"The overall impact of the legislative proposals in the financial area"

Since the 2007/2008 financial crisis, global, European and national authorities have implemented a multi-year regulatory reform programme and introduced a large number of initiatives which are substantially reshaping the way financial markets operate. European policymakers have proposed more than 40 legislative and non-legislative measures, and many technical implementing measures, to build new rules for the global financial system.

Legislators have had to manage multiple competing demands: responding swiftly to the crisis and restoring confidence; and ensuring that such response is well-crafted and considered from different angles in order to minimize unintended effects. The measures have covered a range of activities in different sectors, including banking, securities markets, insurance, asset management, pensions, payments, credit ratings and audit. Taken together, the measures are spread across a number of individual pieces of legislation which were frequently developed and debated separately, with their individual impact assessments and implementation timelines.

Importance of cumulative assessment of regulatory impact

The financial sector is undergoing significant changes as a consequence of the financial crisis reforms[1]. A considerable number of Level 1 regulations and directives have been adopted over the last years but remain to be further detailed by **implementing measures** before they become fully effective.

The overall result of the recent regulatory agenda will be that financial markets are fundamentally re-shaped and more resistant in many ways.

There are a number of capital markets regulations recently adopted (e.g. MiFID/R, EMIR, MAD/R, CSDR, SFTR) as well as various sector-specific EU legislations including on insurance (e.g. Solvency II, IDD, PRIIPs) and asset management (AIFMD, UCITS V, MMFs, ELTIFs, PRIIPs).

It is widely recognised that there are substantial benefits to the appropriate implementation of recent reforms in response to the crisis. Equally, there are increasing concerns regarding the interaction between various reforms and their cumulative economic effect on financial markets, the end-users of those markets, and the economy as the market behaviour of banks, different types of investors, and other market participants changes in response to regulatory reform.

[1] Various papers have sought to assess changes in the banking sector, including EBA's February 2015 report "Overview of the potential implications of regulatory measures for banks' business" which raises the question of potential implications for lending to the real economy.

In May 2014 the European Commission published an *Economic Review of the Financial Regulation Agenda* (ERFRA). Among the conclusions of this exercise, the Commission noted that "the total benefits of the financial regulation agenda, if fully implemented, are expected to outweigh the costs[2]".

The Commission based the bulk of its analysis and review on the specific impact assessments that have accompanied each financial services proposal adopted. In the Commission's words, the aim of the ERFRA was to "examine the overall coherence of the reform agenda and the expected or actual economic impact, including the interactions and synergies between different reforms[3]". It was stated that the full impact of the financial reform agenda can in principle only be assessed in the years to come and that even then it will be difficult to isolate regulatory impacts from other factors and changes.

A number of market participants have therefore seen the ERFRA as a preliminary and largely qualitative analysis, rather than a fully-fledged quantitative and cumulative impact assessment.

As noted by the Commission, the ERFRA should "be understood as the beginning of a longer process of systematic review and evaluation of reforms[4]".

There is clear need for carrying out a process of systematic, quantitative and qualitative assessment of the financial regulation framework over the coming years. An appropriate evaluation process is particularly important as EU institutions place emphasis on the promotion of long-term investment and development of capital markets.

The relationship between regulation and economic growth is a complex one. Sound regulation is vital to market confidence and growth. Various regulations – such as on bank capital, resolution, risk management, supervision and reporting of market data to supervisors – arguably constitute a "cost worth paying" both to reduce the likelihood of future crises, and the whole economy costs of whatever future crises do occur.

But there is an inflexion point beyond which the "cost worth paying" in normal times begins to exceed the benefits of regulation. The real challenge lies in establishing where the tipping point lies. Beyond this point, additional layers of regulation can have a negative net impact on economic growth. They can undermine the effectiveness of reforms and ultimately have unintended consequences on financial stability as markets become less diversified and able to cope with diverse scenarios.

It is important to assess whether, within the overall package of measures, there are some which make a strong contribution to financial stability with proportionate costs and impacts, and whether there are other measures that have less clear financial stability benefit with larger detrimental impacts. The challenge will be to develop further data, both on the individual measures themselves and on their interactions, to allow analysis as to whether the benefits continue to optimally outweigh the costs on an ongoing basis. In other words, it will be important to consider whether the benefits sought can be achieved on the basis of fewer costs to the economic activity and growth.

