European Commission
Directorate-General for the Internal Market and Services

The European Union's roadmap for Financial Reform

Under the political authority of Commissioner Michel Barnier

Introduction

Europe, like many other parts of the world, is currently experiencing the fall-out of the worst financial crisis since the 1929 crash.

The downturn is severely affecting national economies, banks, companies and individual households alike. But it has also triggered an unprecedented response, as the world's 20 major economies pledge to work together to tackle the causes of the crisis. Its roots lie mainly in a collective failure by financial institutions to fulfil their basic mission of serving the real economy by funding companies and their projects.

Instead, many focused on short-term profit. Irresponsible risk-taking was overtly rewarded. Today's liquidity and solvency problems also stem from a moral crisis. To meet these challenges and place Europe's economy back on track, more comprehensive rules, covering the entire scope of financial activities, are needed. The EU has a clear roadmap: implementing the G20 commitments on financial reform. This brochure provides an overview of the legislative measures the European Commission is proposing to the European Parliament and Council of Ministers to prevent any repetition of the present economic and financial crisis. This reform programme is based on four key principles: transparency, responsibility, supervision and crisis prevention and management.

"Changes are needed. We cannot exit the crisis the same way as we entered it. I am certain that we are in a critical period — one in which history will tip one way or the other. One in which we decide whether or not to learn the lessons of the past and choose what kind of financial stability we want to build. Europe must take action to end the lack of transparency and misjudgement of risks, to avert future crises, and remain a world leader in financial services. This is a moment of truth. Together – we can get this right. But it needs everyone's participation. And commitment."

Michel Barnier
Commissioner for Internal Market and Services.

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Transparency

For too long, complexity was an excuse for a lack of transparency, which itself was a major factor in market instability. The crisis has shown that no financial player, market or product should be exempt from appropriate regulation and supervision. Current rules should be strengthened to ensure proper and reliable information is provided to supervisors, investors and the general public on the way financial markets operate. Regulators should also have the appropriate tools to ensure the oversight of the sector. The following initiatives aim to achieve this.

- **AIFM Directive proposal**

Alternative Investment Fund Managers (AIFM) encompass hedge funds or private equity firms that raise finance to invest in operating companies according to more or less risky or high-yield investment strategies. They can be largely beneficial for the markets in which they operate. Yet, their activities may also spread and increase risk throughout the financial system. To prevent this, the Commission wants to ensure common rules are in place to monitor the potential risks for investors, counterparties, other market participants and overall financial stability. Alternative investment fund managers will have to comply with a comprehensive set of criteria before being granted access to EU markets.

- **Derivatives and short-selling**

A derivative is a financial contract between two parties linked to the future value or status of the underlying to which it refers (e.g. the development of interest rates, or of a currency value, or the possible bankruptcy of a debtor). They come in many different kinds and include credit default swaps (CDS) that cover the purchaser if a specific debtor or credit instrument defaults.

Short selling involves selling assets, such as derivatives, that have been borrowed from a third party with the aim of later repurchasing identical assets to return to the lender. If the underlying asset falls in value during this process, the investor makes a profit. While this practice can bring liquidity to markets, it also entails risks. The Commission intends to propose increased transparency to derivative markets and giving regulators more and harmonized powers to limit those risks that can affect the whole financial system.

The Commission is therefore proposing that standard derivative contracts are cleared through central clearing parties (CCPs) to reduce the risk if one party defaults. In addition, information on all European transactions should be reported to trade repositories and be accessible to supervisory authorities.

- **Markets in Financial Instruments Directive (MiFID)**

The Markets in Financial Instruments Directive was adopted in 2004 to increase competition and consumer protection in investment services. The Commission now wants to go a step further by ensuring more transparency in the trading of financial instruments (what price was paid for which asset and when) and better consolidation of market and trading data. This will allow regulators and market participants, such as investors, issuers of securities or investment firms, to have a more accurate overview of the way different instruments trade across Europe.

Responsibility

Consumer and investor confidence in the financial system cannot be restored without tough action against market abuses. Stiffer penalties should ensure financial services providers bear full responsibility for their behaviour. Responsible practices ex ante are also key to preventing short-termism and excessive risk-taking. Corporate governance can help achieve this. The following reforms will further entrench the principle of responsibility into the EU regulatory framework.

