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THE FUTURE OF REGULATORY REFORM – MEP SURVEY 2010

A joint report by Cicero Consulting and ComRes on MEPs' views on future regulatory reform

ComRes

INTRODUCTION

"Shafts of light of a recovering economy have started to appear and this has been driven mainly by the redesigning of the world's financial architecture at G20 level"

This report describes the views of Members of the European Parliament (MEPs) towards future regulatory reforms that seek to enhance the capital standards of the banking sector. The survey was conducted in July 2010 – a time when there was still a high level of stress in the financial markets; when the Basel Committee confirmed its stance on its Basel III proposal; while the European Commission was drafting its legal text on Capital Requirements IV and when the MEPs were preparing their ground to battle for the best interests of their constituents during the course of the new legislative term September 2010/2011.

In less than three years we have witnessed banks collapsing, being nationalised or partially nationalised along with dramatic drops in share prices. These events have all combined to rock not just market confidence but also consumer confidence. But many in the banking sector would support the statement that shafts of light of a recovering economy have started to appear and this has been driven mainly by the redesigning of the world's financial architecture at G20 level. The cornerstone of this new financial architecture is a proposed set of measures to strengthen global capital and liquidity regulations. At the global level this is known as Basel III.

In support of the objectives of G20 and Basel III, the European Commission will be publishing its legislative proposal on Capital Requirements Directive (CRDIV) later this year.

Two elements stand out from the European banking crisis. Firstly, the quality of capital on the banks books and the fact that the regulatory capital held was insufficient to absorb the very significant unexpected losses. Consequently European legislation must place increased emphasis on the importance of provisioning for capital that can help to prevent an institution from becoming insolvent. Secondly prior to the crisis, liquidity risk and its management in particular did not receive the same level of supervisory attention that we now know it should have. In response to this and in line with Basel III, the European Commission is charged with the task of harmonising the quantitative regulatory standard for liquidity in order to improve prudential policy coordination within the European Union. It is hoped that this regulatory reform of capital standards will go a long way in improving the resilience of the financial system. But it is not an easy task.

With this as the backdrop, Cicero Consulting and ComRes surveyed 100 Members of the European Parliament (MEPs) to investigate their opinion as law makers on:

- Preventing a future crisis: the effectiveness of legislative measures such as CRDIV in reducing the frequency and severity of future financial crisis
- Ensuring better supervisory oversight
- The impact of new legislation
- Who's to blame?
- What should happen next?

ENSURING BETTER SUPERVISORY OVERSIGHT

"One in three MEPs support the creation of a new EU single financial services regulator and increasing the powers for the new European Banking Authority"

Between 2000 and 2007 governments of many European Member States favoured pro-cyclical economic policies – more money was spent than saved from tax revenue - and as a result there was little cushion to protect public finances when returns to the exchequer tumbled. This was particularly true for countries with asset bubbles such as Ireland and Spain. The approach of Member States to fiscal policy, prices, costs and financial regulation were clearly not in line with the discipline required for the single currency. In conjunction with this, the disciplinary requirements between banks and national regulators has also been brought into question.

"51 per cent of MEPs from accession countries supported an EU financial regulator in comparison to MEPs from the UK and Ireland among whom only 10 per cent were in favour of such a body"

In response to this lack of discipline one in three respondents stated that there is a need to create a new European single regulator for financial markets in addition to increasing the power of the new European Banking Authority (EBA). Interestingly, 51 per cent of EU Parliamentarians from accession countries supported an EU financial regulator in comparison to MEPs from the UK and Ireland among whom only 10 per cent were in favour of such a body.

What is evident from these findings is that there is significant support among MEPs for greater supervision, if not mandatory supervision, at EU level of economic policies and penalties if provisions within joint fiscal policies are not adhered to.

"60 per cent of EPP MEPs; 44 per cent of S&D; 38 per cent of ECR support greater cross border cooperation"

In addition to increased oversight at EU level there is support among MEPs for greater cross-border cooperation and exchange of information between national supervisory authorities. Of the MEPs surveyed 60 per cent from the centre-right European People's Party (EPP) supported this along with 44 per cent from the Progressive Alliance of Socialists and Democrats (S&D) group and 38 per cent from the European Conservatives and Reformists (ECR). In contrast to this, only 14 per cent of EU Parliamentarians from the Alliance of Liberals and Democrats for Europe (ALDE) respondents supported increased cross border cooperation and information sharing.

