due to uncertainties linked to their sovereign debt portfolio. Moreover, the real economy is being hit by public austerity programmes combined with a reluctance to lend by banks seeking to restructure their balance sheets.

Financial markets have been at the heart of these crises. They cannot remain the same. Inadequacies included regulatory gaps, inadequate supervision, poor corporate governance short-termism in financial institutions, in transparent markets and over-complex products such as derivatives.

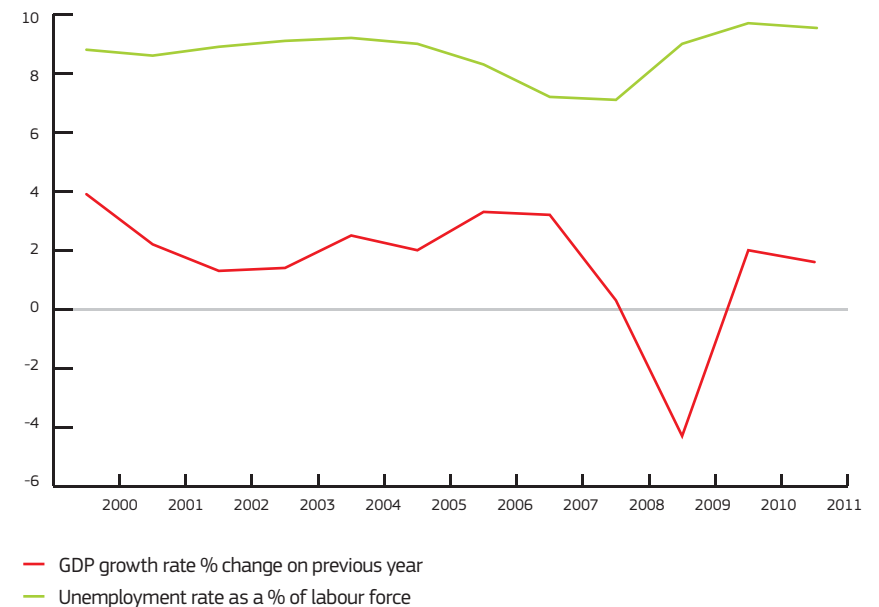
The crisis is global and calls for an international response. The principal forum for a coordinated global approach is the G20, bringing together major advanced and emerging economies. Europe has played a key role in driving forward the global agenda, and is fully committed to implementing it.

“ *The European Union is on the right track to have a new legislative framework for financial services in place by 2013* ”

In collaboration with its international partners, the Commission has been tackling the causes of the crisis through a comprehensive programme of financial regulatory reform, which is well on track towards completion.

The end of 2011 saw the establishment of a new European supervisory framework including legislation that tackles excessive volatility in markets. New rules will affect hedge funds, short-selling strategies and credit rating agencies. In 2011 alone, the Commission put forward twenty-five legislative proposals including two very significant packages revamping the regulation of banks and capital markets.

Figure 1. The impact of the crisis



Source: Eurostat, EU27

In accordance with the Lisbon Treaty, the Commission is the only EU institution that has the “right of initiative” and can put forward legislative proposals. Proposals are forwarded simultaneously to the EU co-legislators, the European Parliament and the Council for “co-decision”. When the Commission’s proposals have been adopted by the co-legislators (usually after a period of between 10 and 20 months of negotiations and subject to a number of amendments), the European Union adopts a new legislative act. For an overview of the Commission’s upcoming proposals, proposals that are being discussed in the EP and the Council and proposals that have been adopted by the EU, turn to the last pages of this brochure for the table on the “financial regulation programme of the European Commission in response to the financial crisis and to G20 commitments”.

The Commission has proposed all the main pieces of legislation linked to G20 commitments. The bulk of these new rules is already going through the legislative process. They ensure safe financial institutions, efficient and resilient markets and appropriate consumer protection.

The programme is not yet finished, there is still a challenging road ahead, but the European Union is on the right track to have a new legislative framework for financial services in place by 2013.

CHAPTER 1

A properly supervised financial system

Strict supervision of the finance sector is essential. The crisis exposed serious deficiencies in cooperation between national supervisors.

To address this, the EU has established new European Supervisory Authorities (ESAs), operational since January 2011: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

In addition, the European Supervisory Authorities have extensive powers in emergencies. If the EU Council decides that turbulent market conditions warrant their use, they coordinate national supervisors and impose the necessary actions in a harmonised way across Europe. Such measures can include bans on short selling of securities for example.

