UNIVERZA V LJUBLJANI

EKONOMSKA FAKULTETA

MARTA BOŽINA BEROŠ

REGULATION AND SUPERVISION OF FINANCIAL ASSETS, TRANSACTIONS AND MARKETS IN EU COUNTRIES AND CROATIA

Doktorska disertacija

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V Ljubljani, dne 30.3.2012 Podpis doktorandke:__________________

REGULATIVA IN NADZOR PODROČJA FINANČNIH NALOŽB, TRANSAKCIJ IN TRGOV V DRŽAVAH ČLANICAH EU IN HRVAŠKI

POVZETEK

V času sedanje ekonomske in finančne krize je med akademiki in praktiki živahna diskusija o finančni regulaciji in finančnem nadzoru v posameznih državah, v EU in na svetu kot celoti. Najpomembnejši razlog za to zanimanje je v tem, ker naj bi ustrezna zakonodaja in nadzor imela pomembno vlogo pri zagotavljanju finančne stabilnosti. Finančna stabilnost je bila nedavno uvedena kot novi ekonomsko politični cilj, čeprav še ni povsem določeno, kakšni instrumenti naj bi se uporabljali in v čigavih rokah bodo. Vendar se vsi strinjajo v tem, da sta finančna regulativa in finančni nadzor nenadomestljivi za finančno stabilnost. V tem smislu je sedanja kriza v nekem smislu prišla prav. Pokazala je na pomembne vrzeli v sedanjem stanju znanja o naravi finančnih sistemov in o ekonomski politiki nasploh. Poleg tega je sedanja kriza pokazala, da sta finančna regulacija in finančni nadzor samo še poglobila krizo.

S tem dogajanjem v ozadju disertacije raziskuje in ocenjuje spremembe in sedanje stanje finančne regulacije in finančnega nadzora v EU. Cilj disertacije je, ugotoviti ali je sedanju evropski regalatorni in nadzorni sistem, to pomeni na nadnacionalni ravni, s svojo teoretično utemeljitvijo, s cilji in z instrumenti ustrezen za vzdrževanje finančno stabilnost v EU, in sicer na nacionalni in nadnacionalni ravni, ter ali koristi vsem finančnim sektorjem. Težišče disertacije je predvsem na nadnacionalem, in sicer na pravilih ali zakonih EU. Ko je težišče na posameznih državah, nas zanimajo tudi le-teta, vendar zaradi razumljivih razlogov samo Hrvaška in od članic EU samo Italija. Z interdisciplinarno analizo štirih stebrov financ, in sicer finančnih aktiv, finančnih transakcij, finančnih instrumentov in trgov, proučuje disertacija, kakšni bi morali biti ustrezna regulacijo in učinkovit nadzor, ki bi podpirali finančno stabilnost v EU. Hkrati naj bi se prilagajali potrebam prihodnjih članic EU, posebej potrebam tranzicijskih držav in med njimi potrebam Hrvaške.

V tem smislu dokazujemo, da v primeru, ko imajo države članice cilj vstopiti v EU, so pred njimi povsem druge zahteve, kot so jih imele druge države, ki so pred njimi vstopale v EU. Pri teh zahtevah gre za to, da prevladujejo potrebe evropskih podjetij, bank in drugih finančnih posrednikov in to preden te države uspejo doseči svoje socialne in ekonomske cilje. Tako "naravnanost k Evropi" terja od njih, da pozabijo na velik del svojih nacionalnih ciljev v gospodarstvu in se posvetijo zadovoljitvi "skupnega dobra". V tem smislu je

"uniformiranost", ki jo prinašata evropske finančna regulacija in finančni nadzor lahko škodi tranzicijskim državam. Tranzicijske države so namreč preveč drugačne od siceršnjih članic EU, da bi se lahko spravile v "single rulebook".

Tako sledi iz disertacije, da centralizacija ni ustrezna pot razvoja finančne regulacije v EU. Sicer je res, da je sedanja finančna kriza postavila pod vprašaj dosedanje razumevanje finančne regulacije in finančnega nadzora ter razumevanje zapletene povezanosti med finančno in politično integracijo Evrope. Hkrati pa je dala priložnost, da nadalje raziščemo soodvisnost med (de)centralizacijo in finančno stabilnostjo. Čeprav je trenutno videti, kakor da se je razprava o "regulatornem nadzoru", in sicer nacionalna nasproti nadnacionalni ravni, prevesila v prid večjega nadnacionalnega nadzora in večje nadnacionalne regulative, ostaja seveda odprto vprašanje, ali bo to v enaki meri koristilo vsem državam EU. Mogoče je, da bosta prekomerna centralizacija in "regulatorna uniformiranost" zabrisali specifične interese majhnih držav EU, posebej tranzicijskih.

Vendar pa ne glede na regulatorni in ekonomski uspeh, ki je bil dosežem z evropsko integracijo in ne glede na pomemben delež suverenosti, ki so države prenesle na EU, vloge nacionalnih držav ni mogoče preprosto odpraviti. Evropski politiki ne morejo predpostavljati, da je na primer EU na poti, da postane popolnoma integrirana "super država". Nacionalne države so še vedno realnost in čeprav imamo v EU ekonomsko in politično integracijo *sui generis*, se mora priznavati in upoštevati regulatorna različnost in pravica držav, da varujejo svoje ekonomske interese.

Ključne besede: finančna regulacija, finančni nadzor, tranzicijske države, finančna stabilnost

REGULATION AND SUPERVISION OF FINANCIAL ASSETS, TRANSACTIONS AND MARKETS IN EU COUNTRIES AND CROATIA

SUMMARY

In the wake of the recent economic and financial crisis there is a vivid discussion among academics and practitioners regarding financial regulation and supervision in individual countries, in the European Union and in the world as a whole. The foremost reason for such interest in this subject derives from the role that appropriate legislation and supervision have in ensuring financial stability. Financial stability has been introduced as the new policy goal, although what instruments are to be used and who would do that has not been quite fixed yet. But all agree that regulation and supervision of financial sectors are indispensable for financial stability. In this regard the last financial crisis was a somewhat fortunate. This is because it disclosed significant gaps in the current state of knowledge about the nature of financial systems and economic policy in general. In addition it revealed that existing financial regulation and supervision have only exacerbated the crisis. Against this background this dissertation explores and assesses the changes and current state of financial regulation and supervision in the EU. The objective is to determine whether the existing European regulatory and supervisory system (at the *supranational* level) with its theoretical rationale, objectives and instruments, is adequate to sustain financial stability across the EU (at both *national* and supranational level) and whether it benefits all financial sectors. The focus is primarily on supranational, EU rules and arrangements; when the focus shifts to "EU countries", it is solely on Italy and Croatia. Following an interdisciplinary analysis of four building blocks in finance (*i.e.* financial assets, financial transactions, financial institutions and financial markets) the thesis determines what could be considered as appropriate regulation and efficient supervision that would support financial stability across the EU and at the same time accommodate the needs of future EU members (particularly those of transition economies such as Croatia).

In this respect, the thesis argues that the perspective of EU membership puts completely different requirements in front of transition economies, than those put before other EU countries. Namely, it gives predominance to the needs of European enterprises, banks and other financial intermediaries, before these countries have even managed to secure their own social and economic objectives. Hence, the "EU commitment" requires them to forsake an

immense part of their national determination in economy and to serve primarily "common needs". In this regard, the "uniformity" brought by EU financial regulation and supervision will damage transition economies the most. Putting aside the political aspect of membership negotiations, the thesis argues that the economic requirements put before transition countries should have been different. In fact, in the case of transition economies "uniformity" shouldn't have been the goal of EU regulation at all; the goal should have been to enhance the operation of national economic systems. Simply put, transition economies are too diverse from other "ordinary" EU Member States to be molded into a "single rulebook".

Thus, the thesis suggests that centralization is not the appropriate way forward in the development of EU financial regulation. It is true that the recent financial crisis has challenged the understanding of financial regulation and supervision and of the complex relationship between financial and political integration within the EU. But it has also given an opportunity to further explore the interdependence between (de)centralization and financial stability. Although for the time being it seems as the debate regarding "regulatory control" between the national and supranational level is over in favor of greater supranational control of regulation, it remains to be seen whether this environment will equally benefit all EU countries. It is possible that excessive centralization and "regulatory uniformity" will blur the specific interests of smaller EU Member States (especially those of transition economies) in the bigger picture of the "European common good" (that is financial stability for the purpose of the thesis). Regardless of the regulatory and economic success achieved by EU integrations and the significant share of sovereignty delegated by Member States to the EU, the role of nation states still cannot be dismissed. European policymakers cannot proceed on the assumption that the EU may be on the way of becoming a perfectly integrated "super-state". They should accept the restraints of integration – both from their political and economic aspect. The nation states are still a reality, and even when part of a *sui generis* political and economic integration such as the EU, their regulatory diversity and the right to safeguard national economic interests should be acknowledged.

Key words: financial regulation, financial supervision, transition countries, financial stability

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1. INTRODUCTION

In the past years vivid discussions took place among academics and practitioners worldwide regarding financial regulation and supervision in individual countries, in the European Union and in the world as a whole. The foremost reason for such interest in this subject derives from the decisive role that appropriate legislation and supervision have in ensuring financial stability. Financial stability has been introduced as the new policy goal although what instruments are to be used and who would do that has not been quite fixed yet. But all agree that regulation and supervision of financial sectors are indispensable for financial stability. This is because *regulation* safeguards the stability of the financial system through clear and well-conceived rules, whilst *supervision* ensures the application of these rules to particular institutions (or groups of institutions) in practice.

But why is finance subject to much more stringent regulation and supervision? In order to answer this question, we first need to set the stage with a few explanations. Finance is part of the information industry. So, for instance, if borrowers and investors with complementary needs could find themselves easily in an economy, then we wouldn't need financial institutions and markets. Since this is obviously not the case, we need *financial institutions* and *financial markets* to allocate savings across time and space via *financial transactions* (The Warwick Commission, 2009, p. 22) to investors in real assets. Financial markets help economies to grow by mobilizing savings (*i.e.* creating *financial assets*) so that consumption could be higher in the future as a result of today's investments. We regulate and supervise finance more attentively than any other economic sector, because finance exhibits such information asymmetries that can cause serious market failures that can have socially devastating consequences. Indeed, the social costs associated with the failure of a financial institution, or the collapse of an entire financial system, are indisputably higher than costs associated with the failure of other sectors in the economy. Regardless of the widespread presumption in favor of free markets, research over the last three decades has shown that free financial markets if ″left to their own devices″ do not produce efficient outcomes when information is imperfect. In addition, in financial markets, private incentives – both at the level of a single institution and the individual market actor, are usually not aligned with social goals.

Thus, there are two principal motives behind regulatory intervention in the otherwise free financial markets: *asymmetrical information* and *social externalities*. As to the first motive, the greatest asymmetry is found between the investment-relevant information available to sellers of financial products and to their buyers (*i.e.* consumers). Thus, an important function of financial regulation is to level the information available to uninformed and unsophisticated buyers of financial products with those of their usually sophisticated sellers. As for the second - social externalities, they occur when benefits of an activity, or costs connected with it, accruing to private persons are not all benefits and costs of that activity. It is only natural then that as a response to these externalities governments ensure, *via* public regulations and supervision, that all the costs of financial activities are being captured by those who make them.

We must have this in mind when we talk about the European financial integration. Prior to the emergence of the global crisis in 2007, Europe's financial system was gradually becoming more integrated. In the EU, the financial integration is part of the Single Market process and is thus actively promoted through various European policies and institutions. However, it is important to note that financial integration has ambiguous effects on the stability of the European financial system. In other words, financial integration has its downsides. On the one hand, financial integration allows better risk diversification and risk spreading. On the other, it increases interconnection across national borders, which means that economic distress can translate more easily across Member States. As a result the potential for spillover effects increases significantly, especially when extreme events occur, and create potentially destabilizing opportunities for regulatory arbitrage. This means that financial institutions can take advantage of the differences in the level of regulation required by different Member States, and thus initiate a possible "race to the bottom". This is a situation where Member States compete among themselves, which will have the lowest regulatory requirements in order to attract financial institutions. But because of competition, all Member States will be forced to "race to the bottom" with their regulatory requirements if they want to attract investors. This in turn, does not prove beneficial for financial stability.

It is clear that changes that the EU financial regulation and supervision have experienced so far, are the results of financial integration. Financial integration namely dictates common regulatory objectives and also shapes supervision. In this context the main research subject of this thesis is the theoretical and historical analysis of common, EU financial regulation that is enforced across EU countries and of the different supervisory models they enabled. In each Member State financial regulation has been influenced by the evolution of the national financial system and by the legal system. However, apart from Member States' implicit commitment to ensure convergence of regulation and supervision, European law does not mandate the exact manner in which finance should be regulated. This means that in regulating finance the accent is on directives, rather than regulations. As such, the majority of EU financial regulations mandates just the objectives to be achieved, not the exact manner. Consequently, the current picture in the EU is, for instance, a combination of different supervisory models imposed onto a "common European financial rulebook". National authorities still have the liberty to implement EU directives in ways they think and determine are consistent with the objectives of their national financial interests, which means that potentially Member States may act exclusively in their own interest, although seldom at the expense of other EU countries.

This discretion of national authorities, which is logical and probably desired by all countries, causes tension, but it just complements the European integration process. This is the tension between financial regulation and supervision whose implementation and exercise are left to national responsibilities in great part; and the desire and promotion of the convergence of financial systems within the EU. This is probably a serious policy challenge for the EU. An integrated financial market requires common regulation and coordinated supervision in order to function well. But EU countries may have different preferences over the shape that these regulations should take or the competences of supervisory authorities. In other words, Member States are likely to pursue different financial arrangements depending on their needs and values, and they should remain entitled to do so despite EU membership. A thick layer of supranational rules that do not leave substantial room for maneuver by national authorities is contrary to the integration based on "core integration principles" (*i.e.* minimum harmonization, mutual recognition, home country control). What the EU needs is not maximum harmonization. In our opinion, the EU needs smarter harmonization.

The fundamental objective of this dissertation is to explore and assess the changes and the current state of financial regulation and supervision in the EU. Therefore we assess the manner in which regulation and supervision are exercised at both supranational and Member State level. However, this does not mean that we analyze national regulatory systems one by one, as this would be confusing and ultimately prove inefficient for our research intent. Rather, the objective is to find out whether the existing European regulatory and supervisory system (at the *supranational* level), with its theoretical rationale, objectives and instruments, is adequate to sustain financial stability across the EU (at both *national* and supranational level), and whether it benefits all financial sectors. Our attention is given primarily to supranational, EU rules and arrangements; when our focus shifts to "EU countries", it is on

Italy as an example of a well-developed, old EU Member State and Croatia, an EU acceding country and transition economy. Through the comparison of these two seemingly different European economies we ascertain specific guidelines and lessons which EU acceding countries, such as Croatia, must follow and learn in order to converge to European requirements from both an economic and legal aspect.

Hence the dissertation focuses on four key building blocks in finance:

(1) financial assets,

(2) financial transactions,

(3) financial institutions and

(4) financial markets.

An interdisciplinary analysis, from the financial, economic, legal and EU law-point of view, of these building blocks enables proper assessment what is the appropriate regulation and efficient supervision and whether they contribute to the financial integration of Europe's markets. Further more, we want to assess, whether the existing framework of regulation and supervision will be appropriate for future EU Member States (such as Croatia).

In our analysis we will first present the theoretical development of financial regulation. It seems to us that much has been said about regulation, while supervision has often been disregarded, as an auxiliary tool. We continue with recent developments toward an integrated approach to financial regulation and supervision, which is now being promoted. In our opinion the latter development was strongly supported by reforms at the national level. This means that nowadays the importance of supervision or "supervisory oversight" as a crucial element in the efficient implementation of complex financial regulation is widely acknowledged. This trend is observed at the EU level as well. In fact, recent European policy papers advocate greater attention to supervision. Naturally, the dissertation also focuses on several policy issues that emerged recently as a result of the last financial turmoil. These issues are mainly connected to weaknesses in the theoretical foundations of EU financial regulation and supervision in Europe. In this context, the dissertation emphasizes microprudential and systemic regulation:

(i) *Microprudential regulation* focuses on the soundness and efficiency of individual financial institutions. It requires a microeconomic approach to regulation and attention to the issue of consumer protection,.

(ii) *Systemic regulation* or macroprudential regulation is designed to oversee the stability of the financial system as a whole.

So there are three purposes of the thesis:

(1) The first is to critically overview the current state of EU financial regulation and supervision and the prospects of their future developments. In doing this we give special attention to the complex structural reforms that are put forward by EU authorities and which make the transition *from exclusively microprudential regulation toward macroprudential regulation*. In addition, we analyze how the main European integration principles (*i.e.* minimal harmonization, mutual recognition and most importantly, home country control) have changed in the last two decades parallel to the changes on the financial markets. We expose weaknesses of these changes, and assess how all these changes happened, and how they support greater centralization within the EU.

(2) The second is to assess whether the objective of completing a Single Market through European legislation (we will focus primarily on EU directives) has been equally successful with respect to financial assets, transactions, institutions and markets. Furthermore, *has the regulatory harmonization in all of these areas been equally beneficial, or has "legal standardization" caused certain unintended practical consequences that bear the potential for instability*?

(3) The third purpose is to ascertain how EU financial regulation functions at national level and which are the main elements of supervision common to the majority of EU countries. We do this in order to draw effective guidelines for acceding countries, such as Croatia. *We determine whether convergence with EU requirements in the area of finance has been beneficial from the aspect of a transition economy, and if it was, what are its main accomplishments as well as drawbacks*? It is our intention to critically assess the current state of finance in Croatia and suggest the manner in which financial regulation (paired with supervision) can sustain economic stability.

Let us now elaborate the manner in which we intend to accomplish the aforementioned goals. The second chapter of the dissertation gives a theoretical overview of financial regulation and supervision – their present state and their development. We will analyze the economic rationale behind these regulatory activities and discuss in greater detail the division between regulation and supervision in theory and practice. Furthermore, we will analyze the development of regulation and supervision from the perspective of the EU. The process of financial integration alone has not created sufficient conditions for harmonization of regulation and supervision among Member States. It still remains to be decided which areas of regulation will be left solely to national jurisdiction as opposed to the ones that should be harmonized at supranational level. In addition, we will analyze if the EU regulation and supervision, which have emerged after the financial crisis are effective in addressing financial stability. We are interested in determining the adequacy and effectiveness of the existing microprudential regulation of financial institutions from a systemic aspect. Furthermore, we will discuss recent regulatory trends observed at EU level, namely that of centralization, competition and co-opetition. As regards supervision, we will research the trend of institutional consolidation of competent authorities at national level. We wish to determine how this trend is reflected at EU level, and whether it represents a better choice for supervision. The second chapter concludes with a discussion of the current framework of European financial regulation and the proposed changes to the institutional set up of supervision.

The third chapter analyses the regulation of financial assets and financial transactions. The premise is that European regulation of financial assets and transactions (imposed through different EU legislation) should clearly constitute rights and obligations associated with specific types of assets and transactions. We are interested to deduce whether regulation in this area determines exactly the risk borne by those who invest in financial assets or those who take part in financial transactions. Our analysis concentrates on some of the most common types of financial assets found across EU countries: securities, bank loans, deposits and financial derivatives; and on two widely used transactions: securities lending and securitization. In addition, we will discuss asset-backed securities, which are a direct by-product of securitization.

The fourth chapter of the dissertation analyzes various types of financial institutions found across the Member States. We are interested in determining their characteristics in theory, and indicating those characteristics that these institutions have acquired in practice. Throughout the chapter we will primarily focus on microprudential regulation of financial institutions (*i.e.* on the financial stability of a specific institution). By following a common methodological approach in their analysis, we will discuss some of the major risks these institutions incur and how European regulation responds to these risks. We whish to determine whether harmonization of financial regulation has been equally successful with respect to different types of financial institutions, and whether it has been equally beneficial for all of them.

In the fifth chapter of the dissertation we analyze the development of the "market-orientation" trend in the EU. This means that, prior to the emergence of the 2007 financial crisis, EU Member States were focused on developing stronger securities markets following the premise that a market oriented economy guaranteed economic growth and prosperity. In addition our research concentrates on the regulation of European financial markets (securities markets in particular) and securities trading infrastructures. We will discuss the different stages of the development of a comprehensive regulatory regime for securities markets in Europe, and how the nature of regulation changed alongside these developments. Special attention will be put on the "regulatory cornerstone" of European securities law, namely on the "Markets in Financial Instruments Directive".

In the sixth chapter of the dissertation we will give a comparative overview of finance in Italy and Croatia. We will give an overview of their experiences in transposing and implementing European financial regulation and supervision. An identical analytical approach will be used to assess both countries. First, we will discuss the historical developments of the Italian financial system and the Italian experience in transposing and implementing EU financial regulation. Naturally, we will also address the current regulatory objectives pursued through Italian financial legislation and supervision of financial institutions. In a similar manner, we will research the development of the Croatian financial system, followed by the analysis of Croatia's experience in transposing EU legislation in the area of finance. Our goal is to analyze whether Italian and Croatian regulation and supervision are adapted to their national economic systems and whether they are compatible with EU regulatory trends and current supervisory practice. Our comparison is not entirely descriptive, as we will give some critical observations directed mainly towards Croatia as an EU acceding country. We are interested in ascertaining whether Croatia's convergence to EU regulatory requirements in the area of finance will contribute to the economic prosperity and stability in Croatia.

The last, seventh, chapter of the dissertation presents the results of our research as a whole, and offers several critical observations and proposals with respect to the dissertation's subject.

At the end of this introductory chapter a few words should be said about the methodological approach used in the research. In this respect the thesis may be divided into five separate parts – the first two parts resting on a common methodological approach while the other three will have a different methodology matrix. The common feature in all the chapters of the thesis will be the reliance on the following scientific methods: classification, comparison, analysis and synthesis. In the first chapter, we will mostly use the descriptive method and the causal –

consecutive analysis. The latter method will also be used in the second chapter. Relevant literature will be used, both from the area of economic and legal sciences. The third and fourth chapter will be based on a common methodological combination of theoretical and data survey. The fifth chapter will predominantly use the methods of comparison and syntheses. In addition, current data and relevant information will be collected and they will be compared with the data available from national regulatory authorities' statistical publications.

2. THEORETICAL ANALYSIS OF FINANCIAL REGULATION AND SUPERVISION

The chapter analyses the theoretical foundations of financial regulation and financial supervision, emphasizing especially the economic rationale and objectives behind these regulatory activities. We analyze the economic rationale of financial regulation and supervision in section 2.1. Section 2.2. discusses in greater detail the division between regulation and supervision in theory and practice. We argue that the difference between them is somewhat similar to the one made between the legislative and executive branch of government, where the former is seen as foundation and the latter is regarded as its enforcement mechanism. In this sense *financial regulation* refers to laws, while *financial supervision* refers to the application of these rules to specific cases in practice. The chapter continues with section 2.3. and the analysis of the development of regulation and supervision in the EU. In subsection 2.3.1. we discuss in more detail the following regulatory trends: centralization, competition and co-opetition. In subsection 2.3.2. our attention turns to supervision and the trend of its institutional consolidation and supranational centralization. Finally, subsection 2.3.3. discusses the European current approach to financial regulation and supervision envisaged after the last financial crisis.

2.1. Economic rationale and objectives of financial regulation

Economic and financial activities are regulated from their beginning through rules of different type, origin and nature as those of social *habitus*, ethics or formal, substantive law. As the famous French philosopher Michel Foucault has observed, economic life takes place within a legal framework consisting of a given regime of property, contracts, currency and financial intermediation (Sennelart, M., 2008). Different legal concepts, such as property rights, enforcement of contracts or the rule of law, are implemented to specific economic contexts. In this way, legal concepts establish a regulatory framework with the overall goal of financial stability. Thus, financial regulation is imposed on markets and their participants as a form of ″legal remedy″ to asymmetries and inefficiencies markets are inherently prone to[1]. The reality is that no economic activity exercised within a community can be absolutely free of legislative norms or other forms of regulations, since different types of legal arrangements limit the interference of individual market actions with the legitimate interests of others within the market. Simply put: *ubi societas ibi ius*.

In this section we argue that a well-developed financial system, which functions within an adequate legal framework, promotes financial intermediation, resource allocation, and supports economic growth, ultimately reducing the possibility of financial turmoil[2]. Moreover, we observe that the economic rationale of financial regulation and supervision lies in the fact that these activities support the effectiveness of financial markets by establishing "rules of the game". They govern the spontaneous order of economic life through laws. Hence, legal frameworks, regulatory systems, and law in general, are fundamental to financial stability and economic development. Still, there is no denying that perfect legal systems do not exist. Even the most finely tuned body of law requires ″maintenance″ on a continuous basis. As McCormick (2006) put simply, one of the objectives of law within finance is to serve the interests of the "market society" (as he refers to a market economy in his writings) and as a consequence this objective is always a moving target (McCormick, R., 2006, p. 22).

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[1] In the broadest sense, asymmetries refer to the existing asymmetric information within financial systems, or more precisely markets, where certain market participants dispose with significantly more market information than others and may use that information at their advantage when engaging into different financial activities (*e.g.* professional, institutional investors). The term ″inefficiency″ also relates to financial markets where some market participants (investors) fail to recognize the good prospects of a certain security or its heading for trouble.

[2] Nevertheless, the period of severe financial duress which followed the 2007-08 economic crisis seems to prove that it was precisely the most developed countries and their financial systems (and between them those countries that were more market oriented) that suffered the most serious consequences with respect to financial stability. It seems as the latest crisis showed that a ″narrower″ financial system guarantees better stability in times of duress.

In order to fully understand the role of financial regulation in the financial system it is first necessary to understand its "economic rationale" and its "objectives". Under the first term we understand the economic justification to regulate economic activity in the first place, which is usually based on specific economic criteria (*i.e.* why regulate). The rationale is to achieve concrete objectives and outcomes secured through the regulation (Llwellyn, D. T., 1999). As for the objectives of financial regulation (*i.e.* what to regulate), they are numerous, they differ across national jurisdictions and are often interdependent[3]. However, it is possible to identify several core objectives common to the majority of regulatory systems. The economic justification for financial regulation in general is connected with the crucial role that the financial system, *i.e.* its components institutions and markets, play within a community. The important role that the regulatory context plays within financial systems wasn't fully acknowledged amongst academics and practitioners until the mid nineties of the 20th century when some of the most discussed banking crisis emerged (Arner, D. W., 2007, p. 13). Later, with the occurrence of financial crises worldwide, awareness has been raised regarding the interaction between law and finance[4]. Greater emphasis was put on the complex relationship between adequate regulatory and supervisory frameworks and efficient financial institutions (with special focus on banking) as well as on the legal underpinning of financial market development. Both economists and lawyers started to agree that there is a strong economic reason to regulate finance. Consequently, financial regulation was aligned with wider social objectives, such as sustaining trust in the financial system, and was established as part of the public legal order. Its broad goal was to change the behavior of financial institutions for better, by enhancing compliance with regulatory requirements.

We have already stated that the nature of financial regulation is dynamic, meaning that its adaptations to market practice and innovations are constant. Consequently, the economic rationale of financial regulation is often elusive as it follows directly the nature of regulation. Nevertheless, certain ″timeless″, core elements constituting the economic rationale for financial regulation, which justify legal intervention in the area of finance, may be identified:

1. market imperfections represented by information asymmetries;

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[3] Objectives are goals (aims) which financial regulation strives to achieve through its provisions.

[4] Before this period, only the 1970s evidenced an international response to crisis situations with immediate responses in the area of financial institution regulation and supervison developed within international arena, more precisely the Basel Committee on Banking Supervision.

2. negative externalities associated with systemic issues;

3. problems of moral hazard and adverse selection. We discuss these elements below.

Ad (1) Financial activity takes place in an imperfect market where investors' welfare is often impaired in different explicit and implicit contracts concluded between them and financial institutions. In essence, market imperfections represented by asymmetric information justify the regulation of finance (Akerlof, G., 1970)[5]. The problem originates from the nature of the products, which are being ″marketed″ in financial markets. Financial products are primarily intangible ″credentials″. Retail investors (*i.e.* consumers of financial products; buyers; investors) cannot precisely estimate the amount of risk associated with such products, as they do not dispose with appropriate information (unlike professional investors or financial intermediaries). Even if they were to engage in collection of information, this would be a costly activity, and one that could give way to ″free rider issues″ (Ribnikar, I., 1994)[6]. Hence, information and disclosure requirements are central parts of the process of making financial markets more effective for investors. We can see that in a situation that involves credence goods, such as financial products, the relationship between contractual parties must involve considerable trust. Different types of financial regulation balance the interests of unsophisticated investors in financial products (seen as a certain type of "consumers") and their sophisticated sellers. They allow investors to make informed purchases and financial choices. Without financial regulation the asymmetry of information would require the

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[5] In economics, information asymmetry deals with the study of decisions in transactions where one party has more, or better, information than the other. This creates an imbalance of power in transactions which may cause the transaction to go wrongly. A classic paper on information asymmetry is Georg Akerlof's ″The Market for Lemons″ written in 1970. Akerlof's paper uses the market for used cars as an example of the problem of quality uncertainty. The summary of the problem is the following: there are good used cars ("cherries") and defective used cars ("lemons"), but because of asymmetric information about the car (the seller knows much more about the characteristics of a car than the buyer), the buyer of a car does not know whether it is a good car or a lemon. So the buyer's best guess for a given car is that the car is of average quality. Accordingly, the buyer will be willing to pay for it only the price of a car of an average quality. This means that the owner of a good used car will be unable to get a high enough price to make selling that car worthwhile. Therefore, owners of good cars will not place their cars on the used car market. Consequently "the bad will drive out the good" in the market. The paper thus describes how the interaction between quality heterogeneity and asymmetric information can cause markets to fail to exist altogether in situations of quality uncertainty.

[6] In economics, "free riders" are those who consume more than their fair share of a public resource (for the purpose of our discussion this public resource is financially relevant information), or shoulder less than a fair share of the costs of its production. Suppose that a retail investor decides to gather information on the quality and riskiness of a financial product he/she is interested in buying. He/she will have to employ considerable own resources to gather such information, through a costly process. However, once he/she has gathered such information he/she won't be able to keep it for him/her self and hide it from other potential buyers of this particular financial product. This is where free riders step in, waiting for information acquired through the use of other's funds to be disclosed. As retail investors are aware of this problem, they typically do not engage in such a ″information quest″.

investors to spend excessive resources to investigate the quality of, and monitor the behavior of, financial institutions[7]. Since they don't have the level of expertise or other financial and institutional means sufficient to exercise effective monitoring, this activity is delegated to a specialist agency, which acts on behalf of investors and the society as a whole. Thus, regulation enhances public confidence in the financial sector by limiting the impact of market imperfections on financial activity. In this manner, it supports "public trust" and "investors' confidence" in finance.

Ad (2) Negative externalities associated with systemic risk are inherent to finance. These externalities manifest themselves in the case of a financial institutions' default. In such cases the social costs of the default exceed private costs (of the sole institution). This in turn mandates the necessity for financial regulation. Since credit institutions still retain a central position in most of the EU Member States (this is especially true for all transition economies, including Croatia) systemic issues are of particular relevance. In finance, systemic risk is the risk of the collapse of an entire financial system, as opposed to the risk associated with an individual entity, group or component of a system. A classic, textbook, illustration of costly systemic issues is that associated to credit institutions (*i.e.* banks) and the specific nature of their business activities. Because of these activities banks are prone to bank runs. The term denotes a cascading effect of illiquidity and then insolvency on other banks that have claims against the first bank. As depositors sense the negative effects of default, and liquidity concerns spill through the market, mistrust in credit institutions spreads creating many sellers of financial products but few buyers. The interlinkages between financial institutions are thus very important issues to consider when addressing regulation of systemic risk. Hence, with respect to systemic risk, financial regulation strives to protect investors against losses connected with an individual credit institution default. In addition, regulation of systemic risk focuses on sustaining public confidence in the system as a whole.

Ad (3) One of the most straightforward economic rationales in favor of financial regulation is represented by the risks of adverse selection and moral hazard[8]. Both arise from a simple fact:

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[7] "*This is rational and economic as each (intermittent and occasional) consumer is unable to appropriate the full benefits of the costs of supervision when undertaken on an individual basis, as the investment of time and resources is inordinate for small, infrequent purchasers*." (Llewellyn, D.T. , 2009, p. 25).

