EUROPEAN
COMMISSION

Brussels, 15.5.2014
COM(2014) 279 final

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

A reformed financial sector for Europe

{SWD(2014) 158 final}

1. INTRODUCTION

In 2008, the world was hit by a financial crisis which was global in scale and imposed significant costs on the EU economy and its citizens. In the immediate aftermath of the crisis, the EU took the lead in a decisive global regulatory response. Together with its international G20 partners, the EU committed to engage in a fundamental overhaul of the regulatory and supervisory framework of the financial sector.

Alongside its control over state aid granted during the crisis, the Commission acted quickly to make immediate regulatory interventions that strengthened deposit guarantee schemes and reformed accounting rules. Following the recommendations of a group of high-level experts set up by the Commission and chaired by Mr de Larosière,[1] in 2009[2] and 2010 the Commission set out the way forward for improving the regulation and supervision of EU financial markets and institutions. It announced a set of legislative measures to bring about a safe and responsible financial sector conducive to economic growth.[3]

Given the interconnections between Member States that share a common currency, it also became clear that there were specific risks which threatened financial stability in the euro area and the EU as a whole. This called for deeper integration to put the banking sector on a more solid footing and restore confidence in the euro, by creating a Banking Union with single oversight and resolution of banks in the Member States of the euro area, and potentially open to all Member States if they wish to take part.[4]

Over the past five years, more than 40 proposals have been tabled by the Commission (many of which are already in force) aimed at restoring market confidence, financial stability, and the integrity and efficiency of the European financial system.

The first positive effects of the reformed financial system can already be observed and continue to unfold. Ongoing monitoring and review will be necessary to further evaluate the implementation and the overall impact and effectiveness of the reforms.

This Communication takes stock of the progress made in reforming the financial system and, where already possible, assesses the overall impact of the EU financial regulation agenda. More detail is provided in the Staff Working Document 'Economic Review of the Financial Regulation Agenda'.[5]

2. THE COST OF THE CRISIS AND THE NEED FOR REGULATORY REFORM

Financial institutions and markets play a vital role in any developed economy. They provide lending to households and businesses. They allow individuals to save and invest for their future and channel savings to support the economy. They help corporations and households to better manage and insure against risks; and they facilitate payment transactions. By performing these key functions, a well-functioning financial system contributes to economic prosperity, stability, and growth. However, failure of the financial system may have profound negative consequences for the wider economy as demonstrated by the recent crisis.

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[1] Report of the High-level Group of Financial Supervision in the EU, 25 February 2009.
[2] Communication on 'Driving European recovery', COM(2009) 114 final.
[3] Communication on 'Regulating financial services for sustainable growth', COM(2010) 301 final
[4] Communication on 'A roadmap towards a Banking Union', COM(2012) 510 final. Communication on 'A blueprint for a deep and genuine economic and monetary union - Launching a European Debate', COM(2012) 777 final/2.
[5] The review only covers financial regulation measures and not the other important reforms taken in other areas in response to the crisis.

In the years preceding the crisis, the financial system had grown significantly in size and had become increasingly interconnected through long and complex global intermediation chains of claims, increasing systemic risks. Across the world, leverage strongly increased, and banks started to rely more on short-term funding and engaged in increasingly hazardous maturity transformation. The rapid growth of the financial sector was also facilitated by a surge in innovative but often highly complex financial products that allowed financial institutions to expand activities, also off their balance sheets.

Policymakers, regulators and supervisors around the world failed to identify and adequately address the risks building up in the financial system. Many activities largely escaped any regulation and oversight. While the operations of the largest financial institutions expanded significantly across borders and markets became increasingly integrated internationally, regulatory and supervisory frameworks remained largely nationally focused.

With the start of the financial crisis, these deficiencies unravelled. What started as a sub-prime crisis in the USA in 2007 quickly spilled over into a full-blown global financial crisis. In Europe, the financial crisis later turned into a wider sovereign debt crisis with significant implications for the economy as a whole.

The economic and financial crises imposed significant costs on the EU economy. Between 2008 and 2012, a total of €1.5 trillion of state aid was used to prevent the collapse of the financial system.[6] The crisis triggered a deep recession. Unemployment rose sharply, and many EU households experienced significant losses in income, wealth and opportunities.