These new European institutions work together with Member States’ supervisors fostering harmonised rules and ensuring strict and coherent implementation. More specifically, they can:

- draw up specific rules for national authorities and financial institutions,
- take action in emergencies, including banning certain products,
- mediate and settle disputes between national supervisors and
- ensure consistent application of EU law.

A European Systemic Risk Board (ESRB) was also established to monitor threats to the stability of the financial system. The ESRB provides early warnings of system-wide risks that may be building up and issues recommendations to deal with them.

“ If the EU Council decides that turbulent market conditions warrant their use, they coordinate national supervisors and impose the necessary actions in a harmonised way across Europe ”

Figure 2. The new European supervisory architecture



CHAPTER 2

More stable financial institutions and markets

The crisis showed how instability can spread from within the financial system to the real economy and damage growth. Existing regulation failed to prevent the fall of financial institutions or contain the spread to other players and the system as a whole. New legislation tackles this.

2.1 Banks and insurance companies

One of the key elements of the Commission's reform programme has been to strengthen the resilience of the banking sector. In July 2011, the Commission proposed to raise banks' capital requirements, a significant step forward in implementing the agreements of the G20.

In parallel with actions to reinforce the banking sector, the Commission is currently preparing a new framework to ensure the solvency of insurance companies. This system which should be fully implemented by 2014, introduces risk-based capital requirements and places greater emphasis on risk management.

Moreover, the aggravation of instability in European capital markets has led the European Council in October 2011 to adopt a five-point plan to exit the parallel sovereign and financial crises. Among other measures, the plan requires that Europe's biggest banks create a capital buffer by means of a process coordinated by the European Banking Authority. Alongside the opening of appropriate funding channels, this process aims at containing the effects of any further shocks in the eurozone and reinforces the credibility and attractiveness of European banks. This will facilitate their access to wholesale funding and thus their contribution to growth and jobs in Europe.



The measures proposed by the Commission should enable the financial sector to be robust enough to stand up to future shocks. But it would be irresponsible not to have plans in place to deal with another crisis.

This is why the Commission is working on an ambitious set of measures to deal with bank resolution. Public authorities will receive a comprehensive box of tools to use when banks are in difficulty. They include early intervention measures to reorganise banks or to resolve failed banks. Cross-border cooperation mechanisms will be established as these were lacking during certain bank failures in recent years. The measures also aim at having robust European financing arrangements in place to avoid further recourse to taxpayers' money to rescue failing institutions.

2.2 Credit rating agencies and auditors

Financial market stability requires resilient financial institutions, but also presupposes well-functioning safeguards and warning mechanisms. Players such as Credit Rating Agencies (CRAs) and auditors have a key role in sending timely warning signals to investors and supervisors on developments that could lead to a systemic crisis. The Commission has proposed new rules to improve the functioning of these bodies.

CRAs assess the chances that companies or governments will be able to repay their debt. However, the crisis showed that CRAs often failed to do this reliably, possibly because of conflicts of interest in cases where they were being paid by the organisations they rated. Incorrect ratings contributed significantly to the financial crisis.

A new EU regulatory regime imposed tough rules on CRAs and made them subject to EU-level supervision by ESMA. Despite these rules, concerns still persist that users rely too much on ratings and do not carry out their own risk assessments. The Commission therefore recently proposed tightening the rules even further in order to reduce reliance on ratings in general, mitigate the concentrated market structure for ratings and underline the special responsibility of CRAs regarding sovereign debt ratings.

Auditors play a key role in verifying that financial statements of companies reflect the true state of their financial situation. The quality of their work and their independent judgement are therefore essential elements for our confidence in companies and markets. In order to ensure appropriate supervision of these players and to minimise possible conflicts of interest that could put their performance into question, the Commission introduced legislative proposals that significantly change the framework at European level in November 2011. These proposals also aim to increase choice and competition in a market currently dominated by the "big four" multinational auditors.