[8] "*There are circumstances when, without the intervention of a regulator, a grid lock can emerge. This can arise when all firms know how they should behave towards customers but nevertheless adopt hazardous strategies because they secure short- run advantages, and they have no confidence that competitors will not behave*

where laws do not frame the limits of economic activity hazardous behavior of participants will occur. If we were to look at the two types of risk from the aspect of the conclusion of a financial contract, we would conclude that adverse selection can manifest itself prior to its conclusion (*ex ante*) while moral hazard manifests after the contract's conclusion (*ex post*). The risk of adverse selection results from financial institutions' expectations. Institutions engage in risky activities adopting hazardous strategies in order to secure short-term advantages. As for moral hazard, this is the risk that a party to a financial contract will not act in good faith, or that it will act in a manner that is detrimental to the counterparty (Hart, O., Holstrom, B., 1987). For instance, in insurance moral hazard lies in the risk that the mere existence of the insurance contract will result with fewer precautions taken on the part of the insured. In the context of finance, the general issue of adverse selection and moral hazard relate to the negative effect of public "safety net" arrangements. These arrangements may have adverse effects on the behavior of financial institutions (or other market participants), as they are aware that risks can be passed on to others within the system (Hart, O., Holstrom, B., 1987, p. 29). This awareness is linked to the existence of a certain type of financial protection (such as the ″lender of last resort″, traditionally the system's central bank, or a public agency which guarantees deposit insurance, etc.). However, safety nets of this type are a contemporary political imperative. Modern financial systems are carefully controlled and internally regulated by a public legal framework everywhere in the world. Thus, as adverse selection and moral hazard cause possible damages for the investors that cannot be completely excluded, it is economically justified to limit their negative impact through regulation.

After careful consideration of the above arguments we can conclude that financial regulation has substantive economic impact:

(1) it reduces transaction costs for retail investors in financial products as they are able to take better informed decisions and gain more confidence in investing[9], and

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hazardously. The detection of hazardous behaviour may occur only in the long run. In such a situation two problems can emerge: adverse selection and moral hazard." Ibidem, p. 27.

[9] One may argue that while financial regulation lowers transaction costs for retail investors, it raises compliance costs for financial institutions. This argument is particularly relevant from the EU perspective, specifically in the context of prescriptive regulation that has been created during the last decade, and particularly in the area of financial markets regulation (for instance, the Markets in Financial Instruments Directive, which will be discussed in chapter 5). If regulation is "excessive" (meaning that it is over-demanded by consumers and over-supplied by regulators) compliance costs of the addressees (*i.e.* financial institutions) will increase. Ultimately, this will reflect on the price of financial products and services (which will be higher). However, although there

(2) it has positive stabilizing effects on the market overall, as market participants are encouraged to align their behavior with wider social objectives (Llewellyn, D. T., 1999).

As for the objectives pursued through regulation, we can argue that they evolve together with economic development. A general observation is that regulatory objectives are usually aligned with public interest and broader socio-economic goals, which must be followed by all market participants. Although the overall objectives of contemporary financial regulation are broad, several "core objectives" can be clearly and simply defined:

(i) Systemic stability,

(ii) Safety and soundness of financial institutions, and

(iii) Consumer (investor) protection.

These narrowly defined objectives form part of an overarching, broader policy aimed at safeguarding public confidence in the stability of the financial system (Llewellyn, D. T., 1999, p. 9). The above listed objectives derive directly from the economic rationale of financial regulation. Neither of them can be delivered by market processes alone but they are rather a result of targeted regulatory intervention.

To summarize, we reiterate that financial regulation is justified by actual market characteristics as well as by the theoretical basis of law and economics. However, financial systems are not made of a set of given activities to which a static legal order can be imposed and then never changed. On the contrary, financial systems represent complex economic-juridical ensembles that are in constant flux and which are necessarily regulated as a whole (Eucken, W., 1951).

2.2. Regulation v. supervision

The section discusses different types of regulations (prudential, conduct of business and systemic) and supervision. Financial regulation *per se* is defined as the establishment of specific rules of behavior, while financial supervision is defined as the general oversight of the behavior of the addressee of these rules (whether financial institutions or market participants) and their compliance with regulation. Both activities are interdependent.

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are certain "costs to regulation" it does not mean that regulation should be dismissed. Overly prescriptive regulation, or excessively restrictive rules that often raise compliance costs have to be seen as inevitable trade-offs or obstacles in the process of creating effective and efficient financial regulation.

Financial regulation cannot achieve its objectives without a set of supervisory measures and instruments. Supervision is meaningless without a set of rules that have to be followed. In this context, their relation is similar to that of the legislative and executive branch of government, with supervision being the executive force of regulation. Although these two regulatory activities differ significantly in their implementation and most importantly in their specific objectives, their final objective is common. They encourage financial institutions and other subjects within the economy not to act contrary to the wider social objectives (so that the final result is financial stability and investor protection). However, a clear theoretical differentiation between regulation and supervision is somewhat difficult to exercise in practice. In contemporary finance the dividing line between regulatory and supervisory activities is often blurred. In fact nowadays, financial regulation assigns rule-making powers to supervisors in order to refine legislation through administrative measures and other forms of ordinances. Thus supervision often implies regulation, where supervisors act as secondary legislators as opposed to public legislative institutions (Darlap, P., Grünbichler, A., 2004). Also, we have to bear in mind that supervision is a four-stage process consisting of: licensing, supervision *stricto sensu*, sanctioning and crisis management (Lastra, R. M., 1996). In our analysis we will concentrate on supervision *stricto sensu*. This activity ensures compliance with financial regulation within the main business areas of finance: banking, insurance and all activities connected with securities. We shall begin this section with an analysis of financial regulation and then turn our attention to supervision.

Despite its practical significance there is no single "textbook definition" of financial regulation. In the broadest sense, we can state that financial regulation comprises laws and rules that govern activities of financial institutions and those of the participants in the financial market, with the aim of maintaining overall financial stability. In a theoretical sense, financial regulation can be seen as an instrument of macroeconomic strategy used to obtain various economic objectives. Regulation reflects economic policy, namely heterogeneous societal preferences through hierarchy of regulatory objectives.

In the majority of European countries lawmakers and regulators prescribe in great detail the exact manner in which addressees should behave in order to meet their obligations. In such cases rules, as fundamental instruments of regulation, provide standards of behavior. These rules should be simple, easily applicable, clear about the obligations of the addressee and congruent with their purpose. Henceforth, in the majority of Member States financial regulation is also rules-based. However, there are certain Member States, such as the United

Kingdom, which follow a different system of regulation. This is the so called principles-based system (as opposed to a rules-based). Here regulators evaluate addressees' behavior according to broad principles, which create incentives for socially desired actions by means of supervision[10].

Regardless of the system that financial regulation follows, we should make it clear that regulation is different from substantive law. Substantive law is a system of rules and principles drawn from statute in civil law jurisdictions, or case law in common law jurisdictions. Substantive law includes private law (*e.g.* contract law), criminal law, and so on. It is not created with finance specifically in mind unless it is directly related to financial services, markets or institutions. Financial regulation, which is discussed and analyzed in this thesis, is based on EU legislation as implemented into national legal systems and specifically designed for the financial area (Hudson, A., 2009, p. 15; Hudson, A., 2004). All things considered then we may conclude that substantive law would be concerned with the establishment of liability schemes for debtors and compensation schemes for investors or those who have claims; whilst financial regulation has a more general scope – to support the functioning of financial markets. Moreover, regulation goes beyond the traditional centrality of state law (*i.e.* national laws that are confined to a specific jurisdiction). Namely, it combines state law with other forms of formal and informal contracts as well as international guidelines (Gottwald, J. C., 2005).

Financial regulation has to be effective and efficient (Llewellyn, D. T., 1999, p. 52). This can be achieved through the optimal distribution of activities between regulation and supervision (about which we will talk later in this section). Different combinations of regulatory activities make up different regulatory approaches[11]. We discuss the following:

(i) Prudential;

(ii) Conduct of business; and

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[10] *"...l'esperienza inglese ci dice che una regolamentazione 'amica del mercato' non cala dall'alto, ma viene realizzata dalle autorità in stretta collaborazione con il management delle instituzioni e dipende dalla capacità di quest'ultimo di assumersi la responsabilità sostanziale di assicurare equità nel rapporto con la clientela."* in Onado, M., Calabrò, G., Saccomanni, F. (2007). However, the (dis)advantages of a rule-based or principle-based regulatory system won't be considered within this dissertation. For a more thorough insight of the issue see for example Financial Services Authority (2008).

[11] Some literature (*e.g.* Carbajales, M., 2006) suggests that these approaches may be scientifically classified as categories or types of regulations. In this thesis we shall refer to them as "regulatory approaches" following the division made by Llewellyn in addressing the rationale for public sector regulation of financial systems (see Goodhart, C., Hartmann, P., Llewellyn, D., Rojas-Suárez, Weisbrod, S., 1998, p.5.).

(iii) Systemic regulation.

The theoretical rationale behind every approach is different and based upon specific economic arguments. Furthermore, every type is directly associated to the accomplishment of a specific objective of financial regulation. For example, whilst prudential and conduct of business regulation are based on the codependency of consumer (investor) protection and soundness of financial institutions, systemic regulation relates to the safety of financial institutions from a purely systemic aspect.

Ad (i) Prudential regulation comprises a set of laws and regulations designed to minimize the risks financial institutions incur in their activities as well as to ensure safety and soundness of both individual institutions and the system[12]. Measures of prudential regulation typically address stability issues at the micro-level, *i.e.* the level of a single financial institution. They are usually two-fold:

(1) general rules related to the stability of financial institutions and their activities (such as capital adequacy requirements or borrowing limits) and

(2) specific rules associated with the characteristic nature of financial intermediation (limits to portfolio investment, regulation of off-balance activities, and other).

The scope of prudential regulation is to respond to financial market imperfections. It ensures that investors can judge and monitor effectively the safety of financial institutions.

Ad (ii) Conduct of business regulation shares its theoretical foundations with prudential regulation. Both are focused on client protection but while prudential rules represent stability guidelines for institutions, conduct of business rules aim at establishing appropriate business practices for financial institutions in dealing with their customers (*i.e.* investors in their products)[13]. The conduct of business rules foster a more transparent relationship between financial institutions and investors. Due to the nature of financial institutions' activities and to agency issues[14] inherent to financial contracts, investor protection issues are more pronounced than in other business areas. The objective of this regulatory approach is better market

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[12] Polizatto, V.P., 1992.

[13] Ibidem, p.6.

[14] Broadly explained, agency issues arise in finance because of the specific relationship between the two parties to a financial contract and the potential conflict of interest inherent to this relationship. Namely, in financial contracts one party is considered to be the principal, while the other party is an agent representing the principal in transactions with third parties. But the agent and the principal may have conflicting interests, which may cause problems and give rise to agency issues.

transparency and greater investor protection. A wide array of legal instruments is used to achieve these objectives. For example: transparency rules, public offers and takeover rules, rules on insider dealing, rules imposing equal treatment of market participants and correct dissemination of information, etc. However, it is important to recognize that conduct of business regulation isn't relevant only to investors. Its broader context is to sustain the credibility and reputation of a financial institution and in it, the conduct of business regulation bears direct prudential relevance[15].

Ad (iii) While the phenomenon of systemic risk is not exclusively limited to finance, the likelihood and severity of its occurrence in this particular economic sector are indisputably higher than in other sectors. Traditionally, systemic risk is associated with banks and other deposit taking credit institutions. The dominant concept within systemic risk is "contagion". Contagion, as a process, refers to the interlinkages and interdependencies within the financial system where the failure of a single institution or cluster of institutions (financial conglomerates) can cause a cascading default effect that could potentially bankrupt or bring down the entire system. Contagion occurs because of the structure of the banks' balance sheet, the interconnection of financial institutions through their network of financial contracts (*e.g.* interbank borrowings) and their interdependency within the settlement system. The preventive regulation may be of two types. The first is the prescription of pre-emptive public policies in order to avoid the occurrence of systemic events (which should be distinguished from *ex post* policies such as crisis management)[16]. Then there are, secondly, activities of the system's central bank that minimize the consequences of systemic shocks (for instance through the ″lender of last resort″ function) if they occur.

As we can see, whilst prudential and conduct of business regulation are more individually oriented (to a particular investor or institution at the micro level), systemic regulation is designed to streamline the system as a whole.

Nowadays, composite cross-border transactions and financial innovation force regulators to envisage a modern regulatory mix comprising prudential, conduct of business and systemic regulation, which prevent financial institutions to make financial choices with undesirable social consequences. By contrast, they force them to align their private interests with wider

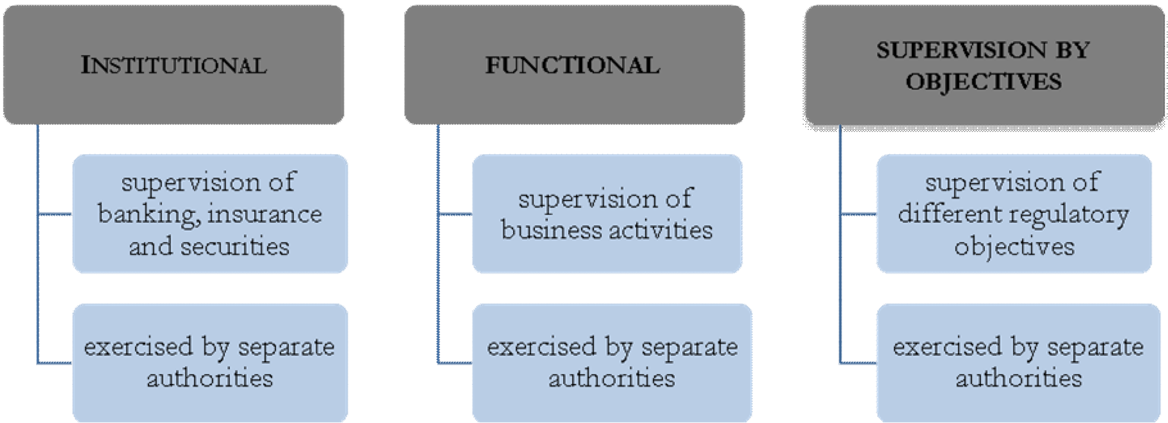
[15] Wymeersch, E., 2007, p.245.

[16] The *ex ante* public policies in this context are represented by rules regarding central banks' oversight, collateral requirements, position caps, and other.

social preferences. These preferences are then formulated as different objectives of financial regulation and are then pursued through an adequate set of instruments and measures employed by supervisory authorities[17].

From an institutional perspective there are three core supervisory models, as demonstrated in the graph below:[18]

2(1) Core supervisory models



Ad (1) The institutional model of supervision follows the specialization of financial activities into banking, insurance and activities connected with securities. First developed as a response to the great crisis of the 1930s this model of supervision is segmented and designated to different fields of business. It is performed over every single area of the financial system by a distinct authority which develops its own techniques, approaches and practices of institutional oversight. This type of supervisory arrangement is thus known as institutional or "sectional"

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[17] At this point it is necessary to explain the relation and mutual influence between the following terms: "regulator" and "supervisor". It was mentioned that regulators make the rules by which financial institutions and markets operate, and supervisors enforce them. Hence "regulation" refers to rule making while "supervision" refers to the application of these rules in practice. However, regulation is a broader term than supervision – since it refers also to policy conduct. It is possible to interchange these terms, and many authors do, mostly when analyzing regulatory structure (see Goodhart *et al*., 1998, p.145.) However, note that: "*Traditionally, and following the American terminology 'regulators' referred to both activities. In recent literature, both terms are increasingly distinguished: usually the pattern for supervision follows that of regulation. In Europe both levels are clearly distinguished*." In Wymeersch, E., 2005.

[18] It has to be noted that the following division of supervisory models is based on the theoretical proposition made by Goodhart *and al*. in Financial Regulation – Why, How and Where Now?, Routledge Taylor & Francis Group, London 1998. Some authors delineate supervisory arrangements in a different manner. For example Wymeersch, E. in The Future of Financial Regulation and Supervision in Europe (cit. above) suggests three different arrangements – institutional, functional (defined by regulatory objectives) and the so called integrated approach to supervision, or Di Giorgio, G., Di Noia, C. (2001, January) where four different approaches are noted: institutional supervision, supervision by objectives, functional supervision and single-regulator supervision. Another important division of institutional models for supervision is the one proposed by Cervellati and Fioriti which is commonly used in the few papers addressing Croatian regulatory reform issues: (i) vertical model which is congruent to the institutional one, (ii) horizontal model (or supervision by objectives) and (iii) the centralized model (or single supervisor). See Cervellati, E. M., Fioriti, E. (2006, January).

supervision, supervision "by subjects" or the "three-pillar" model, as usually three different authorities monitor the main lines of financial business. In this model, supervision focuses on the legal nature of a financial institution irrespective of its activities[19]. For instance, an institution which intends to engage in banking activities, registered as a bank (according to the provisions of national company law) and which limits its business to the banking area, remains within the competences of the supervisory authority specified for banks. If afterwards, the institution extends its business activities beyond its originally defined limits (*e.g.* investment banking and trading in securities) it will still be subject to the same authority. Within this model the supervisory authority controls financial institutions through authorization processes, monitors institutions' business activities (inspections, sanctions) and oversees possible exits from the financial market (suspensions, removals). This model of supervision is particularly efficient in cases when financial institutions have narrow business activities or when they operate in one of the three ″traditional″ areas of financial business. Disadvantages arise when multiple and cross-sectors activities occur within a single institution, which is the case with the majority of European and international financial institutions[20]. In the European Union Greece is the only practical example of the ″pure″ institutional model. A more complex example is that of Italy, where supervision is based on the institutional model but at the same time it includes many elements of supervision by objectives (discussed *Ad (3)*).

Ad (2) In the functional model of supervision, the supervisory authority distinguishes between different activities the financial institution engages into. It considers the business activities of an institution to be "given", or at least more stable, than the institution itself. According to this model of supervision, different supervisory authorities monitor different type of business activities. Thus financial institutions and markets are subject to the control of more than one authority, with each authority being responsible for distinct activities irrespective of the institutions' legal nature. For example, under the functional model if a single institution

[19] "*Although the tasks of the banking and insurance supervisors may be largely the same – both engage in prudential supervision, although over time additional missions such as consumer protection, conduct of business rules, supervision of money laundering and tax policies have been added to the original prudential mission – their supervision will not be integrated, as the dividing line is based on the institutional differences between the two series of firms*." Wymeersch, E., 2005, p.252.

[20] "*In a context where the boundaries separating the various institutions are progressively being erased, it is no longer possible to establish whether a particular subject is a bank, a non-banking intermediary or an insurance company; or whether a group is involved more in one or another of such activities*." Di Giorgio, G., Di Noia, C., 2001 January, p.9.

would engage into banking, insurance or securities transactions, each of those distinct lines of business would be overseen by a separate authority. A challenge for this model is that activities must fall into business categories clear enough for the supervisor to oversee them. This type of supervisory arrangement promotes the specialization of supervisory authorities and represents an attractive solution for the supervision of integrated financial markets. However, its main drawback is the overlapping of supervisory competences when monitoring different activities of the same entity. In addition, there is a greater risk of excessive division of competencies among supervisors. A practical example of the functional model of supervision is Netherlands.

Ad (3) The model of supervision by objectives is based on pre-established regulatory objectives, which then condition the institutional set up of supervision. In this model supervision is divided not by market function but by purpose (objectives). According to the model, financial institutions are subject to the control of more than one supervisory authority responsible for the pursuit of a particular regulatory objective (for instance, overall financial stability or investor protection) regardless of the legal nature of the institution or its business activities. The model was first suggested by Michael Taylor in 1995 and named as the "twin peaks" model where separate supervisors pursued financial stability as opposed to prudential and conduct of business supervision[21]. Taylor's concept was later widely acknowledged and progressively developed in a four and then even six-peak supervisory arrangement[22]. In this model a specialist supervisor, distinct from the central bank, enforces prudential regulation and oversees micro-stability of financial institutions. Another supervisor controls the behavior of different financial intermediaries towards investors, whilst a third one ensures market competition. The most positive feature of this arrangement is that it provides uniform regulation for different entities engaged in same business activities. However, in comparison with the institutional model it is clear that this model may cause multiplication of supervisory competences. Since every institution is subject to the control of more than one specialist authority they will almost certainly be required to produce overlapping reports, which in turn will result with greater costs of regulatory compliance.

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[21] See Taylor, M.,1995. In his article Taylor makes an interesting observation, with which we do not necessarily have to agree, but it is worth noting, especially when we discuss macroprudential regulation. Namely, he argues that two regulatory objectives – systemic protection and consumer protection are potentially in conflict, and that there are profound differences between techniques and instruments of prudential regulation and conduct of business measures, and that as a result they should be enforced by separate authorities.

[22] See Goodhart, C. (1996, December) and Di Giorgio, G., Di Noia, C. (2001, January).

In conclusion let us state that is difficult to ascertain in abstract, which of the above discussed supervisory models can be considered better. In practice, there is a prevalence of mixed supervisory models (*e.g.* the Italian, Croatian, French, and other) that combine elements of different supervisory arrangements. Essentially, regardless of the supervisory model chosen by a country, its overall objective should be to support the accomplishment of regulatory objectives through an adequate institutional structure and cost efficiency.

2.3. Development of EU financial regulation and trends in financial supervision

For the last two decades the academic research of financial regulation and supervision has been closely connected with the phenomenon of European political and economic integration and the resulting harmonization of national legislation. Political and economic efforts within the Union are constantly oriented towards greater convergence of finance through harmonization based on "core integration principles" (*i.e.* minimum harmonization, mutual recognition, home country control). This process requires intensive cooperation between regulatory and supervisory authorities as well as legislators across EU Member States. Without going into technical details of the EU legislative process, this section discusses the basic structure of European Union law, explaining the main types of EU legal instruments, their hierarchy and administrative requirements. We briefly tackle policy developments in European financial regulation, the adoption of different "policy agendas related to quality rulemaking", as well as the issue of convergence of supervisory arrangements across Member States. We begin the section by discussing the legal instruments of European Union law and their legal effect at the level of individual states. We give only a succinct description of these instruments leaving the detailed discussion of regulatory centralization and competition to the following section. In addition we give an introduction to the complex governance structure of EU financial supervision in two sub-sections: 2.3.1. discussing the trend of regulatory centralization in the EU and 2.3.2. discussing consolidation and centralization of supervision.

It is often said that the law of the EU in the area of financial services follows a functionalist approach to regulation. This means that a specific type of financial activity is subject to the same type of regulation irrespective of the type of institution performing it. Accordingly, the three main areas of financial regulation in the European Union are: banking, insurance and activities connected with securities. As part of the EU law, European financial regulation is carried out within the so called Community pillar[23]. The majority of EU laws are adopted under procedures whereby the legislative initiative is delegated to the European Commission. The Commission, in turn, exercises its powers in coordination with committees of national representatives in a procedure known as comitology[24].

European Union law is made up by a body of treaties, law and court judgments, which operate alongside the legal systems of the EU's Member States. It has direct effect within the EU Member States and, where conflict occurs, takes precedence over national law[25]. EU legislation derives from decisions taken at supranational, EU level, yet implementation largely occurs at national level.

The primary source of EU law are the "founding treaties". These are power-giving treaties that set broad policy goals and establish institutions that, amongst other things, can enact legislation in order to achieve those goals. These treaties have been amended and supplemented on numerous occasions during the years. The most recent amendment is the Treaty of Lisbon, which entered into force in 2009[26]. The legislative acts of the EU come in

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[23] Between 1993 and 2009 the EU legally consisted of three pillars. This structure was first introduced with the adoption of the Treaty of Maastricht in November 1993 and was abandoned in December 2009 with the entry into force of the Treaty of Lisbon when the EU obtained legal personality. The Community pillar dealt with economic, social and environmental policies. It was the only pillar with legal personality. The other two pillars were the Common Foreign and Security Policy and Police and the pillar of Judicial Cooperation in Criminal Matters (or the Justice and Home Affairs pillar). Within each pillar a different balance was struck between the supranational and intergovernmental principles of decision-making. It is worth noting that supranationalism was strongest in the first pillar. This way it gave space to centralization forces in the development of financial regulation.

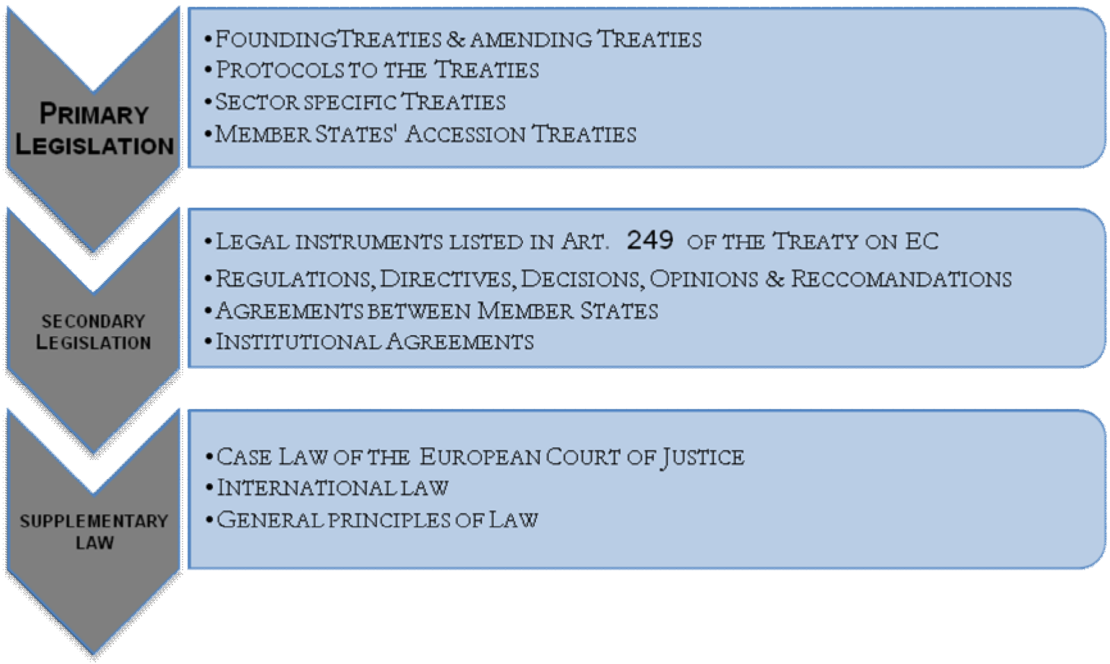
[24] The Lamfalussy Report (which we will discuss in sub-section 2.3.1.) introduced the comitology process. This process refers to the committee system that oversees the delegated acts implemented by the European Commission. In line with Article 5 of Council Decision 1999/468/EC establishing the procedures for the exercise of implementing powers conferred on the Commission. See Chalmers, D., Tomkins, A., 2007, p. 132.

[25] According to the principle of direct effect first invoked in the Court of Justice's decision in *Van Gend en Loos v. Nederlanse Administratie Der Belastingen*, the provisions of binding EU law which are clear, precise, and unconditional enough to be considered justiciable can be invoked and relied on by individuals before national courts. There is a narrower, more classical definition of direct effect that is usually expressed in terms of the capacity of a provision of EU law to confer rights on individuals that they may enforce before national courts. Furthermore, it has been ruled many times by the European Court of Justice that EU law is superior to national laws. Where a conflict arises between EU law and the law of a Member State, EU law takes precedence, so that the law of a Member State must be disapplied. This doctrine, known as the supremacy of EU law, emerged from the ECJ in *Costa v ENEL*. See Craig, P., De Búrca, G., 2008, p. 270.

[26] It is important to note that the Treaty of Lisbon does not replace the current EU and EC treaties. Among numerous changes and alterations in the administrative, institutional and policy sphere, the Treaty also tackles economic and financial issues. In this respect, maybe one of the most significant contributions of the Treaty is that it reaffirms that the powers, which are not conferred upon the EU, shall remain with the Member States. Thus, the powers that are exclusive to the EU level (the so called "exclusive competences") include: monetary policy and Euro, competition policy and common commercial policy (Art. 2b). As for the Single market, it will remain under shared EU and Member State competencies, which suggests that a similar approach shall be taken toward financial regulation. For a detailed insight see the Treaty of Lisbon amending the Treaty on European

two forms: regulations and directives. A further important source of EU law are the "general principles" of law drawn by the European Court of Justice (ECJ) from the common traditions and constitutional rules of Member States and from international agreements and conventions they have signed. The primary legislation or treaties are effectively the constitutional law of the European Union. Governments from all EU Member States acting create them by consensus. They lay down the basic policies of the Union, establish its institutional structure, legislative procedures, and powers. In addition, the EU concludes agreements in international law with non-member countries and with other international organizations; these range from treaties providing for extensive co-operation in trade or in the industrial, technical and social fields and so on, to agreements on trade in particular products.

2(2) Sources of EU Law and their hierarchy



The main types of Community legal instruments that are used in regulating finance are set out in the founding treaties[27]. These are:

(1) Regulations,

(2) Directives and

Union and the Treaty establishing the European Community, signed at Lisbon, 13 December 2007, Official Journal 2007/c 306/01.

[27] See Art. 249 of the Consolidated versions of the Treaty on European Union and of the Treaty establishing the European Community, available at:

http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/ce321/ce32120061229en00010331.pdf

(3) Decisions[28].

Regulations are the most centralizing of all European legislative instruments, whose implementation at national level results in absolute legal uniformity in a regulated area. They are characterized by their general application to categories or persons described in an abstract manner (*addressees*) and by their direct applicability into the national legal order of each Member State. By contrast, directives are only binding as to the result to be achieved through them, whilst the legal form and method used to transpose the directive's provisions into national law are left to the Member State's choice. Finally, decisions are binding upon those to whom they are addressed, the majority of addressees being Member States. Unlike a regulation, a decision is not a general measure but an individual one directed to a specific addressee(s).

As for supplementary law, here the European Court of Justice exercises a pivotal role. This is principally through the creation of legal principles such as "direct effect" and "supremacy". These principles bind EU institutions and Member States. Also, the Court has jurisdiction in various specific matters, conferred on it by the Treaties. It is important to note that the principle of uniformity is a central theme in all decisions by the ECJ, which aims to ensure that the application and interpretation of EU laws does not differ between Member States.

Finally, the general principles of law are rules reflecting the elementary concepts of law and justice that must be respected by any legal system[29]. These principles are given effect when the law is applied, particularly in ECJ judgments.

Since Member States have divergent legal traditions the 'transposition' of the principles of EU financial regulation into national legal systems is often challenging. The main problems encountered are, for instance, the delays in the implementation of directives at national level, which usually result with directives being outdated once they are finally enforced. Another issue is the distortion of the principles contained in the directive's provisions which have to

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[28] Recommendations and opinions are non-binding instruments of Community law. They are of persuasive value only.

[29] General principles of law identified and applied by the ECJ include, for instance, the principle of proportionality, the protection of legitimate expectation and the guarantee of basic rights.

be turned into workable national rules. All of this results in great diversity of both substance and in the types of legal instruments used across Member States[30].

EU financial integration is essentially pursued through legislation. Thus, from the aspect of the EU it is a matter of public interest to create appropriate regulation, where all financial institutions in the Union will enforce common rules[31]. The basic idea is that through the implementation of common EU regulations financial markets will surpass the differences between national economic systems operating in divergent legal environments. So far, three core integration principles: *minimum harmonization*, *mutual recognition* and *home country control*[32], have been the main instruments of financial integration. Irrespective of their initial success the implementation of these principles provoked a debate regarding their applicability to modern finance, which is still going on. We will focus on this issue in sub-section 2.3.1.

But the future of European regulation and supervision is not shaped by EU legislation exclusively. Market developments are another significant force in determining their development. This process is two-sided:

(1) it focuses on consolidation of supervisory authorities in the national financial system, based on institutional integration, and

(2) it suggests that a hierarchical, centralized structure, with monitoring competences allocated at a supranational level with some supervisory powers delegated to the national one, would be optimal for the EU.

