Financial Regulation in the US and EU: Integration or Fragmentation?

Policy Discussion at Bruegel – Rue de la Charité / Liefdadigheidstraat 33, B-1210 Brussels

Wednesday July 3, 2013

Keynote address: The EU Policy Stance

Nadia Calvino, Deputy Director-General Internal Market and Services, European Commission

Intro

I am very happy to be given today the opportunity to discuss EU-US relations in the area of financial services.

First, because this is the definitely the right moment to do so. Notwithstanding current controversies, we are on the verge of commencing what could be a historical trade and investment negotiation; we are at a crucial moment in our discussions with the US on how to regulate global derivatives markets; and –last but not least!-, Commissioner Barnier will be visiting the US and his main counterparts in the two weeks from now.

Second, because it is useful to take a step back and reflect on how well we have worked together since the onset of the crisis.

The crisis originated in US, and was amplified in EU by our own deficiencies. Large responsibility lies with the financial sector, regardless of the nationality of its participants or the place of their activity.

Neither party can preach to the other. We all have to take some ownership for what happened.

More importantly, the crisis has put into sharp relief the interconnections between our financial markets. The examples of the inextricable links deriving from the global nature of the financial system are countless.

The lesson was: we need deeper cooperation between regulators and supervisors across the world, and especially between the largest financial centers.

Where are we now, 6 years after the start of the crisis?

The G20 reform agenda

Our leaders acted together, signing up collectively through the G20 to a number of commitments.

The G20 reform programme has been instrumental in establishing the core elements of a new global financial regulatory framework that will make the financial system more resilient. The Financial Stability Board has been created to develop new principles and standards, and to oversee implementation by G20 jurisdictions.

The G20 commitments include in particular:

- Reforms to improve the stability of the banking system;
- Measures to strengthen the regulation of financial markets and infrastructures;
- Building a single set of high-quality, global accounting standards; and
- Addressing issues around non-cooperative jurisdictions.

G20 reform implementation

G20 members started implementing this reform agenda at home.

In July 2010 the US Congress adopted the Dodd Frank Act, which the U.S. agencies are now working to render effective.

The EU has also delivered and it continues to deliver a major reform programme, as ambitious as that of the US. Last week alone, we made very significant progress on provisions to equip the EU with robust bank resolution arrangements and safer and more efficient capital markets.

Major agreements have already been reached on central issues, such as an overhaul of our supervisory system; the translation of the Basel 3 agreement in EU law; very strict rules on bankers remuneration, and state-of-the art rules for OTC derivatives markets – I will come back to this point in a minute.

This agenda aims at strengthening financial stability, but also at countering financial fragmentation.

Such fragmentation is very expensive: it deepens the crisis and makes it much more difficult to recover.

That is true in Europe, but also internationally: we cannot let protectionism, extra-territoriality and ring-fencing become the name of the game for the international financial system. All our economies will lose out if we go down this route. The 1930s crisis is a painful reminder of the consequences of protectionism in the wake of a financial crisis.

However this is the risk we face if there is inconsistent implementation of international agreed financial reforms.

Let me illustrate the issues at stake with three examples. They relate to banks, accounting and derivatives.

Banking rules

Global banking standards are necessary to allow large international banks to operate across the financial system.

They ensure a level playing field, removing scope for regulatory forum shopping, and help avoid accumulation of risk.

We agreed in the G20 to introduce global standards for bank capital, liquidity and leverage:

- In the EU, these will enter into force from the 1st of January 2014; and
- In the US, the Federal Reserve has yesterday adopted the rules implementing Basel III in time for entry into force by the same deadline.

These standards are complemented by those on resolvability.

The wrong direction of the proposed rules on FBOs

Yet, despite these global standards, the US seems to be moving in a different direction.

For example, the Fed's draft rules on non-US banks present in the US – the Foreign Banking Organisation – do not recognize non-US prudential rules and discriminate against non US banks by adding layers of extra capital, leverage and liquidity requirements.

It is as if the global standards had not been agreed at all!

This will lead to a fragmented system, offering less, not more protection.

If the US continues to pursue this approach, it will inevitably be followed abroad, leading to yet further fragmentation. The costs could be significant.

I understand that the U.S. is seeking to protect its taxpayers' money. So do we in Europe. But we can achieve this aim jointly without fragmenting the market or erecting trade barriers.

Accounting

Five years ago, the G20 decided that companies should rely on a single set of high quality international accounting standards. What has happened since then?

The EU has continued to faithfully implement the International Financial Reporting Standards.