- **Prevention of Market abuse**

The Market Abuse Directive will be revised to ensure that those tempted to engage in insider dealing and market manipulation are deterred from doing so by the threat of effective investigations and severe sanctions. The Commission is proposing to increase the powers of regulators to investigate and penalise market abuse, by, for instance, setting a minimum amount for administrative fines. These could be twice as high as any illegally obtained gain.

The review will close regulatory gaps which have arisen due to changes in the financial landscape since the legislation was adopted. In particular, its scope could be extended to include over-the-counter (OTC) derivatives or financial instruments only admitted to trading on Multilateral Trading Facilities (alternative trading exchanges that provide an additional pool of liquidity for their members).

- **Corporate governance**

The Commission plans to improve an area where significant weaknesses came to light when the financial crisis struck. Firstly, it is aiming for better supervision of senior management by the boards of financial institutions. This would involve limiting the number of mandates board members may hold, improving the fit and proper test to require more expertise for specific issues such as risk management, or mandating supervisors to conduct interviews with board members to check they are sufficiently independent to challenge management effectively.

It also wants to strengthen the risk culture at all levels of a financial institution, taking full account of a business' long-term interests, by giving more authority and independence to Chief Risk Officers. They should have the same standing as the Chief Financial Officer and be able to report directly to the board. In addition, a risk committee would be established at board level to deal with risk issues and monitor correct implementation of the risk strategy throughout the institution.

It is equally important to increase the involvement of shareholders in corporate governance matters by, for instance, disclosure of voting policies and practices of institutional investors, and also of external auditors and financial supervisors. The latter could attend board meetings and so exercise more control over risk taking.

Remuneration policies are key to giving staff and management the right incentives for sound risk management and discouraging excessive risk taking. In July 2010, the EU agreed on new legislation that not more than 50% of a bonus is to be paid out in cash and that at least 40% of the bonus must be deferred over a period of three years at minimum. The new rules apply to management and risk taking staff at banks and investment firms. The Commission is looking for similar requirements for other financial institutions and insurance companies. Non-financial companies were included in a Commission Recommendation that is prompting consideration of the treatment of directors of all listed companies.

Supervision

In a majority of EU countries, more than half the banks are foreign owned. The crisis exposed the coordination shortcomings between national supervisors. It is, therefore, necessary to step up supervision at an EU level in order to detect irresponsible market behaviour and take appropriate action at an early stage. Strengthening the supervisory framework is essential since this determines the success of many of the other measures being taken.

