Hearings of European Commissioners-designate

Jonathan Hill

Financial Stability, Financial Services and Capital Markets Union

Hearing due to be held on Wednesday 1 October at 13.30 hours.

Jonathan Hill, United Kingdom.

EP Committee responsible for the hearing

Economic and Monetary Affairs (ECON)

Biography

Born in 1960, Jonathan Hill (Baron Hill of Oareford) holds a degree in history from Trinity College, Cambridge. He served as a special adviser to Kenneth Clarke at the Department of Employment, Department of Trade and Industry and Department of Health from 1986 to 1989, then as Political Secretary to Prime Minister John Major (1992-94). He then worked for public affairs consultancy Bell Pottinger until 1998, before founding the firm Quiller Consultants. In 2010, he returned to public life, becoming junior Minister for Schools. In January 2013, he was appointed Leader of the House of Lords (the Government's business manager in the upper house).

This is one of a set of Briefings designed to give Members of the European Parliament an overview of major issues of interest in the context of the hearings of the Commissioners-designate. A full set of such Briefings can be found at:
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Background

Financial institutions and markets play a key role in the EU economy. They provide lending to households and businesses and allow individuals to save and invest. They insure against risks and facilitate payment transactions. According to the European Commission, the integration of financial markets enables more efficient allocation of capital and improves long-term economic performance. Financial services policy mainly covers three sectors: the banking system, insurance and securities, for which the European Union lays down rules binding operators and investors. The legislative framework established by the European Union aims to strengthen the financial services sector by improving competition, liquidity and the financial stability of the market, and the performance of financial operators.

Before the crisis, financial services in the EU integrated at a rapid pace, which was evidenced by convergence of interest rates, for example. In particular, in 1999 the Commission launched the **Financial Services Action Plan** (FSAP), a set of 42 measures to improve the single market in financial services. They were designed to harmonise the rules regulating financial services such as banking, mortgages, securities trading, insurance and pensions across the EU. The FSAP was one of the key elements of the Lisbon Agenda, succeeded by the EU 2020 Strategy. The ensuing reforms focused on filling regulatory gaps and building a stronger system of supervision.

It is worth noting that the framework for regulatory standards and the nature of financial markets is increasingly global and financial markets operate in the general framework set by global standard-setting bodies such as the Basel Committee on Banking Supervision. This international dimension is very important: for instance, the regulatory reform agenda pursued by the EU in response to the recent economic and financial crisis has been coordinated with international partners in the G20, so that financial stability can be restored on a global scale.

Treaty base and EP competence

Title IV of the Treaty on the Functioning of the European Union (TFEU), Articles 49, 51, 53, 56, 59, 63, 64 and 65 relate to the right of establishment and free movement of services and capital; Article 75 TFEU concerns measures to control capital movements to combat terrorism; Articles 113, 114 and 115 TFEU address approximation of laws; and Article 127(6) TFEU enables the European Central Bank to be entrusted with supervision tasks for financial institutions. The EP acts under ordinary legislative procedure (codecision with the Council).

Recent developments

The economic and financial crisis has had far-reaching consequences for the EU. Between 2008 and 2012 a total of €1.5 trillion of state aid was provided by European governments to prevent the collapse of the financial system. Significant funds have also been provided by the central banks for **liquidity support** (about €1 trillion was lent by the European Central Bank (ECB) in the 2011-12 period alone). Furthermore, more than 60% of EU citizens surveyed in 2013 stated that, as a consequence of the crisis, they had lost confidence in the financial sector. In response to the crisis, the last legislative term (2009-14) was therefore dominated by regulatory reform for the financial sector.

Since the beginning of the crisis, EU-rule making, traditionally focused on market opening, has increasingly been concentrated on the stability, safety and soundness of the whole financial system (and individual firms), with increased attention paid to the protection of consumers and taxpayers.

Financial integration and the crisis

In its April 2014 report on financial stability and integration, the European Commission stated that 'in terms of financial integration, the European economic and financial area appears substantially more segmented along national borders after the crisis compared to 2007/08'. The International Monetary Fund (IMF) also noted in 2013 an increase in market fragmentation driven by reduced cross-border exposures, especially in the euro area.

Banking Union

In order to prevent the collapse of their banking system, Member States mobilised 13% of their GDP in direct aid and guarantees between 2008 and 2011. For some, this gravely worsened the sovereign debt crisis. Banking Union is the name of a set of initiatives, which, according to the Commission, aim at breaking the vicious cycle between collapsing banks and Member States' debt levels.