Ad (1) We use the term *consolidation* (or more precisely "institutional consolidation") to denote the trend of integrating different supervisory functions within a single authority, or of consolidating different existing supervisors within a single institution. Thus, consolidation is

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[30] *"The regulatory framework in Europe leaves some discretion to national authorities for interpretation and translation into national legislation. This could potentially result in regulatory arbitrage and an unlevel playing field."* Prepared by the *ad hoc* working group of the Economic and Financial Affairs Council, 2004, p.14.

[31] "*Regulation is a normal activity of any government, and this is especially the case for the EU, which has amassed over 150,000 pages of regulation in the Single Market alone.*" In Hardacre, A. (2008). See also Avgerinos, Y.V. (2003).

[32] *Minimum harmonization* means that a piece of EU legislation sets a minimum threshold of specific requirements which national legislation must meet. *Mutual recognition* is the principle of EU law under which most part of legal control takes place in the country of origin and the country of destination acknowledges the former's regulatory power. The EU principle of home country control determines which laws will apply to the goods or services that cross Member States' borders. In short, the principle states that, where an action or service is performed in one country but received in another, the applicable law is the law of the country where the action or service is performed.

defined as the reduction of the number of competent authorities. It is important to note that the consolidation we are referring to in this analysis takes place at national level.

Ad (2) We use the term *centralization* in its administrative sense of vertical centralization – as a form of European governance, where supervisory powers are centralized within a single, supranational authority to which national authorities are subject (or where national authorities cease to exist). The debate about the degree of supranational centralization or overall decentralization in the allocation of supervisory competencies has to take into account the founding principles of the EU, primarily the principle of subsidiarity[33]. This is because subsidiarity is closely related to the principle of proportionality and to the conferment of powers.

Within the debate concerning centralization it is possible to distinguish two contrasting views:

(i) one that supports absolute centralization of supervisory powers, and

(ii) the other that advocates decentralization combined with greater cooperation among national supervisors.

The British, for example, argue in favor of the latter view pointing out that greater cooperation between national authorities would better serve an integrated financial market. The first view, favored by some countries in continental Europe, argues that supervision in Europe can only be efficiently performed by a centralized authority (or several centralized authorities) rather than by a large number of national authorities. In line with this concept, in February 2009, the De Larosière Report proposed a more evolutionary approach. The Report proposes the creation of a more integrated network of supervisors (composed by national authorities, colleges of supervisors for financial conglomerates and more centralized, supranational agencies) involved in both micro and macro prudential surveillance[34]. It is worth noting that already in 2003, Lastra suggested that the trend towards greater centralization of supervision was in a way embedded into the founding Treaty through its ″enabling clause″, comprised in Article 105(6)[35].

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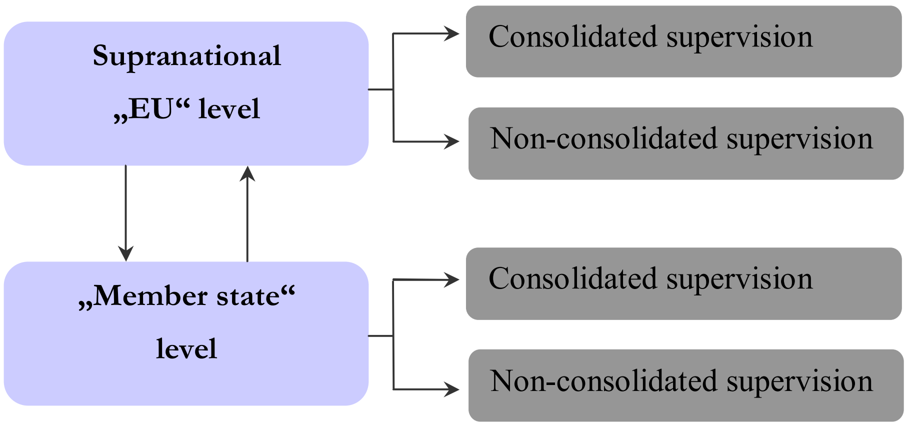
[33] As defined by Article 5 of the EC Treaty.

[34] Report of the High-Level Group on Financial Supervision in the EU (2009).

[35] Art.105.5 and 6 gave only a limited role to the ESCB in the supervision of credit institutions, leaving open the possibility that the ECOFIN Council might confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit and financial institutions with the exception of insurance undertakings.

2(3) The governance structure of European financial supervision



Similar to the issue of financial regulation, the issue of the institutional set up of supervision is a dynamic one. It evolves in direct correlation with market activity. But appropriate supervisory arrangements and their institutional set up cannot be determined by simple theoretical analysis. They result from numerous factors, local or specific, such as a country's financial development, legal tradition or government policy choices. In this respect it is difficult to determine a common institutional set up of supervision, which should be pursued by all EU countries. It is true however, that some factors have a more permanent value in supervision, and that the direct link between market developments and the institutional set up grant the possibility to ascertain certain models as more appropriate. In this context we argue that Europe doesn't need a single supervisor, but rather a simpler version of the current structure of national authorities, which should enforce common financial rules in a more coordinated way.

2.3.1. Regulatory centralization, competition and co-opetition

It seems that the nature and level of EU regulatory centralization and competition evolved in direct correlation with the maturing of the internal market project. Indeed, the convergence of Europe's regulatory systems has been difficult before the adoption of the Single European Act of 1986[36]. Before it, the European Commission had relative success only in certain areas of harmonization (such as quality control of goods, industrial property rights, public procurement and other administrative sectors) but harmonization of financial services

[36] Available at: http://eur-lex.europa.eu/en/treaties/index.htm

remained poor. It was evident that in order to create common financial regulation a more centralized strategy was needed. First envisaged by the European Commission's White Paper of 1985 and implemented through secondary EU law, European financial regulation is founded on three core integration principles that we have already mentioned:

(1) Minimum harmonization,

(2) Mutual recognition and

(3) Home country control[37].

The broad acceptance of the mutual recognition concept allowed for products and services, which legally circulated within one Member State, to be admitted in other Member States without additional regulatory requirements. Mutual recognition required both the abolition of trade barriers ("negative integration") and the setting of common minimum standards ("positive integration"). At the same time, free access to financial markets was conditioned by the minimum harmonization principle that mandated "essential regulatory requirements" that Member States had to comply with in order to gain free access to other European financial markets. In addition, harmonization was guided by the principle of home country control under which the primary task of financial institutions' supervision was left to the competent authorities of the Member State of origin.

Irrespective of the enthusiasm that followed the initial success of the harmonization of financial services, by the end of the 1990s concerns emerged with respect to the fragmented structure of financial markets. In fact markets were still largely fragmented alongside national borders and under the control of national authorities. As a response, in 1999 the Commission put forward the *Financial Services Action Plan*[38] and the *Lamfalussy Report*, a year later[39]. In other words, the EU adopted the stance that the way to achieve integrated financial markets is

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[37] Avgerinos, Y.V. (2003).

[38] Hereinafter referred as FSAP. Available at:

http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#actionplan

[39] This Report comprised the recommendations of the Committee of Wise Men chaired by Baron Alexandre de Lamfalussy which were adopted in the Resolution of the March 2001 Stockholm European Council. It proposed a "fast track" decision-making procedure which differentiated between core principles to be decided upon by the European Parliament and European Council and the more technical measures to be defined by the new structure of "comitology committees". Firstly proposed for the securities markets, this regulatory procedure was quickly introduced for banking and insurance throughout the EU. Available at:

http://ec.europa.eu/internal_market/securities/lamfalussy/index_en.htm . At this point it is also worth to note that both the FSAP and the Lamfalussy legislative model will be discussed in chapter 5., more precisely section 5.2. but from a somewhat different angle, in line with the chapter's topic.

to regulate, and to do so in a quicker and simpler manner. Thus, the EU suggested the introduction of a new rule-making approach in line with the Final Report of the Committee of Wise Men on the Regulation of European Securities Markets[40]. The ″Lamfalussy approach″ proposed by the Report of the same name, changed the governance structure of financial regulation, redistributing powers between the actors at the supranational and national level, and thus constraining Member States to achieve better regulatory convergence[41]. The new regulatory procedure redistributed the powers of EU institutions. More importantly, it limited the possibilities of Member States to pursue individual regulatory approaches by introducing a complex network of regulatory and advisory committees who promoted a harmonized approach in implementing the adopted regulation at national level.

If the FSAP answered the question "*what to regulate*", the Lamfalussy framework showed "*how to regulate*" financial markets in general[42]. The proposed four-level legislative process, with significant powers delegated to implementing committees, allowed the adoption of detailed harmonized rules at a level unprecedented in European financial regulation. According to the framework the "principle" and "detail" legislative measures were separated in regulation. This, in turn, minimized ambiguity in primary legislation and allowed technical rules to follow the underlying principles. Directives became the preferred legislative instrument of financial integration, as opposed to regulations which were inconsistent with the minimum harmonization principle. However, with time, the Directives adopted under the Lamfalussy approach moved away from the minimum harmonization principle towards more "intrusive" harmonization, hence raising concerns as to the degree of regulatory centralization. Let us explain why this "principle revolution" happened (that is, the shift from minimum to maximum harmonization).

On the one hand, the Lamfalussy approach was mainly intended to alleviate institutional rigidity in the legislative process at EU level by speeding it up. This did not preclude the possibility of keeping supranational regulatory standards on a minimum but sufficient level. On the other hand, the leveling-up of regulatory harmonization fostered centralization. This

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[40] Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, available at: http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf

[41] Following the adoption of the Lamfalussy Report the European Securities Committee and the Committee of European Securities Regulators were established. This dual structure is referred to as the "Lamfalussy framework".

[42] Lastra, R. M.: The Governance Structure for Financial Regulation and Supervision in Europe, The Columbia Journal for European Law, Vol. 10, No. 1, Fall 2003.

was primarily due to the maximum harmonization principle that was being implemented more often in directives[43]. In its technical meaning, this principle stated that Member States were no longer empowered to impose "super equivalent regulatory standards" but only those specified within directives. Policymakers argued that the maximum harmonization principle, in line with the provision of subsidiarity, might only be imposed at a EU level out of necessity in order to achieve the aim of market integration. As a result the principle of minimum harmonization was being substituted by a more restricted concept of maximum harmonization significantly reducing Member States' regulatory diversity. From the EU point of view, this limitation of democratic powers of national states to choose the manner in which to regulate finance was only done to support financial integration. But the FSAP and the Lamfalussy Report resulted in overwhelming regulatory burdens imposed to the financial system. In particular, it was questioned if the new legislative processes stifled necessary regulatory competition since despite the "principle revolution" (*i.e.* the emergence of the maximum harmonization principle) regulatory competition in finance decreased and regulatory centralization became more evident[44]. But why is regulatory competition important within finance in general?

Regulatory competition has important policy implications for financial market development. It is used as an instrument to maximize the quality of regulation for a given regulatory burden, ensuring a "race to efficiency" that improves social welfare. The argument in favor of competition and against centralization was that regulatory competition allowed market actors to promptly react to differences in national regulations. Regulatory competition in the EU was first introduced through the mutual recognition principle, where a Member State had to balance its own regulatory interest against the risk of adverse competitive effects for its domestic financial sector by exceeding the common minimum standards[45]. As argued by Hertig (2000, p. 354.) the EU mutual recognition principle relies on the private incentives of market participants as it permits them to choose a single regulatory regime to govern their activities across Member States. However, a possibility of choice is given only if minimum standards are not set too high, otherwise too little diversity will be made between Member

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[43] "*It has been used in the Prospectus Directive (2003/71/EC) to ensure that a single format for prospectuses for securities issues is acceptable throughout the EU.*" Lannoo, K., Casey, J.P.: EU Financial Regulation and Supervision Beyond 2005, CEPS Task Force Report No.54, Bruxelles, January 2005, p.9.

[44] Pelkmans, J.: Mutual Recognition in Goods and Services: An Economic Perspective, Bruges European Economic Papers No.2, College of Europe, Bruges, December 2002.

[45] Tison, M., 2006, p.4.

States, thus limiting the scope of competition[46]. In fact, should minimum standards be set too high they would only act as EU wide barriers to entry protecting established financial intermediaries against new competitors. This brings us to the following issue: namely, the trade-off situation between the so called ″cooperative competition″ and the ″adversarial competition″.

The first type of competition allows financial intermediaries to choose a specific Member State as their ″home″ Member State and thus to choose its regulatory regime as the basis on which they operate across EU. In other words, through the principle of mutual recognition Member States are allowed to offer regulatory packages that will encourage financial intermediaries to choose them as their home Member State. Through this principle a limited race to the bottom, and an unlimited race to the top, have been introduced. Member States with higher regulatory standards than those introduced by EU legislation can safely lower them closer to the minimum EU wide level, without the threat that other Member States will be able to impede access to their markets as a result. At the same time, Member States may more freely advertise more stringent regulatory requirements than those imposed by EU standards. In contrast, there is adversarial competition because Member States continue to have the power to apply elements of their regulatory framework to the provision of all financial services within their jurisdiction[47].

Another significant study of regulatory competition and centralization, made by Esty and Geradin (2000), suggests that regulation should parallel and reflect jurisdictional diversities and complexity[48]. EU wide regulatory competition based on the basic theoretical principles should be speedy, and promote the least-intrusive regulatory intervention, whilst satisfying minimum common standards. The authors argue that optimal governance requires a flexible policy mix of competition and cooperation between governmental (national) actors and non-governmental (supranational, EU) ones. This approach is called *regulatory co-opetition*. It should generate positive outcomes by allowing a "constructive ambiguity" of competition and cooperation between national jurisdictions and regulators. The approach represents a compromise between cooperative competition and adversarial competition between Member States that we have discussed above. It is cooperative because of the mutual recognition

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[46] Hertig, G., 2000.

[47] Ibidem, p. 354.

[48] Esty, C. D., Geradin, D., 2000.

principle that provides Member States with an incentive to compete by offering regulatory solutions that will induce market actors to choose them as their preferred state of origin. At the same time, it is adversarial because Member States still have the power to apply stricter elements of their regulatory regimes to the provision of all financial services within their jurisdiction whilst implementing EU legislation (the so called ″gold plating″ as this phenomenon is known in Britain).

Regulatory co-opetition has three dimensions: (1) inter-governmental – reflecting the dynamics of competition and cooperation among governments, (2) intra-governmental – arising from the relationships between departments and officials within governments, (3) extra-governmental – driven by the simultaneously cooperative and competitive relations between governmental and non-governmental actors[49]. The point is that by supporting inter, intra and extra-governmental competitive pressures and by simultaneously facilitating a degree of cooperation among various participants within the regulatory process we can induce desirable outcomes. In other words and putting an EU context to these arguments, it is our opinion that through regulatory co-opetition, supported by a system of minimum harmonization and mutual recognition, regulators will have positive incentives to achieve regulatory objectives more efficiently.

2.3.2. Consolidation and centralization of financial supervision

Consolidation of supervisory authorities has been the major driving force behind regulatory reform in several Member States in the past two decades. In addition, this trend has strong implications at the supranational level. In fact, if the majority of EU Member States were to adopt a consolidated structure of supervision in their jurisdictions in the future, then it would be viable to consider the possibility of a single, centralized supervisory authority at the supranational level. In the present situation when different institutional set ups of supervision at national level are a reality, it is important to consider and to weigh the costs and benefits of alternative supervisory proposals (*i.e.* the one arguing in favor of institutional consolidation of supervision).

The trend towards consolidation of supervisory authorities was the main driving force of legislative reform at the beginning of the 21st century. This is why several EU Member States

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[49] Ibidem, p. 238.

viewed the establishment of a single national supervisor as an appropriate response to new market circumstances[50]. The Scandinavian countries (*e.g.* Norway and Denmark) led the way in establishing consolidated supervisors[51]. Other western European countries such as the United Kingdom, Austria and Germany followed, delegating central banks' supervisory powers to an independent institution. These are examples of the pure "single regulator model" where a single authority has responsibility over all financial intermediaries and markets. This supervisor pursues all regulatory objectives emphasizing investor protection and microeconomic stability[52]. However, there are different degrees of integration – from the full integration of all supervisory functions within a single institution, to integration that is limited to decision-making bodies, where previously existing institutions are kept in forms of institutional departments[53]. The change in the institutional structure of supervision has not demanded a change in the laws underlying supervision as the single authority continue to respect sectoral differences. These differences led to specific supervisory measures and methods that would still be enforced by a single authority. The trend of institutional consolidation of supervision across Member States has wider implications for candidate countries as well as the Union. However, the benefits of a single supervisor haven't yet been empirically proven and even large, well-developed EU countries have come to question the wisdom of this model[54].

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[50] In Europe the following countries have adopted a consolidated version of supervision: Austria, Belgium, Denmark, Estonia, Finland, Ireland, Iceland, Malta, etc. At the same time there are European countries that do not have a single supervisor: Italy, Greece, the Czech Republic, Poland, Lithuania, Slovenia, Spain, Croatia, and others.

[51] Di Giorgio, G., Di Noia, C. (2003).

[52] Ibidem, p.7.

[53] The United Kingdom model, for example, focuses on all the various functions involved in the supervisory process (from authorization to crisis management). The result is an authority organized according to regulatory functions: authorization, supervision and enforcement, in addition to supporting functions. The Financial Services Authority emerged in 2001 as a supervisor with broad regulatory and oversight objectives. By contrast, Germany organized its supervisory authority according to business functions rather than supervisory functions. The Federal Financial Supervisory Authority (*Bundensanstalt für Finanzdienstleistungsaufsicht*) was established in May 2002. The authority is organized in three separate supervisory directorates for: banking, insurance and securities, as well as three cross-sectoral departments dealing with cross-sectoral issues. Wymeersch, E., 2007, p.268.

[54] As for Community implications, the possibility for the creation of a single pan-European regulatory authority was already suggested by the Lamfalussy Report: *"If the full review were to confirm in 2004 ... that the approach did not appear to have any prospect of success, it might be appropriate to consider a Treaty change, including the creation of a single EU regulatory authority for financial services generally in the Community.[54]"*. As pointed out by Lastra (2003) the choice of words in this sentence was intentional and it clearly demonstrates the preference for the creation of a single, pan- European financial services authority. Moreover, she has observed that*: "a single market in financial services with a single currency does not need a single supervisory*

Some academics argue that the creation of a single European supervisor would assist in enforcing EU regulation uniformly across Member States[55]. They even go further in their arguments, stating that minimum or rather - maximum harmonization is merely a transition towards centralized, supranational legal unity and that the current lack of a pan-European regulator is a dangerous policy absurdity. In their view, the conferment of supervisory competencies to a politically independent, pan-European supervisor would increase the credibility of EU's commitment to achieve a single market for financial services. *Prima facie*, it seems that a single European supervisor is a natural choice to a fully integrated financial market. However, the institutional design of supervision is reactive and not accidental – meaning that it is usually a result of deliberate choices. Building on this premise, the opponents of a pan-European supervisor argue that a more defined co-operation between national authorities should suffice to harmonize regulation and supervision across the EU[56]. Their arguments go further – in a long run a pan-European supervisor would have an excessive concentration of power, a definitive lack of political accountability and a clear democratic deficit.

The arguments of the opponents rely heavily on the notion of subsidiarity as the main principle for any policy action at Community level stating that: "*the functions handed over to the Union should be those which the Member States, at the various levels of decision-making, can no longer discharge satisfactory.* "[57] And for the time being it seems that supervision is still more effectively managed and exercised at the Member State level.

Future changes in supervision have to answer the following question: if a single market in financial services needs supranational common rules, does it also require a centralized supranational authority to oversee their enforcement? The key supportive argument in favor of centralization is that when the regulatory and supervisory divergence of home country control and mutual recognition fail to achieve EU designated policy-goals, centralization of supervision to be the best solution for efficient financial markets.

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authority". See Lastra, R., 2003, p. 53. and the Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, 2001, p. 41.

[55] This possibility is directly implied in the Final Report of the Committee of Wise Men on the Regulation of European Securities Markets: " *...it might be appropriate to consider a Treaty change, including the creation of a single EU regulatory authority for financial services generally in the Community.*" (2001, p. 41.). See also Avgerinos, Y.V., 2003, p.23.

[56] See Lastra, R.M. (2003).

[57] Commission of the European Communities. (1992, October).

As argued and illustrated by Lastra (2003, p. 55.) centralization of supervision in the EU may take following organizational forms:

(1) Centralization according to the model of a "single EU supervisor";

(2) Centralization according to the model of "multiple supervisors" with the European Central Bank authorized to oversee credit institutions and a separate pan-European supervisory authority for insurance and securities; and finally

(3) Centralization of certain supervisory functions (such as the ″lender of last resort″).

However, the possible centralization of one, or few, supervisory competences at the supranational level does not necessarily imply nor legally require the setting up of a single supervisory authority exclusively authorized to exercise these functions. In our opinion an appropriate arrangement of supervision in the EU should be in line with the second suggestion made by Lastra (see above). Meaning that if there has to be a certain degree of centralization in supervision then it should be imposed on financial institutions that are active cross-border, while institutions whose business remains "local" should remain within national supervisory competences. In this way supervision would be congruent with the macroprudential perspective now followed by EU financial regulation (and discussed later in subsection 2.3.3.). This is because financial institutions that are active on a pan-European basis are usually interconnected among them, and thus bear greater systemic significance.

The debate regarding the possibility of centralizing supervision at EU level leads us to consider another important issue – the impact of this trend to the role of national central banks in their jurisdictions. The prospect of future enlargement of the economic and monetary union complicates the debate regarding current supervisory arrangements. The separation between the monetary and the supervisory functions of a central bank is the most contentious issue in the institutional design of regulation and supervision[58]. We argue that any model of supervision has to be connected with the central bank, because there is a strong relationship between monetary and financial stability. Effective monetary policy depends on the possibility of central banks to ensure financial soundness of the banking system, since banks are conduits through which changes in short-term interest rates are transmitted to the wider economy. In addition, information required for the conduct of monetary policy has to be in

[58] For further insight to the correlation of EU trends in supervisory structures and the changing role of central banks see Masciandaro, D. (2006, 2007).

synergy with supervision exercised by central banks. Central banks have to have access to information regarding the creditworthiness and liquidity of individual institutions in order to exercise the ″lender of last resort″ function properly[59]. Thus, from the European perspective it is worth noting that national central banks should and will remain at the center with respect to national economic systems, intermediaries and other national control authorities.

2.3.3. Current regulatory and supervisory structure in the EU

The current EU financial regulation is based on a set of EU laws and several mechanisms for cooperation. As we have already mentioned, directives establish the minimum common standards, which are implemented into national legislation and enforced in all Member States. In addition, we have argued that a single market for financial services needs common rules that govern financial activity. Under these premises, much of the regulatory harmonization has already been achieved.

As we have seen in previous sections, the Financial Services Action Plan and the Lamfalussy approach have both provided the EU with a comprehensive set of rules and legal principles applicable to finance. Acknowledging the political significance of regulatory reform that was mainly initiated by the Lamfalussy Report, the European Parliament emphasized the key role of accountability and transparency of the institutions involved in the legislative process. These principles were then incorporated into the Directive 2005/1/EC which established a new organizational structure of the ″Lamfalussy committees″ for banking, insurance and securities[60].

The three Lamfalussy Level 3 committees are:

(1) the Committee of European Securities Regulators (CESR),

(2) the Committee of European Banking Supervisors (CEBS) and

(3) the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

From the beginning these committees had two principal functions ascribed to them: (i) technical advising as regards national implementing measures of supranational legislation and

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[59] Abrams, R. K., Taylor, M. K. (2000).

[60] Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 amending 73/239/EEC, 85/611/EEC, 91/675/EEC, 93/6/EEC and 94/19/EC and Directives 2000/12/EC, 2002/83/EC and 2002/87/EC in order to establish a new organizational structure for financial services committees, recital (6).

(ii) promotion of consistent implementation and the achievement of regulatory convergence across Member States. They are intergovernmental committees. This means that they consist of national supervisory authorities. The decision making process in these ″Level 3 committees″ is based on consensus as they are not allowed to take majority votes. However, the drawback of this method is that decisions often represent political consensuses rather than a step forward to a more streamlined European regulatory consensus.

But, as we have already noted, irrespective of the relative success of the Lamfalussy legislative model, supervision in the EU remained fragmented. This means that supervisory arrangements differ greatly across Member States with respect to models of supervision in use as well as the institutional set up of supervision. To put simply, supervision in Europe is: decentralized, fragmented and cooperative. The current situation results from certain core integration principles (the home country control and the mutual recognition principles, respectively). The principles of home (or host) country control simplify the supervision of financial institutions and clarify the allocation of responsibilities between supervisors within different jurisdictions. Freedom of establishment has granted financial institutions the right to freely operate on a cross-border basis taking the legal form of branches or subsidiaries. The home country supervisor oversees branches while subsidiaries are controlled locally[61]. In that regard, mutual recognition was a key principle allowing branches of foreign regulated financial institutions to operate locally, recognizing the equivalence of home countries' regulatory and supervisory frameworks to their own.

In Europe, market integration is in contrast with the predominantly locally organized financial supervision. The current EU supervisory system is composed of multiple national supervisors acting within national jurisdictions that are coordinated by bilateral and multilateral agreements between the authorities, but without a central European supervisory strategy or a lead coordinating institution. In this context an urgent issue is the persisting incoherence of supervisory practice and the diversity of the institutional set up of supervision observed across Member States. When European financial institutions had a relatively small percentage of foreign operations in relation to the overall volume of their financial activities, the fragmentation of supervision alongside national borders wasn't a problem. Nowadays, when

[61] As financial institutions operating cross-border prefer the legal form of a subsidiary, the concept was extended to the idea of a lead home supervisor – responsible for coordinating a pan-European overview of a financial institution's activities. For further insight in this issue see the European Financial Round Table website http://www.efr.be/pages/story.asp?news_id=42

the market activity of European financial institutions is dramatically different, such a supervisory landscape is inappropriate. As was demonstrated by the 2007-08 economic and financial crisis, fragmented supervision only fostered spill-over effects and hindered the effective distribution and use of relevant information.

Building against this background the 2009 proposals of the de Larosière Report, aimed primarily at supervision, are an important contribution to the future of European financial regulation. In the aftermath of the financial crisis there was a broad consensus regarding the weaknesses of the existing system and regarding which changes would to make the European financial system more resilient. It is noteworthy that the Report stressed the necessity for coordinated international action, in accordance with the reform proposals put forward by other major players in the international economic arena (such as the International Monetary Fund, the Financial Stability Board, etc.)[62].

For the most part, the Report focuses on issues of financial stability oversight and supervisory reform. It lays out suggestions for:

(i) a new regulatory agenda that should reduce risks and improve risk management;

(ii) a stronger coordinated supervision built on existing structures that will equally emphasize the macro and microprudential aspect;

(iii) effective procedures for crisis management based on common methods and criteria.

Faced with Member State fears of losing regulatory sovereignty the Report suggested that changes should be implemented gradually, over a four-year period and – more notable – it definitely refrains from introducing a centralized, pan-European supervisor that was anticipated since the Lamfalussy Report.

The whole Report is articulated around two core concepts: regulation and supervision. It addresses these concepts at two levels: the macro-economic level and the micro-economic one. Without limiting itself to supervision, the Report analyses whether existing European regulation is relevant, whether it contains incentives towards short-term actions and risk-taking, as well as whether certain areas of financial services completely escape control and regulation.

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[62] Report of the High-Level Group on Financial Supervision in the EU (2009, February, p. 3.).

In this sense, the Report identifies the issue of pro-cyclicality of certain rules (namely those through which the Basel Capital Accord is implemented at national level) as the main culprit for financial instability[63]. Other areas within the Single Market for financial services in need of regulatory repair are identified, and thus the Report consistently argues in favor of a harmonized set of rules. The Report suggests that Member States and the European Parliament should avoid in future the adoption of those types of Community legislation that permit inconsistent transposition and application. Furthermore, it argues that the European Commission and the Level 3 committees should identify those national exceptions the removal of which would support the better functioning of the single financial market and improve the efficiency of cross-border activity in the EU. It seems that the Report argues in favor of more centralization with respect to regulation.

The Report examines the policies and practices of EU financial supervision and proposes short, and long term, changes. With respect to supervisory weaknesses, the Report clearly stresses the lack of macroprudential supervision, and argues that the insistence solely on the microprudential level was one of the prime failures in supervision. Other areas of supervisory shortcomings are identified: lack of cooperation between supervisors, substantial differences in the powers granted to national supervisors, lack of means for supervisors to take common decisions, etc. What the Report proposes is, basically, a new structure for European financial supervision, articulated around two core concepts:

(1) the shift towards greater macroprudential supervision through the set up of a new EU entity - the European Systemic Risk Board (ESRB) and

(2) the transformation of the Level 3 Committees into authorities comprised within a new European System of Financial Supervision (ESFS).

The Report suggests that the European Systemic Risk Board should be set up under the auspices of the European Central Bank and chaired by its President. The role of the ESRB is to gather information on all macroprudential risks in the EU. It monitors and assesses the risks to the stability of the financial system as a whole. The ESRB will fulfill this role by pooling information from national central banks and then create recommendations on macroprudential policy, issue risk warnings, compare observations on macroeconomic and prudential developments as well as give directions on these issues. In this manner this supranational

[63] The effect of procyclicality and the Basel Capital Accord will be discussed in later chapters concerned with the regulation of credit institutions.

body should address one of the fundamental weaknesses of the European financial system – its exposure to interconnected, complex, cross-sectoral systemic risks.

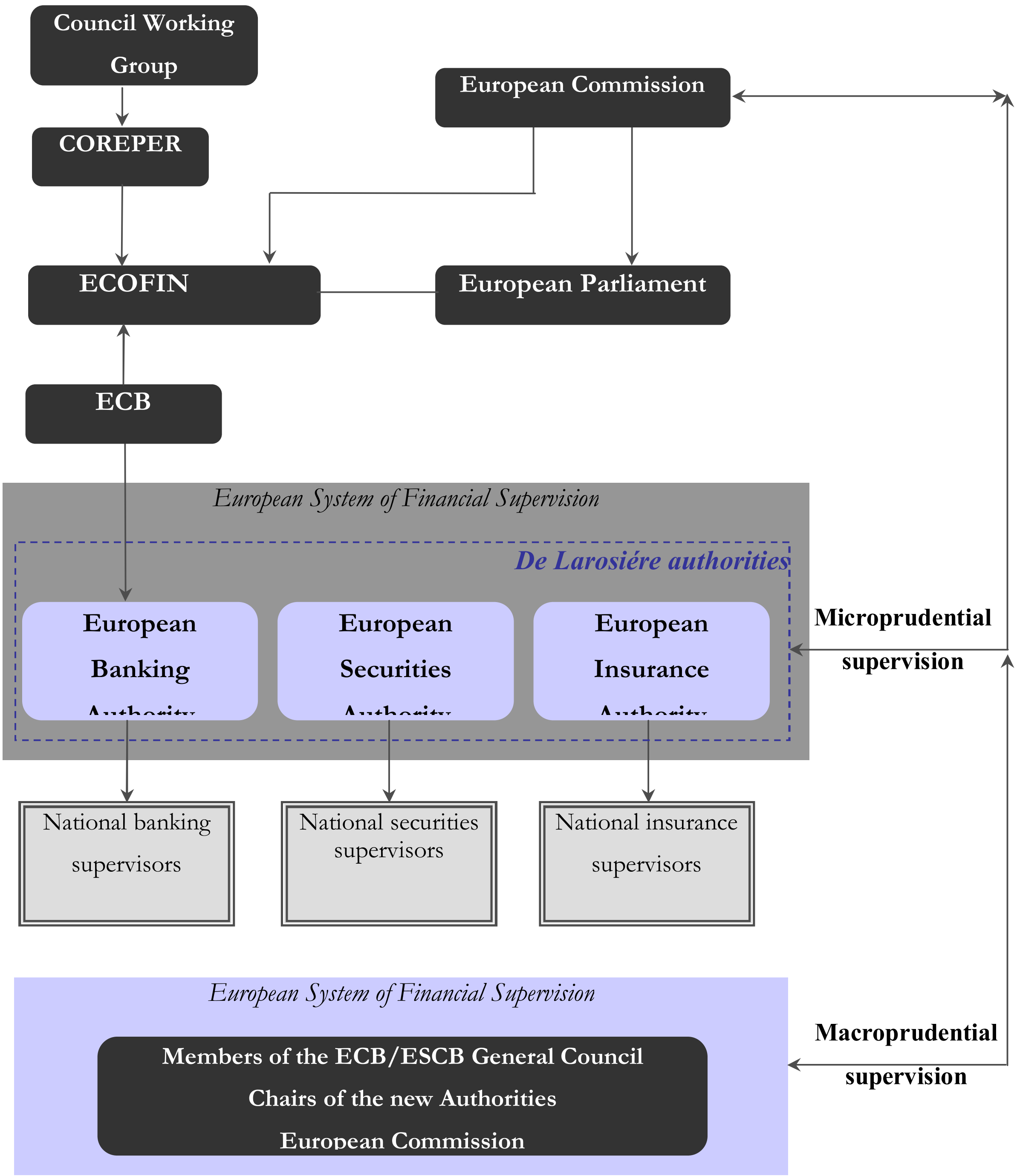
The European System of Financial Supervisors (ESFS) consists of a decentralized network of national supervisors working in coordination with the newly formed European Supervisory Authorities in the area of microprudential supervision. These three new, independent authorities will result from the institutional transformation of the Level 3 Lamfalussy Committees, whose role and legal powers will be considerably expanded. While national supervisors will continue to carry out ″day-to-day supervision″, the Authorities will represent the supranational level and will coordinate the application of common standards of supervision and guarantee efficient cooperation between national authorities. The main additional tasks of the new Authorities on top of the competences of the existing Lamfalussy committees are: (i) legally binding mediation between national supervisors; (ii) adoption of binding supervisory standards and of binding technical decisions applicable to individual institutions; (iii) coordination and oversight of colleges of supervisors; (iv) licensing and supervision of specific EU wide institutions; (v) binding cooperation with the ESRB together with a strong coordination role in crisis situations[64].