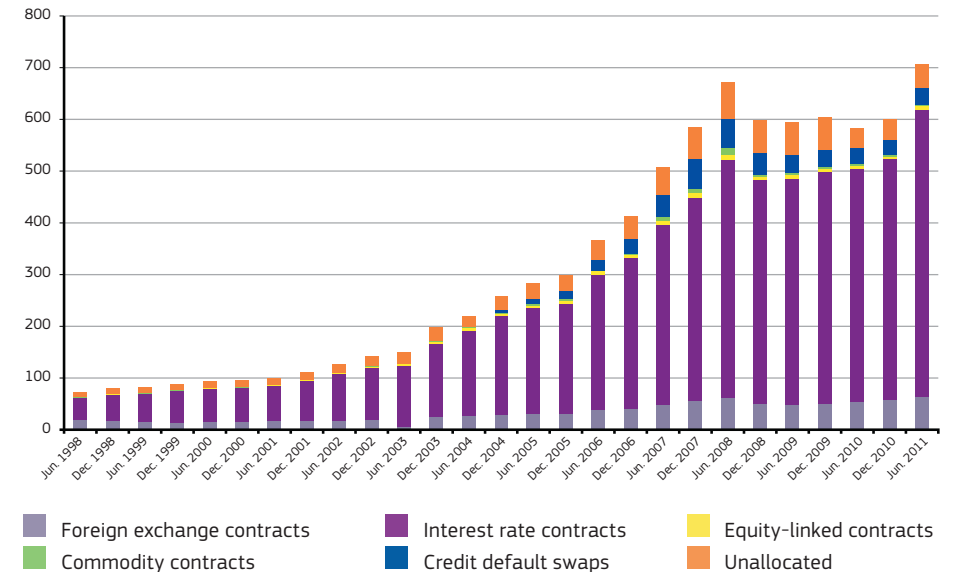
2.3 Securities markets and derivatives

The crisis has shown that significant risks can build up in non-transparent securities market segments that are not subject to adequate regulation and supervision. Transparent trading platforms and central clearing have proven to be more resilient to shocks. Appropriate regulation should therefore allow for increased safety whilst preserving efficiency, liquidity and competition.

Derivatives are particularly complex securities. They are financial instruments whose value depends on an underlying asset, e.g. the price of oil, interest rates or currency developments. Derivatives play an important role in the economy. They can be used as insurance, “hedging” against certain risks or for speculation. But they can also spread risk around the financial system. The use of derivatives has grown exponentially (see figure 2). Most of this growth involved OTC (“Over-The-Counter”) derivatives, traded bilaterally, not on regulated markets.

Legislation proposed in 2010 and 2011 would ensure that all standardised securities, including OTC derivatives, are traded on regulated platforms and cleared by central counterparty clearinghouses, reducing the risk that a counterparty will not pay. The legislation also extends existing rules regarding transparency and conduct of business with new and innovative types of trading platforms, thus ensuring safety and creating a level playing field.

Figure 3. Notional amount of outstanding OTC derivatives



Source: European Commission (Eurostat) and European Central Bank calculations based on Eurostat data

Commodity derivatives

The comparatively high price volatility of raw materials such as food and oil in recent times has given rise to concerns for users and producers of commodities, in particular in developing countries.

While much of the volatility can be attributed to a growing demand and unstable supply, many commentators point to the impact of commodity speculation.

Against this background, the Commission has made proposals to regulate commodity trading. Draft legislation tabled in 2011 will extend rules on market manipulation to OTC derivatives and also grant regulators the power to impose limits on the amount of commodity trading carried out by individual traders.

2.4 Speculative trading practices that may lead to excessive market volatility

While hedge funds may not have been the primary cause of recent events, their activities were not transparent and their risks not sufficiently addressed. EU legislation corrects this by imposing new regulation and supervision on the alternative fund industry, including on hedge funds.

Some trading strategies may lead to excessive market volatility. One example is short selling, practised by certain investors when they think the price of a security will fall. They will sell it without owning it while planning to buy it back later at a lower price, thereby making a profit.

Short selling, in some circumstances, can accentuate downward price spirals, disrupting markets. Legislation has been adopted to increase transparency in short selling with the aim of helping regulators detect risks. In exceptional circumstances, supervisors will have the power to restrict or ban short selling.



Other financial instruments that have come under scrutiny are credit default swaps (CDSs). They perform as a kind of insurance against default by a borrower, but can also be used speculatively, in which case they are called “naked CDSs”. Following European legislation adopted in 2011, the CDS market will be made more transparent and naked CDSs on government debt in the EU will be banned as they are an unhelpful form of speculation.

CHAPTER 3

A more responsible financial system

The financial sector has been characterised by irresponsible short-term behaviour, with a lack of responsibility and accountability.