Similar questions arise in the consumer area. Well-informed consumers are better equipped to compare products and make informed decisions. However, more information does not mean better information. In insurance or asset management for instance, several EU regulations risk overloading consumers with information that arguably provides limited benefit to them when choosing insurance or investment products.

In addition, as recent EU proposals have been discussed in isolation, this has led to a complex and confusing legislative architecture. Not enough attention has been paid to the combined effects and potential unintended consequences of these proposals. The intense regulatory agenda over the past few years – MiFID II, the PRIIPs Regulation, Solvency II, IDD, and UCITS V Directives – has resulted in a series of overlapping and confusing requirements regarding the information that needs to be disclosed to consumers of investment products including insurance, such as the duplication or the inconsistencies between the PRIIPs with UCITS-KIID, MiFID II and the Solvency II Directive or the duplication between AIFMD, UCITS Directive and SRD II, with the cumulative disclosure of identical or very similar information.

[2] Economic Review of the Financial Regulation Agenda, page 17.

[3] Economic Review of the Financial Regulation Agenda, page 6.

[4] Press release, Financial regulation: European Commission presents a first comprehensive review of the EU's reform agenda, 15 May 2014.

In practice, it means that investors risk receiving the same type of information twice or more, but in a different wording and a different format.

Overlapping reporting requirements are also an example of unnecessary duplication of such requirements. Currently regulatory reporting under the UCITS Directive, AIFMD and the future MMF Regulation takes/will take place in different frequencies, different formats and with reference to different contents. These duplications should be removed. The EU should avoid regulatory pieces with overlapping requirements, or that are not fully consistent with each other, or which inadvertently create an unlevel playing field among financial sectors.

Impact of existing and future legislation

A number of additional Level 1 and Level 2 proposed legislations remain under consideration in the current policy process. Critical MiFID/R Level 2 requirements are due to be decided in the coming period, with the potential to re-shape EU markets. Major proposals on Bank Structural Reform and a Financial Transactions Tax are being debated. Meanwhile, EU authorities are undertaking a review of EMIR and elements of the Solvency 2 framework, among other workstreams. Regarding the EMIR review, it will be important to consider the appropriateness of requirements in relation to their financial stability and integrity objectives. Some market participants are still concerned of the costs and liquidity impact, such as pension funds and life insurance companies.

Impact assessments have often focused on a particular market or piece of regulation and as such, the aggregate impact of recent regulations is not well understood. It is therefore important that the new EU regulations are not considered in isolation: their processes should involve the additional demand of assessing overlap and consistency in relation what has already been legislated and what is being developed at global level. Policymakers need in particular to weigh incremental stability benefits (which could be subject to diminishing returns), against the incremental costs.

The European Commission's Better Regulation Package proposed in May 2015 could be valuable in helping legislators make better assessments of proposals and the overall legislative framework. The package includes proposals on the creation of a new Regulatory Scrutiny Board and a Regulatory Fitness of Performance platform.

The international dimension is also an important factor, and a challenge. To restore the competitiveness of the European financial places, it will be important that the EU institutions work more closely with international financial regulatory bodies such as FSB, IOSCO and the IAIS, coordinate further and ultimately to ensure that the relevant international standards are applied in a harmonised fashion.

While various key EU legislations emanate from the global G20 reform package, a number of additional proposals are specific to European jurisdictions. EU processes should also take into further consideration ongoing workstreams at global level which are likely to require future EU implementation. This includes:

- The Basel Committee's work on several banking areas: the proposal for the introduction of capital floors, the calibration of the leverage ratio, workstream on interest rate risk in the banking book, as well as the Fundamental Review of the Trading Book, which is a major initiative to more accurately calibrate capital requirements for bank trading books, seeking to improve transparency and supervisors' ability to address trading risks. The EU implementation of the Net Stable Funding Ratio (NSFR) and proposed minimum total loss-absorbing capacity (TLAC) requirement for banks will also be very important.
- IOSCO's work in the securities sector on credit rating agencies, financial benchmarks or standards for non-centrally cleared OTC derivatives for instance should be taken into account when developing EU regulation in those areas. IOSCO's work on criteria for identifying simple, transparent and comparable securitisations or the FSB/IOSCO development of methodologies for identifying non-bank non insurances systemically important financial institutions are also likely to have a significant influence.