3. THE OBJECTIVES AND EXPECTED BENEFITS OF THE REFORMS

The EU financial regulation agenda has been guided by the aim of creating a safer, more transparent, and more responsible financial system, that works for the economy and society as a whole and contributes to sustainable growth. The reform measures deliver on these objectives by:

- Restoring and deepening the EU single market in financial services
- Establishing a Banking Union;
- Building a more resilient and stable financial system;
- Enhancing transparency, responsibility and consumer protection to secure market integrity and restore consumer confidence; and
- Improving the efficiency of the EU financial system.

The large number of regulatory reforms undertaken at EU and global level, and their broad scope, is a reflection of the diversity and severity of the problems undermining the functioning of the financial system prior to the crisis. No single reform would have been capable, on its own, of achieving all the objectives set out above. Furthermore, it was important not only to address the failings identified by the crisis, but also to anticipate other potential problems that could affect the financial system. The different measures have been designed with a view to complementing and reinforcing each other. While it is too early at this stage to exhaustively identify and assess the complementarities of the reform agenda, many have already emerged (e.g. reforms to the institutional framework strengthening the single market and the functioning of EMU contribute to both financial integration and financial stability; measures to enhance transparency contribute to both financial stability and

[6] See European Commission State aid scoreboard 2013.

efficiency) and further synergies are expected to materialise in the future as the measures are implemented.

3.1 Restoring and deepening the EU single market in financial services

The financial crisis showed that no Member State alone can regulate the financial sector and supervise financial stability risks when financial markets are integrated. In the wake of the crisis, the Commission therefore announced a **consistent response to the crisis** across the whole EU. This also allowed for better coordination with international partners.

Before the financial reform, EU financial services legislation was largely based on minimum harmonisation, allowing Member States to exercise considerable flexibility in transposition. This sometimes led to uncertainty among market participants operating cross-border, facilitated regulatory arbitrage and undermined incentives for mutually beneficial cooperation. The Commission therefore proposed the establishment of a **single rulebook**, providing a single regulatory framework for the financial sector and its uniform application across the EU.

An important step in the deepening of the single market in financial services was the creation of the **European System of Financial Supervisors (ESFS)[7]**, including the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). These Authorities, operating since 1 January 2011, have guaranteed consistent supervision and appropriate coordination among national supervisory authorities in the EU. In addition, the European Systemic Risk Board (ESRB) monitors macro-prudential risks across the EU and issues warnings and recommendations to call for corrective action.[8]

The reform agenda proposed by the Commission was complemented by a cross-sectoral **sanctioning regime** to ensure proportionate and timely enforcement through more effective and deterrent sanctions.

3.2 Establishing the Banking Union

The crisis revealed the incomplete nature of integration in the euro area and weaknesses in the institutional structures supporting economic and monetary union (EMU). The crisis abruptly reversed banking market integration, and fragmentation threatened the integrity of the single currency and the single market. While banks had diversified geographically and engaged in significant cross-border activities, they remained closely linked to the Member State in which they were headquartered, contributing to the negative sovereign-bank feedback loop that weakened banks and sovereigns and resulted in unreasonable financing costs in some Member States. This called for a deeper integration, at least in the euro area, for the supervision and resolution of banks. While Banking Union is mandatory for euro area Member States, it is an inclusive system and open to participation of all EU Member States.

The first pillar of the Banking Union is the Single Supervisory Mechanism (SSM)[9], which transfers key supervisory tasks for banks in the euro area and other participating Member States to the European Central Bank (ECB). The ECB will fully carry out its new supervisory mandate as of November 2014. In preparation for its new supervisory role, the ECB is

[7] See Regulations (EU) No 1092/2010,1093/2010, 1094/2010, and 1095/2010 of the European Parliament and of the Council of 24 November 2010; OJ of 15 December 2010, L 331, and Council Regulation (EU) 1096/2010 of 17 November 2010; OJ L331/1 of 15.12.2010..
[8] The ESFS is subject to a separate review.
[9] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

currently conducting an asset quality review (AQR) and a stress test, in coordination with the EBA, which will be vital for restoring confidence in the European banking system and ensuring a smooth transition towards the SSM. The EBA will remain a central actor in further developing the single rulebook and a coordinated supervisory approach.

The second pillar of the Banking Union - the Single Resolution Mechanism (SRM)[10] – will apply an integrated and effective resolution process at European level for all banks in Member States subject to the SSM. Resolution will be financed in the first place by shareholders and creditors and, as a last recourse, by a Single Resolution Fund, funded through bank contributions.