The driving ideas behind the institutional reform are clear – to foster harmonized rules and coordinated supervisory practice. But the driving force behind them is also evident – centralization. Under the auspices of the ESFS the sector-specific authorities (the previous Level 3 committees) will work in cooperation with national supervisors, but with more legal power (*e.g.* legally binding mediation, binding supervisory standards, etc.). In our opinion this will only increase the tension between greater centralization of regulation at the EU level, and Member States' reluctance to give up national discretions in supervision. We argue that national supervisors should retain a certain degree of national autonomy as they are more familiar with national markets and have direct authority over market participants. Paradoxically, deemphasizing EU supervisory powers in favor of national ones would democratize European financial regulation. This means that Member States would perceive that the power has shifted away from "Brussels technocrats" on to domestic groups, and legislatures – at least in the area of supervision. On the other hand, this could entail a new dilemma of supranational, European markets against national sovereignty in supervision. With respect to this we suggest that supervision should be supranational (*i.e.* centralized) only

[64] Report of the High-Level Group on Financial Supervision in the EU (2009, February).

for systemically important, pan-European financial institutions. In this way, a supranational authority with conferred legal power (maybe even the proposed European System of Financial Supervisors) would ensure that all national supervisors work in the interest of the European financial system.

2(4) Supervision of Europe's financial sector according to the de Larosière report*



* The design of the newly proposed regulatory structure is loosely based on the graphic found in Lastra, R., 2003, p. 67.

CHAPTER'S MAIN FINDINGS

Financial activity takes place in imperfect markets where consumer welfare is often encroached. Consequently, financial regulation and supervision are imposed as ″legal remedies″ to information asymmetries, inefficiencies, and various risks that markets and institutions are inherently prone to. As financial institutions and markets trade in credence goods (*i.e.* financial products) the main elements constituting the economic rationale for financial regulation are: market imperfections represented primarily by information asymmetries; systemic issues; and adverse selection and moral hazard. Financial regulation *per se* is the establishment of specific rules of behavior, while financial supervision is the general oversight of the behavior of the addressee of financial rules (whether financial institutions or market participants) and their compliance with regulation. Financial regulation allows consumers of financial products to make better-informed financial decisions and gives incentives for market participants to align their behavior with wider social objectives. These objectives are achieved through different regulatory approaches: prudential, conduct of business, systemic; and monitored through three supervisory models: institutional, functional and by objectives. We argue that, nowadays, it is more difficult to distinguish between regulation and supervision, as their activities often overlap or are exercised by the same authority.

Academic research in this field has focused on harmonizing national financial regulation within the EU and the pursuit of financial integration through legislation. But future European regulation and supervision are not shaped by EU legislation exclusively. Developments at Member state level, caused by market changes, are another significant force. This in turn means that in the EU there are two main trends manifesting in the area of regulation and supervision:

(i) Consolidation of supervisory authorities in national financial systems; and

(ii) Centralization of regulation at EU level with supervisory competences allocated to decentralized supervisors that enforce financial regulation in an uncoordinated way. This clearly represents a problem to the EU, as it causes tension between the supranational-national level, and among Member States as well. In fact, as EU policymakers call for greater centralization in order to sustain regulatory harmonization in the financial sector (at the expense of national discretions through the "maximum harmonization" principle), not all Member States are willing to give up such an option to protect national interests. The reluctance is more pronounced among Eastern European countries that are still going through transition. Thus we come to the classical tension characterizing the EU – which options and discretions can be left to national supervisors without the fear of hindering regulatory harmonization? Or put simply – does the EU need more centralization in both regulation and supervision? With respect to regulation, we argue in favor of a relatively new approach; the so called regulatory co-opetition. This approach represents a mix of regulatory competition and cooperation between national actors and supranational, EU ones. In our opinion, if supported by a system of minimum harmonization and mutual recognition, this approach would allow regulators to achieve regulatory objectives in a more efficient manner.

Irrespective of this, a new step forward in resolving the above mentioned problem is made in the de Larosière Report. Before giving our critical observations, let us state that the Report sets up a new governance structure for the EU financial system, acknowledging the importance of the coordination of macro and microprudential supervision. This is noteworthy. But, our criticism regards the following. The Report makes clear that the key is to coordinate, not to centralize all regulatory activities in one supranational authority. However, it also makes a definitive step towards an overarching European authority that has a macroprudential perspective, whilst leaving microprudential supervision at national level greatly impaired. This is because of the set up of a European authority responsible for microprudential supervision, which the Report proposes, and which would enact binding mediation and, eventually, overruling of national decisions. We consider this to be an additional move in favor of centralization in Europe regardless of the Reports stated arguments. In fact, although the Report does not deprive national supervisors of their power over national financial institutions in practice (microprudential supervision), the mechanism has changed substantially from a legal aspect. National supervisors will no longer be able to protect their national interests exclusively, as the newly established European authorities will have the competencies to greatly influence their decisions. In our opinion this will only increase existing tensions. In the EU national interests still differ, and the Report's intention to converge supervision on the basis of stringent standards and more centralization can do more harm than good. Such an arrangement cannot be appropriate for all Member States. We argue that although financial regulation is adopted at EU level, supervision should remain in the competences of national authorities. A good idea would be to pursue national supervision with respect to financial institutions whose activities are confined to national jurisdictions. In the case of institutions that are active cross-border, EU regulation and supranational authorities should step in. But none of this is initiated in the Larosière Report. It seems to us that the institutional set up proposed by the Report will only add uncertainties as to supervisory competencies and thus prove time consuming and inadequate for its intended purpose.

3. FINANCIAL ASSETS AND TRANSACTIONS

This chapter focuses on the regulation of financial assets and financial transactions in the EU. Our premise is that the objective of financial regulation in these areas is to define minimal common standards in order to form a harmonized framework of rights and obligations associated with specific types of assets and transactions. In our analysis we focus on those types of financial assets commonly found throughout EU countries: namely securities, bank deposits, bank loans, financial derivatives; and on two widely used types of transactions: securities lending and securitization. Naturally, these transactions can also be viewed as a specific type of financial asset, as claims and/or liabilities are created between the parties to the transaction. But for the purpose of the discussion made in this chapter, we wish to analyze them purely from their transactional aspect. Furthermore, we are well aware of the usage of other financial transactions as well (such as bank lending, selling/buying of various financial instruments, etc.) across Member States. But the transactions we have named interest us the most, as in the aftermath of the financial crisis they were often cited as main culprits for market breakdown. Thus, we are interested in assessing if there is truth in such observations. It is important to say that we make a "detour" back to financial assets in discussing securitization, as our analysis also comprises asset-backed securities, as a direct by-product of securitization.

In section 3.1. we define financial assets from their legal and economic aspect; in addition we give several other categorizations of financial assets. Section 3.2. discusses some of the most important types of assets in Europe and gives an overview of their regulation; in this section, emphasis is put on securities. In section 3.3. we analyze bank loans, focusing in greater detail on mortgage loans. Section 3.4. analyzes securities lending, while the following section, 3.5. discusses financial derivatives. Finally, section 3.6. analyzes securitization and asset-backed securities.

3.1. Classification of financial assets

Our analysis of the European regulation of financial assets has to begin with their broader definition. Financial assets are: "…*assets which require two people to make them so that the law is therefore about two people at either end of the asset, not the asset itself.*" (Wood, P., 2008, p. 3.)[65] Financial assets are interesting from both a theoretical and practical point of view. These assets cannot exist without social interaction between two persons (natural persons or legal entities) regularly referred to as *debtor* and *creditor*. These two persons are bind together either by statutory provisions or by contract, from which the asset derives its value. Financial assets represent a store of value and of liabilities or obligations (depending from the point of view). Their qualities and value are complex to ascertain. Since this makes financial assets prone to uncertainties it is natural that they are subject to regulation. An additional reason for their regulation is the fact that financial assets nowadays are typically intangible and thus are easily transferred across borders. Their "invisibility" makes the assertion of the precise location of the asset very difficult, which inevitably calls for closer regulation.

A purely legal categorization of assets identifies the following broad categories (Wood, P., 2008, p. 3.):

(1) Immoveables,

(2) Tangible moveables, and

(3) Intangibles.

Following the logic of this division, and the arguments of the above made discussion, we conclude that assets, which are subject to financial regulation, are intangible assets.

However, from an economic aspect a radically different categorization of assets can be made:

(1) Real assets; which can be further subdivided to tangibles (*e.g.* machinery; real estate) and intangibles (*e.g.* goodwill; patents; intellectual property);

(2) Financial assets; which are all intangibles by nature (they are claims, or credence goods) but which can further be subdivided to materialized financial assets (*e.g.* cash; currency) and dematerialized financial assets (*e.g.* bank deposits; dematerialized securities).

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[65] Benjamin and Yates (2002, p. 11.) give a different legal categorization of assets: "*Roughly speaking, real assets comprise freehold land and related assets, and personal assets comprise all other asset types. Personal assets are in turn sub-divided into tangible personal assets (known as goods, or 'choses in possession') and intangible personal assets (known as claims, or 'choses in action').*"

Wood (2008, p. 3.) gives, in our opinion, an excellent practical categorization of financial assets. He divides financial assets to:

(1) Legal tender,

(2) Bank deposits as major representatives of the so called ″bank money″,

(3) Bank loans, and

(4) Securities[66].

Wood's categorization seems as the most appropriate one to follow in our research, thus we will adhere to its categories throughout this chapter and its sections.

So far we have categorized financial assets from a theoretical point. But, what does this categorization look like in practice? Which are the most common categories (types) of financial assets found across EU countries? A quick research of the statistical data available from national accounts of EU countries, leads us to conclude that the most common type of financial assets found across the EU are bank loans, followed by various types of securities[67]. The situation is somewhat different if we look at the statistical data regarding the type of assets held by European households, where currency and deposits have supremacy in terms of share, followed by securities[68]. Irrespective of the lead role of bank loans, currency and deposits, we wish to continue this section with the analysis of securities in the first place. This is because during the past decade EU financial regulation has put substantive efforts in securities regulation primarily. Indeed, some of the most important pieces of EU legislation are related to securities (such as the so called "Lamfalussy directives" which we'll discuss later on in this section). Moreover, in comparison with regulation focused on other types of

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[66] The analysis laid out in this chapter will follow this categorization. Other, purely economic definitions and classification of financial instruments, assets and transactions, are given in the International Financial Reporting Standard 9: Financial Instruments (usually referred to just as IFRS 9) published by the International Accounting Standards Board (IASB) in November 2009. Following the IFRS 9 financial instruments are defined as a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. According to the IFRS 9, financial assets are categorized as follows:

(i) Cash;

(ii) An equity instrument of another entity;

(iii) A contractual right to receive cash or another financial asset from another entity, or to exchange financial assets or liabilities with another entity under conditions that are potentially favorable to the entity; and

(iv) A contract that will or may be settled in the entity's own equity instruments.

[67] European Commission (2010).

[68] Ahmandech Zarco, I. (2009).

financial assets, the body of rules dedicated to securities is far more extensive. Thus, it seems only natural to begin the analysis of the EU regulation of financial assets with securities.

3.2. Regulation of securities in the EU

The meaning of the term "security" changed as market practice developed. In the broadest sense, a security is a fungible[69], negotiable instrument that has monetary value. Closer definitions of securities are given by legal and economic literature, as well as by EU legislation. For instance, Moloney (2008, p. 53.) defines securities as intangible assets whose financial value is dependent from the future performance of the issuer of the security. She argues that securities are ″credence goods″ whose quality cannot be assessed in advance and whose effects may take some time to fully emerge. An additional definition of securities is given by Benjamin and Yates (2002, p. 7.); they argue that securities represent a form of transferable financial asset, of which equities and bonds are the most common examples.

From an economic perspective, a security can best be defined through its investment purpose, as a financial instrument that signifies an ownership position in a company (*share*), a creditor relationship with a company or a governmental body (*bond*), or a right to ownership such as those represented by an option or warrant[70]. From an investor's point of view securities operate in two capacities: (i) they constitute personal rights against the issuer, and (ii) they represent an asset.

EU legislation mentions ″transferable securities″. Their definition was given for the first time in the 1993 Investment Services Directive[71]. In 2002 the Financial Collateral Directive[72] in its

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[69] If an asset is fungible, this means that if such an asset is lent or placed with a custodian, it is customary for the borrower or custodian to be obliged at the end of the loan or other custody arrangement to return assets equivalent to the original asset, rather than the specific identical asset. In other words, the redelivery of fungibles is equivalent and not *in specie*.

[70] Options are securities transaction agreements tied to shares, commodities, currencies or stock indexes. In its legal essence it is a contract between a buyer and a seller that gives the buyer the right but not the obligation to buy or to sell a particular asset on or before the option's expiration time, at an agreed price. The warrant is a type of security, usually issued together with a bond or preferred share that entitles the holder to buy a proportionate amount of ordinary shares at a specified price, usually higher than the market price at the time of issuance, for a period of years or to perpetuity. See all in Downes, J., Goodman, J. E. (2006).

[71] See Art. 1(4) of the Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field.

[72] "*'Financial instruments' means shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement ... including units in collective*

Art.2 gives another definition of securities, which is similar to the general law meaning of securities in defining "financial instruments", but without the adjective "transferable". Finally, the Markets in Financial Instruments Directive in 2004, broadens the definition of transferable securities defining them as: *"...classes of securities which are negotiable on the capital market (with the exception of instruments of payment) such as: (a) shares in companies and other securities equivalent to shares in companies, (...) (b) bonds or other forms of securitized debt, including depositary receipts in respect of such securities, (...) (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures"*[73].

Let us list different types of securities most commonly found across EU Member States, and which deserve regulatory attention:

(1) Transferable equity and debt securities,

(2) Units and collective investment schemes (which are in essence units representing securities),

(3) Futures contracts, options and derivatives relating to the above, and

(4) Futures contracts, options and derivatives relating to commodities with the prerequisite that the financial transaction is made for investment and not commercial purposes (meaning that the transaction is not to be settled in cash) (Wood, P., 2008, p. 330.).

An alternative classification of securities divides them according to the aspect of holders' rights, into three broad categories:

(1) Debt securities,

(2) Equity securities, and

(3) The so called "hybrid" securities.

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investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing." Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L 168/43, 27.6.2002.

[73] See Art. 4(1)(18) of the Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.4.2004. We will discuss this Directive and its key provisions in chapter 5.

Ad (1) Debt securities are commonly known as debentures, bonds, deposits, notes or commercial paper, depending on their maturity and other characteristics. Investors in debt securities are owed a debt by the issuer. Thus the relationship between the holder and the issuer is that of creditor and debtor. The terms of issue entitle the holders to the repayment of the principal sum at the security's maturity, as well as to regular interest payments. These securities are typically issued for a fixed term, and redeemable by the issuer upon maturity. They may be protected by collateral or may be unsecured. If they are unsecured they may be contractually "senior" to other unsecured debt, meaning that claims of their holders would have priority over other creditors, in the case of the issuer's bankruptcy. Debt that is not senior is "subordinated". The most common types of debt securities are:

(i) Corporate bonds – debt instruments of legal entities with long maturity, typically at least ten years;

(ii) Money market instruments – short-term debt instruments that may have characteristics of deposit accounts (such as certificates of deposit) and that are highly liquid;

(iii) Euro debt securities – instruments issued internationally outside their domestic market in a denomination different from that of the issuer's domicile (also referred to as Xeno debt securities);

(iv) Government bonds - medium or long term debt securities issued by sovereign governments or their agencies;

(v) Sub-sovereign government bonds – representing the debt of governmental units other than sovereign governments (*e.g.* the US ″municipal bonds″);

(vi) Supranational bonds – representing the debt of international organizations such as the World Bank or the International Monetary Fund.

Ad (2) Equity securities represent a share of equity interest in a legal entity, and may only be issued by companies. The most common form of an equity security is a share, thus the holder of equity is known as a shareholder. The holder owns a share, or fractional part, of the issuing company. Equity securities are not entitled to any payment, but are paid income in the form of dividends at the discretion of the company's management and depending on its annual profitability. However, if the value of the company increases this will be reflected in the value of the shares, so that shareholders have the prospect of capital growth. In the case of bankruptcy, shareholders share only in the residual wealth of the issuer after all outstanding obligations have been paid out to other creditors. However, equity generally entitles the holder to a *pro rata* portion of control of the company. Equity also enjoys the right to profits and capital gain, whereas holders of debt securities receive only interest and repayment of principal regardless of how the issuer performs financially.

Ad (3) Hybrid securities, combine some of the characteristics of both debt and equity securities. The most common types of hybrid securities are:

(i) preferential shares; as an intermediate class between equity and debt securities they entitle their holders to the right to receive interest and/or a return of capital in priority of ordinary shareholders in the event of the issuer's bankruptcy. From a purely legal perspective they are regarded as capital stock and thus they entitle holders to a certain degree of the company's control depending on whether they contain voting rights.

(ii) convertibles; bonds or preferred shares which can be converted, upon the holder's decision, into ordinary shares of the issuing company.

(iii) equity warrants; options issued by the company that allow the holder to purchase a specific number of shares, at a specified price, within a specified time. Usually issued together with bonds or existing equities, they are sometimes detachable from them and traded separately.

As regards the ″material form″ of securities it must be said that securities nowadays can be represented by a certificate (*i.e.* materialized securities) or, more typically, they can be non-certificated meaning they have a dematerialized, electronic or ″book-entry only″ form. Certificates may be *bearer* meaning they entitle the holder to rights under the security merely by holding the security, or *registered* meaning that they entitle the holder to rights only if he (or she) appears on a security register maintained by the issuer of the security or an intermediary that deals in certain securities.

Let us now turn to the core of our analysis in this section. That is, to the regulation of securities in the EU. This area of regulation is particularly concerned with ensuring allocative efficiency in the markets (meaning that securities markets should allocate capital efficiently from business areas showing surplus towards those areas where capital is lacking). European securities regulation also focuses on the regulation of capital raising, in order to promote investor confidence in the markets and to reduce the cost of capital for issuers seeking funding from financial markets. It is noteworthy that regulation does not insulate investors from losses; rather it ensures that investors are adequately informed when making their investment decisions.

These goals are comprised within three key legislative measures that regulate securities as financial assets in the EU:

(1) the 2003 Prospectus Directive,

(2) the 2004 Transparency Directive, and

(3) the 2003 Market Abuse Directive[74].

Below, we discuss the details of these legislative measures.

Ad (1) The Prospectus Directive is the cornerstone of European securities market regulation. The Directive ensures investor protection and capital market efficiency. Its provisions mandate disclosure obligations for issuers of securities offered to the public, or admitted to trading on a regulated market in the EU. Basically, the Directive creates a "passport" for issuers allowing them to raise capital anywhere within the EU. As such, the Prospectus Directive is a maximum harmonization measure. This means that the Directive doesn't allow different regulatory treatment at Member State level. Let us now discuss some of the Directive's articles that have great harmonization significance.

Article 1 describes the purpose of the Directive - to harmonize requirements for the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public, or admitted to trading on a regulated market. The exception is made for money-market instruments whose maturity is less than 12 months; they remain subject to national legislation. As Article 1(2) of the Directive sets a number of exclusions from its scope, we conclude that the Prospectus Directive is "retail oriented" and focuses primarily on specialist securities as well as small offers[75].

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[74] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (OJ L 345/64, 31.12.2003.); Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (OJ L 390/38, 31.12.2004.); Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) (OJ L 96/16, 12.4.2003.). In addition, the admission to trading of securities on a regulated market is governed by the 2004 Markets in Financial Instruments Directive that will be discussed in greater length in chapter 5.

[75] One of the noteworthy exclusions refers to units issued by collective investment undertakings other than the closed-end type as funds in the form of a UCITS are subject to the extensive UCITS regime (Art. 1(2)(a)). We will discuss this regime in chapter 4. Furthermore, government debt and other quasi-sovereign securities are also

A major innovation is the definition of the term "offer to the public" at a pan-European level, given in the Directive. Article 2 (1)(d) states that an "offer to the public" is any: "*communication to persons in any form or by any means presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to these securities*." Uniformity on the application of this concept is of great significance for the Directive's success. Consequently, Article 3(1) provides that Member States shall not allow any public offer of securities within their territories without prior publication of a prospectus.

As for the contents of the prospectus, Article 5(2) requires that it has to include an informative summary. The summary has to comprise essential characteristics and risks associated with the issuer and the securities offered, in the original language of the prospectus. Due to this fact the achievement of the scope of the prospectus, although seemingly straightforward, has proven problematic. Namely, under the Directive's language regime, the host Member State competent authorities may require only that the summary is translated into their official language(s). But the limited nature of the disclosure provided to retail investors in the host Member State, due to the fact that retail investors were not in a position to read the full foreign language prospectus, means that issuers may be liable to risks if material information has not been translated.

Investor protection and mutual recognition of the Directive's regime depend on the prospectuses approval. Article 13 of the Directive provides that no prospectus may be published until the competent authority of the home Member State has approved it. Under Article 17 of the Directive, a prospectus approved by the home Member State competent authority is valid for the public offer, or the admission to trading, in any host Member State. In particular, the host Member State and its competent authorities may not undertake any approval or administrative procedure relating to prospectuses (even if it has visible flaws) (Moloney, N., 2008, p. 157.). Again, irrespective of the straightforwardness of these provisions, a number of weaknesses have emerged. These are represented primarily by the host competent authorities' imposition of translation requirements or additional publication requirements to the prospectus.

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exempt. Further exemptions regard non-equity securities issued by a Member State or by one of a Member State's regional or local authorities, by public international bodies of which one or more Member States are members, by the European Central Bank or by national central banks. In addition debt securities issued by credit institutions benefit from exclusions which are designed to facilitate bond issuance by smaller credit institutions, given that credit institutions are subject to solvency supervision.

A general observation regarding the regulatory value of the Prospectus Directive is that its harmonization impact and standardization value are considerable – comparable prospectuses present investors with tangible evidence of an emerging single securities market and guarantee their protection across the EU.

Ad (2) The Transparency Directive, which was adopted in December 2004 and came into force in January 2007[76], sets a reformed disclosure regime – from one largely based in the requirements of company law to a capital markets, transparency-directed regime.

The main objective of the Transparency Directive was the adoption of a home country control model for ongoing disclosure. The Directive imposes periodic and ongoing disclosure requirements on issuers whose securities are already admitted to trading on a regulated market, situated or operating within a Member State. Consequently, the home Member State anchors the regime and governs how different disclosure obligations are applied. From this we conclude that the definition of the home Member State is crucial for the success of the Directive. Contrarily to the Prospectus Directive, the Transparency Directive is a minimum harmonization measure. This means that Member States are permitted to subject securities issuers[77] to super-equivalent requirements, more stringent than those proscribed by the Directive. The regime adheres to the assumption made by the Prospectus Directive that investor protection is best delivered by delegating issuers' supervision to the Member State of the issuer's registration (Moloney, N., 2008, p. 186.). The governing principle behind these provisions is that identity should be maintained between the competent authority responsible for approving the prospectus and supervising disclosure. Issuers active on a pan-European basis may choose only one home Member State; either the Member State in which they have their registered office or the Member State in which they have admitted securities to trading on a regulated market[78]. Practice has shown that it is usually the Member State in which the securities are admitted to trading that acts as the home Member State.

As support for the ″prospectus passport″, the Transparency Directive also imposes a language regime, relevant for ongoing disclosure. This regime is mainly based on the language regime discussed in the context of the Prospectus Directive, but with variations. When securities are

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[76] Directive 2004/109/EC.

[77] The term ″securities″ covers those financial assets comprised under the provisions of the Prospectus Directive.

[78] The issuer's choice remains valid for three years unless the issuer's securities are no longer admitted to trading on a regulated market in the EU.

admitted to trading on a regulated market only in the home country, "regulated information" must be disclosed in a language accepted by the home country competent authority. In the case that securities are admitted to trading on a regulated market both in the home country and in one or more host countries, information must be disclosed in a language accepted by the home State competent authority as well as in a language accepted by the competent authorities of the host States or a *"language customary in the sphere of international finance"* (depending on the issuer's choice). Where the securities are admitted to trading only on a regulated market in one or more host countries, the issuer may choose either a language accepted by the competent authorities of the host States or a *"language customary in the sphere of international finance"*.

The new transparency regime envisaged by the Directive ensures that all key developments concerning securities admitted to trading on a regulated market are widely available across the EU. Its basic principles support equal access to information across the integrated market regardless of where the investor is domiciled. The anchoring of the transparency regime to the home Member State means that disclosed information is primarily deposited (*filed*) in the home Member State (Moloney, N., 2008). But Article 19(1) of the Directive prescribes also that – regardless of where the issuer's securities are admitted to trading – whenever the issuer discloses regulated information to the market it must at the same time deposit information with the competent authority of the host Member State. This does not imply that the deposited information is subject to oversight as to its accuracy or comprehensibility by that authority. These provisions only aim to provide a minimum guarantee for the timely availability of regulated information and to ensure that investors who are not situated in the issuer's home Member State have access to relevant information. Where securities are admitted to trading on a regulated market in only one Member State that is not the home State, the host Member State is responsible for ensuring dissemination in accordance with this principle[79].

Ad (3) The Market Abuse Directive ensures *"market integrity"* by eliminating *"insider dealing and market manipulation"*. Insider dealing involves the misuse of "inside information" when investing in securities; market manipulation involves giving a false impression as to the supply or price of financial assets, for example seeking to create a false market for shares by making them appear more valuable than in fact they are (Hudson, A., 2009, p. 263.). The economic objective of the Directive is to help the European securities market to create a pool

[79] Ibidem.

of liquid capital readily available for investment. This, however, requires high levels of investor confidence that would be ready to invest in the market. Maintaining investor confidence requires market integrity and therefore the control of market abuse. Following this trail of thought, Hudson (2009) for instance, argues that the ethical dimension of the Market Abuse Directive is subordinate to its economic goal[80].

Under the previous European framework for insider dealing and market manipulation created by the Directive 79/279/EEC[81], a company operating within Member States' jurisdiction had to inform the public as soon as possible of any major new developments which were not public knowledge, and which might lead to significant movements in the price of its shares. The definition of "inside information" for insider trading purposes was set later on, in the Article 1 of Directive 89/592/EEC as: "*information which has not been made public and of a precise nature relating to one or several issuers of transferable securities or to one or several transferable securities, which, if it were made public, would be likely to have a significant effect on the price of the transferable security or securities in question*"[82].

The overall aim of the Market Abuse Directive is to level differences in the protection of market integrity between Member States. The Directive states that market integrity is necessary for an integrated and efficient European financial market and whose efficiency may be harmed by market abuse. The MAD rests on the premise that outsider investors are harmed by the non-disclosure of information; as such early disclosure is seen as a prerequisite for fair pricing in the market. The objective of the Directive is compatible with those set out by the Prospectus and Transparency Directives, and that is to achieve full and proper market transparency. MAD adopts a single definition of "inside information" for the purpose of both setting issuers' obligation to disclose new information as well as preventing information misuses.

The Directive categorizes insiders as members of the issuer's:

(i) Administrative, management or supervisory bodies;

(ii) Shareholders or people otherwise holding capital in the issuer;

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[80] Ibidem, p. 265.

[81] Schedule C, par. 5 of Council Directive 79/279/EEC of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing, OJ L 066, 16.3.1979.

[82] Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, OJ L 334, 18.11.1989.

(iii) People having access to the information through the exercise of an employment, profession or other duties, or by virtue of criminal activities[83].

In this context, the Directive requires from Member States to prohibit insiders to misuse inside information and prohibits them to deal in financial instruments in such a manner that would earn them personal profits or other personal gains. The Directive's provisions make an explicit difference between inside information that has to be disclosed, and the one whose abuse may lead to insider trading. The difference is that issuers are required to inform the public as soon as possible of the inside information which directly concerns them (the so called ″corporate information″) while insider trading can also hinge upon the abuse of inside information which indirectly refers to the issuer market information (Hudson, A., 2009, p. 264.). Article 6(2) of the Directive states certain exemptions from disclosure requirements; for instance, an issuer may delay the public disclosure of inside information provided that such omission is not likely to mislead the public and provided that the issuer is able to ensure the confidentiality of such information.

Another important issue dealt by the Directive is market manipulation. MAD defines it as a process by which a person, or a group of people, inflate or depress the market value of specific securities by dealing in them, while circulating rumors as to the business prospects for those securities. Such manipulation distorts market movements in two ways:

(i) By giving incorrect or misleading information regarding securities, in order to encourage investors to deal in a way in which (or at a price at which) they would not have dealt had if they were aware of the real situation we manipulate the market in the simplest way.

(ii) Another aspect of manipulation would be to enter into a number of transactions with specific securities, so as to make it appear that there is a market for them at a price at which there would not have been such a market if it weren't for those transactions.

Following the above made discussion we may conclude that – in the area of securities regulation – the form of harmonization changed over time due to market requirements. At the beginning regulation followed the principles of minimum harmonization paired with mutual recognition. With market development and certain EU policy reforms, European securities markets moved to maximum harmonization requirements (*i.e.* the Transparency Directive). It is unarguable that regardless of their legislative and implementation weaknesses, the above-

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[83] Article 2(1) of the Directive.

discussed EU directives have determined greater uniformity of regulation at national level as regards securities. The fact stands true that EU legislative initiatives have succeeded to establish the world's first multinational disclosure system, securities issues scheme and the first multinational system of market manipulation prohibition, which should be regarded as a success.

3.3. Bank deposits

As we will discuss in more detail in chapter 4, credit institutions in general – and banks in particular, are of immense importance to a country's economy. Banks collect savings from small and large depositors, make loans, run the payments system, coordinate financial transactions and serve as a center point of the exchange of money throughout the economy. In chapter 5 we will argue that banks lie at the heart of financial markets in continental Member States. Consequently it is not surprising that bank deposits take a large portion within the financial assets of European households[84].

But no bank holds enough liquid funds to redeem all, or a significant fraction of its deposits upon request. This is why bank runs can occur, in the event depositors believe that the safety, or better said – liquidity, of their deposits is questionable and thus try to withdraw them all at the same time.

This section analyzes the characteristics of bank deposits regulation. This regulation is mainly achieved through deposit guarantee schemes (hereinafter DGSs), also known as deposit insurance. Naturally, bank failures are prevented by prudential supervision of banks in the first place; if nevertheless a bank has to be closed, deposit guarantee schemes are activated.

