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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE EUROPEAN CENTRAL BANK

REGULATING FINANCIAL SERVICES FOR SUSTAINABLE GROWTH

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(Text with EEA relevance)

1. CONTINUING THE REFORMS

Since the beginning of the crisis in 2008, the Commission and EU governments have taken the necessary urgent action to safeguard the stability of the financial system including through substantial injections of public money into the banking sector and accompanying measures to ensure that banks consolidate their capital positions.

A safer, sounder, more transparent and more responsible financial system, working for the economy and society as a whole and able to finance the real economy, is a precondition for sustainable growth. It is the essential complement to the efforts Europe is undertaking to consolidate public finances and undertake the structural reforms that will deliver a vibrant economy in the future. A healthy financial services sector should underpin the Europe 2020 strategy, ensuring Europe's businesses, and notably SMEs, can invest for growth and its citizens can plan with confidence for the future. Regulation of financial services needs to be complemented by an ambitious reform agenda for growth, based on the internal market.

Beyond the immediate responses, the Commission has been working to complete a comprehensive financial reform to address short-termism, poor risk management and a lack of responsibility of certain actors in the financial sector and to correct the underlying weaknesses in the supervisory and regulatory framework. Significant progress has already been made, allowing Europe to lead international efforts at G20-level.

Recent market turbulence has confirmed the need to advance swiftly to complete the necessary reforms to ensure the soundness and stability of the financial system at the European and global level.

The next six to nine months will be critical.

The Commission will therefore present the vast majority of the remaining regulatory reform proposals to the Council and European Parliament by the end of the year and the last proposal will be delivered within nine months from now. According to better regulation principles, the proposals are being prepared after stakeholder consultation and impact assessments. The cumulative effects of the various measures on the financial sector as well as on the real economy must be fully taken into account. Such considerations will be fully reflected in the impact assessment and in the calibration of the various measures. In this context, the outcome of the work already underway in the Financial Stability Board and the Basel Committee on the cumulative effects of financial sector reform will be fully taken into account.

The Commission will press for the rapid adoption of these measures so that Europeans can regain full confidence in the soundness of the financial system as one of the pillars for growth.

The European Union must move forward to complete the reform agenda by the end of 2011, , not only to safeguard financial stability and investor protection, in particular through responding to the new challenges exposed in recent market developments, but also to preserve and develop the single market and resist pressure for protectionist responses at the national level.

The EU has taken a leading position in shaping the international response to the crisis. In the next six months, the G20 is scheduled to agree on the broad contours of a new global financial architecture for systemically important financial institutions, measures for crisis management and for a stronger capital framework. The EU is determined to shape this process and ensure that other key players step up to the challenge.

Measures already adopted

*The Commission responded swiftly to the financial crisis (see Annex 2 for a complete set of measures taken). In November 2008 it mandated a group chaired by Jacques de Larosière to examine possible improvements to supervision and regulation. Reacting to the situation in 2008, the **Directive on Deposit Guarantee Schemes**[1] and the **Capital Requirements Directive**[2] were revised swiftly. A regulation on **Credit Rating Agencies**[3] was adopted and the Commission has presented two **Recommendations on remuneration principles**[4]**.** In a number of areas, the EU has shown international leadership by proposing, for example, a macro-prudential risk board for the issuing of risk warnings, retention requirements for securitisation and reform of capital requirements for the trading book. The EU is committed to achieving convergence as far as international accounting standards are concerned.*

2. NEED TO COMPLETE THE WORK IN PROGRESS

The Commission was quick to respond to the recommendations of the De Larosière report, presenting a series of important legislative proposals within a matter of weeks during summer 2009. Several of these key proposals presented by the Commission are now still awaiting approval by the Council and the European Parliament.

To reform the EU's **supervisory architecture,** the Commission has proposed a **European Systemic Risk Board**[5], which will ensure that macro-prudential and macro-economic risks are detected sufficiently early, and three **European Supervisory Authorities**[6] responsible for banking, insurance and securities market, which will ensure reinforced supervision and better co-ordination among national supervisors.