The Banking Union is expected to ensure high, common standards for prudential supervision and resolution of banks in the euro area and participating Member States. It will also improve financial integration and help ensure the smooth transmission of the ECB's monetary policy.

3.3 Building a more resilient and stable financial system

In recent years, the Commission has presented a series of measures to strengthen the stability and resilience of the financial system.

In the **banking sector,** only weeks after the failure of Lehman Brothers in 2008, the Commission proposed to increase the coverage level of **deposit guarantee schemes (DGS**), which led via an interim step to a harmonised coverage of €100,000 since 2010.[11] This measure immediately increased depositor confidence in public safety nets and thereby successfully mitigated the risk of runs on banks across the EU.

The new **Capital Requirements Regulation and Directive** (the 'CRD IV package')[12] is increasing the level and quality of bank capital and setting minimum liquidity standards, making banks more resilient. The CRD IV package also requires banks to build additional capital buffers for future periods of stress and introduces additional capital requirements for systemically important banks to reduce systemic risk in the banking sector. Earlier reforms of the CRD had already addressed key issues such as remuneration policy and risk retention for securitisation.

The Directive for **bank recovery and resolution (BRRD)**[13] will put in place the necessary tools and rules to ensure that the costs of bank failures are not borne by taxpayers, and that EU banks can be resolved in an orderly fashion. It will thereby reduce systemic risk and the need for state aid to maintain financial stability.

The reforms in the banking sector were complemented by reforms to improve the functioning of **financial markets** and increase the stability and resilience of **financial market infrastructures**. The revised **Markets in Financial Instruments Directive (MiFID II)**[14] strengthens organisational requirements and safety standards across all EU trading venues and extends transparency requirements to bond and derivatives markets.

[10] COM(2013)520

[11] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay

[12] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

[13] COM(2012) 280

[14] COM(2011) 656, COM(2011) 652

The **European Market Infrastructure Regulation (EMIR)**[15] and MiFID II improve the transparency of derivatives that are traded over-the-counter and reduce the counterparty risk associated with derivative transactions. By imposing common prudential, organisational and business conduct standards, the **Regulation on central securities depositories (CSDR)** [16] increases the resilience of EU central securities depositories and enhances the safety of the settlement process.

Together, MiFID II, EMIR and CSDR set a coherent framework of common rules for systemically important market infrastructures at European level. A regulation was also adopted to address specific concerns raised by short-selling and credit default swaps.[17]

In addition, as part of the EU effort to ensure financial stability, the reform agenda included a number of key measures to reduce systemic risk stemming from outside the regular banking system[18], including for example the Alternative Investment Fund Managers Directive[19] and the proposed Regulation on Money Market Funds.[20] Work in this area continues.

Stability has also been reinforced by a risk-based regulatory framework for the **insurance sector** (Solvency II)[21], which will improve solvency and risk management standards, thereby increasing the resilience and stability of the European insurance sector.

Taken together, these measures will reduce the build-up or emergence of systemic risk across the financial system, thus reducing the likelihood and severity of future financial crises.

Only for certain particularly interconnected and systemically important banks, does the comprehensive set of measures proposed appear insufficient to ensure that those banks can be resolved without negative impacts on financial stability or intervention by taxpayers. Following the recommendations of the high-level expert group, chaired by Mr Liikanen,[22] in early 2014 the Commission proposed a set of structural measures for those banks, including a prohibition for a bank to trade on its own account and a separation of trading from deposit-taking and other retail banking activities where necessary to ensure resolvability.[23]

3.4 Enhancing transparency, responsibility and consumer protection to secure market integrity and restore consumer confidence

Market integrity requires trust and confidence in the financial system, which in turn depends on transparent and reliable information flows, the ethical and responsible behaviour of financial intermediaries and the fair and non-discriminatory treatment of consumers. The crisis revealed severe shortcomings and a pervasive lack of market integrity, also highlighted by recent scandals and market abuses, including the manipulation of interest rate benchmarks (LIBOR and EURIBOR). The economic damage is difficult to quantify but it is likely to be

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15 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

16 COM(2012) 73

17 Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps

18 See Communication on 'Shadow Banking – Addressing New Sources of Risk in the Financial Sector', COM(2013) 614 final.

19 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

20 COM/2013/615

21 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

22 Report of the High-level expert group on reforming the structure of the EU banking sector (2012), October.

23 COM (2014) 43

large and in excess of the billions of euros of record fines that banks had to pay. The costs in terms of reduced confidence and trust in the financial system are not quantifiable but are also likely to be significant.