The DGS reimburses a limited amount (or it may be a substantial amount) of deposits to the depositors. The amount is specified by the scheme; it is the so called ″coverage level″. If properly designed and implemented, this form of explicit deposit protection greatly supports the confidence of individual depositors in banks as well as general public confidence in the banking system. From the depositor's perspective part of his assets are protected from bank failures by DGSs. From the aspect of financial stability, this type of insurance prevents depositors from making panic withdrawals from their banks, which limits the possibility of bank runs.

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[84] See BME Consulting, 2007, p. 24.

Thus, in this section we will analyze the current structure of deposit guarantee schemes across EU Member States. In addition, we will discuss some of the changes affecting DGSs after the 2007-08 financial crisis.

A broad definition of deposits is given by EU law, specifically by Article 1(1) of the Directive 94/19/EC on deposit guarantee schemes, as: *"…any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable, and any debt evidenced by a certificate issued by a credit institution."*[85] European financial institutions offer different contractual forms of bank deposits. Common types include the following:

(1) Demand deposits (or checking accounts) – these are funds held in bank's demand deposit accounts, disposable on demand, meaning there is no prior notice of intended withdrawal. These account balances are usually considered as money and as such form the greater part of the money supply of a country.

(2) Time deposits – deposits that are not immediately disposable as they are subject to a fixed term or a prior notice period before withdrawal;

(3) Savings deposits (savings certificates, certificates of deposit) – which are not negotiable or whose negotiability is very restricted;

(4) Deposits resulting from a savings scheme or contract – which often involve an obligation on the part of the depositor to make regular payments over a given period of time. The capital amount paid and the interest accrued become available only after a specified amount of time. These deposits are often combined with the issue of mortgage loans, at the end of the savings period, which are proportionate to the accumulated savings.

(5) Deposits at savings and loan associations, credit unions, building societies – which are legally redeemable on demand or on a relatively short notice;

(6) Short-term repurchase agreements (repo contracts) – which are liabilities of monetary financial institutions and as such we will discuss them in more detail in section 3.4.

Given the numerous types of deposits available, it has to be said that academics are divided regarding the merits of deposit insurance. They have been the object of much debate in

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[85] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit guarantee schemes, OJ L 135, 31.5.1994.

literature, with some authors arguing that – in the long run – deposit insurance weakens incentives of credit institutions to act efficiently[86]. It is no surprise then that deposit guarantee schemes vary greatly across countries, with differences with respect to their funding, coverage and administration.

Before our discussion of the details of specific deposit guarantees schemes in Europe, we have to point to the difference between explicit and implicit DGSs[87].

If a country has an explicit deposit insurance scheme it means that it has formally created a DGS by adopting specific legislation, which contains rules concerning: (i) the extent of the insurance protection, (ii) the operation of the scheme and (iii) the type of deposits or depositors protected. The purpose of this type of DGS is twofold: to protect the bank from bank runs, and to ensure depositors' protection. In an explicit DGS depositors are only paid once a bank is closed.

Contrary to an explicit DGS, implicit deposit insurance is activated while a bank is still in operation, through "rescue packages". As such an implicit DGS has the potential of shifting the burden of a bank's insolvency onto taxpayers, as the "rescue packages" devised to keep the bank operating, are often financed by the government.

In the EU deposit guarantee schemes are regulated by Directive 94/19/EC, which we already mentioned above. Although the intention of the Directive was to harmonize the scope and minimum insurance coverage of Member States, its implementation at national level resulted in different levels of deposit insurance. In the following paragraphs we discuss some of the major accomplishments and drawbacks of the Directive.

The Directive identified the establishment of a DGS as complementary to the prudential supervision of credit institutions. It means that DGSs create solidarity between all the institutions operating in the same financial market in the event of a default of one of them. Thus, the Directive requires every credit institution operating in the EU to join a deposit guarantee scheme. Deposit guarantee schemes have to be set up and officially recognized in every Member State. However, a Member State may exempt a credit institution from belonging to a DGS where that credit institution already belongs to a scheme that ensures its liquidity (in another Member State). The Directive also provides the procedures that have to

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[86] See for instance the studies of Demirgüç-Kunt, A., Detragiache, E. (2006) and Demirgüç-Kunt, A., Kane, E. (2001).

[87] This differentiation point is made in Ayadi, R., Lastra, R. M (2010).

be followed in the event that a credit institution does not comply with the obligations imposed by a DGS, as well as sanctions from competent authorities (*e.g.* withdrawal of the credit institution's authorization).

According to the Directive's provisions, when a credit institutions is member of a deposit guarantee schemes in its home country (*i.e.* the Member State where the institution has its registered seat) that scheme must cover the depositors in other Member States where the institution operates through branches. However, it is essential to know that the sole responsibility to reimburse depositors lies with the DGS of the country where the financial institution has its registered seat. This responsibility extends to all legally dependent parts of the institution even if they are located in another Member State[88]. Member States should ensure the same minimum amount of coverage for all deposits of the same depositor within one bank. There is an important exception to this principle however; if the coverage in a host Member State (in the case of branches for instance) is higher or more comprehensive than in the home country, the Directive provides an option for the institution to join the host country DGS for the remaining difference in coverage. This is known as a ″topping up arrangement″.

Indisputably the Directive 94/19/EC succeeded in introducing a common coverage level for deposits. But the forty DGSs currently in place across Member States[89] have different interpretations of the financial obligations implied by their insurance systems and therefore limit the benefits of bank deposit regulation. In 2006 the European Commission addressed this issue in its Communication, arguing that no changes to the existing Directive should be made, but that European policymakers should work on interpretative guidance and recommendations for Member States in its implementation[90]. Nevertheless, the 2007-08 financial crisis has cast a shadow of doubt on the adequacy of the existing national DGSs and has encouraged European policymakers to revise the original directive. The aim is to prevent competitive distortions and uncoordinated actions of national governments taken during the crisis in order to restore confidence in their banking sectors. The proposed changes in deposit insurance wish to increase the minimum coverage level and lay the foundations for a possible common deposit guarantee scheme, or even a centralized deposit guarantee system.

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[88] Branches established by a credit institution, which has its head office outside the EU, must have an equivalent cover to that prescribed by the Directive. In addition, such branches must provide actual and intending depositors with information concerning the guarantee arrangements covering their deposits.

[89] European Commission, COM(2010)369 final, p. 4.

[90] Available at: http://ec.europa.eu/internal_market/bank/docs/guarantee/comm9419_en.pdf

In practice, European policymakers mainly proposed to:

(1) Harmonize the scope of coverage and the arrangements for the reimbursement of depositors;

(2) Reduce the time within depositors are repaid;

(3) Structure sound and credible DGSs that will be sufficiently financed; and to

(4) Allow mutual borrowing between DGSs in certain circumstances.

In October 2008 the Commission put forward the proposal for amending the Directive 94/19/EC[91]. The amendments make substantial improvements of the existing regulation of bank deposits. As a result, in 2009 a new directive was adopted with the intention to support depositors' confidence in DGSs[92]. The improvements adopted by the Directive 2009/14/EC revolve around six elements pointed to by Ayadi and Lastra (2010) in their analysis.

First, the coverage and scope of the amount covered must be credible and harmonized across Member States. A credible deposit insurance system vitally depends on the prompt payment of depositors and a reasonable amount of coverage (as Ayadi and Lastra (2010, p. 218) put it: "*neither to meager to be non-credible, nor too generous to incur moral hazard incentives*"). Second, at a national level, when more than one authority is entrusted with responsibilities in a bank failure, it is important to establish a mechanism that sets the hierarchy of their operations and insures that deposits are reimbursed on time. The third proposal regards the so called "topping-up arrangements". As we have already mentioned, where a credit institution sets up a branch in another Member State where the coverage level is higher (or the scope of coverage is broader) than in its home country, then it has the right to join the host country DGS. As a result, the branches that opted for a topping-up arrangement are insured by two deposit insurance schemes (home and host) and pay premiums for the participation in both. The amendments related to this issue explicitly require schemes to cooperate with each other in order to avoid complications (*e.g.* delays of payments due to a time consuming assertion as to what should be paid under which scheme) and to exchange relevant information. Fourth, there has to be better disclosure to depositors. Schemes should be made widely known and

[91] Available at: http://ec.europa.eu/internal_market/bank/docs/guarantee/dgs_proposal_en.pdf

[92] This is Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay. It should be noted, however, that at the time of writing the directive is under revision, with a pending new legislative proposal by the Commission. See European Commission, COM(2010)368 final.

publicized. Depositors should have no doubts whether their deposits will be covered and to which amount. Fifth, the system of DGSs should be based on risk-based contribution of its participants. This means that credit institutions, which engage into riskier activities, will be expected to pay higher contributions. Finally, for large cross-border banks the traditional collection of DGS's premiums may be inadequate for such large institutions, thus proposals seek to ensure other means of adequate funding. Ayadi and Lastra (2010) note that preference should be given to private pre-funding mechanisms, but if they prove insufficient, they argue that Member State topping-up should be considered.

In conclusion, let us note that Ayadi and Lastra (2010) argue in favor of a European deposit guarantee system as a solution to deposit insurance. In this regard, the newly proposed EU regulatory structure based on the de Larosière Report (in particular, the establishment of the European supervisory authorities that were discussed in section 2.3.3.) is a step towards for the introduction of a centralized DGS. This is by no means a "declarative policy step"; in fact the Commission's July 2010 proposal for the revision of Directive 2009/14/EC addresses the inefficiencies of the existing system and greatly relies on the administrative and supervisory competencies of the newly created European Banking Authority[93]. In addition, it seems that the centralization of DGSs has been well received by academics as well. Beside Ayadi and Lastra, there are other authors who reinforce the argument in favor of a common, European system of deposit insurance. For instance Carmassi, Luchetti and Micossi (2010) propose the establishment of a European deposit guarantee scheme through the creation of a pre-funded, risk-based fund that would protect depositors of large European banks[94].

The authors go even further in their ideas, as they argue in favor of a "European deposit insurance corporation" that would be entrusted with powers to recapitalize or bail out failing institutions in addition to deposit insurance. We observe that essentially, the current proposals for changes in DGSs revolve around three alternatives:

(1) The establishment of an optional DGS that is complimentary to the national ones,

(2) The creation of a single European DGS that would replace the national ones, and

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[93] See European Commission, COM(2010)368 final.

[94] However, it is still debated what will be the position of smaller, local banks in Europe if the envisaged European deposit insurance fund is intended to safeguard only large, regional banks which are highly interconnected on the European financial markets.

(3) A European system of DGSs where DGSs provide each other mutual assistance (Ayadi, R., Lastra, R. M., 2010, p. 220).

There is no quick answer to the question which alternative to follow. In order to opt for one of these alternatives we should closely examine the scope of protection, the coverage level, financing and payment modalities, and so on. But in the present situation where local taxpayers are still the ones bearing the costs of bank failures, and when fiscal policy is uncoordinated across Member States, we argue in favor of creating such a deposit guarantee scheme where systemically important, cross-border banks in the EU would be covered at a European level (maybe through private pre-funding) while national DGSs should cover all other domestic banks. As for the national DGSs, the way forward is harmonization (*e.g.* of DGS operations, financing) and mutual cooperation. Overall every national deposit guarantee scheme in the EU should follow the same overarching objective – to make politically feasible and practically possible to close a bank, as the authorities are certain that depositors will be adequately protected.

3.4. Bank loans

As credit institutions and their prudential regulation will be discussed in great length in chapter 4, at this point we will give a broad, ″working definition″ of credit institutions. We will define them in this section as undertakings whose business is to receive deposits (or other repayable funds) from the large public, and to grant loans for its account and issue means of payment in the form of deposit money. Loans and the activity of lending are central to a credit institution's business. A loan contract is one of the simplest and most common commercial contracts a credit institution enters into. In a loan contract a lender advances a loan to a borrower who has to repay it, and who pays interest on the loaned amount in the meantime (Wood, P., 2008, p. 93).

Hudson (2008) names three basic types of loans:

(1) A loan made by a bank to its customer – the basic form of a loan agreement;

(2) A loan in the form of an overdraft – a permission granted to an accountholder to draw on the facility expressed by the bank account, above the amount of any credit which the accountholder may have in that account. In an overdraft no single sum of money is transferred at the outset of the transaction from lender to borrower, but the borrower uses as much of the loan facility as he requires; and

(3) A loan subject to some security (Hudson, A., 2009, p. 863).

The focus of our analysis in this section will be the last type of loan, where the bank uses a specific form of legal guarantee (*i.e.* mortgage) to protect itself against the failure of a borrower.

In this section we focus on mortgage loans as they represent the most common type of loans made by European banks[95] and because they demonstrated major systemic significance during the last financial turmoil. We will discuss the European regulation of mortgage loans and its specific scope of achieving more responsible lending and borrowing. The European Commission encouraged such initiatives after the 2007-08 economic and financial crisis, due to the fact that the crisis originated from subprime mortgages on the United States markets[96]. In the EU the scope of regulating mortgage loans is to ensure lending is done responsibly. Responsible lending means that credit "products" should at the same time accommodate the needs of borrowers and be adequate to their ability to repay the loan. This can be obtained through the enforcement of regulation that ensures that all credit institutions and lenders act in an honest and professional manner when entering lending contracts. But responsible lending imposes obligations on borrowers as well – they should provide honest and accurate information on their financial conditions and bear responsibility for their own decisions.

We begin our analysis with a definition of a loan agreement and progress towards the definition of secured loans and mortgage loans in particular. Our aim is to ascertain the level of harmonization achieved in this area in the EU, and future prospects of regulatory reform.

Loans are contractual arrangements between a *borrower* and a *lender* where the lender agrees to transfer an amount of money or other fungible goods (known as the "loan capital") to the borrower. The borrower agrees to repay the loan capital at the agreement's maturity and also

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[95] The size of the EU market for mortgage loans is significant: in 2008, outstanding residential mortgage lending (*i.e.* housing loans) in the EU27 amounted to almost 6 trillion EUR, or about 50% of EU GDP. The value of the residential debt-to-GDP ratio in almost all EU countries is very high, with the highest value in the following Member States: the Netherlands 105.6%, Denmark 103.8%, Ireland 90.3%, United Kingdom 87.6%, Sweden 82%. The lowest ratio is in Romania (4.9%). See European Mortgage Federation, November 2009. An important contributing factor to their systemic significance was the growth in securitization, a financial transaction that we will discuss in great detail in section 3.7. In essence, securitization allowed lenders (credit institutions) to pass the risk of their lending portfolios to third parties (investors) and borrowers were left to feel the consequences first hand.

[96] Subprime mortgages are mortgages that are usually extended to borrowers with lower credit ratings. Because of the borrower's lower credit rating, a conventional mortgage is not offered, as the lender considers the borrower to have a higher-than-average possibility of defaulting on the loan. When extending subprime mortgage loans, credit institutions usually charge higher interest rates on the loan, in order to compensate for taking more risk.

to pay periodic amounts to the lender calculated by reference to the capital amount on identified dates (or date) during the loan's life ("interest") (Hudson, A., 2009, p. 863). A lender (namely, bank) usually identifies its target customers and fixes the rate of interest accordingly, within the limits of set by consumer credit legislation. From an economic aspect a bank loan represents a relatively simple exchange of cash flows. In the most common form of a loan there is a transfer of a capital amount to the borrower based on which the borrower calculates the interest, and in the end of the transaction a capital amount equal to the loan is repaid. In a basic loan in which the lender doesn't take any proprietary security (*i.e.* mortgage) the lender transfers the loan capital outright to the borrower. That money becomes property of the borrower. Assuming there are no other specific provisions in the loan contract[97], the borrower has two contractual obligations under the loan:

(i) To repay the principal amount (principal) at the termination of the agreement, and

(ii) An obligation to pay interest during the life of the loan.

The obligation to repay the loan capital is a personal obligation of the borrower to pay an amount equal to the amount that was loaned originally. In an ordinary loan the money is transferred to the borrower while the lender takes the risk that the borrower may default on its obligation to repay. Thus, the lender's rights in a basic loan agreement are purely contractual in nature, unless the lender has taken some form of security as part of the loan agreement[98]. A bank, as a lender, may take security in two different forms:

(1) As *personal security* – in the form of guarantees which ensure that payment will be made by some other person in order to fulfill the borrower's obligations, or

(2) As *proprietary security* – either in the form of a *collateral*[99] or in the form of a *mortgage*. In the first case, some type of receivable, marketable security or other acceptable collateral secures a loan. In the event of the borrower's default, the bank can take legal action to reclaim

[97] If the lender wishes to exercise control on the way the borrower uses the money lent, it can do so through a specific contractual provision identifying the purposes for which the loan may be used incorporated in the loan contract. A breach of such a provision would represent a breach of contract that would entitle the lender to a payment of damages or to the termination of the loan contract.

[98] "To take security" means that a legal structure is used by a bank in the context of a loan transaction, in order to protect itself against the failure of a borrower to make payment to it, or any other failure identified in the loan contract.

[99] Collateral is an asset pledged as security to ensure payment or performance of an obligation. See Fitch, T., 1990. We will discuss the issue of collateral again in section 3.4. and then the technique of *collateralization* in section 3.5.

and sell the collateral[100]. In the second case, the bank is entitled to seize property (typically real estate) of a value, which is sufficient to compensate the borrower's obligation in whole or in part.

Relevant literature and European legislation do not give a single definition of mortgage loans. Nevertheless, we may broadly define them as loans that are secured by real property, through the use of a document, which evidences the existence of the loan, and the limitation of property rights through the granting of a mortgage that secures the loan[101].

The European regulation of mortgage lending (or "mortgage credit" as it is referred to in the EU context, a term coined under German influence) is based on two fundamental documents:

(i) The 2007 Commission's White Paper on the Integration of the Mortgage Credit Markets and

(ii) The 2009 Public Consultation on responsible lending and borrowing in the EU.[102] Both of these documents see the integration of mortgage lending (or *mortgage credit* as it is referred to in these documents) as essential for an efficient European financial system. Specifically, the White Paper contains measures to improve the efficiency and competitiveness of the European markets for mortgage lending, while the measures proposed by the Public Consultation aim at making borrowing more responsible at EU level.

Currently, there is no specific EU law regulating lending. In extending loans, thus mortgage loans as well, credit institutions follow the provisions of the Consumer Credit Directive and the Capital Requirements Directive[103]. A number of Member States apply only selected provisions of the Consumer Credit Directive to mortgage loans. As the Directive's provisions cover loans of a specified amount (between 200 and 75 000 EUR) the majority of mortgage loans (which typically exceed the higher specified amount) are still outside the scope of the Directive. As for the Capital Requirements Directive, its provisions proscribe the authorization, registration and supervision requirements only for credit institutions. No such

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[100] This type of bank loan is usually known as a "lombard loan" in some countries in continental Europe (mainly those of the *ius civile* legal circle: Italy, Germany, Croatia, etc.)

[101] A mortgage is in fact an encumbrance, meaning it is a security interest of a lender in a property which entails restrictions or other limitations to the use or disposal of the property.

[102] European Commission, COM(2007)807 final and 2009, June.

[103] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers repealing Council Directive 87/102/EEC (OJ L 133/66, 22.5.2008.) and Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (OJ L 177/1, 30.6.2006.) respectively.

requirements exist at EU level for non-credit institutions providing mortgage loans, which undermines borrower's confidence in the mortgage market. Even from a general perspective there is still space for improving responsible lending and borrowing in the EU. For instance, some areas that should be revised are:

(i) The dissemination of pre-contractual information,

(ii) The assessment of a borrower's creditworthiness,

(iii) The extending of credit advice, and

(iv) Credit provision in general.

Against this background, in March 2011 the European Commission adopted a proposal for a Directive on credit agreements relating to residential property[104]. This Directive regulates the relationship between lenders (credit institutions) and borrowers (namely, EU citizens). The aim of this proposal is to support the creation of an internal market in mortgage loans, to offer a sufficient degree of borrowers' protection and last, to simplify EU regulation in this field. As in the current situation Member States impose different levels of protection to borrowers the Directive adopted the principle of maximum harmonization in order to level out such differences.

At the time of writing it is impossible to discuss or predict the Directive's impact on the market for mortgage loans. But our analysis of the text of the proposal and the fact that the EU has once more chosen to follow a high level of harmonization makes us critical of such uniform legal solution. Maximum harmonization is neither always appropriate nor necessary. The structure of mortgage markets differs considerably throughout the EU, as do the products available (namely, the types of mortgage loans). It is our opinion that any intervention in this area had to take into account Member States' diversity and thus follow a more flexible approach to regulation, rather than recur to maximum harmonization.

3.5. Securities lending and repo agreements

Securities lending involves the temporary exchange of securities, generally for cash or other securities of at least an equivalent value, with the obligation to redeliver a like quantity of the same securities on a future date (The International Organization of Securities Commissions,

[104] European Commission, COM(2011) 142 final.

1999, July, p. 9). These types of transactions improve financial market liquidity in practice. They can take different legal forms: lending contracts, repurchase agreements (repos), etc. Due to the many contractual varieties securities lending come in, their legal treatment differs across Member States. This impedes the creation of an integrated market for securities lending. Moreover, in transition countries (such as Croatia), another challenge is the poor development of securities lending, with respect to the types of financial instruments used, the supporting infrastructure (*e.g.* payment mechanisms) and the regulation in place. In this section we discuss the typical transaction methods used in securities lending markets. We address the types and sources of risk present in securities lending in general, and the practices used by market participants to manage and reduce these risks. Then our attention shifts to repos in particular; we examine their regulation in the EU and at Member State level. We are particularly interested in repos as they are the primary source of liquidity in Europe. Repo agreements provide money market funding for financial intermediaries while providing a secure home for liquid investments. Repos are also used by national central banks as their principal tool in open market operations to control short-term interest rates. They are attractive as a monetary policy instrument because they carry low credit risk and are flexible enough to be used for liquidity management. This makes the repo market one of the most vital components of the European financial system and it is not surprising then that the repo market is one of the larges financial markets in the EU.

Against this background we discuss the legal obstacles impeding full harmonization of the market for repos. In conclusion of this section we analyze the effect of repo markets on the overall financial stability. We suggest that, as the scale and importance of repo transactions continues to increase, Europe should focus on the development of common market practices in this area.

In capital markets securities are frequently lent between entities, or are used as collateral in financing. These transactions are generally known as ″securities lending″. From a legal aspect most securities lending transactions give the borrower legal title to the securities for the transactions’ duration. From an economic point of view, the terms of the transactions are more similar to a loan agreement[105]. Securities lending transactions can be divided into two categories:

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[105] In securities lending transactions, securities lenders are typically institutions that have access to "lendable" securities, such as: asset managers, custodian banks who hold securities for third parties, pension funds,

(1) ″Securities-driven″ transactions, and

(2) ″Cash-driven″ transactions.

Broadly put, in ″securities-driven″ transactions financial institutions seek to lend or borrow specific securities against collateral. Here market borrowers seek to gain temporary access to specific securities. This may be because they have failed to receive securities that they are due to make delivery on, for instance. In this case, the securities borrower will usually give collateral to the lender of the security in form of another security, cash or other form.

In ″cash-driven″ transactions financial institutions seek to lend or borrow securities as collateral in cash financing arrangements. Thus, borrowers give securities as collateral to obtain cash. The cash lender is not seeking specific securities and will allow the cash borrower to select within defined categories of ″generally accepted collateral″.

Both categories share a similarity – the value of collateral has to exceed that of the cash or securities loaned, and it's usually provided by the giver of collateral (*i.e.* the borrower).

The main contractual forms through which securities lending transactions are executed are:

(1) Securities loans transactions - where the owner of securities lends securities to a borrower, which becomes contractually obligated to redeliver a like quantity of the same security (The International Organization of Securities Commissions, 1999, July, p. 6). The economic motivation behind this transaction is to temporarily obtain the security for other purposes, such as covering short positions or for their use in more complex financial techniques. Securities borrowers are required to provide collateral to assure their redelivery obligation. Typically, the securities lender does not retain legal title to the securities lent; the borrower obtains full title to the securities.

(2) Repurchase agreements[106] - in which one party agrees to sell securities to its counterparty against the transfer of funds, with a simultaneous agreement to repurchase the same or equivalent securities at a specific price at a later date. The general motivation behind repo agreements is the borrowing (or lending) of cash. Parties borrowing securities in a repo are referred to as buyers, while parties lending securities are referred to as sellers. An important distinction between securities lending and classic repos is the maturity of such agreements.

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insurance undertakings, etc. As for securities borrowers, hedge funds, stock traders or proprietary trading desks of investment banks are typical participants.

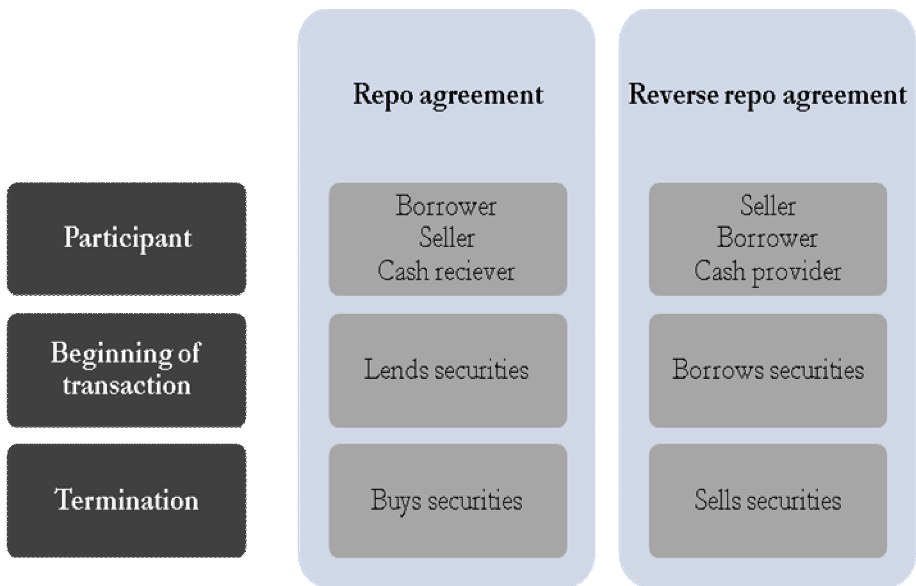
[106] Commonly called *repos*. In Italy these agreements are called ″*contratti pronto contro termine*″, in France ″*pension*″ or ″*la mise en pension*″.

Securities loans are mostly made on an open-end basis, such that loans can be returned or recalled either on demand or after an agreed period. By contrast, repos have a specified duration.

In repo transactions, securities are initially valued and sold at the current market price plus any interest accrued during the duration of the agreement. At the termination of the transaction, the securities are resold at a predetermined price equal to the original sale price plus a previously agreed upon interest rate (the "repo rate"). Thus, in repo transactions fees generally take on an interest component implicit in the pricing of the repo.

At this point, we wish to make an important observation – we distinguish between the terms of repurchase and reverse repurchase agreements. These terms often cause confusion, which can easily be dismissed if we keep in mind the practical side of the transaction. We can make a clear distinction between these terms on the example of a repo transaction between a bank and its central bank. In a repo transaction the central bank buys the securities, whilst the bank sells them. From the aspect of the initiator of the transaction (in our example, the bank) this is a classic repurchase agreement. A reverse repo is simply the same repurchase agreement from the buyer's viewpoint (in this example, the central bank's). Hence, the seller executing the transaction would describe it as a repo, while the buyer in the same transaction would describe the transaction as a reverse repo. Put simply, these transactions are exactly the same, just described from opposite contractual aspects (Ribnikar, I., 1995).

3(1) Distinguishing between repo and reverse repo agreements



(3) *Sell-buyback arrangements* – an arrangement where both the sell and buy trades are entered at the same time, with the purchase transaction for settlement at a future date. This is a

type of forward contract where the repo rate is typically used to estimate the price. In this arrangement, the purchaser of securities (*i.e.* the lender) receives legal title to the securities. He also retains any accrued interest during the life of the transaction. In general, sell-buybacks are limited to fixed-income securities. As these transactions, traditionally, are not fully documented, trade confirmations are usually delivered showing the details of the arrangement and that there is the forward obligation to honor the trade (The International Organization of Securities Commissions, 1999, July, p. 8).

As we have mentioned, in every type of securities lending transaction the borrower is required to provide collateral. Collateral is typically provided in the form of:

(i) Cash,

(ii) Securities, or

(iii) Standby letters of credit. Borrowers tend to prefer different types of collateral depending on their own credit reputation. For instance, a highly rated credit institution will prefer cash which it can obtain at a low cost on the market, while a less highly rated entity may prefer equities or bonds. In addition, lenders typically require margin that is added to the value of the assets loaned to the borrower. The amount of margin depends on the quality, liquidity, and price volatility of the securities lent, the term of the loan, or the creditworthiness of the counterparty.

Before we turn our analysis to regulation of securities lending transactions in the EU, we have to determine the risks encountered in this transactions, which regulation seeks to minimize or dismiss. The main types of risk in securities lending transactions are:

(1) Credit risk - in the broadest sense it is the risk that a counterparty will not settle the full value of an obligation; in the specific context of securities lending transactions it can take form of either: (i) principal risk, or (ii) replacement cost risk. Principal risk is the risk of loss of the full value of securities or funds that a non-defaulting counterparty has transferred to the defaulting counterparty. Replacement cost risk is the risk of loss of unrealized gains on unsettled contracts with defaulting counterparties (The International Organization of Securities Commissions, 1999, July, p. 39).

(2) Liquidity risk – the risk that a counterparty will not settle an obligation when due, but on some unspecified date later. In some circumstances, securities lending can give rise to significant liquidity pressures. For instance, many securities lending transactions provide that

the agreement can be terminated on demand by either counterparty. This in turn puts great liquidity pressure on borrowers that typically do not hold the securities and have to either recall them from other customers or purchase them in the market on spot regardless of how unfavorable the sell conditions are. On the other hand, lenders of securities may face liquidity pressures when they have re-transferred collateral, or in the case when the reinvestment of any cash collateral was not sufficiently liquid to meet the demands of an unexpectedly high amount of returns by borrowers. Another potential source of liquidity risk in securities lending transactions is the collateral. A significant decline in the value of the collateral relative to borrowed securities or funds could result in substantial demands for additional collateral and liquidity pressures.

(3) Market risk – in securities lending, it takes the form of: (i) a counterparty default; (ii) inappropriate margining; or (iii) reinvestment of cash collateral.

(4) Legal risk – the risk of loss because of the unexpected application of a law or regulation or because a contract cannot be enforced.

(5) Operational risk – the risk that inefficiencies of information systems or internal controls could result in an unexpected loss. The costs can arise as losses in the value of the transaction, or as penalties imposed on a counterparty.

(6) Settlement risk – the risk that the completion of a transaction will not take place as expected. In securities lending transactions settlement risk emerges from the time lag between the execution of the transaction and its final completion, or from the time lag between payment and delivery.

(7) Custody risk – the risk of loss of securities held with a custodian as a result of insolvency, negligence or other harmful action by the custodian. However, custodian insolvency shouldn't cause losses for market participants as securities should always be kept in an account separate from other holdings of the custodian and be separable in case of the custodian's bankruptcy.

For now we have determined the risks encountered when engaging into securities lending transactions. Now let us determine how these risks are minimized through regulation in the EU. To discuss all forms of securities lending transactions would be time consuming and inappropriate, as not all securities lending arrangements have the same significance in European financial markets. We have already stated that the repo market is one of the largest financial markets in the EU. Also, we have said that repos support market liquidity. From the EU perspective, the key role of repos is demonstrated by the fact that the European System of

Central Banks uses repos as its main monetary policy tool, to provide (and drain) liquidity from money markets. In addition, financial institutions use repos to manage their own liquidity position, but also to support their activities related to securities. Lastly, the repo market is closely linked to the market in the underlying security or collateral and affects indirectly the price of bonds in other markets. But in the EU, repo markets are fragmented along national jurisdictions. And if repo markets are not fully integrated, this will also be the truth for securities markets (due to their described correlation). Naturally, the EU wants to achieve integrated repo markets. But integration requires substantial reform.

