SPEECH TO THE BRUGES GROUP
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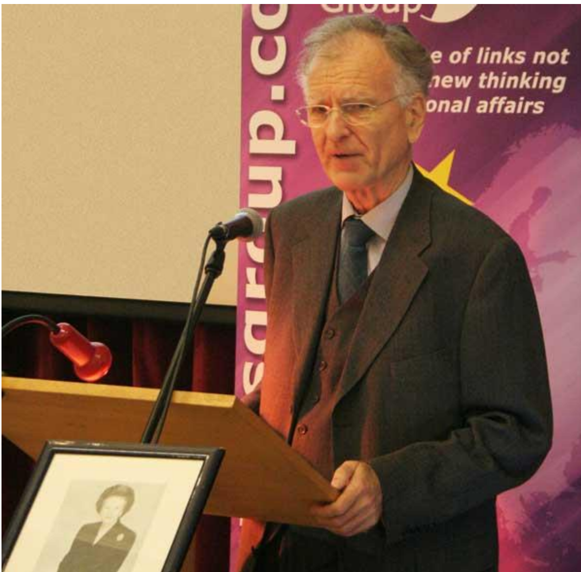
EU Financial Market Regulation: A Strategy of Raising Rivals' Costs

The European Union has recently adopted a number of financial market regulations:

- Credit Rating Agencies (Regulation 1060/2009)
- European Systemic Risk Board (Regulation, Sept. 2010)
- European Banking Authority (Regulation, Sept. 2010)
- European Securities and Markets Authority (Regulation, Sept. 2010)
- European Insurance and Occupational Pensions Authority (Regulation, Sept. 2010)
- Alternative Investment Fund Managers (Directive, Oct. 2010)



I shall focus on the regulation establishing the European Banking Authority (EBA) because this is the most important one for the UK – the City of London. EBA is controlled by a Board of Supervisors composed of the heads of the national supervisory authorities (plus some non-voting members). It decides by qualified majority (in some cases even by simple majority). What are EBA's competencies?

1. EBA may impose "technical standards" (Art.7). This is probably not very important.
2. If the EU Commission and EBA believe that a national supervisory authority breaches EU law, EBA may "adopt an individual decision addressed to a financial institution ... including the cessation of any practice" (Art. 9, Section 6). In other words, it may close, say, Barclays if it wants to.
3. If a qualified majority of the EU Council declares an emergency, EBA may "adopt individual decisions requiring competent authorities to take the necessary action in accordance with (EU) legislation" (Art. 10, Section 2).

   An emergency is defined as "adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the European Union" (Section 1). This is extremely vague and dangerously open to abuse.

4. If two or more national supervisory authorities disagree on the procedure or content of an action required by EU law, EBA may "take a decision requiring them to take specific action or to refrain from action in order to settle the matter, with binding effects for the competent authorities concerned" (Art. 11, Section 3). I shall come back to this later.

The legislation also requires the Commission to report in three-year intervals whether and how EBA's competencies ought to be increased. As Commissioner Michel Barnier said when the regulation was adopted: "This is merely a first step".

Would any of these financial market regulations have prevented the outbreak or the severity of the financial crisis? The answer is: No. Why?

1. The crisis did not break out in Europe – it emanated from the US.
2. National crisis management in the UK and the other member states was satisfactory. There is no reason to believe that the EU would have done better.
3. Cross-border banks like Fortis and Dexia were taken care of in bilateral or trilateral negotiations among the national supervisory authorities of the countries concerned (Benelux and France). To involve all 27 national authorities of the member states through EBA would have been less efficient.
4. The crisis has not been caused by the hedge funds.
5. The credit rating agencies were the first to call alarm (in August 2008).

Has the financial crisis shown that financial supervision ought to be centralised at the EU level? Again the answer is: No. Why?

- The crisis has not been caused by banks or regulators consciously taking excessive risks due to regulatory arbitrage.
- Instead, the crisis was due to two huge errors:

  i) the banks erroneously thought that their provisions against risk were sufficient,

  ii) the regulators erroneously thought that their regulations were sufficient.

  This twofold error was a necessary condition for the occurrence and severity of the crisis. Without

  it, regulatory arbitrage would not have been a problem.
- Now that the error has been exposed, the banks and the national supervisory authorities are drawing the right lessons, and they have a perfectly sufficient incentive to do so.

- The European Commission did not foresee the crisis either.

Where error is the problem, three remedies are called for:

1. more transparency in financial markets – a task that can be left to the national authorities,
2. stronger precautions against risk, notably higher equity requirements – the task of Basel III, not the EU,
3. diversity of regulatory experiments so that the best practice can be found and be imitated. Collective EU regulation suppresses this process of discovery and leads to overregulation – especially if it is decided by qualified majority.