"Only 24 per cent of MEPs were in support of handing greater power to central banks"

In terms of tackling macro-prudential risks at the national level only 24 per cent of EU Parliamentarians were in support of handing greater power to central banks. MEPs do believe there is a need to improve the standards of national supervisory authorities and 33 per cent stated that training would be the best way of achieving this.

It is clear from the above findings that MEPs believe that the future stability of the eurozone is dependent on more stringent and effective surveillance and co-ordination. In addition it is evident that MEPs believe that domestic options to solve their indebtedness has not worked and in many cases could not even be considered and consequently there is a need at European level to provide solutions and surveillance, namely through increasing the power of intervention for the EBA and establishing European Financial Services Regulator. The fact that such a move would reduce national sovereignty seems to be a price that MEPs are willing to pay.

PREVENTING A FUTURE CRISIS

Given the huge costs of this current financial crisis, there is a consensus among policy makers and politicians that it is important if not imperative to prevent future ones.

"Key reforms to prevent a future crisis - increased cross border cooperation; regulation of complex financial products; and enhanced capital requirements"

EU Parliamentarians surveyed were relatively evenly divided between what reforms they believe will have the biggest impact on preventing a future crisis.

THE TOP 3 SUGGESTIONS FOR FUTURE REFORM

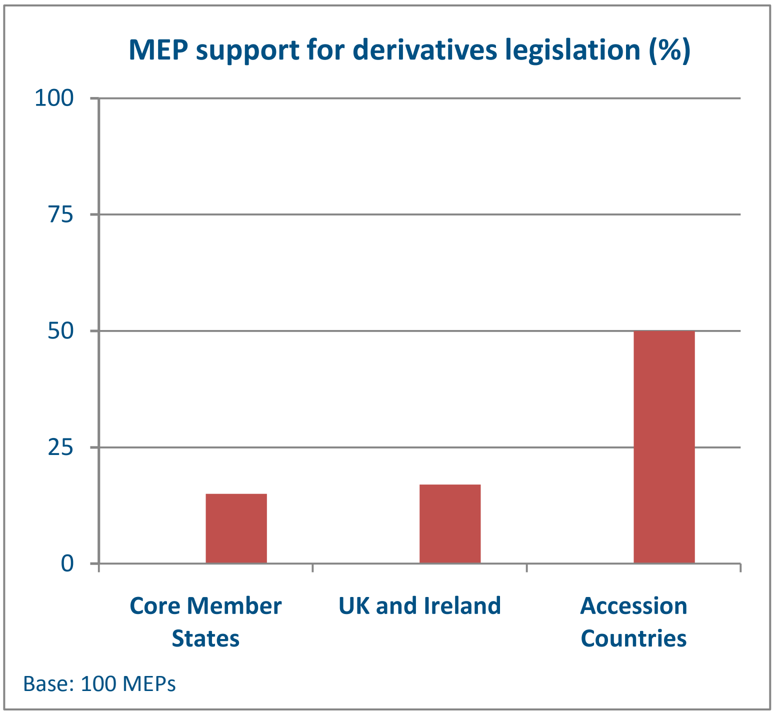
- **39%** of respondents believe enhanced cross-border regulatory supervision would be most effective
- **25%** suggested increased regulation of complex financial products such as derivatives is required
- **23%** supported enhanced capital requirements as being most effective

“50 per cent of accession country MEPs support the derivatives legislation”

These findings are indicative of the major legislation that is currently working its way through or into the European Parliament, namely:

- The new EU supervisory package, trialogue negotiations to resume in September;
- The Regulation of Market Infrastructures (including trading of OTC derivatives), with a European Commission legislative proposal expected in September 15;
- Capital Requirements IV which the Commission is currently drafting and expected possibly before November.

What is interesting to note is that 50 per cent of Members of the European Parliament from accession countries support the advent of the derivatives legislation – Regulation of Market Infrastructures, in comparison to just 15 per cent from core Member States and 17 per cent from Ireland and the UK.