According to EU law a "repurchase agreement" is defined as: *"any agreement in which an institution or its counterparty transfers securities or commodities or guaranteed rights relating to title – to securities or commodities where that guarantee is issued by a recognized exchange which holds the rights to the securities or commodities and the agreement does not allow an institution to transfer or pledge a particular security or commodity to more than one counterparty at one time, subject to a commitment to repurchase them – or substituted securities or commodities of the same description – at a specified price on a future date specified, or to be specified, by the transferor, being a repurchase agreement for the institution selling the securities or commodities."*[107] As regulation of repo agreements has developed within national jurisdictions, this means that there are significant differences in their legal treatment across Member States. Such legal uncertainties relate to the structure of the agreement, its execution, tax treatments and other differences of regulation. In addition, the infrastructure that allows the delivery of securities involved in repos and/or the settlement of trade are not well connected in all Member States. Some of these problems can have relatively simple solutions, but the majority of them affect the core concepts of national legal systems (such as property law or bankruptcy law). As a consequence the integration of repo markets and the common regulation of repos is difficult to achieve in the EU.

The Giovannini Report[108], ordered by the European Commission to identify key issues that obstruct integration of repo markets in the EU, pointed to three priority areas in need of reform:

(i) Netting,

(ii) Documentation, and

[107] Article 3(m) of Directive 2006/49/EC.

[108] Report of the Giovannini Group (1999, October).

(iii) Collateral.

Ad (i) For instance, when a bank or other credit institution enters into several repo or reverse repo contracts with the same counterparty (typically a central bank) it will record a series of new assets (*collateralized loans*) and liabilities (*borrowings*) on its balance sheet. Netting is the ability to offset these assets and liabilities in the balance sheet, as it allows mutual obligations of counterparties to be offset. From a legal aspect, there are three types of netting:

(1) *Payment or settlement netting* – this type of netting addresses the settlement risk arising where two or more same currency payment or same securities delivery obligations are due between two parties on the same maturity date and from the same clearing location. It leaves only the net amount payable or deliverable.

(2) *Close-out netting* – refers either to the right to terminate the transaction early or the right to offset accelerated obligations. In most jurisdictions this type of netting has to be provided by a special law and explicitly allowed by the contract.

(3) *Novation netting* – this type of netting is associated with the involvement of central clearing counterparties. In clearing a repo agreement, a central clearing counterparty (CCC) interposes itself between the original parties and becomes either the buyer to the seller, or the seller to the buyer. In law, this is known as *novation*.

Within the EU law netting is addressed by the provisions of the Directives regulating capital adequacy, more precisely by the Directive 2006/48/EC. A definition of novation netting can be found in the Directive's Annex III, pt.7 (i): *"bilateral contracts for novation between a credit institution and its counterparty under which mutual claims and obligations are automatically amalgamated in such a way that this novation fixes one single net amount each time novation applies and thus creates a legally binding, single new contract extinguishing former contracts"*[109].

Ad (ii) Appropriate legal documentation is vital to effective risk management in financial transactions. Repos are often regarded as risk-neutral because the value of the cash is balanced out by the value of the collateral. But for this to be effective, each party's obligations in a repo contract must amount to a sure claim on the collateral, stipulated by the contract. In this context, standardization of documents is crucial for it ensures that all participants hold proper documentation. Standardized documentation should provide legally

[109] Directive available at: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

enforceable ways of minimizing this risk of counterparty's default, as it would ensure risk protection mechanisms.

Ad (iii) By taking collateral, financial market participants control credit risk. Collateral has value only if it is effective from a legal aspect. In the context of repo transactions this legal effectiveness is seen as:

(1) *Effectiveness of transfer of title* – repo transactions require the transfer of title of the repo securities to the purchaser (lender).

(2) *Location of securities* – where securities are held in a depository or by a custodian, it can be problematic to determine the location of such securities in certain jurisdictions. Thus, legislation should clearly designate the location of the system for legal purposes.

(3) *Finality* – once a lender has taken collateral it has to be certain that the payment or delivery of collateral is treated as final. In the EU, "collateral certainty" is addressed in the Settlement Finality Directive and the Financial Collateral Arrangements Directive[110]. But to act solely at the EU level won't resolve all the problems of collateralization. The Giovannini Report suggested that further legal improvements have to be both at national as well as the EU level. The aim of regulation should be to allow participants in the market to adopt a single and consistent approach to collateral that would be equally valued across markets and jurisdictions.

Regardless of the fact that more than a decade has passed since the Giovannini Report, the regulation of repo agreements hasn't experienced significant changes in the EU. Domestic regulation still continues to shape the contractual forms of repos. This in turn sustains the fragmentation of the markets along national jurisdictions, causing legal uncertainty that undermines liquidity. In the aftermath of the financial crisis, the EU is well aware of the potential threats that repo markets may pose to financial stability. Their interconnectedness with money markets is key in sustaining liquidity in times of financial duress. As a consequence, tensions exist between Member States that continue to subject repos to national regulation and the requirement for more integration in this market posed by the EU. For the

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[110] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities systems (OJ L 166/45, 11.6.1998.); Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L 168/43, 27.6.2002.). See also Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009 amending Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities systems (OJ L 146, 10.6.2009.) and Directive 2010/78/EU of the European Parliament and of the Council of November 2010 (OJ L 133, 15.12.2010.).

time being, there is no common regulation that would harmonize repo agreements across Member States. We think that soon the EU will recur to more centralization in repo markets. We suppose that the EU is likely to insist on greater collateralization of repo agreements through the use of central clearing counterparties (CCPs) and central securities depositories (CDSs). This would improve the legal standardization of agreements across Member States and facilitate finality settlement of cross-border repo transactions, which would sustain confidence of participants in the market. In our opinion proposals for regulation should be carefully considered in order to avoid unintended damage, particularly given the greater reliance that governments have placed on repo markets during the last financial crisis.

3.6. Financial derivatives

Regardless of the fact that the role of financial derivatives across EU countries is fairly modest in comparison to the United States where derivatives have first emerged and were subsequently widely used[111], an analysis of their regulation in the EU is in order. This is especially true since financial derivatives represent a new investment opportunity in Europe, one that is often characterized by opacity and risks[112]. Not all EU countries have the same level of market discipline and – we should say – market integrity that would allow them to reap the benefits of this financial asset equally. Especially in transition countries, such as Croatia, it is necessary to impose clear regulation to financial derivatives if we wish to create a secure environment of market discipline and legal certainty.

In this context, this section considers the economic and legal aspect of financial derivatives. We analyze how financial derivatives are regulated in the EU and how principal risks associated with derivatives are managed through regulation. The section begins with a consideration of the various definitions of the term "*derivative*" that can be found in economic and legal literature. We outline the basic concepts related to their economic function, their

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[111] This role is even more modest if we observe the situation in the so called "New Member States" and in acceding/candidate countries, where the role of financial derivatives remains marginal. See European Commission (2011, February).

[112] "*The use of financial derivatives has grown exponentially over the last decade. Most of this growth was driven by over-the-counter derivatives transactions (OTC). At the end of 2009 the size of the OTC derivatives market by notional value equaled to approximately 615 trillion USD. (...) While notional amounts provide a measure of market size and a reference from which contractual payments are determined in derivatives markets, they do not correspond to amounts truly at risk. Gross market values provide some measure of the financial risk from OTC derivatives. At the end of 2009, the total gross market value stood at 21.6 trillion USD, one third lower than at the peak reached a year earlier. The corresponding credit exposure was 3.52 trillion USD, about 22% lower than the peak reached a year earlier.*" See European Commission, SEC(2010) 1058/2.

different forms in practice (options, forwards, and swaps), their structure and the major risks associated with derivatives. Finally, we turn our attention to recent proposals of EU regulation of derivatives.

From an economic and legal aspect the term "derivative" is not associated to a single definition in literature, nor does EU legislation offer a common definition of these instruments. Instead, the term is used to cover a range of financial products the value of which is derived from another, underlying financial product or benchmark (Hudson, A., p. 12). Benjamin (2007, p. 65) defines a derivative from a legal perspective, as a *"bilateral contract: (i) under which the rights and obligations of the parties are derived from, or defined by reference to a specified asset type, entity, or benchmark, and (ii) the performance of which is agreed to take place on a date significantly later than the date on which the contract is concluded"*. In their Dictionary of Finance and Investment Terms, Downes and Goodman (2006) define a derivative as a: *"...contract whose value is based on the performance of an underlying financial asset, index or other instrument."* (Downes, J. Goodman, J. E., 2006). A broader definition of derivatives should also comprise the economic core of the transaction. Following this logic derivatives can be defined as contracts for the exchange of cash (or delivery of flows) made between two parties, each of which flows is equal to the other at the start of the contract. This is a financial arrangement that involves mutuality and that is valued by reference to different market benchmarks (*e.g.* current market rates, prices or levels).

We have to point out that the legal concepts behind modern financial derivatives are well established in contract theory. But the novelty in derivatives lies in the use of these core concepts with a somewhat new economic intent. Namely, they are used with the intent to create bespoke financial instruments on which complex mathematical models are added in order to allow the predicting, estimating and pricing of derivatives (Hudson, A., 2009, p. 1090).

Irrespective of their new economic intent, the commercial reasons behind derivatives are well known. The first one is "hedging" or the protection against some existing obligation. The second is "speculation" on the future movement of a benchmark on which the derivative is based. The first reason is connected to the management of the risk of an existing obligation and the attempt to manage that risk by creating an entitlement to receive a new income stream, which would counteract the eventual loss resulting from the original obligation. Hedging is based on the ability to find a derivative whose value will move contrary to the value of an existing investment in order to balance out the eventual losses. Thus, derivatives attempt to better manage the risk associated with an obligation by matching income and risk of a subject. As for speculation, the counterparties in a derivative contract are allowed to speculate on the future performance of some identified, underlying benchmark. But no factual investment has to be made. Instead, derivatives replicate the performance of a real market in virtual form by supposing that some notional investment was made, and that the return generated by that investment was payable between parties. In this way, derivatives enable the contracting parties to assume trading positions in relation to the anticipated movements of financial markets in the future. Thus, derivatives exploit the advantage of mismatches in prices or market conditions by speculating and consequently generating arbitrage opportunities (Hudson, A., 2009, p. 1094).

It is worth noting that both hedging and speculation point toward a common, key economic concept behind financial derivatives – cash flow management. The speculator uses it to generate income whilst the risk manager (hedger) seeks to offset one cash flow with a different one, which operates in an inverse manner[113].

From the contractual aspect there are two basic forms of derivatives:

(i) Options and

(ii) Forwards or *futures*[114].

Ad (i) From a legal perspective an option is a contract between two parties: a buyer and a seller of the option. This contract gives the buyer of the option the right, but not the obligation, to buy or to sell a specified underlying asset on or before the expiration date, at a previously agreed price. An option to buy an asset is called a "*call option*" and an option to sell an asset is called a "*put option*". Call options can be exercised so that the option holder becomes the owner of the underlying assets; this is known as physical settlement. Alternatively a call option, or a put option more usually, can be settled purely by cash settlement. Cash settlement works by calculating how much profit the option holder would

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[113] Hudson, A.: Dealing with Derivatives, p.7., www.alastairhudson.com

[114] See Ribnikar, I., 1996. He notes that nowadays the so called "second-generation" derivatives are much more common than the first-generation ones. The difference between them is that the second-generation derivatives are not dealt on spot markets and their underlying asset is typically represented by another derivative. Similarly, Hudson (2002) distinguishes between three basic types of derivatives: options, forwards and swaps. Furthermore, he argues that all derivatives contracts are variants of options, and that option theory is the basis of the structure and pricing of more complex derivatives. See Hudson (2006, p. 28).

have made by buying or selling the number of assets identified in the option contract on the dates specified in the contract[115].

Ad (ii) Fundamentally, forward and futures contracts have the same function: both allow subjects to buy or sell a specific type of asset at a specific time, at a given price. However, the contractual details differ. First of all, futures contracts are exchange-traded and are standardized. Forwards on the other hand, are private agreements between two parties, which are not standardized in terms and conditions. Because forwards are private agreements, there is always a chance that a party may default on its obligation. By contrast, futures contracts are executed through clearinghouses that guarantee the transactions. Thus the probability of counterparty's default in a futures contract is limited. These characteristics also determine how forwards and futures are traded; as fully standardized contracts futures are traded on organized trading venues (exchanges), while forwards – as "bespoke" contracts are traded bilaterally, *i.e.* off-exchanges, or as commonly referred, over-the-counter (OTC)[116]. Secondly, the specific details concerning settlement and delivery are quite distinct. For forwards, settlement of the contract occurs at the contract's termination. So forwards possess one settlement date. By contrast, futures contracts are "marked-to-market" daily, which means that daily changes are settled day by day until termination. Consequently, settlement for futures contracts can occur over a range of dates.

If we start to analyze a futures contract from its economic aspect we will come to the conclusion that it is similar to the option contract. But from a legal aspect these contracts bear major differences. A futures contract may be defined as an agreement that gives the right to purchase or sell, a specified quantity of an asset at a fixed price, on a fixed date in the future[117]. In essence, futures contracts are a promise to supply a particular financial asset at a set price on a set date (*e.g.* any financial index – currency, interest rate or stock index). In a

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[115] There are different ways of settling an option: (i) on a particular date – known as the European option; (ii) over a period of time between specified dates – known as an American option; and (iii) on specific dates during a period of time – known as an Asian option.

[116] The 2007-08 financial crisis has brought the OTC derivatives market to the forefront of regulatory attention. As this is a very opaque market by its nature (due to the private negotiation of contracts where any information concerning the counterparties is only available among them) the financial crisis has highlightened the lack of information on positions and exposures of individual institutions in OTC derivatives as a regulatory issue of highest relevance. The lack of information in OTC markets prevents regulators from a timely detection of risks building up at individual institutions and in the system as a whole, preventing them from accurately assessing the consequences of a default of a market participant and therefore to respond in an adequate manner.

[117] Financial theory considers futures as two synthetic options in which the buyer is acquiring the right to buy or sell at an identified price in the future, and the seller enters into an inverse relationship.

futures contract the contractual relations are not between the buyer and the seller, but between each party and the clearinghouse (the exchange), which administers the contract. Consequently, any counterparty risk is placed on the clearinghouse.

We can categorize futures as: long term and short term. Long term futures contracts specify that physical delivery has to be made upon the contract's maturity. Therefore the right that is being transferred on the buyer in a long-term futures contract is the right to receive a commodity for a stated price at a stated time in the future. The futures price is the price that the market would pay on the asset that is to be physically delivered in the future, if that asset existed at the time the contract was concluded. By contrast, short term futures contracts usually specify cash settlement rather than physical delivery. Consequently, the right that is being transferred on the purchase of such a contract is the right to receive the cash equivalent of the price for that asset (Hudson, A., 2006, p. 14).

The prices in a futures contract are quoted as an amount less the implied interest rate on that asset. Therefore, the price of a futures asset moves in inverse correlation to movements in interest rates. This makes futures excellent hedging instruments against movements in interest rates. If interest rates fall – the price of futures rises; there is an inverse correlation – meaning that an opposite movement in the other will compensate a movement in one variable.

A major development in the area of derivatives contracts was the emergence of the ″second generation″ of derivatives, mainly represented by swaps[118]. There are two basic types of swaps:

(1) Currency swaps; this is a foreign-exchange agreement between two parties to exchange aspects of a loan in one currency (such as the principal and/or interest payments) for equivalent aspects of an equal in net present value loan in another currency. A typical currency swap obligates the parties to exchange the agreed currency amounts on the initial exchange date, generally the effective date (Henderson, S. K., 2003, p. 33). The most simple currency swap structure is to exchange the principal only with the counterparty, at a rate agreed now, at some specified point in the future. Such an agreement performs a function equivalent to a forward or futures contract. Another possible structure for a currency swap is to swap only interest payment cash flows on loans of the same size and term. Again, as this is a currency swap, the exchanged cash flows are in different denominations and so are not

[118] A swap can be defined as an exchange of one security for another that changes the maturities of a bond portfolio or the quality of the issues in a stock or bond portfolio. See Downes, J., Goodman, J. E., 2006.

netted[119]. This type of swap is also known as a *"cross-currency interest rate swap"* or simply cross-currency swap. Finally, it is possible to combine the exchange of loan principal, as in the first structure, with an interest rate swap. In such a swap, interest cash flows are not netted before they are paid to the counterparty because they are denominated in different currencies. As each party effectively borrows on the other's behalf, this type of swap is also known as a *"back-to-back loan"*.

(2) Interest rate swaps; these are agreements between parties to make periodic payments to the other party in the same currency. One party agrees to pay the other on a specified date (or dates) an amount calculated by reference to the interest which would have accrued over a given period on the same notional principal sum, assuming different rates of interest are payable in each case. The aim of the contract is to obtain funding at a preferential rate of interest, or to alter the cost of funding of an existing loan debt. As "over-the-counter" financial products[120], interest rate swaps exist in a huge number of varieties and can be structured to meet almost any specific need. The most common interest rate swaps are:

(i) *Fixed-to-floating* – the so called "vanilla" interest rate swap, where reciprocal payments of amounts of interest are made;

(ii) *Fixed-to-fixed* – a less common variation of the contract where one party may agree to pay a fixed rate to a notional amount over a specific period of time against payment of fixed amounts by another party; and

(iii) *Floating-to-floating* – this type of interest rate swap compares two floating rate indices, but in other respects its payments are calculated as for the fixed to floating swap. It is often referred to as a "basis" swap, because payments are determined by reference to changes over the term in the potential difference in fluctuation between two floating rates – the so called basis risk[121]. It is the risk that the hedge may not move precisely inversely to the instrument

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[119] An example of such a swap is the exchange of fixed-rate US Dollar interest payments for floating-rate interest payments in Euro.

[120] Over-the-counter or OTC financial products are those products that are traded in some context other than a regulated market or formal exchange. Typically, these are securities which are traded through a dealers network (such as financial derivatives), meaning they are traded directly between two parties, in contrast to exchange trading which occurs through facilities constructed with the purpose of trading (*i.e.* exchanges).

[121] The basis risk is the risk that two essentially similar interest rates may over time behave asymmetrically. Some authors add legal risk and moral hazard as well. The risk of moral hazard in derivatives' trading may arise in different contexts. For instance, the derivative itself may induce one party to behave in a manner adverse to the interest of the counterparty. Or the behavior of one party (usually that of a financial institution) may be influenced by its compensation structure with respect to its trading operations. This influence is largely based on

hedged. Indeed, the only fully effective hedge is a reversed transaction with precisely the same terms. This basis risk is inherent to the derivatives market.

Let us now turn our attention to the risks associated with derivatives transactions and, following, to the European regulation designed to minimize those risks. Two principal risks commonly associated with derivatives' trading are:

(1) Market risk, and

(2) Credit risk.

In the context of derivatives, market risk is the risk that external market rates or prices, for the remaining term of the derivatives contract, will change so that the transaction will become unfavorable for a party; or as calculated at maturity of the derivative, a party will pay out more than it will receive (Henderson, S. K., 2003, p. 248).

As for credit risk in a derivatives contract, this is the risk that the counterparty won't be able to perform its obligations upon maturity. However, credit risk associated to derivatives has additional, specific elements. Henderson argues (2003, p. 283) that derivatives convert other existing risks into credit risk. For instance, a party which hedges a currency exposure through a derivative has eliminated its currency risk but incurred credit risk in respect of its counterparty. Furthermore, he argues that credit risk associated with derivatives' trading is highly volatile, as it increases and decreases with rate movements, making it highly unpredictable. Therefore, the use of derivatives may result in greater aggregate credit risk in the financial system and can cause systemic issues. However, it is unlikely that many parties will have significant credit exposures in respect of derivatives to any one party, or that any given counterparty would have significant derivatives credit exposure to a single counterparty. As the derivatives market is wholesale in nature, the credit quality of a typical counterparty is higher than that of other market participants[122]. But Henderson rightfully argues that derivatives can bear strong systemic significance, as their concentration is usually limited to few, systemically significant financial institutions. If risk is concentrated in a sector of particular significance to the functioning of financial markets, a single unexpected event may threaten the solvency of the overall financial system. And this was precisely the

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bonuses that are determined by current profit and performance that basically support short-termism rather than a long-term view and business strategy. See Henderson, S. K., 2003, p. 35.

[122] Threatening in this context means an amount of credit risk that would seriously impair the financial stability of a creditor which was not paid when due. See Henderson, S. K., 2003, p. 283.

experience of the last crisis. But Henderson continues on a somewhat positive note; he suggest that derivatives shouldn't pose systemically significant threats even if they are concentrated within few financial conglomerates typically the subjects with the largest exposures to derivatives are usually highly creditworthy and responsible. Arguably, this fact was not evidenced by the last financial crisis.

In this context we have to state that there have been different views as to the role played by derivatives in the last financial crisis. The common agreement is that, although derivatives did not cause the crisis, certain types of these contracts (especially OTC traded derivatives as well as specific types of swaps) have played an important role. The combined effect of derivatives' characteristics (in particular leverage) and the OTC derivatives market (high level of customization, lack of transparency, interconnection of market participants and lack of regulation) had devastating consequences for the European financial system during the crisis[123]. There are two aspects to this issue. First, regulators do not know the exact size of any segment of the OTC derivatives market due to its opacity. Some may argue that regulators could obtain data required from national authorities, but this would not result in a full picture, as most of this data is incomparable (because of differences in samples and methodologies used). Second, the regulators typically do not know the detailed breakdown of the positions of the counterparties of the entities they regulate. Since the OTC derivatives market is not only European but global, a specific regulatory authority would have to obtain at least part of its data from a third-country authority. This is time consuming and does not always provide necessary information. As a practical consequence, regulators do not understand how big are the risks accumulating on the balance sheets of the entities they regulate. Nor do they understand the interconnectedness of those entities. A similar problem affects market participants. In principle, they know what is their exposure to any of their counterparties. But they do not know what is the exposure of any of their counterparties to other market participants. A practical consequence is that:

(1) as the counterparties to an OTC derivative contract know only their direct exposures, the collateral set aside to secure the exposure is inadequate as it is valued through incomplete information[124];

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[123] By its very nature the OTC derivatives market is opaque. This is because OTC derivatives are privately negotiated and consequently information concerning the derivative is only available to the contracting parties.

[124] Collateralization is widely used by participants in derivatives markets worldwide, as a sort of proprietary guarantee. Collateralization minimizes the exposure of counterparties in derivatives contracts. The term

(2) in unfavorable market conditions, the lack of transparency generates mistrust among market participants, possibly leading to liquidity restrictions.

Taking into account the above-discussed practical implications of the problems associated with financial derivatives, the EU opted in favor of more stringent regulation in this area, and one that will keep a macroprudential perspective. European policymakers acknowledged the main shortcomings of the current organization of the market for derivatives, with respect to both OTC derivatives and those traded on organized trading venues. After a through consultation process with market participants and other interested parties, the European Commission proposed a "paradigm shift" in the regulation of financial derivatives in the EU. The scope of regulatory reform is to avoid market participants exploiting differences in national rules and creating opportunities for regulatory arbitrage due to the fact that there is no supranational regulation. In fact, as we have already argued, if derivatives are regulated it is only on a national level, with major differences in the scope and coverage of regulation. And even then, not all EU Member States recur to regulation of derivatives. Thus, the European Commission opted for a supranational approach to regulation. One that will take into the account the specificities of this asset class as well the specificities of national markets for derivatives.

The main principle proposed by the Commission is that derivatives can no longer be viewed as financial instruments for professional use, for which light regulation is sufficient. Regulation of derivatives in the EU should opt for a more stringent approach, in order to allow a precise assessment of risks associated with derivatives. As a result, the proposed measures will shift derivative markets from predominantly OTC bilateral trading to more

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"*collateralization*" denotes a variety of ways of taking security when entering into derivatives contracts. All techniques used for collateralization share the same logic – they identify the counterparties' exposures to each other under their transaction, and put aside securities or cash equal to their net exposure in the event that one of them defaults on its obligations. In the case of derivatives this means that market participants have to identify the market value of all of their outstanding transactions (known as "marking to market") covered by the collateral agreement. Having identified that one party – *the debtor*, owes a net amount to its counterparty – *the secured party*, the debtor is required to put aside an amount of assets in the form of securities or cash – *the collateral*, equal to that net exposure. This way large notional exposures, which parties owe to one another under derivatives transactions, are reduced to a much smaller net amount. Collateral is usually provided in cash (*currency*) or securities. The securities used as collateral are most often bonds (typically high quality, sovereign bonds). As a rule, the more volatile the value of non-cash collateral, the greater is the risk that the collateral will decrease in value. All of the commercial issues concerning collateral, such as the type of asset taken as collateral, the measurement of exposure, the formal and regulatory requirements governing the manner in which property over collateral is to be provided, are covered by the provisions of the Directive 2002/47/EC. For a detailed insight into the various collateralization techniques see: Hudson, A., 2009.

centralized clearing and trading. In this context the objectives of the Commission's proposal for regulation of derivatives are:

(i) Mandatory reporting of OTC transactions – either to trading repositories (authorized by the newly established European Securities and Markets Authority discussed in the 2 chapter) or central clearing counterparties (CCPs).

(ii) Central clearing – through central clearing counterparties authorized to operate across EU countries *via* a "passporting system". This would limit the exposure to counterparty risk.

(iii) Standardization of derivatives contracts and making central clearing mandatory for such derivatives;

(iv) Collateralization in bilateral clearing and added capital charges for bilaterally cleared products – this should provide incentives for central clearing.

As the proposal of the European Commission is still going through the legislative process, it is difficult to ascertain when (and if) such regulation will be adopted. Not to mention that it is virtually impossible to predict its market impact. What we can observe, nevertheless, is that the Commission once again opted for a "maximum harmonization" measure in proposing the adoption of a Regulation with respect to derivatives. This high level of centralization is justified with economic reasoning. The Commission argues that legislation concerning derivatives should be applied throughout the EU with exactly the same scope, without any residual powers of national legislators to impose super equivalent rules ("gold plating"). Some of the objectives mentioned above, namely the use of a CCP and standardization, require absolute uniformity as to the scope of application and the conditions of its application throughout the EU without the possibility for diverging implementations by national authorities. In this sense the adoption of a Regulation feels as the most obvious choice to the EU[125].

3.7. Securitization and asset-backed securities

In this section we analyze securitization as a type of financial transaction. In doing this we follow its economic logic – the transformation of illiquid financial assets into liquid ones,

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[125] European Commission, SEC(2010) 1059 as well as the Communication from the Commission to the European Parliament, the Council, The European Economic and Social Committee, the Committee of the Regions and the European Central Bank, COM(2009) 563/4, p. 10.

more precisely into securities. These securities are called asset-backed securities as their value and income payments are derived from, and collateralized (*backed*) by, a pool of underlying assets. We first explain the economic scope of securitization, the functioning of its transaction and the different transaction types. We will discuss the limitations and differences with respect to the type of assets that can be subject to securitization (securitized) across the EU. Then we will turn to the regulation of securitization in the EU where we especially consider special purpose vehicles (SPVs) and their regulation at both national and EU level.

Securitization literally means translating a financial instrument (or a group of financial instruments) into a security (Hudson, A., 2009, p. 1196). We broadly define it as a process by which a range of cash receivables (or other assets characterized by the fact that they generate income) are grouped together and offered to investors in the form of a security, in return for a capital payment from the investors (Hudson, A. 2009; Fitch, T., 1990). Or we define it as a process where loans, receivables and other financial assets are pooled together, and where their cash flows or economic values are redirected to support payments on related securities[126]. Securities created in the process of securitization are generally called asset-backed securities (ABS). They differ from usual capital market-instruments that typically represent an exposure to the issuer's business (*e.g.* shares, bonds) as these securities practically represent an exposure to a "pool of specified assets". As explained, the pool is typically a group of small and illiquid assets that are unable to be sold individually. By pooling them together (through securitization) the risk of investing into underlying assets is diversified because each security represents a fraction of the total value of the diverse pool. What is essential to understand is that investors in ABSs are exposed to the risks of the asset pool, not the risks of the originator's business. Therefore an ABS does not represent a claim on a legal entity, but a pool of assets.

The legal effect of this is very important. The asset-backed investor enjoys preference over a traditional investor (one that invests in the company's bonds, for example) as a claimant on the assets of the originator. A traditional investor has a claim against the originator – if the

[126] The majority of jurisdictions do not provide a precise, legal definition of securitization. Definitions of the term are usually found in those countries that provide for specific laws on securitization, with the notion varying from jurisdiction to jurisdiction. For example, in Italy, Article 1 of the Italian law on securitization (Legge 30/04/1999 n. 130, GU n. 111) proscribes that the term applies to *"securitization transactions carried out by way of non-gratuitous assignment of pecuniary receivables whether already in existence or arising in the future, and identifiable as a pool* (*blocco* in Italian) *where the assignment of more than one receivable is involved."* Moreover, the Italian law excludes synthetic securitization from its scope and it doesn't mention any other legal technique used for securitization other than the traditional ones. In Spain securitization is described as a financial process whereby cash flows arising from the underlying assets are converted into fixed income securities.

originator encounters financial problems the investor's claim is subject to the provisions of bankruptcy law, which in many EU Member States is a time-consuming procedure. By contrast, an investor in ABSs has claims over the originator's assets, taken off balance through securitization. Therefore, the assets subserve the claims of the investors before any other creditor can claim them. Some authors even find the creation of this legal preference to be the essential economic element of securitization[127].

There is no single definition of securitization found in relevant literature or given by EU legislation. The most important piece of EU legislation related to securitization is the Capital Requirements Directive, more precisely the 2006 Banking Directive[128]. The Directive defines securitization as: *"a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme."*[129]

The economic rationale of securitization is to allow financing when debt or equity financing are not feasible solutions, because of different economic circumstances (either the entity entering into securitization has too much debt or the capital markets are not responding adequately to the entity's issuance of new debt or equity, etc.). Thus, financing through securitization is better suited to the needs of the specific investor. In this context, securitization has become a synonym for "structured finance"[130]. In addition, securitization is often referred to as an "asset-backed financing technique". This means that the investor is essentially exposed to the risks inherent to the underlying asset.

So what type of financial assets may be securitized? Are there any economic limitations? Theoretically, the basic form of securitization can be applied to virtually any asset that has an ascertainable value and that generates a reasonably predicable future stream of revenue. But

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[127] Fabozzi, F. J., Vinod, K., 2007, p. 6.

[128] These Directives and their prudential requirements will be discussed in detail in chapter 4. For now, we will concentrate only on those provisions which relate to securitization-relevant issues. See Directive 2006/48/EC.

[129] Article 4(36) of the 2006 Banking Directive.

[130] "Structured finance" denotes a financial instrument that has been made, or better said, tailored to the needs of the issuer of the instrument. From the investor's perspective it also means an instrument structured to meet the risk-return and maturity needs of the investor rather than a simple claim against an entity or an asset. See Kothari, V., 2006, p. 14.

in practice, for the transaction to be economically feasible certain requirements must be met. These requirements regard the legal nature of the financial assets.

They are:

(1) *Credit* – the receivables must be sufficient to cover the notes issued by the buyer to finance the purchase price;

(2) *Saleability* – the originator has to transfer the receivables to the buyer without expense or formality or the consent of the debtors. In all jurisdictions the transfer of receivables can be carried out through a bilateral assignment agreement between the originator and the special purpose vehicle (SPV; sometimes referred to as *special purpose entity*, or *structured investment vehicle*). An alternative, but seldom-used technique, is the transfer of the contractual relationship or its novation by a trilateral agreement between the debtor, the originator and the SPV. In certain jurisdictions the receivables can be assigned without notifying the debtor (the so called ″silent transfer″ effective in Austria, Belgium, France, the Netherlands, etc.). By contrast, certain EU jurisdictions (such as Spain and Italy) regard the notification as mandatory if the transfer is to be effective against third parties[131]. The majority of EU jurisdictions allow restriction agreements between the debtor and the originator that prohibit the transfer of receivables through so called ″non-assignability clauses″. Any deviation from this clause makes the assignment ineffective[132].

(3) *True sale* – the sale must be treated as a complete and final transfer of the receivables from the originator to the buyer so that the receivables are no longer assets of the originator for the purposes of bankruptcy, capital adequacy or security requirements.

Due to these requirements the types of assets that can be securitized greatly vary across Member States. The most commonly used types of financial assets are residential and commercial mortgage loans, as well as a wide variety of lease receivables, consumer loans, and other receivables.

In practice the sole transaction of securitization can take the following form:

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[131] In Italy the assignee must give notice of the effected assignment by way of publication in the Italian Official Gazette and registration of a notice in the relevant companies register. As regards ancillary rights associated to the receivables being transferred, in some EU jurisdictions they are automatically transferred (together with the receivable) without further requirements – this is the case in Italy for example.