A well-functioning internal market for financial services presupposes stringent, efficient and harmonised rules for all operators, coupled with an effective supervisory framework, strong, dissuasive sanctions and clear enforcement mechanisms. The proposed new supervisory architecture will provide the backbone for reinforced cooperation and a more harmonised, European supervision, allowing a holistic supervisory view, including of macro-economic

1 1994/19/EC as amended by 2009/14/EC.
2 Directive 2006/48/EC.
3 Regulation(EC) No 1060/2009 (OJ L 302, 17.11.2009, p. 1).
4 C(2009) 3159 and C(2009) 3177, both of 30.4.2009.
5 COM(2009) 499, 23.9.2009.
6 European Banking Authority - COM(2009) 501 - European Insurance and Occupational Pensions Authority (COM(2009) 502 final), European Securities and Markets Authority - COM(2009) 503 -, all dated 23.9.2009.

factors. Once up and running the new European Supervisory Authorities will be instrumental in developing technical standards, creating a real Single Rule Book.

It is now urgent to reach agreement before the summer break so that the new authorities can be up and running in 2011. The Commission is actively working to find a compromise between Council and Parliament which will respect the positions of both institutions, ensuring, however, that the new Authorities have the effective powers they need.

With regard to **alternative investment fund (including hedge funds) managers**, the proposed Directive[7] will create a comprehensive and effective regulatory and supervisory framework at the European level, providing robust and harmonised regulatory standards for all managers and enhancing transparency towards investors. It is important to reach an agreement soon, in particular with regard to the treatment of managers and funds in third countries, maintaining a level playing field whilst ensuring a high level of investor protection.

Binding rules on remuneration and enhanced capital requirements for trading book positions will come into force once there is agreement on the third revision of the **Capital Requirements Directive (CRD III)**[8]. As for the trading book requirements, a convergent global implementation is needed. To this end, the Commission is working in a constructive manner with the international key partners.

The Commission is working actively with the co-legislators to reach agreement on all of these files before the summer break.

3. FORTHCOMING PROPOSALS

The Commission will complete its full financial reform programme in the coming months, articulated around four main principles: enhanced transparency, effective supervision and enforcement (where substantial progress has already been made as set out above), enhanced resilience and financial stability, and finally strengthened responsibility and consumer protection. These principles are intrinsically interlinked and the fundamental objectives of the reforms can only be achieved if these main principles are approached together in a coherent manner. Many of the proposals listed below fulfil objectives relevant to several of the principles.

The complete set of planned measures with estimated adoption dates are set out in annex 1.

1. Enhanced transparency

Transparency is indispensible for well-functioning markets and trust and mutual confidence between market participants. The lack of transparency regarding certain transactions, products and market participants was one factor that contributed to the recent crisis. Consequently, enhancing transparency is one of the overarching objectives of the EU's financial reform. But proper and reliable information for supervisors, the investor community and the general public about the operation of financial markets and the interlinkage between different actors is one important means to promote a more stable and more sound financial system, which is less inclined to short-termism, excessive risk-taking, and pro-cyclical behaviour.

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7 COM(2009) 207.

8 COM (2009) 362.

A first Regulation **on Credit Rating Agencies**[9] **(CRAs)** was adopted in 2009 in order to respond to major weaknesses in the activities of credit rating agencies. Both regulators and credit rating agencies are preparing for implementation of these rules by 7 September 2010. The Regulation has introduced mandatory registration for all credit rating agencies operating in the EU and put in place a number of rigorous requirements to ensure that proper oversight and regulatory standards apply, diminishing conflicts of interest.

There is an emerging view in Europe and internationally that the deficiencies in the current rating processes, as exposed by the crisis, have not yet been sufficiently addressed. The lack of competition in the rating industry is a particular concern. Without favouring any particular option at this stage, the Commission is examining structural solutions including the need for an independent European credit rating agency or stronger involvement of independent public entities in the issuing of ratings.