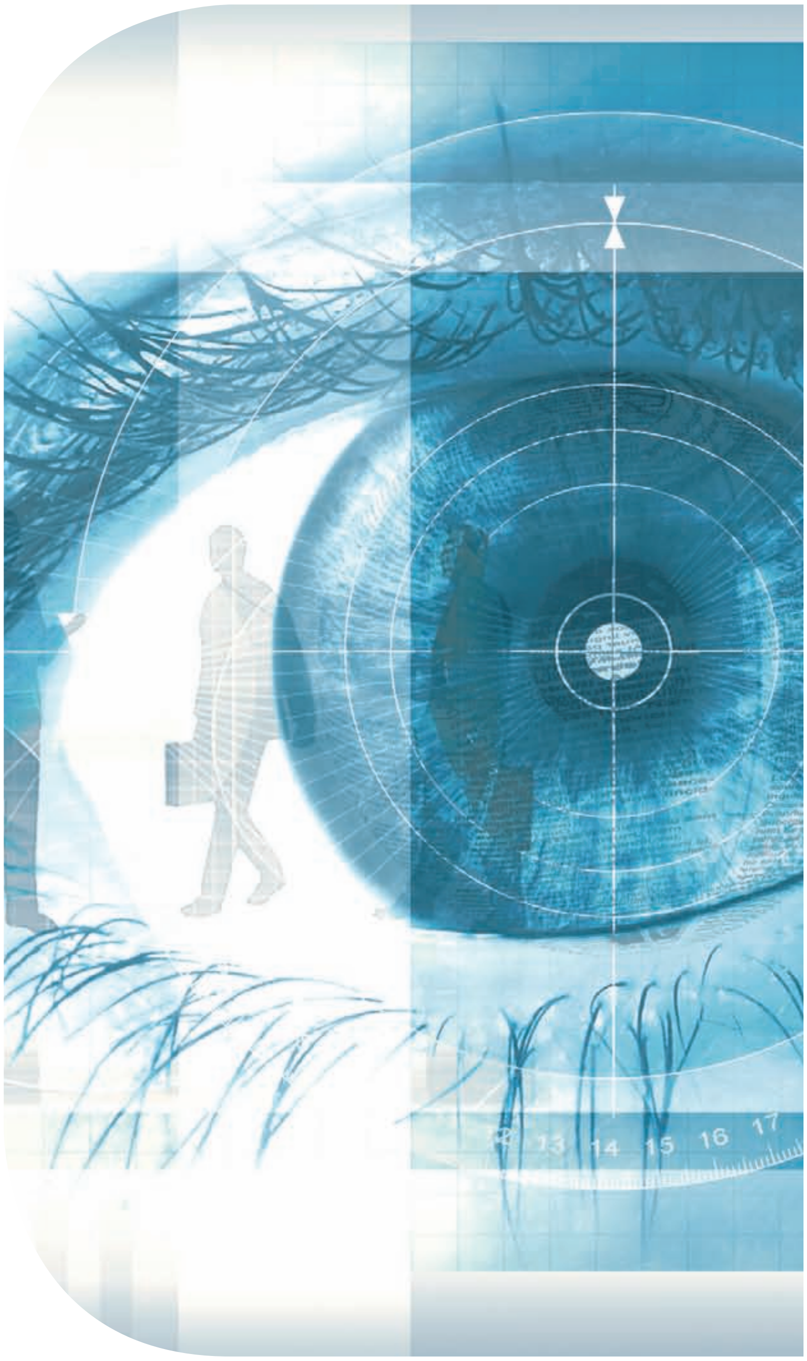
- **European supervisory framework**

The new framework, to be in place in early 2011, consists of a new European Systemic Risk Board to ensure that macro-economic risks are detected sufficiently early, and three sectoral European supervisory authorities: a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA). These authorities have a key role in establishing a genuine 'Single Rule Book'.

- **Credit rating agencies**

Credit rating agencies (CRAs) issue opinions on the creditworthiness of companies, governments and sophisticated financial structures. Since 2009, CRAs have had to register and comply with several rigorous requirements on oversight and regulatory standards to diminish conflicts of interest. However, recent developments have shown the need for additional measures, especially on the impact of ratings on users outside a particular jurisdiction, to improve the way the CRA sector works in practice.

The Commission is, therefore, proposing to increase EU supervision of CRAs by requiring them to register with the ESMA. The authority will have exclusive supervisory powers over the agencies and be able to request information, launch investigations and perform on-site inspections. In addition, issuers of structured financial instruments – a pre-packaged investment strategy based on derivatives – would have to provide all interested CRAs with access to the information they have given to the one they have chosen to issue a rating. This will make unsolicited ratings possible. The Commission will review the functioning of CRAs and, if need be, propose additional measures.



Crisis prevention and management

The Commission wants to prevent any future crisis turning into a real catastrophe. To this end, a culture of prévoyance, or foresight, has to be entrenched in the financial system. The following initiatives aim to achieve this.

- **Capital Requirements Directive (CRD)**

In order to improve the quality and quantity of capital held by banks and to avoid having to rely on taxpayers' money again, the Commission is proposing to introduce an effective liquidity system of 'capital buffers' that may be drawn on in bad times, and to tackle excessive reliance on leverage.

- **Accounting standards**

The Union is working to reach a global agreement on accounting standards that would not destabilise sound businesses by intensifying economic trends, while guaranteeing an accurate view of finances. This is the EU's main concern with the 'fair value' concept.

It will ensure that accounting standards, which are primarily intended to provide useful information to users for their decisions, better reflect the fundamental value of a company. This will link in with other public policy objectives, including prudential regulation and financial stability.

- **Resolution funds**

The orderly winding up of a bank comes at a high cost. This stems from the various measures, such as total or partial transfer of assets or liabilities, to keep the viable part operational (in a 'good bank') while managing the rest (in a 'bad bank') in the best possible way.