3.1 Corporate governance and remuneration

Control of management by shareholders within financial institutions has been insufficient and risk management weak. Inadequate remuneration structures led to excessive risk taking and short-termism. New rules strengthen checks and balances to help prevent a repetition. The EU has introduced binding rules on compensation practices.

Further legislative initiatives were tabled in 2011, increasing the responsibility of boards in financial institutions and improving the supervision of senior management in order to establish a sound risk culture at all levels.

Remuneration in banks and investment firms

Legislation in force from 1 January 2011 for banks and investment firms requires that:

- *upfront cash bonus payments be capped at 20% to 30% of total variable remuneration,*
- *at least 40% of variable remuneration be deferred for at least three to five years,*
- *at least 50% of variable remuneration be in shares which must be kept for a certain period.*

3.2 Sanctions

Stiffer penalties can help to ensure that financial services providers bear full responsibility for their behaviour. But sanctions differ widely across Member States and are sometimes very low.

The Commission has proposed EU-level measures to achieve greater convergence and sufficient deterrence of national regimes. It also proposed to increase the powers of supervisors to investigate and penalise market abuse, by for instance, setting a minimum amount for fines. These could be twice as high as any illegally-obtained gain.



“*The Commission proposed to increase the powers of supervisors to investigate and penalise market abuse*”

CHAPTER 4

A more consumer-friendly financial system

One major lesson to be drawn from recent market developments is the need to strengthen consumer protection and restore public confidence in financial markets.

Stakeholder consultation on financial services initiatives

The proper involvement of all categories of stakeholders in policy-making is essential to improve the quality and relevance of EU legislation. This is especially true of those stakeholders with fewer means to make their voice heard: consumers and end-users, trade unions and SMEs.

The involvement of these stakeholders in financial services policymaking is ensured through two dedicated Expert Groups (the Financial Services User Group and the Group of employees' representatives) and through their representation in all other Expert Groups.

Furthermore, EU institutions have decided to finance an expertise centre to provide non-industry stakeholders with technical expertise on financial services issues.



4.1 Deposit guarantees and investor compensation

Bank account holders must have confidence that their savings are safe, even if their bank fails. EU legislation therefore ensures that bank deposits in Europe are guaranteed up to €100,000 for each depositor.

The Commission has proposed to further harmonise and simplify the protection of deposits, ensure faster payouts and improve the financing of deposit guarantee schemes.

Similar proposals were tabled to ensure a minimum of €50,000 protection for investors in investment products in the event of fraud or failure by an investment company.

4.2 Responsible mortgage lending

Taking out a mortgage loan is one of life's most important long-term financial decisions. The Commission has proposed legislation ensuring that residential mortgage lending is tailored to consumers' needs and their ability to repay. All lenders and intermediaries must act in an honest and professional manner, before, during and after the lending transaction.

“*The Commission has proposed legislation ensuring that residential mortgage lending is tailored to consumers' needs and their ability to repay.*”

4.3 Financial inclusion and payments

There are still around 30 million adults in Europe without a bank or payment account who do not have access to electronic payment systems, tools that have become increasingly essential for everyday life. The Commission recommends granting a universal right of access to a basic payment account for all EU citizens and residents. If necessary it will propose legislation in this area.

The Commission has also been cooperating with banks to facilitate payments in the eurozone known as the “Single Euro Payments Area, “SEPA” and has tabled legislation to speed up its completion.

4.4 Retail investment products

The retail investment market is largely dominated by so-called “packaged retail investment products”. These can be difficult to compare and are often complex for retail investors to understand. Sellers of these investments can face conflicts of interest since they are often paid by the producers rather than directly by customers. The Commission has therefore proposed legislation to ensure appropriate distribution and information to investors.

CHAPTER 5

A growth-creating financial system

It is not sufficient for the financial system to be stable. The key function of the financial system is to finance the “real economy”, in particular companies which need financing for investment and job-creation.

All legislation proposed by the Commission is assessed to ensure that it will not hamper the financing of the real economy. A comprehensive assessment of the impact of all reforms proposed by the Commission will be published in early 2012.

But the Commission does more than just that. A number of Commission proposals will positively stimulate the financial sector's contribution to funding the real economy as part of the Commission's efforts to strengthen and complete the single market in the financial sector.

5.1 Venture capital and socially-responsible investments

The Commission is proposing to create a Europe-wide market for venture capital and socially-responsible investment funds, allowing them to raise funds and to invest anywhere in the EU. This will boost these sectors, crucial for start-up companies with high growth potential, and for companies involved in social and environmental activities.

