Lecture 4: Fundamentals of EU financial regulation.

After considering the first and the second feature of financial regulation, which are the fact that financial regulation is special and that it is delegated by the Parliament to independent administrative agencies, now we address the third feature of financial regulation that is the fact that financial regulation is based on EU laws.

What is the European Union and how it works?

The European Union (EU) is a unique international organisation. It is unique because, on one hand it shares the features of international organisations, and on the other hand it has very specific characteristics which make the EU more similar to federal states than to international organisations. As any other international organisations, the EU is an organization in which Member States remain independent and sovereign nations. At the same time, in the EU the Member States, at least in part, pool their sovereignty in areas of common interest (a feature typical of federal states):

a) by delegating part of their sovereignty to a third Entity, which is the EU made of independent appointed officials or representatives elected by people of Member States, in a process which is technically called *supranationalism*

b) by taking decisions among themselves, either by majority vote or by unanimity, approach, which is more similar to international organisation, called *intergovernalism*

This mix of supranationalism and intergovernalism is reached through the concept of competence, an idea that can be found all over the institutional framework of the EU. Competence defines what the EU can do and the perimeter of the competence of the EU is set forth by a specific agreement among the Member States. This agreement is called “the Treaties” and it is characterized by the presence of two different treaties joint together:

1) the Treaty on European Union (TEU), which is the Treaty on the very basics of the EU

2) the Treaty on the Functioning of the European Union (TFEU), which is the Treaty establishing the actual structure and the organisational processes of the EU.

The EU competences.

The competences of the EU present some limits. The limits of EU competences are governed by the principle of conferral, which is stated at art. 5(2) of the TEU. Under this principle, “*the EU may act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. Competences not conferred upon the EU remain with the Member states*”. In other words, the perimeter of the powers of the EU competences is the perimeter defined in the Treaties, and the competences of EU are exceptions to the general rule that Member States are sovereign.

The competences of EU, which are identified through the principle of conferral, may be organised in two main groups.

1) The first and the smaller group is identified by *exclusive competences*.

   When the EU has exclusive competences referred to a specific field, the EU only may legislate and adopt legally binding acts in that matter, and the Member States cannot do anything unless

the EU empowered them to do so, or otherwise Member States are required to implement the EU acts. For example, competition across the EU is a matter of exclusive competence of the EU. Therefore, if there is a problem in competition (for example the existence of a cartel, or some abuse, or dominant position) across the EU, the only international entity competent to deal with that is the EU. Another example of exclusive competence is represented by monetary policy, obviously for the Member States whose currency is the euro. In this case, the only competent authority who decides monetary policy is the EU, and more specifically the European Central Bank. Single Member States do not have any power about monetary policy.

2) The second main group is identified by *shared competences*.

   With shared competences, both the EU and the Member States are competent in a specific field. Both the EU and the Member States may legislate and adopt legally binding acts, but the Member States may exercise their competence only if the EU has not done so or has ceased to do so. The most important example of shared competence is the regulation of the internal market or consumer protection.

The shared competences of EU are not illimited as the exclusive competences but find a limit in two very important principles. And in the specific, the use of EU shared competences is governed by the principles of subsidiarity and proportionality.

Under the principle of subsidiarity, the EU may act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, but can better achieved at EU level, either because of the scale or the effects of the proposed action. In more simple terms, the principle of subsidiarity means that if it possible that something is done my Member States let Member States do it. The EU may intervene only if Members States are unable to get a certain result in that field and this result can be better achieved at EU level.

Under the principle of proportionality, the content and form of EU action may not exceed what is necessary to achieve the objectives of the Treaties. In more simple terms, the principle of proportionality says that the EU should do only what is necessary to achieve a certain result and nothing more. The less the EU can do, the better.

If you think about this idea of shared competences being the rule, and the exclusive competences being the exceptions, or if you think about these two limits, you can understand the uniqueness of the EU. And in effect, the EU tends to be still an international organization where the features of a federal state are very constraint.

The EU's governance.

The EU governance is organized by the Treaties around an institutional framework, where each institution acts within the limits of the powers conferred on it in the Treaties, and in conformity with the procedures, conditions, and objectives set out in them.
As far as law-making and interpretation are concerned, we have four institutions involved:

1) the *Council.*

   The Council is the institution within the EU reflecting the interests of Member States. It consists of a representative for each Member States at ministerial level and meets in different compositions depending on the policy area being addressed. So, for example, when an

economic matter is involved the Council meets with the ministers of finance (EcoFin); when the area is agriculture, the Council meets with the ministers of agriculture and so on.
The Council acts by a qualified majority, except where the Treaties provide otherwise.
So, the Council is basically within the EU the institution representing the Member States and it is the place where are taken the political decisions.