Specific attention is needed with regard to sovereign debt so as to ensure that the methods used are appropriate. The lack of due diligence by banks and other financial institutions and the lack of alternative "benchmarks" in order to assess investment reliability also merit particular attention. The current regulatory structure in which credit ratings are embedded in financial regulation needs thorough review.

The Commission will present its conclusions on all these issues in September.

In the summer, the Commission will propose legislation to improve the functioning of **Derivatives Markets.** This will be instrumental in increasing transparency on a market which is important but currently very opaque. The proposal will strengthen the EU's financial market infrastructure, promote the standardisation of derivatives contracts and develop central clearing parties for derivative contracts to substantially reduce risk. It will provide access to information in trade repositories about all kinds of transactions for all European supervisory authorities.

Moreover, the Commission will propose improvements to the **Markets in Financial Instruments Directive** (MiFID)[10] in order to strengthen pre- and post-trade market transparency and bring more derivatives onto organised trading venues.

2. Effective supervision and enforcement

The proposed new supervisory architecture referred to above is one crucial step towards improved and more effective supervision. However supervision must be ensured through effective enforcement mechanisms, including where needed sanctions to promote responsible market behaviour and where appropriate to tackle irresponsible and excessive speculation.

On 2 June, the Commission proposed a revision of the **Credit Rating Agencies Regulation**[11] to introduce centralised EU oversight of credit rating agencies, entrusting the European Securities and Markets Authority (ESMA) with exclusive supervisory powers over credit rating agencies registered in the EU.

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9 Regulation (EC) No 1060/2009 (OJ L 302, 17.11.2009, p. 1).

10 Directive 2004/39/EC, (OJ L 145, 30.4.2004, p. 1), as amended by Directives 2006/31/EC 2007/44/EC and 2008/10/EC.

11 Regulation (EC) No 1060/2009 (OJ L 302, 17.11.2009, p. 1).

Whilst the deterrent effect of sanctions is a necessary part of the good functioning of any sector, sanctions in the financial sector are largely unharmonised, leading to diverging practices among national supervisors. The Commission will tackle this issue through a thorough revision of existing sanctioning powers and their practical application. As a first step, the Commission will present a **Communication on sanctions in the financial services sector** to promote convergence of sanctions across the range of supervisory activities.

3. Enhanced resilience and stability of the financial sector

Enhancing resilience and stability is a holistic exercise that must be done through a number of complementary measures. Improved resilience starts with higher capital standards and must be coupled with increased transparency rules, reinforced supervision and enforcement. It also requires a significantly improved risk culture and corporate governance at all levels of a company. As a last piece of the puzzle, a complete set of tools on crisis prevention and management needs to be in place.

Following intensive work in the Financial Stability Board (FSB), the G20 and the Basel Committee, amendments to the **Capital Requirements Directive**[12] **(CRD IV)** will be proposed by the Commission in order to improve the quality and quantity of capital held by banks, introduce capital buffers and ensure the build up of capital in good times which may be drawn on in more adverse economic conditions. The directive will also address excessive reliance on leverage and introduce an effective liquidity regime. The proposal for legislation on derivatives referred to already will also strengthen resilience though robust requirements for Central Counterparties that clear OTC derivatives.

The recent crisis has shown that crisis prevention has to start inside companies, involve more active and responsible shareholders and managers and rely on reinforced internal control systems[13]..

A comprehensive crisis management framework has to be in place when other lines of defence have proved insufficient. In October the Commission will publish an action plan on **crisis management** leading to legislative proposals for a complete set of tools for prevention and resolution of failing banks. This will ensure that public authorities are able to resolve failing financial institutions whilst minimising the impact of failures on the financial system, limiting damage to the economy and the use of public sector resources. A Communication on options for bank resolution funds, in order to finance resolution of banks, was presented by the Commission on 26 May[14].

