Commentary: The European Version of Obama's Financial Regulation Proposal

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Part V of President Obama's proposal for financial services regulation reform acknowledges the fact of our global economy: "Without consistent supervision and regulation, financial institutions will tend to move their activities to jurisdictions with looser standards, creating a race to the bottom and intensifying systemic risk for the entire financial global system."

The President's proposal suggests that the term "global" is meant to refer to the G-20 nations, since the proposal makes references to agreements reached at the G-20 summit in April. The group of G-20 nations, in addition to the European Union and the United States, also includes Argentina, Australia, Brazil, Canada, China, India, Indonesia, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea and Turkey. Four members of the European Union – France, Germany, Italy and the United Kingdom – are also members.

The G-20 is not the United Nations, and one can easily speculate about why some nations are considered important to the global regulation of financial services, and therefore included as members, while others are left off the list. The European Union is the largest economy in the world, followed by the United States. The 19 nations represented – the European Union is not a nation-state – would be on the list of the 31 largest economies in the world. However, Spain, The Netherlands, Poland, Belgium, Sweden, Austria, Greece and Denmark, which are all members of the European Union, as well as Switzerland, Norway, Iran, Venezuela and Taiwan are not G-20 members, but have larger economies than some of the other members of the G-20. Moreover, the four G-20 members of the European Union have ceded much of their regulatory authority over economic matters, including financial regulations that are not purely local in nature, to the European Union, raising doubts about their importance in fashioning a global regulatory system.

It is safe to say that the G-20 has no plans to establish a global financial regulator. At most, there are proposals to establish a "College of Regulators" to facilitate communication among regulators from the G-20 nations.

With global financial regulation off the table, the second best solution is a regime of parallel regulation. In theory, if everyone adopts the same regulations, no financial institution would have an incentive to move activities into a less regulated environment. So the phrase "consistent supervision and regulation" appears to mean that everyone in the G-20 will impose equivalent regulatory regimes.

Parallel regulation is, however, much more complicated than it sounds. Different cultures have different assumptions about the purposes of regulation that are reflected in their legal regimes and even their languages. As a result, they start at different places and travel on separate paths. This makes it difficult to end up at the same place.

Not much has been heard from China and the other Asian nations in the G-20 about globally consistent regulation. On the other hand, the European Union has been especially enthusiastic about creating a regulatory regime intended to line up with President Obama's proposal. The European experience illustrates the difficulties of the process.

As discussed in last week's column, the cornerstone of President Obama's proposal is to transform the Federal Reserve System into a systemic regulator. All systemically important financial institutions, including the largest banks, broker-dealers, insurance companies and hedge funds, would be designated Tier 1 Financial Holding Companies, subject to regulation by the Fed. A college of US regulators, called the Financial Services Oversight Council, comprised of the heads of the Federal Reserve System, CFTC, a newly created Consumer Financial Protection Agency, FDIC, FHFA, a newly created National Bank Supervisor, and the SEC, as well as the Secretary of the Treasury, will advise the Fed. But, it will largely be up to the Fed, following standards mandated by Congress, to determine which institutions are Tier 1 FHCs and how these institutions will be capitalized and managed.

The European Union doesn't have a system wide regulator of any part of the financial services industry. Nothing like the Federal Reserve, SEC or CFTC exists in the European Union. The European Central Bank has the power to control the money supply in Europe, but does not have supervisory powers over any investment or commercial bank. The European Commission has the authority to adopt securities and banking regulations that apply to all 27 members of the European Union, but interpretation and enforcement of those regulations remains the responsibility of national regulators. It is as if there were a Securities Exchange Act of 1934, but instead of the SEC, each of the Securities Commissioners of the 50 states were responsible for the implementation, interpretation and enforcement of this statute.

The United States has something along these lines in the regulation of insurance. There is no federal insurance regulator, and President Obama's proposals would not create one. Instead, each of the 50 states has its own laws regulating the insurance industry. Other than those insurance companies that are designated Tier

1 FHCs, Obama would only create an "Office of National Insurance" within Treasury to promote national regulatory coordination and represent insurance regulators at the global level.

To meet the United States halfway, the European Commission proposes to establish three European regulatory agencies: The European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities Authority (ESA). Collectively, these new agencies are described as the "European System of Financial Supervisors" (ESFS) or the European Supervisory Authorities. In general, these three new agencies would still rely on national regulators for direct supervision of regulated entities and enforcement. But, they would have rulemaking authority, a dedicated staff and budget, and the legal authority to insist that national regulators enforce their rules in a uniform way.

To ensure that the three new agencies work together and to avoid regulatory gaps, the Commission proposes to establish a "steering committee" composed of representatives of each agency and a member of the European Commission. Moreover, each of the agencies would be permitted to participate in meetings of the other agencies as observers. This steering committee is the closest analog to President Obama's proposal that the Federal Reserve be granted authority to act as a systemic regulator.

The European Commission also proposes to establish a "European Systemic Risk Council" (ESRC) that would have functions similar to President Obama's Financial Services Oversight Council. The ESRC would not have any legally binding powers, but would serve primarily to provide advice to the ESFS.

By my count, the ESRC would have 33 members, consisting of the President of the European Central Bank, the Governors of each of the 27 national central banks, the Vice-President of the European Central Bank, the Chairpersons of each of the new European Supervisory Authorities and a member of the European Commission. In addition, the Governors of the 27 national central banks would be entitled to bring along one representative of the national regulators of financial institutions as observers. The Chairman of the Economic and Financial Committee of the European Commission would also attend as an observer. All told, some 67 people might be expected to participate in any meeting of the ESRC. And, let us not forget the lawyers and clerical assistants who can be expected to whisper into participant's ears during meetings. In hopes of getting anything done with such an unwieldy group, the Commission would also create a small steering committee of about 10 to run the meetings.

All of the complication is required because the European Union is not truly a sovereign power. Instead, it is an alliance of 27 nations, who have agreed to relinquish some authority over some economic matters to the Union. In that cultural and political context, the establishment of a “federal” securities regulator with some of the power of the SEC is a radical venture, and the institution of three federal regulators with powers over all of the financial services industry seems fantastic. It means that the 27 nations must relinquish substantial power over financial institutions located within their borders to the new European Supervisory Authorities.

The elaborate structure of the ESRC and ESFS reflects the political need to compensate for this loss of authority by providing regulators for each nation a seat at the table. But, it is extremely difficult to achieve anything approaching consensus in such large groups, which is one of the reasons by Obama’s plan spurned proposals to create a collegial systemic regulator for the United States.

European financial institutions and issuers have a paranoid fear of the SEC and can be expected to lobby hard against every part of a proposal that would create a federal regulator to supervise their businesses. It remains to be seen whether the 27 sovereign nations that comprise the European Union will be willing to take things this far.

Assuming the best case, that all of this comes to pass, we will still be a long way from globally “consistent supervision and regulation.” The agencies that comprise the European Securities Authority will be infants with only a shadow of the powers held by their U.S. counterparts. Nothing like President Obama’s Consumer Financial Protection Agency is even contemplated. This is the most that can be hoped for from our friendly alliance with the European Union, which represents an economy that is almost one-third larger than the United States.

On the other hand, our global economy requires a globally level regulatory playing field for financial institutions. Perhaps even a tiny step in the direction of globally consistent financial services regulation is to be applauded.

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