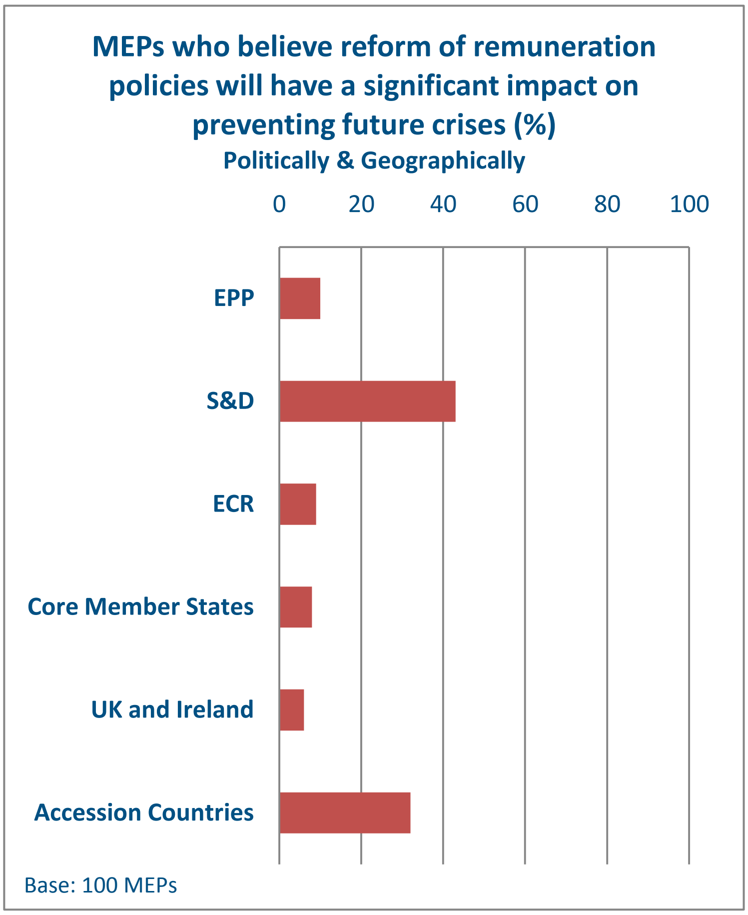


"Only 17 per cent of MEPs support the Financial Transaction Tax as a means of preventing future crises"

Despite a strong political wind blowing from Germany and France to progress the development of a global financial transaction tax - a tax that could be placed on a financial activity including the profits and bonuses paid by banks – only 17% of respondents supported this an effective standalone preventative measure.

"Only 15 per cent of MEPs believe that reform of remuneration policy will have a significant impact on preventing a future crisis."

Surprisingly, despite a disproportionate amount of attention being given to executive remuneration in the media and public debate, only 15 per cent of EU Parliamentarians believe that reform of remuneration policy will have a significant impact on preventing a future crisis. In stark contrast, this percentage doubles for accession country MEPs – 32 per cent of whom believe remuneration reforms are required in order to prevent incentivised risk-taking in the future.



IMPACT OF NEW CAPITAL STANDARDS ON THE WIDER EUROPEAN ECONOMY

"The number one impact of enhanced banking capital standards is the reduction of the overall level of systemic risk."

It is clear from previously outlined results that Members of the European Parliament welcome the increased focus on effective supervision and the prospect of more effective collaborative supervision of cross-border operations. In line with this 66 per cent of MEPs from accession countries and 44 per cent of core MEP respondents believe that the number one impact of enhanced banking capital standards is the reduction of the overall level of systemic risk. In addition to this the views of MEPs from core Member States, accession countries, the UK and Ireland were very similar, 27 per cent, 21 per cent and 23 per cent respectively, in agreeing that with these measures in place there would be a reduction in the possibility of future bail-outs being required. MEPs however are divided on what the impact of this will be for the wider economy and end users. The dividing line can be drawn between core Member State MEPs and MEPs from the accession countries, as well as the UK and Ireland.

"50 per cent of MEPs from the UK and Ireland believe lending to SMEs will become more costly. Only 17 per cent of core MEPs support this view"

A negative knock on effect which 50 per cent of MEPs from the UK and Ireland highlight is that lending to consumers and SMEs will become more costly. This figure is in stark contrast to respondents from core Member States such as Germany and France, with only 17 per cent of MEPs believing lending to end users will be negatively impacted upon. A relatively low proportion of core Member State MEPs, 35 per cent of accession country MEPs and 22 per cent of UK and Irish Parliamentarians believe that that these new capital standards would result in less lending to consumers and SMEs - 20 per cent of core Member State

