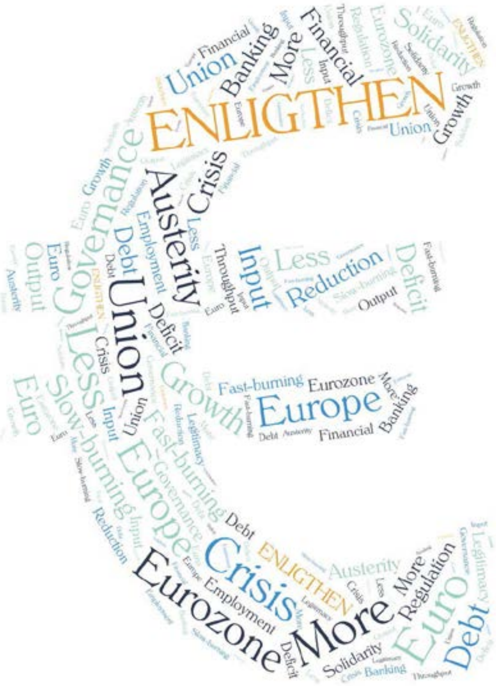
Round-Table 3 / WORK PACKAGE 1

EUROPEAN GOVERNANCE & THE TWIN NECESSITIES OF
The LEGITIMACY OF THE EUROPEAN UNION'S MODES OF GOVERNANCE AFTER THE CRISIS: IMPERATIVES, PROCESSES & RESULTS



TECHNICAL

BACKGROUND NOTE

Finance Watch
Making finance serve society

PART I – POLICY ENVIRONMENT

Introduction

In the aftermath of the 2007-2008 financial crisis, a 'Call for a Finance Watch' was launched in 2010 leading to the creation of an association called Finance Watch (FW) in June 2011. The first hires took place shortly thereafter and the Secretariat was operational in the autumn of 2011, with a mission to analyze financial legislation proposals from a public interest perspective and lobby the European (EU) institutions and beyond with the resulting recommendations. The history and activities of FW directly relate to the (lack of) legitimacy of the EU legislative process, in particular when it comes to finance. It was recognized by politicians and civil servants (including at national level) that in this field there was simply no counterweight to the (legitimate) private interest lobbying – while such counterweight has existed for decades in fields such as employment (e.g. trade unions) and environmental law (e.g. Greenpeace, WWF) or in that of development policy (e.g. Eurodad, Oxfam, Global Justice Now!), to name but a few.

In this first part we list a few reflections related to the post-crisis financial reform agenda and the related policy process. These reflections do not constitute official FW positions; they aim at feeding a thought-provoking discussion. Moreover, we do not pretend to have an answer to every issue raised, quite the contrary: we think these issues would deserve an in-depth analysis.

1. The historical roots of the crisis

The depth of the financial crisis and the trauma of an imminent collapse of the entire system could have triggered a fundamental questioning of the origins of the crisis and the future of the financial system. The G20 clearly failed to do that, issuing general calls to end an 'era of irresponsibility' and to rein in 'the [financial] excesses that led to the crisis'. It could be argued that irresponsible bankers or the sector's excesses should not be blamed for the crisis: they only made the most of the opportunities opened by twenty years of liberalization and deregulation (culminating in the late 90's). European and National politicians and civil servants are responsible for legislation that opened markets and removed many barriers that, while restricting investment opportunities, avoided a major financial crisis for more than thirty years after WWII. This led, in turn, to a well-documented financialization of the economy – with, for example, total assets of EU banks nearly doubling just between 2001 (below €25 Tr) and 2011 (near €45Tr), and still at that level end of 2014.

From our experience and contrary to popular belief, the underlying paradigm that supported and justified the liberalization and deregulation of the financial system (and the resulting financialization of the economy) is still very much framing discussions and policy options. Such paradigm can be described approximately as follows: "the effectiveness of the financial sector in serving the economy and society is inversely proportionate to the level of financial regulation". In that spirit, the sector is currently demanding that post-crisis rules (though most have yet to be implemented) be softened if it is to contribute to stimulating growth.

To summarize our point, we believe that the crisis should have led to a full-fledged impact assessment of more than twenty years of financial liberalization and deregulation from a public interest perspective, as a basis for the discussions around the post-crisis financial reform agenda. This assessment would still be extremely valuable today and would benefit from a comparative perspective with the regulatory system put in place following the financial crisis of 1929.