The Commission has therefore proposed a set of measures to enhance transparency of financial markets. The financial reform agenda aims to restore trust in the financial system and to significantly enhance market integrity. The reforms will benefit all users of financial services, in particular customers, and investors.

The revised **Market Abuse Regulation and Directive on Criminal Sanctions for Market Abuse** (MAR/CSMAD)[24] will establish stricter rules to better prevent, detect and punish market abuse. The Commission proposal for a **Regulation on financial benchmarks** seeks to enhance the robustness and reliability of benchmarks and prevent their manipulation.[25]

A combination of reform measures have been adopted or proposed to ensure that **consumers and retail investors** have efficient, timely and non-discriminatory access to financial services. Supervisory and regulatory authorities will ensure that financial services providers do not exploit information asymmetries against their customers' interest. The measures provide in particular for the establishment of EU-wide responsible mortgage lending standards;[26] better information disclosure and higher standards for financial advice and distribution;[27] enhanced protection of the assets of retail investors;[28] more transparency and comparability of bank account fees, the establishment of a quick and simple bank account switching procedure and access to basic bank accounts.[29] These measures will increase consumer trust in financial markets and products.

The Regulations on **Credit Rating Agencies** (CRAs)[30] are increasing the independence and integrity of the rating process and enhance the overall quality of ratings. Complementary **audit reforms** will improve the quality of statutory audits in the EU and, combined with reforms of the international **accounting standards** that apply in the EU, will help rebuild investor confidence in the financial system.[31]

3.5 Improving the efficiency of the financial system

By addressing the underlying market and regulatory failures, the financial reform agenda aims at improving the efficient functioning of the financial system.

Improved **disclosure and reporting requirements** in various reform initiatives increase the transparency and reduce information asymmetries in the system for all market participants, supervisors and consumers.

The establishment of the **Banking Union** and the **single rulebook** contribute to efficiency by levelling the playing field and facilitating cross-border activities. Similarly, the reduction in implicit subsidies for systematically important banks and proposed restrictions on the activities of large complex and interconnected banks (i.e. structural reform) will help reduce

[24] COM (2011) 651 and COM(2011) 654
[25] COM (2013) 641
[26] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010
[27] For example, COM(2012) 352.
[28] For example, COM(2012) 350.
[29] COM(2013) 266
[30] Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies
[31] COM(2011) 779 and COM(2011) 778

competitive distortions, correct related mispricing of risk and consequently improve the functioning of the market and allocation of capital.

The improved prudential framework for banks and the new risk-based capital requirements for insurers in **Solvency II**, combined with improved risk management standards, will induce financial institutions to better internalise the risk of their activities and contribute to more efficient, risk-adjusted pricing.

The access provisions contained in **MiFID II, EMIR** and the **CSDR** will reduce access barriers to financial market infrastructures and promote competition along the whole securities trading chain. In the same vein, the revised **CRA Regulation** and the **audit reforms** facilitate market entry and increase the visibility of new entrants.

The financial regulation agenda strikes a balance between strengthening financial stability and allowing a sufficient and sustainable flow of finance to the real economy. The reform measures devote particular attention to small and medium-sized enterprises **(SMEs**), given their particular difficulties in securing external finance and their important role in creating employment and fostering sustainable growth. The EU financial regulatory framework has been adapted considerably over the last three years.[32] The problems SMEs face with regard to accessing finance have been addressed from different angles and include measures to ease access to capital markets to raise capital directly,[33] make lending to SMEs more attractive,[34] and introduce new frameworks[35] in the field of investment funds.

4. THE COSTS OF THE REFORMS

Financial reform leads to economic costs for financial intermediaries as it introduces compliance costs and requires adjustments to the way business is conducted. These costs have been estimated in the impact assessments of the legislative initiatives and are discussed in more detail in the accompanying staff working document. A significant part of these costs are **adjustment costs during transition.** Overall, costs are expected to be more than offset by the benefits of the enhanced stability and integrity of the financial system.

Costs to financial intermediaries are inevitable and, to a certain extent, a sign of the effectiveness of the reforms. For example, a reduction in the implicit subsidy for certain large, complex and interconnected banks will increase their funding costs but at the same time reduce the costs for taxpayers. Similarly, the reforms induce a re-pricing of risk, which creates costs but these costs are matched by the benefits of avoiding excessive risk-taking because of underpriced risk in the market. Thus, **costs to financial intermediaries are often compensated by wider economic and societal benefits**.