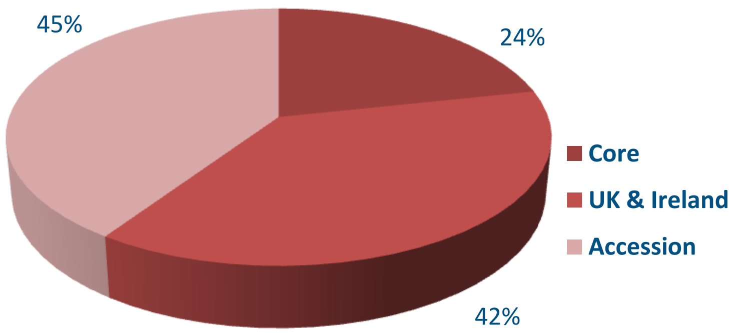
MEPs, 35 per cent of accession MEPs and 22 per cent of UK and Irish EU Parliamentarians supported this view.

Therefore taking these two results together it is clear that while MEPs do not strongly believe that the overall impact of new capital requirements will result in less lending to consumers and SMEs there is a strong view among UK and Irish MEPs, supported by 33 per cent of accession MEPs, that the cost of lending will increase for the end user.

MEPs are also divided on whether these new capital standards will result in a potential reduction in economic growth. Nearly double the proportion of MEPs from accession countries, the UK and Ireland (42 per cent and 45 per cent respectively) believe the latter will be the case in comparison to 24 per cent of MEPs surveyed from core Member States. This reflects commentary to date on CRDIV which highlights the fact that while the reforms have the potential to dramatically increase funding requirements for banks in the short-term it could negatively impact the markets by limiting the flexibility of funding resources and products. As a consequence 19 per cent of Members surveyed believe that there could be a level of distortion in global competition leading to a loss of competitiveness for European banks.

The latter reflects the concerns of many industry players that while huge increases in capital and funding is required it is also important that reform of capital standards are implemented in a transitional manner so that the real economy is not damaged given the fragile state of much of the EU banking system.