Finally, the Commission will continue to work towards global convergence around one set of high quality international **accounting standards** as a fundamental building block for enhanced financial stability.

4. Strengthened responsibility and consumer protection:

One major lesson to be drawn from recent market developments is the need to restore the confidence of consumers and investors in financial markets by taking firm action against

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12 Directive 2006/48/EC.

13 To this end, the Commission is adopting, simultaneously with this Communication, a Green Paper on Corporate Governance in financial institutions and remuneration policy, launching a consultation on a wide range of corporate governance and remuneration issues.

14 COM(2010) 254.

those actors who abuse the system. The regulatory framework must provide the right incentives to curtail excessive speculative and risky behaviour and make sure that the financial services sector works for the benefit of citizens and the real economy.

The Commission will propose appropriate **measures on short selling and credit default swaps** based on the findings of the ongoing detailed investigation, which will provide a comprehensive insight into the functioning of financial markets with particular reference to sovereign debt. The measures will also address 'naked' short selling. The Commission will propose solutions to give the EU the means for a coordinated response to events such as excessive speculative use of the CDS market. This should include emergency powers for regulators (to be coordinated in the future by ESMA).

In the context of enhanced market stability and integrity, the **Market Abuse Directive**[15] will be revised in order to extend its rules beyond regulated markets and to include derivatives in its scope of application.

As one fundamental step to restore consumer confidence, the Commission will propose a revision of the **Deposit Guarantee Schemes Directive**[16], on the basis of the Report required by this Directive, to ensure further harmonisation of the rules to ensure effective protection for depositors throughout the EU. In parallel, the **Investor Compensation Schemes Directive**[17] **will be revised** to increase protection of investors. In the insurance sector, a **White Paper on Insurance Compensation Schemes** will examine the possibility of introducing European rules protecting insurance policy holders in case of a failing insurance company.

Legislative proposals on **packaged retail investment products** will be presented to promote consumers' interests in the sales process. The Commission will also propose changes to the legislation applicable to the **UCITS depositaries function** in response to the Madoff fraud, which revealed the need to further harmonise certain aspects of the level of protection offered to UCITS investors.

4. CONCLUSIONS AND NEXT STEPS

The speedy conclusion of the financial services reform process is a key pillar of building future European growth, and an essential complement to fiscal consolidation and structural changes. By next spring the Commission will have proposed all the necessary elements for a fundamental improvement of the way Europe's financial markets are regulated and supervised.

Implementation of these measures will be carefully calibrated in order to avoid restricting economic growth, which is now returning to Europe, and to avoid pro-cyclical effects. Appropriate impact assessments will be carried out to this end. Co-ordination with the EU's major international partners, some of which are also introducing fundamental reforms, will be key. International regulatory convergence, including in accounting rules, will help improve confidence in markets, and divergences can hinder recovery. The G20 has a key role to play in this respect.

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15 Directive 2003/6/EC.
16 Directive 94/19/EC as amended by Dir 2009/14/EC.
17 Directive 1997/9/EC.

The Commission calls for strong political commitment from the **Council and the European Parliament** to give top priority to agreeing on the **priorities, timing and delivery** of these reform measures**.** The Commission also looks to the financial services industry to continue to contribute actively and constructively to shaping the reforms. **The last piece of legislation should be adopted by the end of 2011 at the latest, allowing for implementation in national law by the end of 2012.**

ANNEX 1: FULL LIST OF INITIATIVES WITH KEY DATES FOR COMMISSION ADOPTION AND COMMISSION PROPOSALS FOR ENDORSEMENT BY THE COUNCIL AND EUROPEAN PARLIAMENT