2) the *European Parliament*.

The European Parliament is the institution representing the EU citizens. It consists of a number of members elected by direct universal suffrage. It acts by a majority of the votes cast, save as otherwise provided in the Treaties.
So, the European Parliament reflects directly not the interests of the single Member States, but the EU citizens an all, and therefore in the European Parliament what counts are the parties (left-wing, right-wing, and centre parties).

3) the *European Commission*.

The European Commission is the engine of the EU. It promotes the general interest of the EU, taking all the appropriate initiative to that end. It is composed by one national of each Member State chosen by the Council on the ground of general competence and European commitment, and whose independence is beyond doubt. In other words, even though each Member State has a component in the Commission, this component is not a representative of the Member State, but it is someone chosen because capable and independent, and will serve the interests of the EU as an all rather than its own Member State.

4) the *Court of Justice of the European Union*.

The Court of Justice is the court system of the EU. It ensures that the law is observed in the interpretation and application of the Treaties. It consists of one judge from each Member State, chosen by common accord of the governments of the Member States from persons whose independence is beyond doubt and who possess adequate qualifications.

The co-decision-making procedure.

How the laws are made in the EU?

Depending on the policy area involved, the law-making process follows different procedures rules. But the ordinary procedure is the so-called co-decision procedure. Under this procedure, the Council and the European Parliament decide together about legislation to be adopted based on a proposal by the European Commission. On an ordinary basis, any proposed act can be passed only if both the Council and the European Parliament agree on the relevant text. If you remember the roles played by the Council and by the European Parliament, you will understand that asking them to agree on a certain matter means that the legislation should reflect both the interests of the Member States and the interests of EU citizens, and obviously also the interests of EU because the proposal is set forth by the European Commission. So, this kind of complicated procedure of law-making aims having a legislation which is fully democratic.

The EU legal acts.

In the exercise of the EU competences, the EU institutions may adopt different legal acts:

1) *Regulation*

   Regulations are acts of general application, binding in their entirely and directly applicable in all Member States.

2) *Directive*

   Directives are acts of general application, binding as to the result to be achieved, but which leave the Member States the choice of form and methods. For this reason, compared to regulations, directives are supposed to be less strict for Member States and leave some roles of discretion to Member States in their applicability

3) *Decision*

   Decisions are acts of special application, binding in their entirety on the person or entity to which it is addressed. A decision applies to a single specific situation. For example

4) *Opinion and recommendation*

   Opinions and recommendations are general acts with no binding force. They are generally called in legal terms, soft laws. They can be considered a way to suggest something in field in which for some reasons the regulation cannot be produced because it will be too complicated. They can have the same impact of regulations or directives.

The basic framework of EU financial regulation.

EU financial regulation is ultimately based on the EU objective of "establishing a common market" which is "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured". More precisely, a single financial market where investors, borrowers, and capital raisers can access national markets of Member States across the EU. This symbol financial market, as a part of the internal market, is supposed to generate broader and deeper financial markets, and therefore should drive a reduction in the cost of capital for firm and the promotion of growth and employment because of the competition across the EU.

In general, the basis for the achievement of a single market is provided by the free-movement guarantees, which prohibit any discriminatory and free-movement restrictive national rules. The cornerstones on which the internal market is based are the freedom to establishment and the freedom to provide services.

The freedom of establishment states that anybody in EU, both physical persons and firms, may have the right to establishment, and therefore the right to pursue activities as self-employed persons and to set up and manage companies or firms. As a consequence, an Italian firm can establish in Germany and so on. Restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State are not allowed.
The freedom to provide services states that restrictions on the freedom to provide services within the EU are prohibited in respect of nationals of the Member States who are established a Member State different from that of the person for whom the services are intended.

Despite these two guarantees, which represent the cornerstone of the internal financial market, the presence of regulatory barriers within the Member States may obstruct the achievement of the common market. We distinguish between two kind of barriers. Those that can be cancelled because represent a real restriction of the freedom of establishment and of the freedom to provide services. They are designed to protect national markets from competition. And those that can be considered valid because aim to protect some general interests of the Member States. These ones, which can be named non-tariff barriers, can represent a very powerful obstacle for the realization of a single market because they multiply the cost of compliance for the firms wanting to provide services or establish in another member state.
The main tool provided by the Treaties to remove regulatory barriers is the harmonization process. According to this process, the EU tries to create same rules across Europe. This harmonization process complies with the principle of proportionality, because the EU pursues its objectives by appropriate means commensurate with the competences which are conferred upon it in the Treaties, and as far as EU action complies with the principle of subsidiarity it is possible to demonstrate that regulating in an harmonized way the all matters across the Europe allows to reach the objectives of the Treaties better than need to domestic context.