[132] However, certain jurisdictions (Austria, Malta, Greece) consider these clauses to be of little relevance, deeming them null and void from a legal perspective. See European Financial Markets Lawyers Group, 2007, p. 39.

(1) The sale to a special purpose vehicle (traditional securitization), and

(2) Synthetic securitization[133].

In the passage below, we analyze the traditional transaction type in greater detail.

At the outset of securitization, an entity identifies assets that can be securitized. These assets are typically “receivables”, meaning that they represent rights to payments at future dates. The entity transfers these assets away from its own balance sheet by selling them to investors who pay capital sums for them. This is done indirectly, through the involvement of a third party – the so called special purpose vehicle. Thus the owner of receivables (*the originator or seller*) sells receivables to the SPV (*the purchaser*) for a purchase price payable on sale. With the transfer of the assets to the SPV the originator dismisses the risk of having to make payments to investors. For this reason, the originator will often structure the transfer so that it constitutes a ″true sale″. This means that the sale is sufficient to remove the receivables from the originator’s bankruptcy estate in the event of bankruptcy[134]. To raise funds to purchase these receivables the SPV issues securities in the capital markets. The SPV grants security to the investors over the receivables to secure the borrowing while the investors receive income from the original receivables. In order to ensure that the receivables are sufficient to repay the investors when due various forms of ″credit enhancement″ may be used. This means that a third party may give a guarantee to the SPV, or the originator may agree to make a subordinated loan to the SPV, or the SPV may retain part of the price for the receivables until the notes are repaid (Wood, P., 2008, p. 450).

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[133] In a synthetic securitization the SPV enters into a credit default swap (CDS) with the originator whereby the SPV agrees to pay the originator its losses on the originator’s loans (the reference obligations) to its borrowers (the reference entities) in the event that adverse credit events should occur in relation to the loans (*e.g.* insolvency of the borrower). The effect is similar to that of a guarantee or other insurance. Under the credit default swap the originator pays the SPV an amount equal to the part of the interest to which the originator receives on the loans to its borrowers and the SPV agrees to pay the originator’s losses on those loans if adverse credit events occur. In order to meet these payments, the SPV issues notes to investors on terms that, if the SPV has to pay the originator, the principal amount payable to the noteholders is reduced. There are usually several ″tranches″ of notes (according to risk associated) with the riskiest tranche bearing the first loss, so that the senior notes can be highly rated. The proceeds of the issue are invested by the SPV in low risk government bonds or other secure investments. The interest that the SPV must pay to the noteholders is paid out of interest on these bonds plus the amounts payable by the originator under its CDS out of the interest it receives on the reference loans concerned. When the SPV has to pay the originator it sells some of the government bonds; at the end of the transaction it sells all the remaining bonds so as to pay off the notes. The economic result of a synthetic securitization is as if the originator had insured the loans with the SPV, and the SPV had reinsured with the noteholders.

[134] In the majority of EU Member States, the SPV is structured as "bankruptcy remote". This means that the SPV is unlikely to be affected by the originator’s bankruptcy.

The notes are typically rated by a credit rating agency. Usually the loan has a higher rating than a direct loan to the originator would have, because the investors look only to receivables not the general credit rating of the originator. In fact, securitization extracts from a lower rated entity some of its receivables; the goal is to obtain low cost capital market funding by separating all, or a part of an originator's receivables, from the risks associated with the originator.

After closer examination of the stages in a securitization transaction we wish to turn to the regulation of securitization in the EU. Primarily, we note that the 2006 Banking Directive distinguishes between traditional and synthetic securitizations (Art. 4(37) of the Directive). The Directive acknowledges that traditional securitization is prevalent in most EU countries. As we have explained above, in the ″traditional″ securitization the purchaser is a specially formed single purpose company that is legally independent of the seller. We have seen that the objective is that the SPV should not be consolidated on the balance sheet of the seller. This means that the originator is insulated from the insolvency of the SPV, and the investors in the SPV are insulated from the insolvency of the originator. Precisely in this legal characteristic of the SPV lie the majority of problems which regulators readily accuse securitization of. In order to understand their origin, let us look more closely to the legal and economic nature of a SPV.

A special purpose vehicle is a legal entity created to fulfill narrow, specific and temporary objectives. Typically, a SPV is established solely for the purpose of the securitization transaction. The types of vehicles vary across jurisdictions and can take different legal forms depending on the provisions of the local law (*e.g.* limited liability company, or limited liability partnership, or other form of cooperation or trust). The main distinction between jurisdictions is that some may structure SPVs as funds without legal personality while others they are companies with legal personality. Certain EU jurisdictions (such as France, Spain, and sometimes – although more rarely, Italy) have created specifically dedicated forms of vehicles usually named ″securitization funds″ without legal personality with independent management companies dedicated to acquiring assets and securitization. Nevertheless, in the majority of EU countries the most common legal form used for the establishment of a SPV is the limited liability company[135].

[135] See European Financial Markets Lawyers Group, 2007.

The SPV must be an independent company and not a subsidiary or affiliate of the originator. The newly formed company has to be established in such a way that it reduces the likelihood of bankruptcy, which could interfere with the flow of cash through to investors (Wood, P., 2007). Usually the SPVs are not owned or legally controlled by the originator of the securitized assets. It seems that this prerequisite has been at the core of some of the failures related to securitization during the last crisis. This potential instability is then further amplified through the so called Banking Directive, which defines the minimum requirements applicable for recognition of significant credit risk transfer in securitization[136]. As a result some proposals indicate that changes should be made as to the degree of economic exposure that financial institutions must retain in relation to affiliated SPVs. Such is the purpose, for instance, of the provision under the EU Capital Requirements Directive that investors only invest in securitization, if the originator retains a certain degree of exposure to the assets[137]. Moreover, the Basel Committee on Banking Supervision reiterates that after an institution has engaged into securitization involving an SPV, supervisors should ensure that institutions assess how their aggregate risk position has changed; whether they have transferred risk, transformed risk, or increased its original risk position. This is a consequence of the regulatory arbitrage that was to some extent allowed under the Basel I Accord. Under the provisions of Basel I institutions were able to lower their capital requirements by transferring to SPVs those assets that required higher levels of regulatory capital, while retaining on their balance sheets those assets that required lower capital levels. While the introduction of Basel II reduced such regulatory arbitrage, further improvements of the Accord should be done in order to prevent abuses of SPVs economic function[138].

From a EU perspective it is important to note that European policymakers do not favor the possibility of a single Directive for securitization. We agree with this stance. This is because the full harmonization of securitization laws in the EU would affect a number of legal areas

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[136] As regards traditional securitization, the originator (*i.e.* credit institution) may exclude securitized exposures from the calculation of risk-weighted exposure amounts if the significant credit risk associated to these exposures has been transferred to third parties.

[137] All three amandments of the Capital Requirements Directive (CRD II, CRD III and CRD IV) affect securitization. CRD II already forces investors to ensure (before they can buy a piece of a new securitization) that the originator has complied with the "skin in the game" rule. This means that the originator should hold at least 5% of the securitizations it creates at all times. The Capital Requirements Directive will be analyzed in greater detail in chapter 4. The Directive and its amendments are available at:

http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

[138] The Basel I and Basel II capital frameworks, as well as their recent changes, will be discussed in chapter 5. For more on this subject see Basel Committee on Banking Supervision, 2009, September, pp. 35-36.

that are closely connected with some core legal concepts (*e.g.* insolvency procedures), which greatly differ across jurisdictions[139]. This reason is especially important since in Europe securitization is mainly concentrated in few countries (the United Kingdom, Spain, the Netherlands and Italy) with very different legal traditions. Another suggestion is the possibility of creating a ″European passport for securitization SPVs″. As national securitization markets tend to be highly concentrated with only a limited number of active participants, activities of the SPVs often remain limited to the domestic area. Opportunities to develop "pools of securitized assets" from other jurisdictions are not yet fully realized. In this sense, a more coherent application of harmonization principles to securitization would create new opportunities for investors in cross-border securitizations. Finally, the ongoing regulatory reform – notably the Basel III Capital Accord and the amendments to the Capital Requirements Directive – are both likely to affect securitization[140].

CHAPTER'S MAIN FINDINGS

In this section we have examined the regulation of different types of financial assets in the EU. In doing this we have made the presumption that financial assets are created between two persons (debtor and creditor) bound together by statutory provisions, or by contract, from which the asset derives its value. We have determined that financial assets have to be regulated, as they are credence goods whose quality, value and risk are difficult to ascertain. Our analysis focused on the most common types of financial assets in the EU: securities, bank deposits, bank loans and financial derivatives. In addition, the chapter analyzed the EU regulation of a specific financial transaction – securitization.

With respect to securities regulation we conclude that regulation moved from minimum to maximum harmonization requirements. EU directives in this area, which regulate securities and their issuance, have achieved substantive harmonization of regulation at national level.

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[139]A feasible regulatory solution would be the adoption of a Directive that would harmonize only certain legal aspects related to securitization; one that would help to create common terminology and a better understanding of securitization concepts across Member States. This Directive could be based on the principles set out in the EFMLG Report, which cover certain legal areas that are considered ″critical″ and where convergence of national securitization laws is urgently required at EU level. At the same time, the recommendations of the EFMLG Report could be put forward as amendments to existing EU legislation – such is the case with some of the amendments proposed in the CRD IV regime for credit institutions. See the report of the European Financial Markets Lawyers Group, 2007.

[140] The Basel III Capital Accord and the Capital Requirements Directive will be examined in detail in chapter 4.

EU legislative initiatives have succeeded to establish the world's first multinational disclosure system, securities issues scheme and the first multinational system of market manipulation prohibition, which is a success. But national compromise has often limited the effectiveness and the scope of this achievement. Thus, we consider the success of EU regulation of securities to be partial; although wholesale financial markets are integrating, European securities markets remain largely fragmented along national lines.

Our analysis of bank deposit regulation concentrated on deposit guarantee schemes (DGSs). Deposit guarantee schemes protect depositors in the case of bank bankruptcy, as they see that depositors are reimbursed up to a specified amount (the so called "coverage level" specified by the scheme). The intention of EU regulation in this area (Directive 94/19/EC) was to harmonize the scope and minimum coverage across Member States but its implementation at national level resulted with different levels of protection. Currently, there are around 40 DGSs in Europe. Clearly this causes legal uncertainties and hinders the confidence of depositors. Would constituting a centralized DGS, a sort of pan-European deposit guarantee system, be a viable solution? We dismiss such a possibility regardless of the authors that argue in favor of a "European deposit insurance corporation" entrusted with the power to recapitalize (or bail out) failing institutions, in addition to deposit insurance. We argue in favor of creating such a DGS where systemically important, cross-border banks would be covered at a European level (maybe through private pre-funding) while national DGSs should remain competent for domestic banks. As for the national DGSs, the way forward is harmonization (*e.g.* of DGS operations, financing) and mutual cooperation.

In this chapter we have analyzed the European regulation of mortgage loans. These are one of the most common types of loans made by European banks (the so called residential or housing loans). In the EU the scope of regulating mortgage loans is to ensure lending is done responsibly. This means that credit products should: (i) accommodate the needs of borrowers, and (ii) be adequate to their ability to repay the loan. Regulation of mortgage loans varies substantially across Member States (some EU countries do not even have specific legislation focused on this type of financial asset). As an answer, the EU opted for a centralized approach to regulation. In March 2011 the European Commission adopted a proposal for a directive regulating mortgage loans. The Directive adopted the principle of maximum harmonization in order to level out differences in regulation across Member States. It is still impossible to predict its impact on the market for mortgage loans. But we are nevertheless critical of such a uniform legal solution that is based, once again, on maximum harmonization. Maximum harmonization is neither always appropriate nor necessary. The structure of mortgage markets differs considerably throughout the EU, as do the products available (namely, the types of mortgage loans). It is our opinion that any intervention in this area had to take into account Member States' diversity and thus follow a more flexible approach to regulation.

Our examination of securities lending mainly focused towards repo agreements. Repos are vital for sustaining liquidity in the markets and are consequently widely used by both national central banks and financial institutions. But the markets for repos are still fragmented along national jurisdictions and thus repos come in various contractual forms, causing legal uncertainties and undermining smooth market functioning. In addition, there is no common EU legislation directed to repos. In fact, only certain aspects of repo agreements are subject to EU regulation – such as collateralization and settlement of the transaction. It is our opinion that in the aftermath of the crisis, Europe will recur to greater centralization of repo agreements. Its aim should be to improve standardization of repo agreements across Member States and facilitate the settlement of cross-border repo transactions. But any future proposal for regulation in this area should be carefully considered in order to avoid unintended damage, particularly given the greater reliance that governments have placed on repo markets during the last financial crisis.

In the last section of the chapter, our attention focused not only on the traditional types of financial assets, but also on some innovative types, primarily on financial derivatives. Derivatives represent a new investment opportunity in Europe, one that is often characterized by opacity and risks. But not all EU countries have the same level of market discipline and market integrity that would allow them to reap the benefits of this financial asset equally. Prior to the emergence of the last financial crisis regulation of financial derivatives was mainly done at national level (but many EU countries choose not to regulate derivatives at all). Lately, a new trend emerged with respect to derivatives regulation at the EU level. The trend seeks to restrict market participants from exploiting differences in national rules and recurring to regulatory arbitrage since there is no supranational regulation. Future EU regulation wishes to make derivatives more transparent through standardization and central clearing. The Commission's recent proposal is still going through the legislative process, thus it is difficult to ascertain when (and if) such regulation will be adopted. But what we can observe is that the Commission once again opted for a "maximum harmonization" measure in proposing the adoption of a Regulation.

We feel that, from the perspective of EU countries, securitization has been more discussed than practiced so far. This is even more the case in EU acceding countries, such as Croatia. Nevertheless, the numerous debates around securitization and its typical association with financial derivatives pushed us to examine the transaction more closely (traditional securitization in particular). After examining securitization from both a legal and economic aspect as well as the different types of securitization, we argued that the major problem lies in the legal nature of special purpose vehicles (SPV), which are constructed as "bankruptcy remote" entities. This means that they are not owned or legally controlled by the originator of the securitized assets. As a consequence, once the securitized assets have been removed from the originator's balance sheet (on to the balance sheet of the SPV), the originator retains little interest in their future performance. In our opinion, after an institution has engaged into securitization competent authorities should ensure that they assess the manner in which this transaction affected their original risk position (has it changed the nature of risk encountered; has it transferred risk; has risk increased). In addition, we believe that the originator should retain some exposure to the securitized assets. Otherwise originators could lower their capital requirements by transferring to SPVs those assets that require high levels of regulatory capital, while retaining on their balance sheets those assets that require lower capital levels. At the same time we dismiss the possibility of a single EU Directive for securitization. Full harmonization of securitization would affect substantially a number of legal areas closely connected with the roots of national legal systems (*e.g.* insolvency procedures) and as such would be probably contested by Member States. A feasible regulatory solution would be the adoption of legislation that would harmonize certain aspects related to securitization. For instance, that would create common terminology and better understanding of securitization concepts.

Our analysis in this chapter allows a general conclusion regarding the regulation of financial assets in the EU. At the beginning, EU's intention was to standardize the types of financial assets available in Member States, and to harmonize the rights and obligations associated with each type of asset. In achieving this goal the favored tool was legislation. Directives and regulations were, and are still being, enacted with respect to securities, bank deposits, loans, financial derivatives, and so on. Although EU's intervention in this area was based on minimum harmonization in its beginning (paired with mutual recognition) it gradually evolved towards greater centralization. This means that almost all of the recent regulation of financial assets is based on the maximum harmonization principle. Naturally, "legal uniformity" created through this principle cannot be equally beneficial for all types of financial assets. Whilst, in our opinion, securities regulation can reap the most positive effects of such harmonization, regulation of other assets (bank deposits and loans) should be more flexible and allow for some acceptable degree of "national diversity".

4. FINANCIAL INSTITUTIONS

In this chapter we are interested in the regulation of various financial institutions active across the EU. We ascertain their institutional characteristics in theory, and indicate those characteristics that have developed in practice. Throughout the chapter we focus primarily on regulation, which is mostly microprudential (*i.e.* it focuses on the stability and soundness of a specific institution). Where appropriate we address the issue of enforcement of these rules or supervision. Every section in the chapter follows a common methodological approach: we first differentiate between the economic and legal, and sometimes EU law-specific, definition of a particular financial institution. Then we examine the type of business the institution engages into; we discuss some of the major risks incurred; and finally, we analyze the EU regulation imposed on that specific institution. Section 4.1. is dedicated to the analysis of monetary financial institutions (or banks more precisely) their business activities, and the attempts to limit their exposure to risk through regulation (by imposing capital adequacy requirements, for instance). Section 4.2. gives an overview of the heterogeneous group of non-monetary financial institutions, of their business activities and their regulation. Subsection 4.2.1. examines collective investment schemes (Undertakings for collective investment in transferable securities) whilst subsection 4.2.2. analyzes the representatives of the alternative investments industry in the EU. Finally, section 4.3. focuses on insurance undertakings and their new prudential regulation in Europe.

4.1. Classification of financial institutions

In the broadest sense, financial institutions are defined as institutions that provide financial services for their clients or members. The most important financial service provided by financial institutions is financial intermediation[141]. These institutions collect funds from the general public (or from other legal entities) and invest them in various types of financial assets. Thus the investments made by financial institutions are their assets, and they may take the form of loans or securities. In this context, loans and securities are regarded as direct investments of financial institutions, whilst market participants who hold the financial claims issued by these institutions are said to have made indirect investments (Fabozzi, F. J., Modigliani, F., Jones, F. J., 2010, p. 22).

We can also define financial institutions as publicly or privately owned legal entities that act as a conduit between suppliers of funds (*investors*) and users of funds (*borrowers*) [142].

Another interesting and useful definition of financial institutions is given by Fabozzi, Modigliani and Jones (2010, p. 21) who observe that business entities, in general, include nonfinancial and financial enterprises. Nonfinancial enterprises manufacture products (such as cars, electrical appliances, and computers) and provide non financial services (*e.g.* transportation, utilities, programming). Financial enterprises, which are commonly referred to as financial institutions, provide services related to one or more of the following:

(1) They transform financial assets acquired *via* the market into a different and widely preferable type of asset that becomes their liability (this transformation is from an investor's aspect). This function is performed by financial intermediaries, the most significant type of financial institutions[143].

(2) Exchange financial assets on behalf of customers or for their own accounts;

(3) Assist in the creation of financial assets for their customers, and then sell them to other market participants;

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[141] Hence, the use of the widely accepted term "financial intermediary" as a synonym for financial institutions.

[142] According to Black's Law Dictionary a financial institutions is a: *"...business, organization, or other entity that manages money, credit, or capital, such as a bank, credit union, savings-and-loans association, securities broker or dealer, pawnbroker, or investment company."* Garner, B. A. (Ed.), 2004.

[143] Following this argument, we conclude that the term of financial institutions is wider than that of financial intermediaries. In fact this chapter actually focuses on the regulation of monetary and non-monetary financial intermediaries.

(4) Provide investment advice to other market participants;

(5) Manage the portfolios of other market participants.

Another categorization of financial institutions is based on to the way in which they obtain and invest funds. According to this characteristic, there are two basic types of financial institutions:

(i) *Depository financial institutions* - which accept deposits from the general public and channel them into lending activities (*e.g.* commercial banks, savings and loan associations, mutual savings banks and credit unions);

(ii) *Non-depository financial institutions* – which collect funding directly from financial markets by selling securities to the public (*e.g.* brokerage firms, insurance undertakings, pension funds, investment firms, payment services providers)[144].

Within the EU there is a specific categorization of financial institutions in place. The categorization is given by the European Central Bank (*i.e.* in the Bank's terminology and the explanatory notes which follow the Banks's statistical reports). Accordingly, financial institutions in the EU are categorized as:

(1) Monetary financial institutions (MFIs) and

(2) Other financial institutions (OFIs).

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[144] See Fitch, T. P., 1990. In this thesis we discuss the majority of institutions comprised under the term of "non-depository financial institution". However, we make an exception in regard of pension funds and payment services providers (or payment institutions). This is not because of their irrelevance, on the contrary, it is more because of their exhaustiveness. For instance, the subject of national pension schemes and pension funds is very important, particularly with respect to better coordination of fiscal and economic policies at EU level. At the same time, this means that if we were to discuss their functions and regulation we would move beyond the focus of the thesis, entering the vast area of social security schemes and fiscal policy. Although this would not be the case for payment institutions, we do not consider them in detail in the thesis as we focus more on "institutional components" of a financial system (*i.e.* banks, investment funds) than the sole infrastructure. However, it must be emphasized that the issue of payment services regulation is intensively debated in the EU. Especially following the adoption of the so-called Payment Services Directive (Directive 2007/64/EC) and the definition of payment services providers (Art. 1(1) of the Directive), European policymakers have denoted payment services regulation and the smooth functioning of payment systems as a prerequisite for financial stability. In addition, regulation of payment institutions concerns consumers as well – if the EU will succeed to level-out and harmonize regulation of currently fragmented national payment systems, this would mean more choices and lower transaction prices for consumers. For a more thorough insight on this subject see: Rispoli, Santoro, Sciarrone Alibrandi, Troiano (Eds.), 2009.; Mecatti, I., 2009. Finally, see Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and repealing Directive 97/5/EC, and Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management, OJ L 319, 5.12.2007.

Ad (1) MFIs are those institutions that form the money-issuing sector (the broad money or M3[145]) of the Euro area. These are: *"…resident credit institutions as defined by Community law and other resident financial institutions the business of which is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic terms), to grant credits and/or make investments in securities."*[146]

MFIs include the Eurosystem, credit institutions and non-credit institutions (mainly money market funds[147]) whose business is to receive deposits from entities other than MFIs and to grant loans and/or invest in securities. In the group of MFIs the most significant sub-category are credit institutions, and among them commercial banks (hereinafter we will refer to them as "banks" for simplicity).

Ad(2) OFIs are all those institutions, besides insurance undertakings and pension funds, which incur liabilities in forms other than currency, deposits and/or close substitutes for deposits, from legal entities other than MFIs; and which do not participate in the creation of broad money (M3). OFIs comprise heterogeneous legal entities, such as:

(i) Investment funds,

(ii) Financial leasing or factoring companies,

(iii) Special purpose vehicles,

(iv) Financial holding companies,

(v) Securities and derivatives dealers, and

(vi) Insurance undertakings and investment funds (Gurley, J. G., Shaw, E. S., 1960, p. 193). These institutions perform an intermediary role by purchasing securities and creating non-

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[145] The "broad money" or M3 is a monetary aggregate. It comprises M2 or "intermediate money" (constituted from "narrow money", *i.e.* currency, banknotes, coins and balances which can immediately be converted into currency, and in addition deposits with a maturity of up to two years and deposits redeemable at a period of notice of up to three months) and marketable instruments issued by the MFIs. Also, certain money market instruments – such as repurchase agreements and money market fund shares/units are included. A high degree of liquidity and price certainty make these instruments close substitutes for deposits. As a result of their inclusions, M3 is less affected by substitution between various liquid asset categories than narrower definitions of money, and is therefore more stable.

For more on money aggregates see: http://www.ecb.int/stats/money/aggregates/aggr/html/hist.en.html

[146] See: http://www.ecb.int/home/glossary/html/glossm.en.html#518

[147] Money market funds are those collective investment undertakings of which the units are, in terms of liquidity, close substitutes for deposits and which primarily invest in money market instruments and/or in other transferable debt instruments with a residual maturity up to and including one year, and/or in bank deposits, and/or which pursue a rate of return that approaches the interest rates on money market instruments. Ibidem.

monetary claims on themselves, which then take the form of savings deposits, shares, equities and other obligations (Gurley, J. G., Shaw, E. S., 1960, p. 193).

Keeping in mind all the different definitions of financial institutions found in relevant literature, we will nevertheless adhere to the categorization and definition given by the European Central Bank throughout this chapter, as our analysis focuses primarily on financial institutions in the EU.

4.2. Monetary financial institutions

In this section we examine the banking business in Europe and the regulation that has been imposed to banks during the last two decades. We give special consideration to EU legislation containing capital adequacy requirements, as the most important type of prudential regulation of banks. We point to the fact that European legislation actually stems from the harmonization of prudential regulation of banks at international level. At international level, capital adequacy requirements take the form of *soft law*[148]. These *soft law* standards are then transposed through EU directives as the preferred legal instrument in banking regulation.

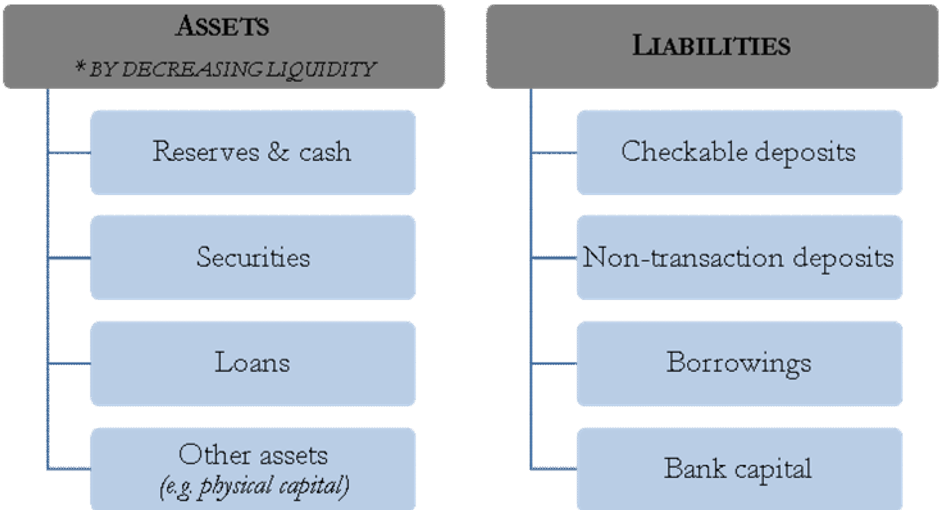
In this section we will briefly examine the rationale for banking regulation. We will discuss international regulatory proposals put forward in this area by the Basel Committee for Banking Supervision, after which we will turn to banking regulation in the EU. While the Basel Accords, as international *soft law* agreements are left to voluntary implementation to countries worldwide, the capital adequacy requirements mandated by the EU directives are legally binding for all Member States. But has this "standardization" of regulatory capital been equally beneficial for all banks in the EU? Special focus shall be given to the issue of procyclicality associated to banking regulation. In conclusion we will present an overview of banking regulation reforms proposed in the aftermath of the 2007-08 financial crisis that emerged in the form of a revised Basel Accord.

In order to examine banking regulation, we first must understand what a bank is, and what it does for business. EU law defines a bank as *"an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account" or*

[148] The term denotes quasi-legal instruments which are not legally binding, or whose legally binding force is somewhat weaker than the binding force of "traditional law" (often referred to as hard law). The term is traditionally associated with international law. Examples of soft law instruments are: the majority of resolutions or declarations of the United Nations General Assembly, or for instance, code of conducts and communications of the European Commission.

"an electronic money institution"[149]. It is exactly because of the nature of their business that banks are subject to a greater amount of regulatory control than any other financial institution. In fact, Lastra (1996) argues that the mere nature of the bank's balance sheet presents characteristics that are potential sources of instability demanding specific regulatory attention: (i) asset-liability mismatch; (ii) risky asset portfolio; (iii) low capitalization (Lastra, R. M., 1996, p. 81). Although all financial institutions face asset-liability management problems the bank's inherent mismatch between short-term liquid deposits and longer-term, non-marketable assets has direct implications to the stability of the banking system.

4(1) The structure of a bank's balance-sheet



By borrowing short and lending long, banks provide credit that allows the real economy to grow and expand. However, the credit creation process is fragile and prone to undermining effects of purely psychological origins. This means that if bank's depositors and lenders were taken by collective distrust in its stability, and if they were to draw all their money back at once, the bank would be faced with a serious liquidity crisis. This is because no bank holds enough reserve money that would allow her to reimburse all her depositors at once (this is something we have already discussed in the 3 chapter, in section 3.3. dedicated to bank deposits and deposit guarantee schemes). As a result this event could set in motion a cycle of insolvency and illiquidity throughout the banking system (thus, it may have systemic effects) due to the interconnectedness of banks operating within the system. Naturally, we do not imply that capital adequacy guarantees bank liquidity[150]. Capital adequacy requirements are

[149] See Art. 4. of Directive 2006/48/EC.

[150] We have to keep in mind that when we talk about liquidity, we actually talk about the asset side of a bank's balance sheet. Capital reserves, on the other hand, are examined as a segment of the liability side.

primarily connected to bank solvency. But, we wish to point to the fact that regulators often overlook the interaction between solvency and liquidity. This means that if banks hold sufficient capital they are able to obtain extra liquidity from other banks (on the interbank lending market) or the central bank (against adequate collateral) more easily. In addition, if banks would hold capital reserves above those prescribed as minimum by regulations, they could act as a "buffer" against shocks to asset prices ("liquidity requirements" or "liquidity standards"). Irrespective of this important connection between capital adequacy and liquidity, there has been little work on the determinants of liquid asset holdings. This is partly due to the lack of regulators' interest. Given the lack of an international agreement on these "liquidity standards", and since much of the work done by the EU in this area focuses directly on capital adequacy rather than liquidity determination, in the following paragraphs we examine capital requirements only.

All EU countries require from banks operating within their jurisdiction to hold a minimum level of capital as a cushion against unexpected losses and potential insolvency. These are "capital adequacy requirements" (or "capital requirements" in short). Capital requirements ensure that risks will be mitigated successfully and that a financial institution will have at least the minimal level of resources to honor its commitments. Adequately capitalized institutions are able to provide credit to consumers and business without interruptions throughout the economic cycle and thus supporting economic growth continuously.

When holding capital reserves, financial institutions distinguish between:

(i) Regulatory capital – which is defined by regulators as the minimum level of capital that institutions should maintain at all times in order to be able to meet the claims of their creditors;

(ii) Economic capital – which is the amount of capital that the banks' shareholders would prefer the bank to hold in the absence of prudential regulation;

(iii) Rating agencies' capital – which is the amount of capital required by rating agencies in order for the institution to obtain a certain rating; and

(iv) Actual capital – the actual capital the bank holds is the capital chosen by banks' shareholders[151].

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[151] Masschelein, N. (2007), p.11.

Irrespective of the type of capital set aside this capital always represents a liability on the bank's balance sheet. Thus the real issue is that of how much capital is necessary for a bank to absorb losses and still allow her to provide lending effectively (since the cost of capital raises the cost of credit)?

The answer to this question is created under the auspices of international regulatory initiatives. These initiatives are then filtered down to national level (or the supranational in the case of the EU). Currently, the most significant capital adequacy requirements are set as *soft law* in the form of the Basel Accords (the Basel I, II and the newly proposed Basel III Capital Accord from October 2010). The result of many years of negotiation between banking supervisors gathered in the Committee on Banking Supervision (domiciled at the Bank for International Settlements) these Accords represent a suitable framework of banking regulation that can be replicated across jurisdictions. The Committee's work focuses on two main areas: capital adequacy and supervision of cross-border establishments. Let us briefly describe how the Basel Accords developed during time.

Capital adequacy was the subject of the 1988 Report[152] that would later become known as the Basle Accord (or the Basel I Accord as it is now referred to) that provided a "risk-based capital framework" primarily focused on credit risk. The Accord consisted of two main parts: a framework for measuring capital (aimed at achieving greater capital convergence) and a set of minimum standards that strengthened capital positions of major international banks. The 1988 Accord set a common capital ratio of 8% of risk-adjusted assets as the minimum capital standard for banks worldwide. The design of the Accord rested upon a single pillar based on credit risk as the one affecting the lending activities of banks. This was one of the major shortcomings of the 1988 Accord. As the nature of banking business changed and as banking activities broadened, banks faced new risks whose impact on their business became more enhanced.

The second Basel Capital Accord (Basel II) was published in 2001 and implemented in 2004. The new Accord aligned the regulatory capital required with the underlying risks[153]. It promoted a more forward-looking approach to capital supervision that encouraged banks to identify their risks and to develop and improve their risk management techniques. Without

[152] The report is available at: www.bis.org

[153] Bank for International Settlements (2004, June).

going into the framework's complex technical details it is possible to explain the fundamental principles on which the Basel II Accord is built on. The Accord has a three-pillar design:

(1) Pillar 1 – containing minimum capital requirements that cover three types of risk: credit, market and operational risk.