Initiatives	Commission adoption	Political agreement
Measures proposed , under negotiation:		
Alternative Investment Fund Managers Directive	April 2009	Summer 2010
3rd Revision of the Capital Requirements Directive (CRD3)	July 2009	Summer 2010
Supervision package (European Systemic Risk Board and European Supervisory Authorities)	September 2009	Summer 2010
Communication on options for bank resolution funds	May 2010	n/a
Forthcoming proposals:		
UCITS – implementing measures	June 2010	June 2010
Revision of Credit Rating Agencies Regulation (EU-level supervision of CRAs)	June 2010	By end 2011
Green Paper on Corporate Governance in Financial Institutions	June 2010	By end 2011
Creation of a Financial Services Users Group	Summer 2010	n/a
Revision of the Deposit Guarantee Schemes Directive	July 2010	By end 2011
White Paper on Insurance Guarantee Schemes	July 2010	n/a
Revision of the Investor Compensation Schemes Directive	July 2010	By end 2011
Derivatives – legislation on market infrastructure	Summer 2010	By end 2011
Revision of the Financial Conglomerate Directive	Summer 2010	By end 2011
Second "Omnibus" Directive of changes to sectoral legislation to align it with the proposals on supervision	Summer 2010	By end 2010
Directive on legal certainty of securities holding & transactions	September 2010	By end 2011
Regulation on SEPA (Single European Payments Area), setting a deadline for transition to SEPA	September 2010	By end 2011
Communication on a framework for crisis management	October 2010	n/a
Measures on short selling/credit default swaps	October 2010	By end 2011
Initiative on access to minimum basic banking services	October/November 2010	By end 2011

Communication on sanctions in the financial services sector	December 2010	n/a
Revision of the Capital Requirements Directive (CRD4)	December 2010	By end 2011
Revision of the Market Abuse Directive (securities)	December 2010	By end 2011
Review of the Markets in Financial Instruments Directive	Spring 2011	By end 2011
UCITS – depositories function	Spring 2011	By end 2011
Implementing measures for Solvency II Directive on capital requirements for insurance undertakings	Spring 2011	By end 2011
Packaged Retail Investment Products legislative proposals	Spring 2011	By end 2011
Crisis management legislative proposal (including bank resolution funds)	Spring 2011	By end 2011
Insurance mediation Directive revision	Spring 2011	By end 2011
Further amendments to the Credit Rating Agencies Regulation	Spring 2011	By end 2011
Legislation on corporate governance	Spring 2011	By end 2011

ANNEX 2: MEASURES PROPOSED/ADOPTED TO DATE

Initiative	Commission adoption	Status
Solvency II Directive (capital requirements for insurance undertakings)	July 2007	Adopted December 2009
Amendment of the Settlement Finality Directive and the financial collateral directive (securities)	April 2008	Adopted May 2009
Recast of the UCITS Directive	July 2008	Adopted July 2009
2nd revision of the Capital Requirements Directive for banks– amendments to securitisation rules, large exposure limits, supervisory colleges, liquidity risk management and quality of capital.	October 2008	Adopted May 2009
Deposit Guarantee Schemes Directive amendment	October 2008	Adopted March 2009
Credit Rating Agencies Regulation	October 2008	Adopted September 2009
Communication on remuneration principles	April 2009	See annex 2 for next steps
Financial literacy – Dolceta on-line education programme, new modules	n/a	Launched April 2010
Communication on Packaged Retail Investment Products (PRIPS)	April 2009	Legislative proposals forthcoming
Alternative Investment Fund Manangers Directive	April 2009	Co-decision underway
3rd revision of the Capital Requirements Directive for banks – capital requirements for the trading book and re-securitisations, disclosure of securitisation exposures, and remuneration policies	July 2009	Co-decision underway
Supervision package (European Systemic Risk Board and European Supervisory Authorities)	September 2009	Co-decision underway
Prospectus Directive amendments (securities)	September 2009	Co-decision underway
Communication on Crisis Management in the Banking Sector	October 2009	Further Communication in autumn 2010 and legislative proposal in Spring 2011
Communication on Derivatives	July & October 2009	Legislative proposal forthcoming