The compliance of some parts of EU financial regulation with the subsidiarity principle may be problematic. In particular, the regulation of pan-EC actors (for example: banks, financial conglomerates, trading exchanges) generally fits well, but is more difficult to justify as far as local markets tend to display particular cultural and structural features and local regulators have an in-depth knowledge of their markets. Practically, this problem almost never troubled the creators of the current EU financial regulation regime

Evolution of European Financial Regulation.

Now we have to focus on the evolution of European security regulation and the features which now European security regulation has.

1977 is the beginning of what it is called the first phase of European security regulation. In this phase Member States try to reach harmonization through a high-level-of-detail strategy whose purpose was to remove obstacles to integration by rendering Member States regimes equivalent. This approach was very ambitious but proved to be a complete failure. The reason is that when EU try to find an agreement among many Member States on a very detailed regulation, each Member State tries to get a regulation written in its own interest with a high degree of discretion. The only way to make it possible was to introduce in a single regulation a number of derogations or options which are a complete disaster in terms of harmonization.

As a consequence, this approach, which basically goes from 1977 to 1985, was soon abandoned and a new approach was followed. This new approach, which is quite important because it still working in general financial regulation, is based on two main ideas:

1) the idea of *mutual recognition*
2) the idea of *minimum harmonization*

Mutual recognition basically means that what is recognized in a Member State should be automatically recognized in another Member State and minimum harmonization means that the conditions for recognizing something are harmonized throughout Europe in their vary basics, without entering into many details. Imagine a bank; a bank to perform its activity should be recognized and authorized by the local supervisor. With mutual recognition, a bank recognized by the local supervisor is authorized to perform its activity across Europe. With minimum

harmonization, for example the capital requirements, which are the conditions to avoid negative externalities by banks, are harmonized and so the same throughout Europe.
Mutual recognition was adopted as integration technique, minimum harmonization was chosen as the mean to avoid regulatory barriers.
The final point to be consider refers to the regulatory control. It can be allocated to the home Member State (which is the Member State where the intermediary has is seat) or to the host Member State (which is the Member State where the intermediary performs its activity abroad). This new approach states that regulatory control should be in principal allocated to the home Member State even if the activity of the intermediary is performed in another Member State.

This "mutual recognition-minimum harmonization" approach proved to work pretty well, and it is still one of the cornerstones of European Financial Regulation. At the same time, at the end of the last century, this model proved to be unsuccessful and ill-equipped to cope with the arrival of monetary union and with the Internet explosion. Both these two features allowed an upsurge in cross border activity which the model was unfit to cope with.

As a consequence, large areas of regulation remained either unharmonized (for example, the control of market manipulation or conduct-of-business rules) or deficient (for example, the disclosure regimes mutual recognition), allowing what is called regulatory protectionism which is an approach that uses the law as a way to protect domestic firm from competition from abroad. The articulation of home Member State control proved to be incomplete. The supervisory co-operation turned to be underdeveloped. And finally, it was not clear which were the objectives of regulation, for example capital adequacy should be meant to be oriented to correct market failures or should have served other purpose.
For these reasons, in 1999 started what it is called the third phase of European Financial Regulation. In 1999 the European Commission set out the Financial Service Action Plan. It was a very ambitious reform program consisting in 42 measures designed to achieve two objectives:

1) support the liberalisation and integration of EU capital market through a more effective harmonization of national rules to support mutual recognition, strengthening the idea of home Member State control and limiting host State control

2) provide the integrated pan-EU marketplace with an upgraded regulatory environment for a changed risk environment

This program was very strongly pushed by the UK, which at the time was a member of the European Community, and basically used the financial regulation as a quid-pro-quo to increase its economic power in financial markets and to have a regulation across Europe based on the British model.

