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Europe Rues Dashed Hopes of Financial Regulation

Article by Gaspard Denis
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The first months of the 2020s have already proved immensely testing and worrying times. A global health pandemic is exacting a terrible human cost and appears to be triggering a severe economic crisis too. After the great financial crisis that began in 2008, the European Union set out to fix its banking system in such a way to avoid a repeat. In this analysis, Gaspard Denis tracks a failed history of banking regulation, exposing the opportunities for reform missed along the way

In January 2014, in the pages of the *Green European Journal*, we reviewed financial regulation five years after the subprime mortgage crisis. At the time, while acknowledging the progress made, there were concerns that the momentum might wane as the trauma of 2008 faded. Five years down the line, this pessimistic prediction can be tested against the facts.

At the risk of fuelling the prevailing disenchantment with democracy, it must be said that the much-feared regulatory fatigue has materialised. Worse, in some cases, it has even turned into backward steps. This negative outcome is the result of various factors: the outright abandonment of ambitious reforms; the deliberate non-implementation of adopted measures; the watering down by the Commission of provisions set out in framework legislation;[1] and the relaxation of rules – originally intended to be simple and effective – through exemptions and weightings.

Five concrete cases demonstrate this verdict of failure.

Structural banking reform abandoned

In January 2014, the European Commission presented legislative proposal for structural reform of the banking sector that raised high expectations among civil society groups. The 2008 crisis highlighted the systemic risk posed by banks that are "too big to fail". Because of their size, complexity, and interdependence with other credit institutions, difficulties for one of these banks have the potential to undermine the entire financial system.

To address this systemic risk, the Commission proposed two main measures. The first was to prohibit "proprietary trading", the practice of large banks buying and selling financial products on their own account and for their own profit. The second was to separate banks' core activities from their high-risk activities.

The Commission's proposal was ambitious in its objectives but contained several major shortcomings.

First, the definition of proprietary trading was too vague. It would allow banks to continue to take speculative positions for their own benefit while making them appear, to supervisors, to be activities on behalf of clients or intended to hedge a particular risk. Second, the envisaged separation between core banking and high-risk activities was not automatic: the final decision would rest with national banking supervisors following a thorough risk analysis. Finally, the proposed regulation contained so many potential exemptions as to make uniform implementation impossible. This was particularly the case for EU member states such as France, Germany or

Belgium, which have adopted equivalent, or even more lax, legislation in this area.

While the structural reform envisaged by the Commission was much less far reaching than civil society had hoped for, it was still unacceptable to Conservative, Liberal, and some Socialist members of the European Parliament. The Greens, for their part, demanded that the reform go further than the Commission's initial text, proposing an automatic separation of banking activities. The adoption of a common position in Parliament quickly became impossible. The text was rejected in the Council too, when, in June 2015, member states limited themselves to minimalist general principles.

The Commission formally withdrew the plan from its work programme in October 2017. It invoked the "better regulation" imperative to justify the decision. This process, launched in 2014 by the Juncker Commission, sought to make the EU less bureaucratic by substantially reducing its legislative output. Three years earlier, in a letter to the first Vice-President of the Commission, Frans Timmermans, the Fédération Bancaire Française and the British Bankers' Association lobby groups had already used the same anti-bureaucratic argument to push for a stop to banking reforms that were in fact highly political.

Dysfunctional prudential rules

In December 2018, the Council and the European Parliament reached agreement on the revision of the banking package that covers rules for the European banking system (generally referred to as CRD V and CRR II.) These rules are called "prudential" requirements in the sense that they aim to strengthen the resilience of the EU banking sector so that it can better absorb economic shocks, while ensuring that banks continue to finance economic activity.

On paper, the package appears convincing. But, as is often the case with banking regulation, the devil is in the details. In reality, the ratios adopted are set to avoid imposing additional constraints on large banks.

For example, the leverage ratio, which is supposed to limit the proportion of the bank's assets financed by debt, is much too low. By setting its threshold at only 3 per cent, the European legislator has rendered it inoperative for two reasons. First, with a ratio averaging at 4 per cent, all major banks already complied with this standard before its official entry into force. Second, many academics advocate a much higher threshold, between 10 and 15 per cent, to effectively limit bank borrowing.

Another example is the introduction of the net stable funding ratio (NSFR) to encourage banks to use stable sources of funding to finance their activities. Again, in principle, there is nothing to complain about. Except that the European legislator calibrated this ratio in a much more flexible way than recommended by the Basel Committee on Banking Supervision, the global body for banking standards. In particular, for the treatment of derivative exposures, the rules on stable funding were much loosened. As a result, the major European banks will be able to continue to finance their derivative transactions (often of a highly speculative nature) by taking on very short-term debt. The ultimate consequence of such deviations from international standards is a greater risk of financial instability.

Green light for food speculation

Food speculation has worrying international consequences. In 2008, 2009, and 2011, high price levels and volatility in commodity derivative contracts led to significant increases in agricultural commodity prices. As a result, shortages of basic foodstuffs and hunger riots broke out in Africa, Latin America, and South Asia.

In response, Parliament and the Council agreed to adopt new rules to reduce the scope for speculation on food prices and other commodities such as oil, cotton, and metals in January 2014. The new legislation was adopted within the framework of reworked European rules on the markets for financial instruments (Markets in Financial Instruments Directive). More specifically, the rules set limits on the financial positions that traders can hold on commodity derivatives markets. The objective is to impose a ceiling for financial actors on the number of contracts concluded on a given commodity in a given period of time.

Even though the Parliament and the Council had laid down the principle of a limit on agricultural commodity speculation, the Commission still had a free hand in setting the specifics of such limitation and its application – through the adoption of so-called "technical standards". Well aware that lobbyists were closely tracking the legislative process, several civil society organisations spoke out at the time to warn against attempts to water down the new measures.

Unfortunately, that is precisely what happened. Adopted at the beginning of 2017, these technical standards defined by the Commission set far too high thresholds to effectively limit excessive speculation on commodity derivative contracts. The technical standards set a per-trader limit of 20 per cent for a handful of derivatives contracts related to foodstuffs intended for human consumption and 25 per cent for other commodity derivatives. By way of comparison, the position limits in the United States are significantly lower, in the range of 5 to 15 per cent.[2]

Footnotes

[1] Through the adoption of delegated acts or regulatory technical standards.

[2] Sven Giegold, on behalf of the Greens/EFA Group, 08/02/2017. "Motion for a resolution on COMMISSION DELEGATED REGULATION (EU) No …/… of 1 December 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits to commodity derivatives (C(2016) 4362 final)"

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