The US still prefer to rely on its domestic standards. This has a direct impact on the current convergence process. There is a real risk that the IASB and FASB fail to agree on a converged standard on impairment of financial instruments – a crucial norm for financial institutions and markets. As requested by the G20, this dialogue must continue. But we need a robust standard on impairment before the end of this year.

Derivatives

Let me turn now to derivatives.

In 2009 the G20 leaders agreed on an ambitious global regulatory reform of OTC derivatives markets.

At their meeting in Pittsburgh they agreed to do three things.

- First, to reduce the risk they required all standardised OTC derivatives to be cleared through central counterparties;
- Second, to strengthen supervision they required the reporting of all trades to trade repositories; and
- Third, to increase market transparency, they agreed to move standardised derivatives trades to trading venues where appropriate.

Implementing these agreed reforms requires three things:

- Firstly, each jurisdiction has to introduce them into its laws;
- Second, this has to be done in a consistent way;
- Third, and crucially, the rules must work together.

Progress in Europe

Europe has done its bit: our clearing and reporting law – the European Markets Infrastructure Regulation or 'EMIR' – entered into force on 16th August last year. Our reporting requirements will apply after the Summer, and our clearing rules in 6 months' time.

Agreement has now also been reached on our mandatory trading rules in the Council of Ministers and negotiations with Parliament are starting.

Anybody who says that Europe is lagging behind in regulatory reforms is, frankly, ill-informed and mistaken.

The US is the only other country that is as advanced as the EU.

Europe's rules are strict

Our rules are also robust.

Sometimes they are identical to those in the US. In other respects they are even tougher.

Let me draw some comparisons:

- Unlike the US, the EU does not exempt Foreign Exchange derivatives from clearing.

- All of our regulated financial firms must report, clear and trade. We do not exempt small banks like the US, because we have learned the hard way that small banks can have systemic impacts on our financial system.
- The capital standards for CCPs in Europe are also a lot tougher than in the US. Mandatory clearing has not magically removed $600 trillion of risk from the system; it has moved it into CCPs. Regulatory reform must equip them to withstand financial Armageddon and prevent taxpayers from footing the bill if a CCP ever goes into default.
- The protection of clients is also robust in Europe. Individual segregation gives the highest possible protection. 'Omnibus gross segregation' or even the complete absence of segregation at CCP level – as applied in the US – does not provide the necessary level of protection in our eyes, as we have seen after the demise of MF Global.

Don't get me wrong. This is not a beauty contest. This is to demonstrate that our rules are as strict, if not stricter than in the US; and that we need to engage in a constructive process, which can be applied even with these differences.

Global rules in a global market

It is critical to understand why, even with some differences, we should be prepared to recognise each other's rules.

Derivatives trades are truly international trades. Even if OTC derivatives reform in Europe has been swift and solid, it will not reach its full potential unless our rules work seamlessly with those beyond our borders. Trades will be re-booked, markets will fragment and the G20 objectives will not be met.

Cross-border regulatory issues are therefore of critical concern. Regulators have spent the past two years discussing how their international patchwork of local rules should work together so that all derivative trades are regulated in a broadly similar way.

Nevertheless, international agreement on this remains elusive.

Regulators have so far been unable to agree on how to iron out the many inconsistencies between national rules.

Without such agreement, trades may be aborted or avoided and risks may be built up by a consequent lack of hedging.

Equivalence or Substituted Compliance

Regulators know what the best tool is to resolve these inconsistencies: namely a wide application of 'equivalence’ or 'substituted compliance' by regulators to as many entities and transactions as possible.

If G20 countries share the same objectives and each adopt regulations of similar effects, then it is both logical and reasonable to rely on the enforcement of the other country's rules.

'Equivalence’ or 'substituted compliance' means that financial intermediaries know which rules will apply, leaving no room for arbitrage; financial stability will be better preserved; and supervisors will have the necessary access to information.

If each jurisdiction takes a unilateral approach, applying its own rules, then we would have a Tower of Babel of rules! And we would have no means to ensure that these rules would be consistent.

This could be the greatest regulatory failure of all times.

'Equivalence’ or 'substituted compliance' are not novel ideas: they are a longstanding principle of international law – the principle of comity – that has been recognised in legal systems around the world.

Regrettably, some US regulators have so far not been prepared to apply ‘substituted compliance’ for all transaction-based rules, preferring to apply local rules to entities abroad.

We wonder why.

‘Substituted compliance’ and ‘equivalence’ are by no means a lax approach to financial regulation. The assessment of equivalence or substituted compliance must be done in a rigorous manner. And

Governments and regulators should not abdicate their responsibilities if the rules of one country do not meet demonstrably higher standards in another.