In order to realize the objective of the Financial Service Action Plan, some forms of legislative tools were needed because the ordinary EU legislative procedure was too slow to reach the results at which the FSAP was aimed. For this reason, in 2001, a specific Committee, the Committee of Wise Men, constituted by the Council, was put in charge of the elaboration of a possible new law-making process: *the Lamfalussy law-making process*.
The Lamfalussy law-making process was quickly endorsed in 2001 by the Stockholm European Council and became the special law-making process followed in financial regulation to provide an appropriate regulation quickly and effectively.
This approach started being used from 2001 but became particularly important after the financial crisis of 2008 and the entry into force of the Treaty of Lisbon in 2009, when it was adjusted to the new regulatory and supervisory framework. According to this new framework, in order to favour a

higher degree of harmonization and convergence across Europe, a significant role was given to specific independent administrative agencies at EU level. These agencies are called European Supervisory Agencies (ESAs) and they are:

1) the European Banking Authority (EBA) for the banking industry
2) the European Securities and Markets Authority (ESMA) for capital markets
3) the European Insurance and Occupational Pensions Authority (EIOPA) for the insurance sector

The Lamfalussy law-making process was a mechanism originally designed without these ESAs, which entered into force after 2009, but that was adjusted to the introduction of these new agencies keeping the model of the law-making process integrated.

How the Lamfalussy law-making process work.

The Lamfalussy law-making process is articulated in 4 different levels.

The first level is the political level and it is characterized by the Framework Acts set forth by the Council and the Parliament. The Framework Act is the frame of the regulation in a certain subject (matter) composed by broad principle and more general standard.

These broad principles, which are set forth at level one by the Framework Acts, translate into more detailed regulation at level two.

The second level is composed by what, in technical terms, are called:

a) Delegated Acts
b) Implementing Acts

prepared and approved by the European Commission, or by:

c) Regulatory Technical Standards
d) Implementing Technical Standards

prepared by the ESAs and endorsed by the Commission.

Level two, basically, details the frame that is set forth at level one, details the standards into the relevant matter by Delegated/Implementing Acts or by Regulatory/Implementing Technical Standards.

The Acts are prepared basically by the ESAs which advise the Commission about their content. Then, the Commission follows these advises and prepare a directive or a regulation. With Technical Standards the process is more or less the same. The only difference is that instead of having the Commission directly in charge of the Acts writing these Acts with the advice of ESAs, Technical Standards are directly written by ESAs and endorsed by the Commission.
At level two the specific regulation is prepared in part by technical authorities, like ESAs, and in part by an executive technical institution, like the European Commission. In other words, level two is much more technical than political than level one.

The third level is characterized by the so-called soft law. It basically is a system of guidelines and recommendations, which are prepared directly by the ESAs, with no binding force but with a very

strong capacity influencing actual behaviours of intermediaries or supervisory agencies in the local Member States. As we can see, also in the level three, technical authorities like ESAs play a very important role.

Finally, at level four the ESAs and the European Commission control the actual enforcement of the law which was prepared at the three previous levels.

The Lamfalussy law-making process is an approach which tries to put together the necessary political endorsement of regulation and the role of technical authorities to identify the details of regulation and to avoid regulatory protectionism by single Member States. This approach clearly favours a very strong harmonization across Europe because the broad principles set forth at level one are detailed very precisely at level two and even more at level three leaving a very small room for discretion by local Member States, and therefore pushing harmonization to the maximum level. Obviously, the role played by technical authorities but also by the Commission leaves a lot of room for activity by groups of interest trying to influence the decisions of the technicians generating the usual problem about delegation of law-making power.

The risk of harmonization.

Cross border activities are typically affected by market failures and externalities. Market failures are determined by the transaction costs which are implied in the presence of multiple regimes. Externalities are generated by behaviours in a single Member State affecting the wellbeing of others Member States. This was the case of the financial crisis of 2011, where the crisis of an intermediary on a Member State had the risk of generating a negative externality on other Member States, impacting the stability of the Europe. Harmonization is generally regarded as the strategy to fix these problems.
Moreover, harmonization is capable to support mutual trust between regulatory regimes, because harmonization helps different Member States which are treated alike to cooperate and to be mutual and trust each other in the development of supervision. Secondly, harmonization may limit the extent in which national regulators use regulation as a protectionism tool. And moreover, harmonization can protect financial stability and avoid the fiscal risk borne by the Member States in the cases of systematic crisis. The more regulation is harmonized and enforced in an harmonized way, the less is possible that behaviours in a single Member State generate externalities against other Member States, and therefore generate fiscal risk (which is, for example in the case of Europe crisis, the need for a single Member State to put financial resources to make the Europe stable before an instability of the Europe determined by misbehaviours by intermediaries of another Member State).
At the same time, harmonization has several disadvantages. More in detail, harmonization

a) restricts regulatory innovation, which is typically incubated at national level
b) is vulnerable to regulatory capture
c) may determine over-regulation and increase costs of compliance