During the last parliamentary term, the European Parliament (EP) and Council adopted key pieces of legislation to build Banking Union: the **Bank Recovery and Resolution Directive**, binding all 28 Member States, introduces the principle of 'bail-in', under which not taxpayers, but creditors and shareholders, as well as banking sector-financed resolution funds will pay for banks' mistakes; the **Single Supervisory Mechanism** (SMM) centralises the supervision of the largest financial institutions in the euro area – and in countries which choose to join SSM – under the ECB, in order to detect risks at early stages; and the **Single Resolution Mechanism**, applying to banks covered by SSM, will manage bank resolutions *via* decisions taken by a Single Resolution Board, and using a Single Resolution Fund financed by the banking sector.

Banking Union also involves a single rulebook, binding on all financial institutions in the EU. This framework includes the Directive on **Deposit Guarantee Schemes**, protecting savings up to €100 000 in the event of a bank's bankruptcy, and the Capital Requirements IV Directive (CRD IV) and Regulation obliging banks to keep sufficient capital reserves and liquidity.

Reforming financial markets

Furthermore, in order to ensure stricter regulation and oversight of financial markets, three European authorities to supervise banks, markets, and insurances and pensions started operating in 2011. They are complemented by the European Systemic Risk Board which seeks to detect risks to the financial system and issue early warnings.

The 2011 Directive on **Alternative Investment Fund Managers** was adopted to increase transparency of hedge funds and private equity, and reinforce investor protection. It also aimed to discourage excessive risk-taking, by regulating the amount of remuneration allowed. The supervisory and regulatory framework was also strengthened for complex financial instruments with the adoption of the Regulation on **Short-selling** and Certain Aspects of **Credit Default Swaps**, and the Regulation on Over-the-Counter Derivatives and Market Infrastructures. This was followed in 2014 by the adoption of a Directive and a Regulation on Markets in Financial Instruments (MIFID) which addressed existing legal loopholes in order to increase safety of financial markets, minimise systemic risks and better protect investors. In particular, they regulate high-frequency trading and aim to curb speculative commodity trading. Collective investment markets in Europe have been further regulated by the Undertakings for Collective

Investment in Transferable Securities (the so-called UCITS V) Directive that defined which entities can be depositaries of collective investments, increased asset protection and depositaries' liabilities in case of insolvency, introduced remuneration policies, and harmonised administrative sanctions.

The Directive and Regulation on **Credit Rating Agencies** aim to reduce over-reliance of financial institutions on credit ratings, introduce a transparent calendar for ratings of sovereign states, give the possibility for investors to sue for negligence, and reduce possible conflicts of interest (capping agencies' shareholdings in rated entities).

Retail finance, consumer issues and insurance

Consumer protection was further strengthened by the Directive on **Credit Agreements Relating to Residential Property** which was adopted by the EP and Council in 2014. It introduced a ban on misleading advertising, the right for borrowers to repay their loan early and measures to prevent irresponsible lending, and mandated clearer information to consumers about conditions and risks. Furthermore, a proposed regulation on key information documents for packaged retail investment products (currently the subject of provisional agreement between the EP and Council) will make it mandatory for producers, such as banks or insurance companies, of those products to provide a concise standardised document with key facts in clear language, specifying the type of investment, returns, risks and costs, so that retail investors can understand and compare products.

The regulation of the **insurance sector** has been strengthened by the so-called Omnibus II Directive adopted by the EP and Council in 2014 which (together with the Solvency II Directive) creates a risk-based regulatory and supervisory framework for the insurance sector.

Financial crime

The Directive and Regulation on **Market Abuse** introduced criminal sanctions and high fines for practices such as insider dealing, unlawful disclosure of information and market manipulation, and gave authorities greater powers to investigate.

Recent reviews of financial reforms

In its 2014 economic review of the financial reforms, the European Commission argues that the regulatory shortcomings and market failures which contributed to the crisis have been effectively addressed. Measures such as stronger supervision, increased transparency and limiting excessive risk-taking will increase financial stability, and reduce the likelihood and impact of possible future crises. The Commission claims that economic analysis and the available evidence indicates that the total benefits of reforms are likely to be greater than their costs.