CRD IV will result in reduced economic growth



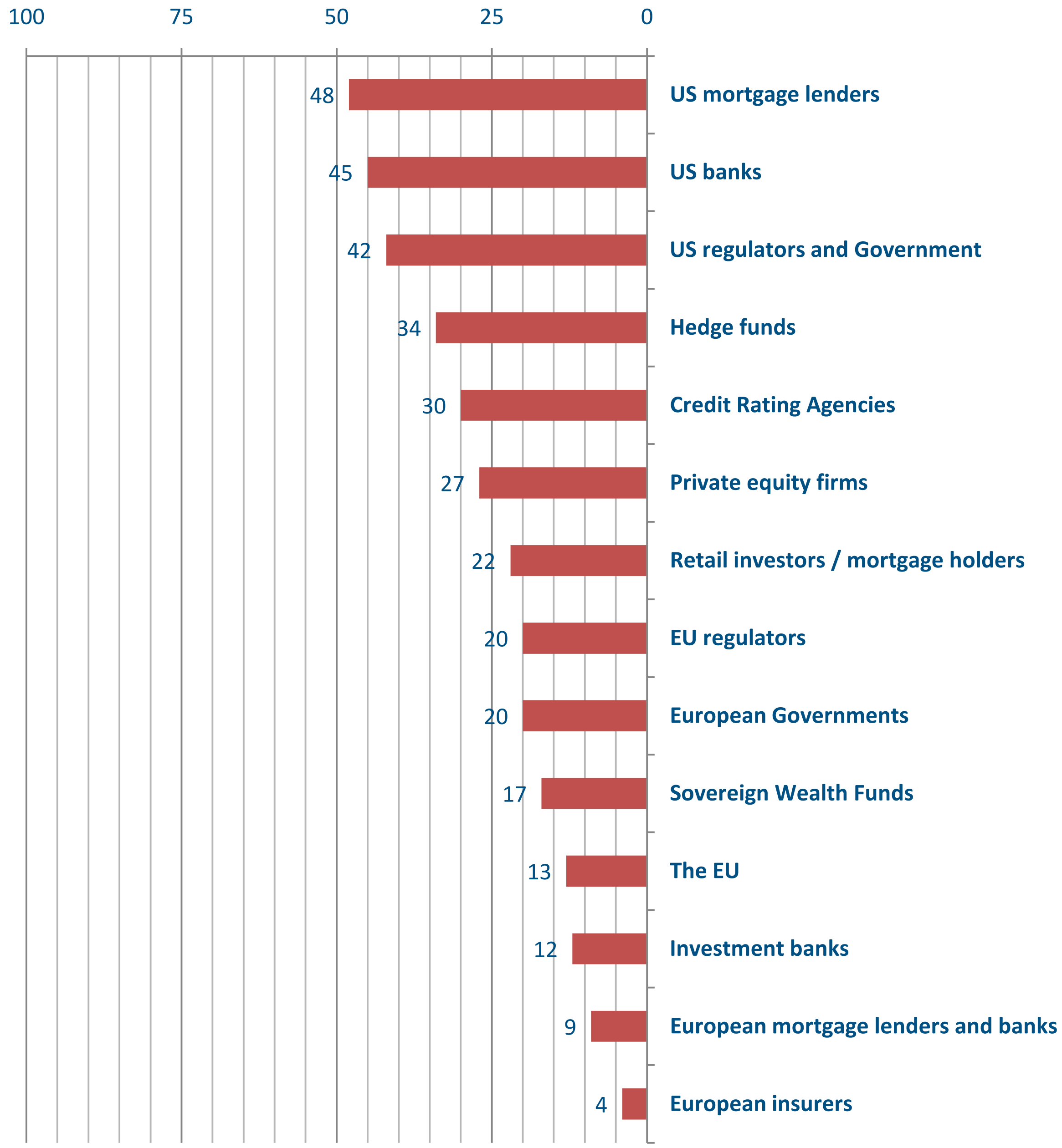
Base: 100 MEPs

WHO'S BLAMING WHO?

"Respondents from the four biggest political groups within the European Parliament – EPP, S&D, ALDE and ECR - all named the United States as most to blame for the current financial crisis"

"Blaming European governments for their role in the crisis features in the top three of just three of the eight political parties surveyed - ALDE, ECR and EFD"

MEPs rating the following actors as most to blame for the crisis (%)



Base: 100 MEPs

WHO'S BLAMING WHO?

"Across all political groups, at least one of the following ranked in the Top 3 "to blame" targets: US mortgage lenders; US regulators and US government; and US banks"

The blame game is always interesting. Respondents from the four biggest political groups within the European Parliament (EPP, S&D, ALDE and ECR) all named the US institutions as most to blame for the current financial crisis. The largest number of MEPs from S&D and ECR both targeted US regulators and the US government as most at fault, whereas the EPP's number one culprit was US mortgage lenders. For ALDE it was the US banks that caused the havoc. Only the far right political party Europe of Freedom and Democracy (EFD) laid the blame at the feet of European governments. Interestingly, across all political groups, at least one of the following ranked in their Top 3 "to blame" targets: US mortgage lenders; US regulators and US government; and US banks.

It is true that the first symptoms of the financial crisis appeared in the US in 2007, reaching its peak in September 2008 with the collapse of Lehman Brothers. However the crisis then took on a global dimension. At first there was no doubt that the epicentre of the crisis was the US and that emerging economies and Europe became victims of the contagion due to the high level of financial inter-linkages with the US economy. However this initial European assessment turned out to be wrong. Despite Europe not experiencing a widespread subprime crisis or any bank defaults, the fact the EU banking system is so large (91 banks) and highly integrated made its foundations inherently weak. Since early 2010, the financial crisis morphed into a sovereign debt crisis with a very obvious geographical implication. It is now clear that the epicentre of the second act of the crisis is the eurozone.

"Credit rating agencies are consistently ranked among all political parties as the seventh and eighth most likely to be blamed for the financial crisis"

However, blaming European governments for their role in the crisis features in the top three of just three of the eight political parties surveyed - ALDE, ECR and EFD. Surprisingly, blaming EU regulators was only included in the top five of the ECR group and it featured as the ninth most popular response in the EPP group. In contrast, EU mortgage lenders and EU regulators were all deemed less popular blame targets among respondents.

Across all political parties EU mortgage lenders and regulators were outside of the top five most popular targets of blame. EU Parliamentarians therefore are holding the US mortgage lenders most responsible for the crisis followed by European governments.