Under qualified majority voting, the majority of highly regulated countries (say, France) have an incentive and the power to impose their high level of regulation on the minority of more market-oriented countries (say, the UK) in order to weaken the latter's competitiveness. In the political economy literature, this is called "the strategy of raising rivals' costs". The common level of regulation that is imposed on the minority is even higher than the level originally prevailing among the majority because the majority is no longer constrained by the competitive pressure from the minority.

Following the financial crisis, the French government has pursued the strategy of raising rivals' costs in a deliberate and consistent manner:

1. Jacques de Larosière, a former Governor of the Banque de France, was appointed chairman of a "High-Level Group on Financial Supervision in the EU" by the European Commission in 2008.
2. Michel Barnier, a French politician, was appointed EU Commissioner for the internal market (including financial market regulation) by the President of the Commission in 2009.

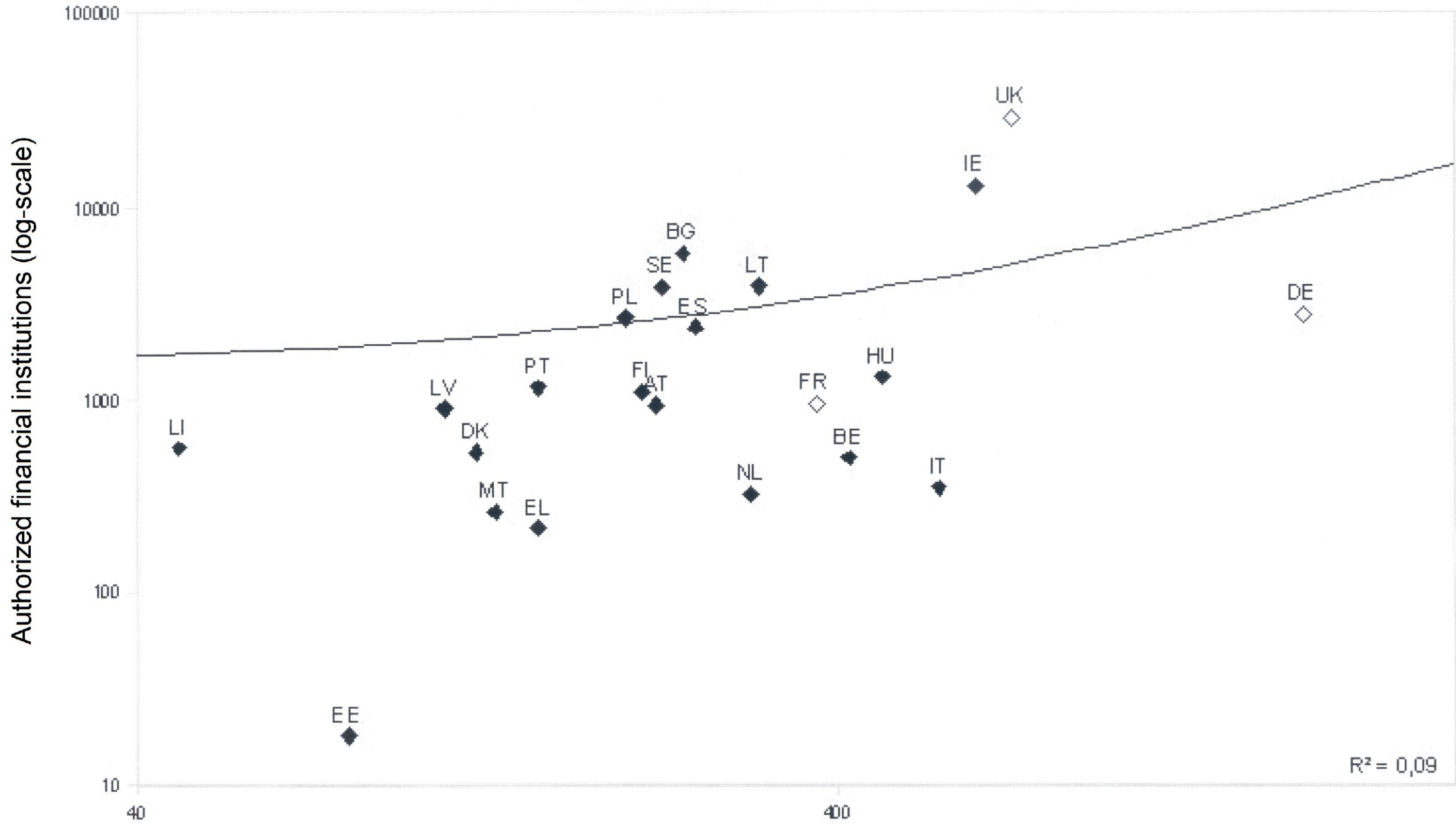
3. Jean-Paul Gauzès, member of the European Parliament for the French ruling party UMP, was elected rapporteur for the legislation on financial market regulation (also in 2009).
4. The three new EU Supervisory Authorities are modelled on the French "three-peaked approach" which is unique among the industrialised countries.