There is no reason for such costs to be borne by taxpayers. Therefore, the Commission is proposing to establish an EU network of pre-financed bank resolution funds. These will all have the same essential features and be sufficiently financed to cover the failure of an average sized bank. This is not an insurance policy for banks to be used for bailouts, but is designed to ensure that a bank's failure is well managed and does not destabilise the financial system. No bank should be too big to fail.

- **Consumer confidence**

The most visible effect of a bank failure is on depositors. The Commission is proposing to review the Deposit Guarantee Schemes Directive to increase protection for depositors throughout the EU in the event their bank fails. The aim is to ensure that every bank in Europe guarantees up to EUR 100,000 to all depositors.

The Commission also wants to overhaul the Investor Compensation Scheme Directive to better protect investors up to EUR 50,000, not against normal, investment-related risk, but against any fraudulent misappropriation.

Attention is also being given to ways to improve the insurance guarantee scheme.

Regulating Financial Services for Sustainable Growth

A table with initiatives taken, initiatives proposed and future initiatives.
The European Commission is committed to introducing all future initiatives below by spring 2011. The last piece of legislation should be adopted by the European Parliament and the EU Member States by the end of 2011 at the latest, allowing for implementation into national law by the end of 2012.

Transparency	**Initiatives taken:** Undertakings for Collective Investments in Transferable Securities (UCITS) implementing measures **Initiatives proposed:** Alternative Investment Fund Managers (AIFM) Directive **Future Initiatives:** Measures on short selling and credit default swaps including ‘naked short-selling’. Derivatives – legislation on market infrastructure UCITS depository function Revision of the Insurance Mediation Directive Regulation on Single European Payments Area (SEPA) Initiative on access to minimum basic banking services Proposals for improvements to the Markets in Financial Instruments Directive (MiFID) Amendment of the Settlement Finality Directive and the Financial Collateral Directive (securities)
Responsibility	**Initiatives taken:** Third revision of the Capital Requirements Directive (CRD3) - including amendments to securitisation rules, large exposure limits, supervisory colleges, liquidity risk management and quality of capital 2009 & 2010 White Paper on Insurance Guarantee Schemes Solvency II Directive (capital requirements for insurance undertakings) **Initiatives proposed:** Proposal for a revision of the Deposit Guarantee Schemes Directive and the Investor Compensation Schemes Directive to restore investor and consumer confidence. **Future Initiatives:** Fourth revision of the Capital Requirements Directive (CRD4) Review of the Market Abuse Directive Directive on legal certainty of securities holding & transactions- Review of the Prospectus Directive Communication on Sanctions in the Financial Services Sector
Supervision	**Initiatives proposed:** Financial Supervision Package Regulation on the supervision of Credit Rating Agencies Packaged Retail Investment Products legislative proposal **Future Initiatives:** Directive specifying the competences of the European Supervisory Authorities (Omnibus II Directive)
Crisis prevention and management	**Initiatives taken:** Green Paper on Corporate Governance in Financial Institutions Communication on options for Bank Resolution Funds **Future Initiatives:** Communication on Framework for Crisis Management Legislation on Reforming Corporate Governance Legislative proposal on Crisis Management Revision of the Financial Conglomerate Directive

Table as of 30 July 2010. For more information and the latest state of play on these and other financial reform proposals:
http://ec.europa.eu/internal_market or contact the European Commission by sending an e-mail to **markt-info@ec.europa.eu**

The way forward

The European Commission is determined to deliver on the commitments the EU made at the London and Pittsburgh G20 summits in 2009. The Union's position will be substantially strengthened if it is able to demonstrate that it has done its own homework on regulation, supervision, banking reform and speculation. Only then will it be possible to create a level-playing field globally. It is also essential that all G20 countries press ahead with their own reforms to avoid the kind of regulatory arbitrage that was part of the vicious circle leading up to the crisis.

Once this is achieved, the financial sector will be placed on a new, sounder and more responsible footing. It will be at the service of the real economy, fulfilling its mission of enabling citizens and businesses to borrow, invest and ultimately create the growth and jobs that Europeans need and deserve.

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