- The EBA is currently developing guidelines to set aggregate limits or tighter individual limits on exposures to shadow banking entities which carry out banking activities. Although at this stage no additional capital charge is required, the setup of an aggregate limit might force most banks to unwind core and performing assets in order not to overcome the imposed concentration threshold with a high adverse impact on banks' balance sheets.

The IAIS's work, in the insurance area, three separate capital standards are in various stages of development at international level: a Basic Capital Requirement (BCR) and a Higher Loss Absorbency (HLA) requirement for systemic insurers and an International Capital Standard (ICS) for internationally active insurance groups. It is very unclear at this stage how these new capital requirements will interact with those in Solvency II, raising questions in terms of consistency of requirements.

Interaction with Capital Markets Union

While the regulatory reform programme remains to be completed, building a Capital Markets Union (CMU) has emerged as a new flagship project for the 2014-2019 European legislative cycle. The promotion of equity markets, high quality securitisation, venture capital, alternative investment funds, ELTIFs and other funding mechanisms are key priorities for EU policymakers in order to develop greater depth and diversification of financing sources for the economy.

However, building a single European capital market means taking stock not only of how capital markets currently function, but of how they will function after the post-crisis legislative reforms have been implemented.

EU Finance Ministers have stressed that in order to ensure cross-sectorial consistency, work to prepare the CMU should carefully evaluate the cumulative effect of legislative changes since the financial crisis and assess the need for proportionate measures to:

- enhance liquidity and market making, especially on asset classes where liquidity has recently diminished;
- improve cross-border investment in corporate debt and equity securities;
- increase investment capacity in the Union, where necessary through appropriate adjustments of the prudential framework for key finance providers, such as insurance companies, while taking due account of financial stability considerations;
- remove barriers to marketing and growth of investment funds and their operation cross border, in recognition that such funds are a significant source of finance in the EU[5].

All of these objectives have been impacted by the recent regulatory reform agenda in different ways. Finally, a coherent EU financial services regulatory framework should also ensure all legislative proposals are consistent with each other. Currently there are existing proposals that go counter to the building of a Capital Markets Union. The proposed Financial Transaction Tax (FTT) is a potential hurdle for the CMU, which would risk causing distortions to the creation of an EU single market and ultimately would jeopardise long-term savings, growth and investment as it would channel investments to products not subject to FTT.

The objectives of CMU will demand that the regulatory framework is not just calibrated to ensure safety and protection, but also be fit for the purpose of promoting growth and integration of EU markets. It is important that future assessments measure the appropriateness of the regulatory framework against the objectives of CMU as outlined by EU Finance Ministers.

Conclusion

The current period represents an opportunity to take stock of what has been done to address the lessons of the financial crisis and what further work is needed to strengthen the financial system and achieve well-functioning capital markets.

[5] ECOFIN conclusions 16 June 2015.

It is therefore welcomed and timely that the European Parliament is undertaking an exercise on *Stocktaking and challenges of the EU Financial Services Regulation: impact and the way forward towards a more efficient and effective EU framework for Financial Regulation and a Capital Markets Union.*

Sound regulation is essential to support a strong financial sector and underpin the economic recovery. It is important to take a holistic view on how regulations targeting different sectors interact with each other and the cumulative effect they may have on the economy, consumers and financial markets.

Establishing a process for regularly assessing the cumulative effect of existing regulations should inform future initiatives and the development of CMU.

As expressed by Commissioner Hill, "when you legislate at speed, in the middle of a crisis, you can't always get that balance exactly right – so now is a good time to take a step back and look at the cumulative impact of our regulation and check whether it is working in the way we had intended[6]".

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[6] Commissioner Jonathan Hill, Speech at FIBI Conference, 15 June 2015.

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 Secretariat or the Chair of the Financial Industry Committee.

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