

EPFSF Briefing “EU/US regulatory and supervisory dialogue”

Introduction

The EU-US relationship brings with it substantial economic benefit - total US investment in Europe amounts to \$702 billion, and currently supports over 4.1 million jobs. As illustrated by the financial crisis, transatlantic (and global) financial market integration carries contagion risk as well as bringing economic benefits. However, an effective transatlantic dialogue which is founded on close cooperation, proportionality, shared regulatory outcomes and open markets will help to stimulate growth, mitigate the risk of further crises and reform the current global financial system.

This was recognised in the European Parliament's resolution of 26 March 2009, in which it stated that “*the EU-US relationship is the most important strategic partnership for the EU*” and that “*coordinated action on tackling global challenges... is of fundamental importance to the whole international community*”.¹

The Transatlantic Financial Markets Regulatory Dialogue (FMRD) has over the last few years proved to be an important tool for addressing technical issues of importance for the EU and the US, furthering a good relationship between officials on both sides of the Atlantic and strengthening coordination between EU and US representatives.

The last 18 months have seen policy discussion and proposals being developed at every level – global, regional and national – most notably G20. Enhancing global co-operation and co-ordination is strongly supported by the industry and will play a pivotal role in developing consensual regulatory policy and mitigating the risk of regulatory arbitrage and protectionism.

Cross-sectoral issues for the Transatlantic Agenda

- 1) **Global policy setting and coordination** – as the focus moves towards implementation, so a deeper and more transatlantic approach will become even more important, particularly in the case of increasingly international markets. Coordination should serve to deliver the highest possible degree of consistency within the international regulatory framework and, on the other hand, avoid contradictions in overlapping legislation and extra-territoriality of national legislation.
- 2) **Prudential regulation** – there is currently significant divergence between EU and US approaches in dealing with systemic risk. It is important that a consistent transatlantic approach is adopted to minimise duplication, market distortions and moral hazard.
- 3) **Accounting** – it is important to achieve a single set of high quality, global accounting standards. Much work has already been done on this issue; however, not only has progress been slow but with respect to financial instruments there is a growing divergence between the EU and US approaches.
- 4) **Financial stability contribution** – at the request of the G20 the IMF has prepared initial recommendations on a range of options intended to ensure that the financial sector makes a substantial contribution towards paying for government intervention. If not coordinated at an international level and if full account is not taken of the risk mitigating impact of enhancements to prudential regulation, governance and risk management, there is a risk that this might impair competitiveness and hamper economic recovery.
- 5) **Supervisory recognition** – the focus should be on equivalence of outcomes rather than rules' harmonisation. Supervisory recognition can be achieved on a unilateral, bilateral or multilateral basis².

¹ European Parliament resolution of 26 March 2009 on the state of transatlantic relations in the aftermath of US elections (2008/2100 (INI))

² Guidance Paper No 3.5, International Association of Insurance Supervisors

- 6) **Information-sharing** – work towards mutual recognition should focus on information sharing thus reducing duplicative and sometimes inconsistent reporting requirements. The establishment of transatlantic supervisory colleges for all internationally active groups is a valuable first step to achieving this outcome.

Sectoral priorities in the transatlantic agenda

Insurance

Collateral requirement in the US has for long been a key concern for European insurers. Despite numerous US acknowledgements of the need to change the current collateral requirements, the issue is far from being solved. The fragmented insurance regulation in the US, regulated and supervised at state level, further add to the difficulties in solving this issue. Current Congressional proposals for an Office of National Insurance/Federal Insurance Office (ONI) are positive developments. The proposals give the ONI powers to negotiate and enter into International Insurance Agreements on Prudential Measures on behalf of the United States and could pre-empt state insurance regulatory measures. It is however vital that the final pre-emptive powers of the ONI are suitably robust to ensure it is effective in practise. The proposals could be a starting point for addressing the collateral problem.

Furthermore, under Solvency II, decisions on regulatory equivalence or mutual recognition with third countries can be taken at EU level. However, in absence of a federal counterpart in the US, the European Commission will not be in a position to conduct an equivalence assessment or negotiate a mutual recognition agreement with the US, since the Solvency II Directive refers explicitly to a “third country”.

The US is also pursuing tax initiatives that effectively introduce double taxation obligations for foreign insurers, thus decreasing the competitiveness of the US insurance market and create new market barriers to EU insurers and reinsurers underwriting US risks.

Securities trading

A large amount of the order flow in securities traded on EU markets originates from US investors. Access of U.S. institutional investor with assets in excess of \$100 million to EU markets is permitted through SEC Rule 15a-6. This rule exempts European foreign brokers or dealers from the registration requirements of the Securities Exchange Act provided certain burdensome conditions are met. A similar exemption for European exchanges and their issues is not available, thus impairing US investors' access to European markets through US brokers acting as direct members of European exchanges.