Critics of the reforms argue that frequently the time pressure, and the magnitude of the issues faced by the legislators, contributed to insufficient quality of drafting of the detailed rules, consultations and impact assessments. Some also claim that the cumulative effect of reforms will create excessive risk aversion, cause deleveraging and reduce lending (especially to small and medium-sized enterprises) and that too many stability-oriented measures may stifle economic growth.

European Parliament

The Lisbon Treaty increased the EP's role as co-legislator with the Council on internal market issues. The ordinary legislative procedure is now extended to Articles 51 (freedom of establishment), 56 and 59 (services) and 64 and 75 (movement of capital and sanctions) of the Treaty on the Functioning of the EU.

The EP in its co-legislator capacity contributed significantly to the legislation founding the European System of Financial Supervision, which consists of the European Systemic Risk Board, the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority, not least through Parliament's 2010 initiative on cross-border crisis management in the banking sector(Ferreira report) However, in response to another Parliament legislative initiative from March 2014 (Giegold report) aiming to strengthen **European supervisory authoritie**s, the outgoing Commission has left to its successor the decision upon the need for further legislation.

It also helped to shape the Banking Union through negotiations on the legislation for its different pillars. Particularly important was the conclusion of an **inter-institutional agreement with the ECB**, which establishes that the latter institution is accountable to, and overseen by the Parliament, in respect of its new tasks under the Single Supervisory Mechanism. The EP has also ensured that, in the negotiations on the Single Resolution Mechanism and the Bank Recovery and Resolution Directive, political considerations in deciding on ailing banks will be limited, and that strict criteria will govern the use of public money for bailing out banks.

Parliament has also consistently pushed for the creation of a genuine Economic and Monetary Union and for stronger democratic oversight over anti-crisis facilities (for instance its legislative initiative from November 2012, Thyssen report) as well as for improvements in the economic stability framework of the euro area (Feio report, 2010).

The EP ensured that the CRD IV Directive and Regulation contain provisions which cap bonuses, require banks to set more and better capital aside as a buffer, incentivise banks to lend to SMEs and increase their transparency *via* financial disclosures.

In negotiations of rules for deposit guarantee schemes, the EP secured that the total amount of the guaranteed deposit would be available to depositors within seven working days. MEPs also succeeded in inserting clauses which make it possible to protect for at least three months part, or all of, amounts higher than €100 000 if they are of temporary nature (such as the proceeds of selling a house).

The EP has also played a major role in regulating the financial markets. MEPs ensured that the Regulation on Credit Default Swaps contains provisions improving the transparency of complex financial instruments and the possibility to ban certain types of risky trading. In negotiations on the 2012 Derivatives Regulation, the EP successfully insisted on an **obligatory reporting requirement** for all European derivative transactions. The data are to be made accessible to supervisory authorities. MEPs also successfully requested that the 2014 Markets in Financial Instruments Directive contains stricter controls on algorithmic and high-frequency trading (including a mechanism which interrupts trading when price volatility becomes too high) and a new regime limiting the positions (volumes) actors may hold in commodity derivatives. In the 2011 Directive on Alternative Investment Fund Managers, the EP supported marketing to investors throughout the EU being allowed without prior national authorisations, as well as actions against so-called asset-stripping.

In 2012, the EP adopted amendments to the Single European Payments Regulation, seeking to make the migration to the Single Euro Payments Area (SEPA) easier for EU citizens through successfully insisting on a single deadline for shift for all payments, enabling banks to offer services which cover the switch from national systems, and phasing out the need for Business Identifier Codes (BIC). Also in 2012, Parliament adopted a legislative initiative report on access to basic banking services (Klute report). In 2014, the EP voted on the Payment Services Directive II (which extended the scope of the Directive to cover so-called 'third-party providers') and the Interchange Fees Regulation (which sets caps on such fees for consumer debit and credit cards).

Priorities and challenges

President-elect Jean-Claude Juncker has declared that the new Commission will be determined to ensure full implementation of the new supervisory and resolution framework in order to increase the robustness of the EU banking sector. By 2019 he also intends to develop the Capital Markets Union (CMU) covering all 28 Member States, aiming to maximise the benefits of capital markets and non-bank financial institutions for the real economy.

The novel concept of the **Capital Markets Union** was included in Juncker's top ten priorities for the new Commission in July 2014. Currently the debate on CMU is at an early stage and no official statements have been released by the Commission.