There are also some revealing quotations:

1. A recommendation from the De Larosière Report: "The Group recommends intensifying co-ordinated efforts to encourage currently poorly regulated or "uncooperative" jurisdictions to adhere to the highest level international standards" (Recommendation 28, p. 66).
2. Jean-Paul Gauzès: "Dans un pays comme la France, il y a une vraie tradition de surveillance des institutions financières. L'avantage d'une supervision européenne serait d'étendre les mêmes règles partout" (Le Figaro, 7 July, 2010).
3. Christine Lagarde (French Minister of Finance): "We need a City that plays by different rules" (Financial Times, 4 December, 2009).
4. Nicolas Sarkozy in a speech in La-Seyne-sur-Mer: "Do you know what it means for me to see for the first time in 50 years a French European Commissioner in charge of the internal market, including financial services, including the City (of London)? I want the world to see the victory of the European model, which has nothing to do with the excesses of financial capitalism" (Times, London, 2 December 2009).

Which countries are highly regulated and which are not? The following table shows that the number of regulators increases with the number of banks. But most countries deviate from the average relationship indicated by the regression line. The UK and Ireland have fewer regulators than one would expect given their number of banks. The group which has far more regulators than predicted includes Italy, Greece, Malta, the Netherlands, Belgium and France.

The extent of financial market regulation in the EU member states



Staff of national financial supervisory institution (log-scale)

Source: Stephany (2010)

French governments have used the strategy of raising rivals' costs in other fields before, for example, in the regulation of labour markets and the arts market. In both fields, the level of regulation is high in France and low in the UK. The strategy of raising rivals' costs is supported by the Commission which thereby increases its power.

The following table contains the results of an opinion poll. People in the 27 EU member states were asked whether the financial crisis ought to be tackled on the national or the EU level. The centralisation of financial regulation at the EU level is rejected by a majority of voters in nine member states which together command a blocking minority in the EU Council. Thus, the governments of these nine countries did not vote as their citizens wanted them to vote.

Fighting the financial crisis on the national or EU level?
Results from an opinion poll (Eurobarometer 72)

country	on national level	on EU level	difference	votes in the EU Council	population share in per cent
Spain	23	44	-21	27	8.88
Luxembourg	14	34	-20	4	0.10
Slovakia	11	30	-19	7	1.09
Poland	16	34	-18	27	7.74
Portugal	13	30	-17	12	2.14
Cyprus	17	32	-15	4	0.16
Belgium	11	24	-13	12	2.13
Denmark	6	19	-13	7	1.10
Estonia	12	25	-13	4	0.27
France	15	26	-11	29	12.78
Latvia	17	26	- 9	4	0.46
Slovenia	12	20	- 8	4	0.41
Italy	19	25	- 6	29	11.92
Finland	15	20	- 5	7	1.07
Greece	16	21	- 5	12	2.26
Lithuania	14	19	- 5	7	0.69
Ireland	13	15	- 2	7	0.85
Malta	20	22	- 2	3	0.08
subtotal				206	54.13
			qualified majority:	255	62.00
Germany	25	24	+ 1	29	16.72
Austria	21	19	+ 2	10	1.68
Czech R.	20	16	+ 4	12	2.08
Bulgaria	32	26	+ 6	10	1.57
Hungary	29	21	+ 8	12	2.05
Sweden	25	15	+10	10	1.83
UK	21	10	+11	29	12.25
Romania	38	26	+12	14	4.38
Netherlands	39	14	+25	13	3.31
total				345	100.00

How can this strategy of raising rivals' costs be stopped? Commission and Council have claimed that EU financial regulation can be based on Art. 114 TFEU which permits qualified majority voting. The British government has disputed this interpretation. The article has been introduced by the Single European Act in 1987. That was the time of Margaret Thatcher. Margaret Thatcher, surely, did not mean to sign up to qualified majority voting on the financial regulation of the City of London.

Art. 114 requires that the regulations "have as their object the establishment and functioning of the internal market". The internal market is defined in Art. 26 TFEU as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured". But differences between the national financial regulations are perfectly compatible with the free movement of capital. They are process regulations, not product regulations.

Since the internal market article (114) and qualified majority voting do not apply to financial process regulation, the British government could have gone to court had it not voted for these regulations. But the Court usually sides with the Commission because both have a vested interest in centralising policy at the European level.

However, the British government could still demand a clarification of Art. 114 at the occasion of the next revision of the EU Treaties. This would not be a repatriation of powers. The British government would be seeking protection against a misinterpretation of the Treaties or what is really a breach of good faith. The amendment would clarify that Art. 114 does not apply to process regulations, notably financial market regulations, because they are fully compatible with the free movement of goods, persons, services and capital.

Last week the 27 governments of the EU member states have agreed that they will amend Art. 122 TFEU to perpetuate the bail-out facility for the eurozone. If the German government seeks clarification of Art. 122, why should not the British government seek clarification of Art. 114? The envisaged amendment of the Treaty is an opportunity, not a nuisance, for the British government.