The transition process to a more stable financial system is particularly challenging as regards its potential impact on the real economy. However, the current difficulties in the market and wider economy cannot be attributed to the regulatory reforms (but rather the lack thereof). They relate much more to the problems built up before the crisis and their consequences, including the evaporation of trust in the market and related liquidity squeezes, weak bank

[32] Communication on 'An action plan to improve access to finance for SME's', COM(2011) 870 final
[33] Proposed Article 35 of MiFID
[34] Article 501 of Regulation EU 575/2013 (CRD IV package)
[35] Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds and Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds. See also COM/2013/462.

balance sheets, high private and public debt levels, low interest rates, the recession and weak economic growth prospects.

In order to minimize costs and potential disruptions during the transition, **phasing-in periods** have been granted.[36] Furthermore, where significant adverse effects have been anticipated, the **rules have been adjusted** (e.g. the long-term guarantee package in Solvency II[37]) or, under certain circumstances, **exemptions have been granted** (e.g. for pension funds and non-financial corporates in EMIR). Where rules entered uncharted waters, **observation periods** have been applied (e.g. with regard to the leverage ratio and liquidity regulation of banks). Finally, ongoing monitoring and review of all reforms will ensure that they deliver their intended benefits while avoiding undesired effects including those arising from interaction between different reforms.

5. CONCLUSIONS

Taken together, the reforms proposed by the Commission to implement the comprehensive financial regulation agenda agreed by the G20 and set out in the Commission's Communications of 2009, 2010 and 2012 address the regulatory gaps and market failures that were laid bare by the crisis.

Our proposed reforms empower **supervisors to oversee** markets that had been beyond their reach, and bring **transparency for all market participants** over activities that were previously known only to a handful of insiders.

Our proposed reforms establish ambitious new standards to **limit excessive risk-taking** and make financial institutions **more resilient.** When risks nevertheless materialise, **the burden is shifted away from taxpayers to those who will earn profits** from activities giving rise to these risks.

Our proposed reforms **make financial markets work better in the interest of consumers, small and medium-sized enterprises** and the economy at large.

Our proposed reforms put the onus on **all actors including managers, owners, and public authorities** to ensure that financial institutions and market participants **abide by the highest standards of responsibility and integrity**.

Overall, our proposed reforms will help reduce the likelihood and impact of crises occurring in the future. The financial system is already changing and improving in key aspects. This is expected to continue as the reforms take further effect. But the situation must be **carefully monitored**. As the economic situation is changing, so are risks and vulnerabilities for the financial system. The Commission will **remain vigilant and proactive**, preserving the overall reform and responding to **new risks and vulnerabilities** as they emerge.

While the reforms will give rise to some **costs**, many of these are transitory in nature. Economic analysis and available evidence indicates that the total expected benefits of the financial regulation agenda, once fully implemented, will likely **outweigh the expected costs**. Phasing-in and observation periods will help reduce the transition costs.

Much has been achieved in a short time, but the reform process is not yet fully accomplished. **Some important reforms still need to be adopted by the co-legislators** (e.g. on bank structural reform, shadow banking, financial benchmarks). The Commission calls on the

[36] E.g. for capital and liquidity requirements in the CRD IV package.
[37] As amended in Omnibus II. COM/2011/0008 final

Council and the European Parliament to give priority to agreeing these proposals. Work in a few remaining areas is still under preparation. In particular, work on a resolution framework for non-banks and to address concerns in shadow banking is ongoing at EU and international level.

With the majority of reforms agreed, the focus now moves to **effective implementation and consistent application** of the new regulatory framework. Ongoing monitoring and review is necessary to evaluate implementation and the overall impact and effectiveness of the reforms. The Staff Working Document 'Economic Review of the Financial Regulation Agenda' is a first step in this process. When completing implementation of reforms, **ensuring regulatory and supervisory convergence between all major financial centres around the world** remains a significant challenge. The Commission will continue to promote an internationally coordinated approach in the area of financial regulation and expects its partners to implement their commitments effectively.

Going forward, political attention must increasingly shift to **tackle Europe's need for long-term financing** and to **develop a more diversified financial system** with higher shares of direct capital market financing and greater involvement of institutional investors and alternative sources of finance. As set out in the March 2014 Communication on long-term financing, addressing these issues is a priority to reinforce the competitiveness of Europe's economy and industry.[38]

[38] COM(2014) 168 final