‘Substituted compliance’ and ‘equivalence’ are not an 'all or nothing' approach either. In Europe, our approach to equivalence is flexible.

- It permits separate decisions for trades, for reporting, for risk mitigation, for CCPs.
- It can distinguish between the rules of different regulators in the same country.
- EU equivalence decisions can be conditional.
- They can be flexible enough to recognize that the same objectives can be achieved by different means in other countries.

They are truly outcome based; they do not seek to export EU rules or to impose ‘reciprocity’.

And what is more important: they work in practice. The EU has adopted important equivalence decisions in areas such as rating agencies, accounting and auditing. Processes leading to decisions are well underway for insurance and post-trading infrastructures.

On the US side, a welcome move by the SEC has been to drop the reconciliation requirement between IFRS and US GAAP.

We are not aware that investors have suffered from these decisions. Quite to the contrary, they benefit from a more open, coherent and competitive marketplace.

We are therefore convinced that ‘equivalence’ and 'substituted compliance', backed by close day-to-day supervisory cooperation, must apply as a matter of principle between responsible international regulators of financial markets.

This is the only way forward to protect financial stability, while allowing the financial sector to allocate capital efficiently throughout the world.

This is the modern and effective way of regulating global financial markets. Unilateralism and the blind application of national rules to all foreign markets participants will get us nowhere.

And, again, if these rules are not effectively enforced, then regulators must be able to apply the brakes on ‘equivalence’ and 'substituted compliance'.

Reformed supervision in the EU

Our recent and current efforts in the EU to streamline supervision will facilitate reliance on each other rules.

With the creation of EBA, ESMA and EIOPA, US agencies have natural interlocutors. Cooperation and equivalence or substitutive compliance will hence be made much easier. And the strong role for the ECB as a single banking supervisor for at least all euro area countries will also make cooperation and mutual trust easier.

So now that the famous hotline to the EU that the US have been looking for is in place; now that Europe is implementing in a strict manner all G20 reforms and going often beyond, are we going to see the US put in place rules that actually move away from international cooperation?

Having told us to get our act together -which we are now clearly doing-, are the US suggesting that they cannot trust our systems and that only their rules can apply?

The Transatlantic Trade and Investment Partnership

I would call upon all US authorities to respect international commitments and comity.

- First, I would strongly encourage US regulators to make the widest possible use of substitutive compliance. We are implementing our common G20 standards, so you can trust us.
- Second, I would hope that the US authorities can maintain a cooperative approach across the board – revising the proposed approach on Foreign Banking Organisations and working towards more coordinated approaches on structural measures for banks.

- Third, I would hope our US counterparts recognize that we have a great opportunity with the launch of the Transatlantic Trade and Investment Partnership – the TTIP.

We must have serious discussions on financial regulation within the TTIP, setting up the necessary instruments to make our regulatory systems work together by agreeing on a common approach to equivalence and substitutive compliance.

We are open as to what should be exactly done in the TTIP, and what should be done elsewhere. But we would miss a golden opportunity if we would not use the TTIP to deepen our regulatory cooperation and place it on a more solid legal footing.

The existing informal regulatory dialogue has served us well, but we must draw the lessons from the crisis and change gear. A deeper regulatory and supervisory cooperation at the bilateral level will allow us to materialize and amplify the benefits of international work done in the G20 and the FSB.

The EU is not seeking to develop specific EU/U.S. standards, which could undermine the G20 process.

The EU is not seeking to weaken its own or the U.S. achievements in developing legislation that strengthens financial stability.

On the contrary, the EU would like to seize the opportunity of the TTIP to ensure effective, strict and consistent implementation of internationally agreed principles and standards.

Only by working together in the strict application of global standards can we set an example for the rest of the world.

If we fail to do this, then we will be sowing the seeds for future crises.

Conclusion

These are delicate times for Europe and the United States. The solidity of our relationship is being tested.

But the world needs a strong Europe and strong United States.

A strong Europe and strong United States that work closely together to achieve growth and stability.

This is particularly true if we look at financial markets, at a moment where our societies are still suffering from the financial crisis that sent the world economy to the verge of total breakdown.

Both the US and the EU are regulating the financial system responsibly and seriously. But we need to cooperate better to deliver optimal results.

We must maintain the benefits of an integrated financial system – and integrating it further still – and work together to manage the risks.

Al Gore once used an old African proverb that says: “if you want to go fast, go alone. If you want to go far, go together”.

By acting together we can protect better financial stability, and achieve sustainable growth through integrated markets.

END