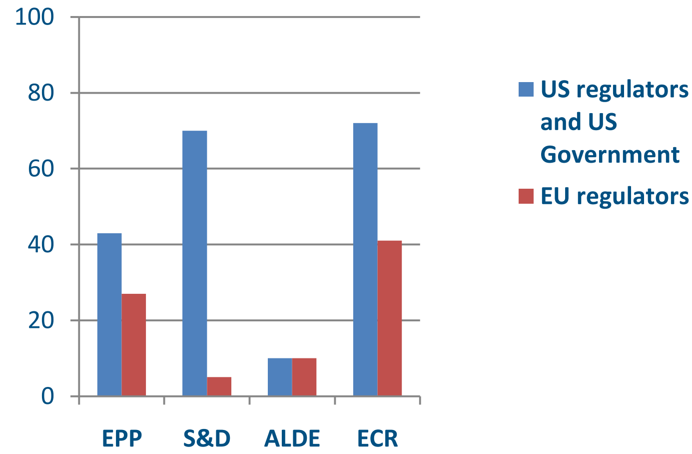
Despite the exposure of the role that credit rating agencies played in giving AAA seals of approval on large portions of even the riskiest pools of loans which lured many unsuspecting investors in areas of risk they did not foresee, credit rating agencies are consistently ranked among all political parties as the seventh and eighth mostly likely to be blamed for the financial crisis. This is somewhat lower than expected given the future legislative action that the European Commission will be taking in this area. ALDE was the only political party where credit rating agencies feature in the top three actors most to blame for the financial crisis.

Hedge funds remain on the radar of two political parties. Out of 12 possible blame targets, hedge funds featured in the top three of the EPP and the top five of the S&D group. By contrast ALDE did not include the sector as a possible target.

"MEPs have recognised that financial services customers have a part in the blame game. All political parties point the finger of blame at retail investors and mortgage holders."

All political parties point the finger of blame at retail investors and mortgage holders. It was only in 2008 after the onslaught of the credit crunch that Europeans began saving more and spending less. It took a massive fall in stocks and the property bubble to burst for the proverbial penny to drop – that Europeans could no longer live off credit; live in a way that was beyond their means; and continue to believe in the wealth effect.

Blaming regulators: the EU v. the U.S. (%)



Base: 100 MEPs

MEPs have recognised that financial services customers have a part to play in the blame game. Retail investors and mortgage holders are listed approximately seventh and eighth across all political parties for contributing to the development of the financial crisis.

CONCLUSIONS – SUMMARY OF KEY FINDINGS

47 per cent of S&D affiliated MEPs are in favour of a Financial Transaction Tax, compared to only 10 per cent of EPP MEPs

Similarly, 43 per cent of S&D MEPs think a reform of remuneration policies will have a big impact on preventing a future crisis, whereas this is 10 per cent among EPP and 9 per cent among ECR Parliamentarians

Restricting the role of international financial centres is regarded by 67 per cent of respondents affiliated to the Confederal Group of the European United Left–Nordic Green Left (GUE/NGL) as a reform that could prevent a future financial crisis, as opposed to 24 per cent of S&D MEPs

In terms of nationality, 66 per cent of EU Parliamentarians from accession countries see a reduction of the overall level of systemic risk as a result of enhanced capital requirements, compared to 38 per cent of core EU Member States MEPs and 27 per cent among UK and Irish MEPs

One in three MEPs support the creation of a new EU Single Financial Services Regulator and increasing powers for the new European Banking Authority

60 per cent of EPP MEPs; 44 per cent of S&D; 38 per cent ECR support greater cross border cooperation

CONCLUSIONS – SUMMARY OF KEY FINDINGS

From a nationality point of view, there is a clear difference between on the one hand UK and Irish MEPs - of which only 6 per cent would like to increase the power of the new European Banking Authority - while on the other hand 39 per cent and 40 per cent of core EU Member States and accession countries respectively would like to do so

50 per cent of accession country MEPs support the derivatives legislation

Only 17 per cent of MEPs support a Financial Transaction Tax as a means of preventing future crises

50 per cent of MEPs from the UK and Ireland believe lending to SMEs will become more costly. Only 17 per cent of core MEPs support this view

42 per cent and 45 per cent of accession country and UK & Ireland MEPs believe that CRD IV will result in reduced economic growth. Only 24 per cent of MEPs from core countries support this view

MEPs recognised that financial services customers have a part in the blame game. All political parties point the finger of blame at retail investors and mortgage holders

Among S&D-affiliated EU Parliamentarians, 71 per cent believes that US banks are to blame for the economic crisis

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