According to observers, the EU is in need of 'non-bank' finance to support growth and jobs in the coming years. Lack of funding opportunities is most evident for job-creating SMEs. Traditional sources of financing are insufficient as indebted governments seek primarily to balance their books and the troubled banking sector cannot finance the economy alone. The EU is dependent on its banks much more than the US, on measures such as the size of bank balance sheets in relation to gross domestic product (GDP), while European capital markets are much smaller than their American equivalents. According to many commentators European policy-makers seem to fear that the banking sector is now hindering recovery.

The IMF argues that there is a large body of research finding evidence that capital-market development supports economic growth. In a recent speech Yves Mersch, a member of the Executive Board of the ECB advocated the creation of a CMU, which would **improve the allocation of capital** and thus contribute to growth and employment in the EU. Such a CMU should however be based on transparency, development of industry-wide standards and harmonisation of the securities settlement market. Regulation should concern only areas which may trigger systemic risk. Others argue that CMU should be based on five pillars: removing the remaining obstacles to free movement of capital; transparency, especially in the areas of SMEs and infrastructure finance; spreading best practices; standardisation (especially of insolvency procedures); coordinating taxation to avoid creating undesirable incentives.

The first steps towards the development of alternative financing instruments are already taking place. The ECB and the Bank of England recently published two joint papers on **revival of the securitisation market** (repackaging of loans so they can be sold on financial markets) in Europe, suggesting a possible separation of simpler and more transparent products, which could benefit from lighter regulation, from more complex ones which could potentially be toxic.

In his letter to Commissioner-designate Hill, Juncker states that his priority is to make the banking sector more robust so that it can increase its lending to the real economy. He also indicates that there will be an examination of banking regulation in the context of ensuring social fairness, particularly concerning management incentives and consumer rights.

Lord Hill should contribute within the first three months of his mandate to the 'jobs, growth and investment' package (which aims to generate €300 billion in investment over the next three years), by proposing measures to improve the investment environment and long-term financing of the economy such as revival of securitisation markets, lowering the costs of raising capital and finding channels other than banks for companies' funding.

Furthermore, Lord Hill is mandated to continue the reforms of the financial services sector to **boost their resilience and stability** while taking into account the interests of consumers and retail investors. He will be responsible for revision of the European Systemic Risk Board and the three Supervisory Agencies, particularly their governance and financing. Finding ways for these agencies to be fully funded by the sectors they supervise will also be part of his mandate. He will, in addition, contribute to the modernisation of legislation on digital/electronic payments, to facilitate online purchases and assess whether virtual currencies should be regulated.

In a recent speech, Michel Barnier – the outgoing Commissioner for Internal Market and Services – said that the reform of the 29 biggest European banks, regulating shadow banking and reform to prevent manipulation of major economic indicators are three major policy issues to be completed.

In the finance and banking area, ensuring that the Banking Union and the European System of Financial Supervision work efficiently will be one of the main priorities of the new Parliament. To achieve this, the **single market in financial services** needs to be completed and a unified regulatory framework requires further development. Furthermore, the EP will need to scrutinise the transposition and implementation of the new rules on banking, insurance and securities markets.

New legislation in the area of structural reforms to banks and shadow banking will be decided by the EP and Council. Investment protection policy is also an area that needs further development and a major issue for the new legislative term. Current proposals that need to be finalised include the insurance mediation directive, the anti-money-laundering package, the regulation on financial benchmarks and the regulation on money market funds.

European Added Value

According to the EP European Added Value Unit's study 'Mapping the Cost of Non-Europe, 2014-19', completing the Banking Union and further regulation to avert crisis could yield potential efficiency gains of around €35 billion per year. Having a fully integrated and effectively regulated EU financial market could bring benefits of €60 billion per annum in respect of interest rates alone. Creating a common deposit guarantee scheme for vulnerable states within the euro area has a potential benefit of €30 billion per year.

Further reading

Mapping the Cost of Non-Europe, 2014-19 / Joseph Dunne, European Added Value Unit, European Parliament, July 2014.

Financial services: major legislative proposals / Factsheets on the EU, European Parliament, 2014.

Commission Communication on 'Reformed Financial Sector for Europe', May 2014.

Financial Services, European Commission website.

Balance of Competences review: Single Market – Financial Services and the Free Movement of Capital, HM Treasury, July 2014.

For a European capital markets union – Securing stability, overcoming fragmentation, speech of Yves Mersch, Member of the Executive Board of the ECB, 10 September 2014.

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