Instead, the financial industry asking (see letter dated 3 October 2014) for a cumulative impact assessment of the various pieces of EU financial legislation adopted following the crisis – even though most of it has yet to come into force…

2. The immediate response to the crisis

It is widely agreed that governments were forced to intervene on a massive scale to rescue financial institutions to avoid a collapse of the entire financial system. Bail-out programs were designed differently in the US and the EU. In general, little was demanded to financial institutions in exchange for the bailouts – in contrast with, for example, the model applied by Sweden following its 1992 banking crisis (banks had to issue ownership interest to the government in exchange for the bailouts).
In the US, the Federal Reserve initiated a Quantitative Easing program as early as November 2008, in addition to its bailout program. The European Central Bank was slower to go down that route. It is far from obvious that this choice to channel cheap money to banks rather than directly investing in the economy leads to optimal results. Some would argue that it could further feed the growth of the financial sector and lead to bubbles similar to the ones that led to the 2007-2008 crisis. In any case, given the risks (and expected benefits) at stake, this policy option would deserve a proper debate.

3. The post-crisis policy response

To help structure the discussion, we will use the following categories to characterize steps in the legislative process (see our webinars on the EU legislative process – 31.05.13 – and on the level 2 process – 02.04.15):
-**Level 0:** every discussion and debate that shape the legislative agenda (future legislative proposals) – following the crisis, this process mostly took place at international level (G20 and supranational bodies such as BIS, IOSCO etc.)
-**Level 1:** the EU legislative process itself – from informal and formal consultation by the Commission in the process of drafting legislation to a final compromise between the Parliament and the Council, voted by both institutions. The output of level 1 is a law – directive or regulation.
-**Level 2:** the translation of level 1 articles of Law into more granular, technical rules. EU laws give a mandate to the Commission or Supervisory Authorities (in finance: EBA, ESMA and EIOPA) to produce delegated acts or technical standards that further specify thresholds, levels and formulas applicable to the level 1 text.
-**Level 3**: coordination between national authorities in applying the law
These categories refer to the Lamfalussy process.

As mentioned above, the most important element of the post-crisis policy response is the initial framing (i.e. **level 0**). It is at that level that key financial industry stakeholders, directly consulted by their Ministries of Finance in preparation for G20 summits (when they are not directly part of the national delegation) managed, for example, to put the focus on the transparency and security (or risk-management) aspects of global derivatives markets while excluding the much more obvious question: what is the rationale and social benefit for that market (measured in notional amounts outstanding) to be more than ten times the size of the global economy (measured in GDP), when the vast majority of those contracts do not involve a non-financial counterparty?

In a few words, this is a summary of our experience with the different levels:
-**Level 0**: opaque, informal, strongest imbalance in terms of interest representation
-**Level 1**: rather transparent and open (more on the Commission and EP side than at the level of the Council) – importantly, it still requires significant resources to get involved in the process
-**Level 2**: difficult for civil society or any non-industry party to engage because discussions become very technical
-**Level 3**: if there is still attention on the file, opportunity to engage for national stakeholders

PART II – KEY POLICY CONCERNS

-The G20 financial reform agenda did not set the proper level of ambition: it should not have been limited to building embankments attempting to protect citizens in case of a future tsunami of financial losses – the primary focus should have been the nature and size/volume of the activities, i.e. the outcome of deregulation and financialization. Are these activities worth the risks involved in the first place?
-The G20 financial reform agenda is far from being implemented, let alone in a harmonized manner across jurisdictions
-Capital requirements as set by Basel III rely too much on banks' internal models (amongst other problems), raising serious doubts as to their effectiveness to absorb potential losses.
-Banking Union in its current form will fail to prevent European citizens from bearing the losses of failed banks in the event of a systemic banking crisis
-Too-big-to-fail has not been addressed, to the detriment of most stakeholders. While the objectives set by the Commission for its proposed legislation on Banking Structure (see Article 1, p.22) are appropriate, the current negotiations are likely to fail to deliver the measures required to reach those objectives.

PART III – PREVALENT POLICY OBSTACLES

-There was a clear **shift in EU political momentum** from stability to growth and jobs: industry lobbies are seizing the opportunity to push forward a deregulation agenda – putting all their weight behind what has been branded as 'better' and 'smarter' regulation (civil society is getting organized to watch related developments).
-While **finance is global**, regulation and supervision are regional at best (supervision is still national!)
-There is still a strong imbalance in interest representation when it comes to financial reform