In the wake of the 2008 historic transatlantic mergers between the New York Stock Exchange and Euronext on the one hand and NASDAQ and OMX on the other hand, cooperation between the EU and the US in securities has become even more important.

In 2007-2008, the SEC conducted two separate but linked initiatives: a possible mutual recognition in securities with eligible jurisdictions (such as the EU) that would apply to brokers and exchanges on the one hand, and a public consultation concerning the possibility of improving the functioning of Rule 15a-6 to make it less burdensome and applicable more widely, on the other. These moves were followed with great interest by the broker and exchange industry; the introduction of mutual recognition and the reform of Rule 15a-6 would have had the effect of increasing wholesale business in the transatlantic marketplace.

The financial crisis has, however, generated an understandable reordering of EU and US regulatory priorities with the result that the targets for improving cross-border market and customer access and fostering a streamlined globalisation of securities markets has slipped down the agenda.

Consistent with the G20 view, which recognised “the critical importance of rejecting protectionism and not turning inwards in times of financial uncertainty”³, Europe remains committed to progressing mutual recognition. Having launched a call for evidence on mutual recognition with non-EU jurisdictions in June 2009, CESR is expected to publicly consult on the matter by summer 2010.

From a regulatory point of view, the EU and the US have to move together if they want to reduce risks throughout the financial system. Global markets, products and services e.g. hedge funds or OTC derivatives need a global approach. The risk of regulatory arbitrage is serious and the world financial system could not survive another crisis.

³ Press Release issued by the Leaders of the Group of 20 on 15th November 2008

Banking

Next to the abovementioned need for harmonised accounting standards, the main topic for the EU-US dialogue on banking relates to the implementation of capital and liquidity standards adopted by the Basel Committee on Banking Supervision. Given the huge expected impact of current proposals, coordination is essential to protect the level playing field and to avoid an undue impact on the real economy resulting from a distortion of the level playing field.

First, the Basel II framework should be fully implemented and applied in the US, as it is in the EU through the Capital Requirements Directive (CRD). Second, revisions to the Basel II framework should be implemented and applied in a consistent way on both sides of the Atlantic, both as regards substance and timing. Revisions currently under consideration are referred to in the EU as CRD 3 and CRD 4.

OTHER SECTORS

Credit Rating Agencies: The EU agreed in 2009 on a comprehensive Regulation of Credit Rating Agencies, and the US are currently in the process of amending their regulation of Nationally Recognised Statistical Rating Organizations. While both sets of rules serve similar purposes, their drafting has taken place in a largely uncoordinated matter. The interaction of the two sets of rules remains to be analysed.

OTC derivatives: Against the background of the September 2009 G20 agreement, both the EU and the US are working on proposals aimed at tightening regulation of the OTC derivatives markets and encouraging the CCP clearing of “eligible” contracts. However, while there seems to be broad high-level consensus between the EU and US, there continues to be some key difference (e.g. defining “eligibility” and OTC execution (as opposed to clearing). While some of these differences should be capable of reconciliation, others may need to be preserved in the interests of market functionality.

Conclusion

The EU and the US have to move together if they want to reduce risks throughout the financial system. Global markets, products and services need a global approach. The risk of regulatory arbitrage is serious and the world financial system could not survive another crisis.

As the process of developing policy moves towards implementation, closer co-ordination between the EU and the US will become critically important – and that process of transition has already commenced. A properly targeted dialogue will bring substantial economic benefits to our respective economies and help serve as a blueprint for global regulatory reform and licensing recognition. In the words of former Vice President Verheugen to the College following a meeting of the TEC *“The need for closer transatlantic cooperation was never as urgent as it is today. Moreover in an increasingly multi-polar world, the transatlantic partnership is the indispensable alliance of the 21st Century, a force for stability and prosperity in the world economy”*⁴.

In order to achieve such a goal, effective regulatory dialogue between stakeholders of all levels is essential to ensure regulatory reform best fits the needs of its markets. The Financial Market Regulatory dialogues play a key part in achieving this.

The observation of the European Commission that “protectionism and the retreat towards national markets could only lead to stagnation, a deeper and longer recession and lost prosperity” and that “an unequivocal message is essential to hold off these threats” suggests that the European Commission and regulatory authorities on both sides of the Atlantic should consider holding a summit at the end of the year (once changes in the regulatory infrastructure become clearer) to discuss, as a minimum, the basis, principles and criteria for mutual recognition. This is particularly important insofar as strands of extra territorial application of domestic rules and elements of protectionism are beginning to emerge in the programme of regulatory repair. Indeed, the widespread acceptance of the need for regulatory change should provide a unique opportunity to converge standards and take concrete steps towards mutual recognition.

⁴ Note provided by Vice-President Verheugen’s office to guide the Commission’s approach to the next meeting of the TEC, TransAtlantic Business Dialogue, August 2009

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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