5.2 Promoting SME-oriented capital markets

A Commission proposal for revised legislation on securities markets will give greater visibility to capital markets active in the sector for small and medium-sized enterprises (SMEs). These markets will carry special SME labels while listing and reporting requirements for shares traded in these markets will be eased. This will help to encourage SMEs to seek funding directly from the markets.

CHAPTER 6

Conclusion

The only way out of the current crisis is through stability and growth. The reforms described in this booklet are designed to achieve these goals. They will promote stability by making the financial sector more resilient to crises. They will contribute to growth by helping financial institutions carry out their core activities, lending and long-term investing. The single market in financial services is one of the key drivers of growth in Europe. It must be reinforced, not rolled back.

Whilst the regulatory process is not yet finished, the Commission already proposed most of the key elements of its financial reform programme in 2011, while implementing all G20 commitments. They must be adopted rapidly by the Council and Parliament, in order to be in place by the target date of 2013. We must keep to this deadline, in order to build confidence in our financial sector. The sovereign debt situation, which is being tackled, must not be used as an excuse for delay.

The financial sector, which has been a part of the crisis, must be part of the solution. A new European financial sector must emerge from this crisis, more stable, more responsible, less speculative, less short-termist, and more oriented towards long-term growth. The Commission is playing its role in ensuring that this happens.

REFORMS PROPOSED BY THE EUROPEAN COMMISSION, ADOPTED & IN THE PROCESS OF BEING ADOPTED BY THE EUROPEAN PARLIAMENT AND THE COUNCIL OF MINISTERS			
	BANKS AND INSURANCE UNDERTAKINGS	FINANCIAL MARKETS	CONSUMERS
July 2010	CRD3: NEW RULES ON REMUNERATION, PRUDENTIAL REQUIREMENTS AND GOVERNANCE OF FINANCIAL INSTITUTIONS*		REVISION OF DEPOSIT GUARANTEE SCHEMES* REVISION OF INVESTOR COMPENSATION SCHEMES
September 2010	INTRODUCTION OF THE EUROPEAN SYSTEMIC RISK BOARD AND THE EUROPEAN SUPERVISORY AUTHORITIES FOR BANKING, SECURITIES AND MARKETS, AND INSURANCE*		
October 2010		PROPOSAL ON OVER-THE-COUNTER DERIVATIVES* PROPOSAL ON SHORT SELLING AND CERTAIN ASPECTS OF CREDIT DEFAULT SWAPS* PROPOSAL ON HEDGE FUNDS AND PRIVATE EQUITY*	
December 2010	REVISION OF FRAMEWORK ON CREDIT RATING AGENCIES REFORMS (PART 2)*		
March 2011			SEPA PROPOSAL (SINGLE EURO PAYMENTS AREA)
July 2011	REVISION OF THE CAPITAL REQUIREMENTS FOR BANKS (CRD4)*		PROPOSAL ON MORTGAGE CREDIT RECOMMENDATION ON ACCESS TO A BASIC BANK ACCOUNT

PROPOSALS BEFORE END 2011			
	BANKS AND INSURANCE UNDERTAKINGS	FINANCIAL MARKETS	CONSUMERS
October 2011		REVIEW OF THE FRAMEWORK FOR MARKETS IN FINANCIAL INSTRUMENTS (MIFID) AND MARKET ABUSE* REVIEW OF THE FRAMEWORK FOR RULES ON ACCOUNTING AND THE TRANSPARENCY	
November 2011		REVISION OF FRAMEWORK CREDIT RATING AGENCIES (PART 3)* REFORM OF THE AUDIT SECTOR	
December 2011		PROPOSAL FOR A VENTURE CAPITAL REGIME	
2012			
	PROPOSAL FOR A FRAMEWORK FOR CRISIS PREVENTION AND MANAGEMENT FOR BANKS*		
		PROPOSAL FOR CENTRAL SECURITIES DEPOSITORIES	
	SOLVENCY II IMPLEMENTING MEASURES	PROPOSAL ON PACKAGED RETAIL INVESTMENT PRODUCTS (PRIIPS)	
	REVIEW OF THE INSURANCE MEDIATION FRAMEWORK	REVIEW OF THE UCITS FRAMEWORK (Undertakings for Collective Investment in Transferable Securities)	
Proposals adopted by the European Union, the date is that of the Commission proposals	Commission proposals being discussed in the Parliament and the Council	Upcoming Commission proposals	*G20 proposals

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