(2) Pillar 2 – dedicated to supervisory review and transparency of supervision, as well as to risk management. This means that the principles contained in this pillar proscribe how supervisors will review a bank. In this sense, supervisors should evaluate how well banks assess their capital needs relative to their risks, and they should intervene if needed[154].

(3) Pillar 3 – market discipline and disclosure information. This pillar sets out detailed disclosure requirements for banks allowing the comparison of banks' capital adequacy by third parties.

4(2) The three-pillar design of the Basel II Capital Accord

* Source: Her Majesty's Treasury (2003, December, p. 5).

The capital adequacy requirements of the Basel II Accord were accepted worldwide. But its implementation at national level showed that the framework consisted of overly prescriptive rules. As a consequence the Basel II Accord endured constant criticisms the majority of which pointed to the inappropriateness of its ″one-size-fits-all″ solution for capital adequacy. One of the criticisms that we find interesting is that of the procyclical effect of the Basel II

[154]The entire measurement of risk is done following the Value at Risk (VaR) model. This methodology considers the level of probability of an investor losing money based on a calculation taking account of the historical performance of the investment and the credit rating of the entity in which the investment is made, which in turn establishes the interest rate required for an investment with that level of risk. See Hudson, A., 2009, p. 745.

provisions[155]. In response to this criticism, and with the experience of the 2007-08 financial crisis, the Basel Committee decided to revise the Accord. The proposed reforms impact:

(i) The microprudential level – by raising the resilience of individual banks at times of financial duress;

(ii) The macroprudential level – by addressing system wide risks, that accumulate in the sector over time, as well as the procyclical amplification of these risks, that we wish to discuss later in this section.

The newly reformed Basel III Accord follows the three-pillar foundations of previous accords, whilst introducing certain new elements[156]:

(1) *Raising the quality, consistency and transparency of the capital base* – this means that the minimum standard for common equity which is fully available to absorb losses, will be strengthened, *i.e.* raised. Such standards existed in the past, but they were set extremely low, at just 2%, and thus were seldom ignored by banks. The new standards for common equity are significantly tougher. The absolute minimum for Core Tier 1 capital is now 4.5%, and the new minimum for Tier 1 capital in general has now been raised to 6%. The minimum for Total capital (or Tier 2) remains at 8%. In addition, there is now a "*conservation buffer*" of another 2.5 percentage points that banks should accumulate during good economic periods. The conservation buffer is added on top of all the tier capitals; hence, the bank needs 7.0% Core Tier 1 capital, 8.5% Tier 1 capital and 10.5 % of Total capital. If there's some type of financial stress and if banks are forced to write down a lot of bad loans, they can rely on this buffer[157]. In addition, there is now a "countercyclical buffer" in place. This buffer will be activated when credit in an economy is growing faster than the economy itself. The scope of this buffer will be discussed under point (4) of this paragraph, but for now let us just state that its amount isn't determined by the Accord. Rather, national regulators decide the actual percentage (always within the conservation buffer range). The calculations discussed above can be better explained through a graph.

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[155] Procyclicality is the manner in which the banking system interacts with the real economy to exacerbate the economic cycle. The procyclical mechanism is characterized as lending moving in correlation with the economic cycle. This means that in an economic upswing credit will be readily available, while during an economic downturn, lending tightens.

[156] See Basel Committee on Banking Supervision. (2009, December, p. 7) as well as the newly reached agreements available at: http://bis.org/press/p100912.htm

[157] But that will bring them extra regulatory oversight, and they won't be able to pay dividends.

4(3) Basel III Accord reform proposals of the capital base

Calibration of the capital framework Capital requirements and buffers (as percentages)			
	Core Tier 1 capital (Common Equity)	*Tier 1 capital*	*Total capital*
Minimum	***4.5***	***6.0***	***8.0***
Conservation buffer		***2.5***	
Minimum plus conservation buffer	***7.0***	***8.5***	***10.5***
Countercyclical buffer range		***0 – 2.5***	

*Source: http://www.bis.org

(2) *Enhancing risk coverage* – Basel framework proposes to raise capital requirements for both trading book and securitization exposures. Pillar 2 supervisory standards are raised and Pillar 3 disclosure requirements are strengthened. In addition, capital requirements for counterparty credit exposures arising from banks' derivatives, repo agreements and securities activities are strengthened.

(3) *Supplementing the risk-based capital requirement with a leverage ratio* – that should mitigate the risks of destabilizing deleveraging processes. This way, in times of financial duress, the banking sector won't be forced by the market to reduce its leverage in a manner that would foster downward pressures on asset prices. This leverage ratio is used to measure the bank's ability to meet its financial obligations, and is usually calculated as the ratio between total and liquid assets.

(4) *Reducing procyclicality and promoting countercyclical buffers*[158] – in theory, any capital requirements can potentially amplify the cyclical fluctuations of the economy. In imperfect financial markets, where frictions emerge, an accelerator mechanism may generate feedback from capital to the real economy. Therefore, risk-based capital requirements could generate procyclicality, because risk itself fluctuates both in quantity and value.

[158] Countercyclical buffers are variable capital reserves that banks would have to accumulate during economically good times. Banks could draw upon these reserves to continue lending and borrowing when economic conditions worsen. Countercyclical buffers could also help to moderate the buildup of leverage in the financial system by raising the cost of credit, and so dampening demand, when there is evidence that levels of credit growth are above established benchmarks.

In order to conclude that capital regulation induces procyclical effects we should first examine whether the minimum capital requirements under Pillar I act in this manner, and then if such cyclicality survives the supervisory review process under Pillar II. Second, it should be ascertained that the banks' response to the regulatory changes does not offset the additional procyclicality, through voluntary accumulation of countercyclical buffers, for instance. And finally, we should assess whether any resulting additional cyclicality in bank lending affects real activity. Many empirical studies have examined these issues[159]. What was common to their findings was that they pointed to the combined introduction of Basel II and the "mark to market" accounting system as the main culprits for procyclicality. Namely, in a "mark to market" regime, an increase, for instance, in asset prices quickly translates into stronger capital for banks. This, in turn, triggers additional demand for assets and a further increase in their prices. It is precisely when times are good that toxic assets will become part of a bank's balance sheet. Typically there will be a high demand for such assets in the market due to their profitability regardless of their risk. Because of high demand, the mark to market system will give them a high value. This "accounting value" however, does not reflect their real, economic value. Banks, on the other hand, won't have a problem with such assets, as their capital base is perceived to be strong as long as they comply with capital adequacy requirements. But during an economic downturn, "mark to market" accounting generates downward spirals in asset prices, which in turn creates excessive losses that have no relation to underlying economic reality.

Based on the findings of such studies a worldwide consensus has been reached that the provisions of Basel II enhanced procyclicality (Angelini, P., Enria, A., Neri, S., Panetta, F., Quagliariello, M., 2010, October). Thus, the measures proposed under the Basel III Accord should dampen any excess cyclicality of the minimum capital requirement; promote forward looking provisions; conserve capital to build buffers at individual banks and the banking sector that can be used in times of stress; and achieve the broader macroprudential goal of protecting the banking sector of periods of excessive credit growth.

(5) *Addressing systemic risk and interconnectedness* – in contrast to procyclicality, which amplified shocks over time, the interconnectedness of many large banks, transmitted negative effects across financial systems. These measures act as a direct response to the poor

[159] See for instance: Goodhart, C., Segoviano M. A. (2004); Goodhart, C., Hofmann, B., Segoviano, M. A. (2004); Danielsson, J., Embrechts, E., Goodhart, C., Keating, C., Muennich, F., Renault, O., Shin, H. (2001).

perception of risks that certain banks pose for the system; as a whole their aim is to help supervisors measure the importance of banks to the stability of the financial system and the real economy in order to adjust regulatory requirements for systemically significant banks.

As we have already argued, both Basel II and III rules take form of an agreement whose implementation at national level remains voluntary. The EU rules in this area are binding for all Member States. On the European level a legally binding implementation of capital requirements has been put through in the form of a directive. The first EU rules on capital adequacy were created along the lines of the Basel I Accord and implemented into Community legislation through the Solvency Ratio Directive, the Own Funds Directive (later incorporated into the so called Consolidated Banking Directive and recast in 2006 by the Second Consolidated Banking Directive) and the Capital Adequacy Directive I (which incorporated market risk) [160]. The latter Directive was amended by CAD II in order to allow the use of VaR models. In 2006 the CAD III Directive implemented the requirements of the Basel II Accord[161].

In order to implement the requirements of the Basel II Accord in a more coherent manner the new Capital Requirements Directives (hereinafter CRD) was adopted in June 2006 and came into full effect in 2008[162]. The directives comprised in the CRD contain binding capital adequacy requirements for all credit institutions and securities issuers in the EU Member States[163]. The purpose of the CRD is to stipulate how much capital banks and investment firms must retain in order to cover their risks and protect their depositors.

The structure of the CRD is similar to that of the Basel accords:

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160 Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions OJ L 386, 30.12.1989., p. 0014 – 0022. This Directive set a minimum required capital adequacy for all EU credit institutions measured as the proportion of own funds of the risk adjusted value of a bank's total assets and certain off-balance-sheet items.; Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions OJ L 124 , 05.05.1989., p. 0016 – 0020. It defined the items that could be included in the banks' own funds calculation. It was composed of 'tier 1' capital which is the capital of the bank and the disclosed reserves, general provisions and subordinated debt.; Council Directive 93/6/EEC.

161 Directive 2006/49/EC.

162 The Capital Requirements Directive, comprises the Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast). It was approved by the Council of Ministers on 11 October 2005. It was published in the EU Official Journal on Friday June 2006.

163 Later amended by the European Commission, COM(2008) 602 final.

(1) Pillar 1 – covers the capital required for credit risk, operational and market risk. It contains generic rules for calculating different types of risks which determine banks' risk-weighted assets (RWA). It stipulates the amount of 8% RWA as the minimum capital requirement for banks.

(2) Pillar 2 – covers the supervisor's evaluation whether a credit institution complies with the Directive's requirements. In this context, it sets out the basis for the supervisory review process (SREP) as well as the framework for the internal capital adequacy assessment process (ICAAP) of banks. In addition, a wider number of risks than those covered in the first pillar are covered (*e.g.* business, concentration risks as well as the banks' expectations in general).

(3) Pillar 3 – covers disclosure requirements and explains the conditions for the stability of financial institutions. The objective is to raise the level of market discipline by giving external actors a better understanding of banks' capital adequacy calculations and the procedures involved.

Since the CRD implements the capital requirements stipulated by Basel accords, its provisions had to undergo revision twice (in order to follow the changes made to the accords). The first revision of the CRD happened in October 2008 ("CRD II", IP/08/1433) while the second one happened in July 2009 ("CRD III", IP/09/1120)[164].

In addition, the Directive's revisions sought to dismiss some of the negative impacts observed during its implementation in practice. This is especially true for procyclicality, which was exacerbated with the implementation of the CRD at national level. But the CRD is not the sole culprit for the amplification of procyclical effects. Procyclicality resulted from the years preceding the last financial crisis, when banks were eager to take risks more aggressively (for a higher return) without compensating them with adequate capital reserves. When the bubble burst, banks were forced to seek fresh capital in an unfavorable capital environment, which in turn led to the tightening of their lending, and consequently exacerbating negative cyclical trends in the real economy[165]. But banking and financial markets are inherently cyclical. It is to be expected that the risk appetite of banks will increase during economic upswings, when

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[164] The revisions made in the CRD II relate to own funds, large exposures, supervision and securitization. The revisions made in the CRD III relate to capital requirements for trading books and re-securitization, the disclosure of securitization exposures.

[165] Procyclical trends usually follow the direction of and enhance a current economic cycle. Within the financial system such effects are reflected as the tendency of financial activity to amplify business fluctuations, which in turn may contribute to financial instability.

risks are perceived to be lower. However, during economic downturn, lending criteria tightens, creating negative effects in the real economy. The question then is how should regulatory capital, which acts as a buffer in times of economic duress, adjust to these inherent cyclical trends? Does the answer lie in more stringent regulation?

Contrary to popular opinion, we argue that requiring banks to hold higher capital reserves would not improve their stability. In fact, such a requirement would only have anticompetitive effects with respect to other financial institutions in the system. In order to dampen the procyclicality of the current capital requirements framework, different measures will have to be used in synergy. European regulators are aware that tighter prudential rules are needed, but that at the same time, there is a risk that by imposing higher capital requirements in the aftermath of a crisis the economic recovery will slow down[166].

Regulations should be flexible enough to allow banks to hold less capital during economic downturns (in order to increase liquidity), but also to allow them to return almost automatically to a proscribed capital amount when there are clear and undisputable indications that the time of crisis has passed. Thus, the solution provided by the Basel III Accord on countercyclical buffers seems adequate[167].

In this context, the European Commission has decided to revise once again the Capital Requirements Directives. The proposed changes, known as the "CRD IV", will supplement the two existing sets of revisions mentioned earlier. At the time of writing the Directive’s revisions are still not adopted, thus it is difficult to foresee their market impact. But, we once again observe the main intention of the EU in regulating banks – more centralization.

National approaches to capital requirements are not sufficient for an integrated banking system in the opinion of the EU. In fact, they typically result with conflicting capital adequacy requirements. Thus, the EU – with its third revision of the Capital Requirements Directives – wishes to support harmonization of liquidity standards.

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[166] Similar objectives were agreed at international level in April 2009 at the G20 Pittsburgh Summit. Its Declaration reiterated that efforts should be made to strengthen the overall regulation of financial institutions but at the same time that new prudential standards should be phased in as "financial conditions improve and economic recovery is assured" http://www.g20.org/Documents/g20_summit_declaration.pdf

[167] In the context of EU law, the "countercyclical buffer" is referred to as "dynamic provisioning" (see the text of the Capital Requirements Directives).

4.3. Other financial institutions

Typically, Other financial institutions (OFIs) are subject to less stringent regulatory measures than monetary financial institutions and are normally required to set aside less regulatory capital. As they enjoy lighter regulatory treatment, OFIs adopt financial innovations much faster and thus represent an efficient institutional solution for highly specialized financial activities (*e.g.* investment in financial derivatives) in the market. Their light-regulatory regime derives from the fact that OFIs are not subject to asset-liabilities mismatch in the sense characteristic to the balance sheets of banks (that we have discussed earlier). In addition, systemic contagion is less likely to originate from OFIs. But, recently, the latter argument became debatable. This means that OFIs' interconnectedness with monetary financial institutions in the financial markets (specifically with credit institutions, or banks) through the offering of common products (*e.g.* bancassurance) gives them a new systemic significance.

This section is a short introduction to the following subsections, each one examining different types of OFIs. The representatives of the OFIs category have been chosen according to their prevalence across Member States (*e.g.* investment funds, insurance undertakings), or because of the regulatory challenges they pose due to their complexity (alternative investments funds). Our analysis is divided into three subsections.

Subsection 4.2.1. examines the regulation of investment funds in the EU through the analysis of Undertakings for collective investment in transferable securities (UCITS)[168]. The purpose of UCITS is to raise investment capital from members of the public and then to reinvest it for profits. UCITS can have different legal forms depending whether they are constituted in accordance with:

(1) Contract law, when they take the form of common funds managed by management companies;

(2) Trust law, when they take the form of unit trusts; or

(3) Statute, when they are structured as investment companies[169].

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[168] See Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 375, p.3; recast by Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302/32.

[169] Art. 1(3) of Directive 2009/65/EC.

Thus, the UCITS can take almost any type of legal structure, provided that the structure allows a group of investors to pool their investments in a way that results in its common administration by a manager.

In subsection 4.2.1. we elaborate in detail the development of the European regulation for UCITS during the years. We analyze the design of UCITS prudential regulation and how it changed over the years, ascertaining its benefits and shortcomings. We conclude by discussing the amendments proposed by the new UCITS IV regime that should be adopted by EU Member States by the end of July 2011.

In subsection 4.2.2. we analyze the regulatory approach to the alternative investment industry in Europe (represented by hedge funds and private equity funds). We use the term "regulatory approach" intentionally, as these funds are not regulated under EU law. For the time being, their regulation doesn't seem likely. By contrast, the EU seems to favor a light "regulatory approach" to the alternative investments industry for the time being, leaving regulation to national jurisdiction.

Subsection 4.2.3. examines insurance undertakings and their regulation in the EU. We observe that prudential regulation is vital for the insurance business, as insurance undertakings are prone to high risks of moral hazard. This is because they conclude long-term contracts with their clients ("insurance policy holders") whose value is dependent on the behavior of the insurer after the contract's conclusion. Hence, moral hazard mandates transparency requirements and investor protection which are enforced through prudential regulation. But, since nowadays insurance undertakings are more connected with other financial institutions (banks, for instance) their liquidity and solvency is becoming equally important (due to the increased systemic significance of insurance). Thus, in this subsection we will focus on the analysis of the current European regulatory regime for insurers – the Solvency II.

4.3.1. Undertakings for collective investment in transferable securities

In the broadest sense Undertakings for collective investment in transferable securities (UCITS) can be defined as a type of "collective investment scheme" that gives access to retail investors to European capital markets. The term "collective investment scheme" (specific to English law and in EU law) refers to an open-ended investment fund. Their scope is to collect funds from the general public and then to reinvest them in securities (or other financial assets on the capital market) in order to gain profits that investors can share. Collective investment schemes are particularly important for the retail investor. They ensure better risk-spreading and management of assets. In addition, the retail investor makes a cost-effective investment. In fact, even if he/she has the skills necessary to decide on the individual purchase of securities in the markets, the retail investor usually does not have a sufficient amount to invest to make economic sense. Thus, collective investments are likely to offer cost-effective means for retail investors to invest.

The subject of UCITS is burdened with terminological and definitional implications. Relevant literature often uses different terms such as: collective investment schemes, pooled investments, investment firms, open-ended vehicles, etc[170]. Throughout this subsection we will use the term of "collective investment scheme" or "investment fund" interchangeably as they may be found in EU legislation and relevant literature.

The "cornerstone" of the EU prudential regulation for UCITS is the Directive on the coordination of laws, regulations and administrative provisions relating to Undertakings for Collective Investment in Transferable Securities in December 1985[171]. The Directive gave a fundamental definition of UCITS as undertakings: *"(i) with the sole object of collective investment in transferable securities or in other liquid financial assets; and (ii) with units which can, at the request of holders, be repurchased or redeemed, directly or indirectly, out of those undertakings' assets"*[172]. Obviously, the Directive's intention was for UCITS to have a specific legal structure, namely that of an open-ended investment fund. This stems from the fact that the Directive specifically requires that the units of the collective investment scheme must be capable of ″repurchase″ or ″redemption″, directly or indirectly, out of the UCITS's assets. This intention is further confirmed in Art. 2(1) that lists different legal entities (with investment purposes) excluded from the Directive's scope. One of the most significant exclusion is listed in the first paragraph of the Article, and refers to UCITSs ″of the closed end type″[173]. In a closed-ended type if fund, an investor may sell his/hers units through a

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[170] See, for instance, the numerous terms noted in Kovas, A. (2006, February).

[171] Available at:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1985L0611:20050413:EN:PDF

[172] Article 1(2) of the Directive 85/611/EEC.

[173] *"Collective-investment schemes may be broadly divided into the closed-end type and the open-ended type. In a closed-end scheme restrictions apply to the redemption of the units representing the capital of the scheme: in effect the investor buys a share in a company the main activity of which is investment and holds the usual equity risk held by shareholders. Liquidity is provided by open market sales.* (…) *By contrast, in an open-ended scheme*

secondary market in which another investor buys it. In an open-ended type of fund, the investor redeems his/hers investment by selling his/hers units back to the fund. This is an important difference. The operator of an open-ended structure needs to be able to meet foreseeable future redemptions. And this in turn means, that a substantive share of the fund's assets needs to be marketable and also sufficiently liquid to enable redemption of the unit from the investor.

The 1985 UCITS Directive was the first to lay down common requirements for the organization, management and oversight of investment funds in Europe. The Directive was based on minimum harmonization. This meant that Member States were still allowed to apply stricter requirements than those set out in the Directive to those UCITS, which were situated within their jurisdiction. The 1985 UCITS Directive was designed primarily to promote free movement of collective investment schemes across EU borders. Hence, the 1985 regime was primarily "product oriented". This intention will continue to characterize UCITS regulations until recently. But before entering the discussion regarding the shift in regulatory objectives in this area, let us first examine the foundations of the UCITS prudential regime that originated in 1985.

4(4) Design of UCITS prudential regulation

STRUCTURAL PRINCIPLES	INVESTMENT RULES	UCITS PASSPORT
• redeemability at net once asset value on demand country • segregation of assets • valuation any time units are issued or redeemed • separation of functions (depositary)	• list of eligible assets • risk diversification • no borrowing • no direct investment into commodities; real estate • limit to global exposure	• EU-wide marketing authorized in home • notification procedure • very limited host country involvement

* Source: World bank UCITS presentation, of 6 June 2006[174]

The 1985 Directive regulated investment companies, management companies and depositaries of collective investment schemes. One of the Directive's major accomplishments was the establishment of the so called "UCITS passport". The UCITS passport meant that once a

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of whatever form units are issued continuously, or at short intervals, at a price related to current net asset value and may be redeemed by unit-holders at request, again at a current net asset value, or a price related to it." See Moloney, N. (2008, p. 249).

[174] Available at: www.siteresources.worldbank.org/.../Worldbank_**UCITS**_presentation(06.06.06).ppt

UCITS was authorized by the competent authorities of its home Member State, it could operate freely across borders. As we have already mentioned, the regime under the 1985 UCITS Directive was "product oriented". This means that the UCITS passport main intention was to allow free cross-border marketing of UCITS products (that is, fund units). This, in turn, has proven to be somewhat restrictive for the development of this sector.

In addition, the 1985 UCITS Directive was criticized for its Article 19 (which establishes in which instrument a UCITS is permitted to invest in) whose interpretation at Member State level was seldom divergent.

Thus, over the years the UCITS regime has sustained major amendments. The most significant ones were made in January 2002 with the adoption of two new directives dedicated to investment funds[175]. These Directives laid the foundations of a new regulatory framework, one that is commonly referred to as the UCITS III regime[176]. The most important change that the regime introduced (and one which interests us the most) was the broadening of UCITS ″investment horizons″. According to the previous regime UCITS were allowed to invest in shares and bonds only, but UCITS III allowed them to invest in new types of financial assets. The provisions of the 2002 UCITS Directives specified that a UCITS can invest in:

(1) *Listed transferable securities and listed money market instruments* – the 2002 Directives introduced the definition of "transferable securities" as shares in companies and other securities equivalent to shares, bonds and other forms of securitized debt, that are negotiable and that carry the right to acquire transferable securities. A definition of money market instruments was also given, as those instruments that are normally dealt in on the money markets that are liquid and whose value may accurately be determined.

(2) *Units of other regulated funds* – UCITS III made it possible for UCITS to invest in UCITS and other funds that meet certain specified criteria[177].

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[175] The amendments were made using the "re-casting technique" which allowed substantive changes to the existing legislation. Directive 2001/107/EC ("Management Company Directive") and Directive 2001/108/EC ("Product Directive") are both referred to as UCITS III. The Management Directive gives management companies a "European passport" to operate throughout the EU and widens the activities which they are allowed to undertake. It introduces a simplified prospectus with more accessible and comprehensive information in order to assist cross-border marketing of UCITS. The "Product Directive" removes barriers to the cross-border marketing of units of collective investment funds by allowing funds to invest in a wider range of financial instruments. See Ernst & Young (2003, June).

[176] As opposed to the initial 1985 UCITS Directive that became known as the "UCITS I" regime.

[177] Investment is limited to 10% of the assets of the UCITS (or 20% of the assets, if a home Member State permits) and 25% of the value of the target fund.

(3) *Bank deposits* – the Directive permitted investment in deposits that are repayable on demand or that are maturing in no longer than twelve months, held at a credit institution authorized by a Member State.

(4) *Financial derivatives* – with the prerequisite that the assets underlying the derivative must consist of instruments that may be held directly in a UCITS fund.

Some of these instruments (money market instruments, financial derivatives, etc.) raised concerns among Member States about the changing nature of UCITS. This meant that many of them asked whether UCITS remained appropriate for retail investors, or whether retail investors understand the changes that were made. This was immensely important since retail investors typically perceived UCITS as safe investments.

Thus, the key concern should be whether consumers understand the new risks associated with the new products UCITS may invest into. The problem is that, although retail investors may understand that these new products minimize the extent of market risk borne by the fund (by sheer diversification of investments made) they do not understand that there may be other risks added as a consequence. But, consumer understanding does not require that the retail investor understands in detail the way in which the product operates. Instead, the retail investor should only understand how to use the product. As a result of all these facts, during the implementation of the UCITS III regime, regulators became more aware that efforts should be made to improve investor protection and the quality of information.

In July 2009, the European Commission put forward the UCITS IV Directive[178]. This Directive recast the original 1985 Directive and thus substantially reformed several areas. One would expect, from the above made discussion, that investor protection and disclosure of information would be at the heart of the new Directive, and fortunately this is the case. In addition, the concept of cross-border fund distribution and operations is also central to the Directive. With the UCITS IV Directive the European Commission wanted to enhance three main elements:

(1) Investors protection,

(2) Industry efficiency and competitiveness, and

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[178] Directive 2009/65/EC (OJ L 302/32, 17.11.2009.). The Directive's Level 1 measures, were approved by the European Parliament and the Council of Ministers in January and May 2009 respectively. The European Commission completed the implementation measures (Level 2) in July 2010. The Directive will have to be transposed into national legislation across all EU countries by 1 July 2011.

(3) Cross-border sale of shares or units of funds.

In the following passage, we centre our discussion on investor protection. This is because for the time being investor competence is low, information asymmetries are significant, sale is segmented to national jurisdictions and inconsistent harmonized rules apply.

The change that is supposed to improve investor protection and boost their confidence is that affecting the disclosure regime. Regulators departed from the premise that the ″simplified prospectus″ provided by previous directives regulating UCITS wasn't successful in delivering basic information on the UCITS product and their risk. The new disclosure rules provided by UCITS IV target the ability of individual investors to better understand disclosed information and to use it appropriately. This solution represents a substantive change. Namely, the traditional principle of extensive and highly detailed disclosure information has been replaced by a ″outcome-driven″ approach (Moloney, N., 2008, p. 241). This means that the previous format of overly prescriptive prospectus information has been replaced with the concept of ″key investor information″ (KII) that is readily available to the investor. The KII ″distils″ financial information, which is available to investors and which usually, distorts their perceptions. The KII in turn, directs disclosure towards practical investment needs of an average investor. The KII concept departs from the presumption that average, retail investors should understand all the information presented in the prospectus. To this end the KII takes the form of a fact sheet, which lists financially relevant information in a non-technical language and which guarantees uniform disclosure across the Union[179]. In this way the KII would assist the retail investor in making an informed investment decision. Retail investors of all levels of expertise will benefit from the KII document either as a quick first point of comparison before seeking detailed information or as a good introduction to the fund and to the questions to ask their financial advisors.

At the time of writing it was not possible to discuss concrete results of the UCITS IV regime as the Directive is yet to be implemented at national level (the timeframe is July 2011). It remains to be seen if the new regulatory solutions shall suffice to create a level playing field for collective investment schemes in the EU. Nevertheless, it is clear that the UCITS IV regime makes a noteworthy step forward in the investment policy – to a more retail-oriented regulation of collective investments, and that the key investment information reform positively affects retail market disclosure. The KII, as a ″citizen summary″ at first may seem

[179] See Art. 78 of the Directive 2009/65/EC.

as a more symbolic reform rather than one that will bring real benefits. However, its message is important – after years of product-orientation in the UCITS regime, European policymakers have finally decided to translate the regime in a more consumer-oriented framework. Nevertheless we should keep in mind that it is very difficult to design an effective regulatory regime that would limit the risk of selling to retail investors such investment products that are inappropriate for them due to the risks associated.

4.3.2. Alternative investments industry: hedge funds and private equity

In the European Union the term ″alternative investments″ refers to those funds that are not regulated under the provisions of the UCITS IV Directive[180]. The most prominent role in European alternative investments is taken by hedge funds and private equity funds, as different types of alternative investments[181].

Naturally, we are aware of the fact that these funds attract investments mainly from professional investors or wealthy individuals, and as such they are not numerous. However, the value of their assets and their connection with more traditional type of financial institutions, calls for a closer examination.

In the broadest sense hedge funds and private equity funds can be defined as lightly regulated private "pools of capital" that invest and compensate their managers with a share of the fund's profits (the greater the profit the more the manager earns). As their investment strategies are different as well as the type of financial assets they invest in, the specific nature of both funds should be reflected in the regulative framework they are subject to. In this subsection we examine hedge funds and private equity funds separately, the risks that they pose for overall financial stability and whether these risks can be minimized through regulation. Then, our attention turns to recent EU regulatory proposals put forward for the alternative investments industry.

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[180] The definition of alternative investments from an economic perspective is somewhat clearer. It states that the term refers to any type of investment other than stocks and bonds and includes such institutions as hedge funds, funds of hedge funds, managed futures funds and other non-traditional asset classes. See Downes, J., Goodman, J. E. (2006).

[181] The European Parliament uses the term "*sophisticated alternative investment vehicles*" which encompasses alternative investment funds distinct from the traditional UCITS. A variety of terms has been used by other institutions. The Basel Committee on Banking Supervision employs the term "*highly leveraged institutions*" encompassing hedge funds and other institutions that are lightly regulated and that employ significant leverage in their activities. For further insight see Garbaravicius, T., Dierick, F. (2005, August, p.9).

Hedge funds

There is no common definition of a hedge fund in European legislation and neither does Member State legislation offer a formal definition of hedge funds. Relevant literature and international regulatory authorities define them as investment funds opened to a limited range of investors (that is to the sophisticated, professional investors or wealthy individuals not the general, retail investor) that engage into a wide range of investment and trading activities and pay a performance fee to the investment manager[182]. Thus, they are not funds that operate within the traditional detailed regulatory framework intended for those investment funds that are designed with retail investors in mind. Hedge funds are a type of privately owned investment funds that use: (i) leverage to magnify returns, (ii) short-selling to limit market risk exposures and (iii) charges investors a performance fee[183]. An additional definition of hedge funds is given by Downes and Goodman in their Dictionary of Finance and Investment Terms (2006) from the perspective of common law: *"(a hedge fund) is a private investment partnership (for US investors) or an off-shore investment corporation (for non-US or tax-exempt investors) in which the general partner has made a substantial personal investment, and whose offering memorandum allows for the fund to take both long and short positions, use leverage and derivatives, and invest in many markets."*

As the name implies hedge funds seek to hedge some of the risks inherent to their investments using a variety of methods, most notably short selling[184] and derivatives; but also a variety of complex trading strategies, such as arbitrage and other market neutral financial techniques[185]. These strategies are not unique to hedge funds, as other financial institutions also engage into

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[182] "*There is no legal or even generally accepted definition of a hedge fund, although the US President's Working Group on Financial Markets (1999) characterized such entities as 'any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.*'" Ibidem, p.8. In addition to single hedge funds, there are funds of hedge funds. These are funds that invest in a number of other hedge funds providing diversification and selection services to retail investors, who usually lack higher degrees of expertise or who do not meet minimum investment requirements. Their fees are lower than those in single hedge funds and they often offer monthly or quarterly redemption.

[183] The Hedge Fund Standards Board. (2009, February).

[184] Short selling is a term which refers to the sale of a security or commodity futures contract not owned by the seller. This technique is used to either take advantage of an anticipated decline in the price or to protect a profit in a long position. An investor borrows stock certificates for delivery at the time of short sale. If the seller can buy that stock later at a lower price, a profit results – if the price rises, however, a loss results. A commodity sold short represents a promise to deliver the commodity at a set price on a future date.

[185] A strategy undertaken by an investor or an investment manager that seeks to profit from both increasing and decreasing prices in a single or numerous markets. Market-neutral strategies are often attained by taking matching long and short positions in different stocks to increase the return from making good stock selections and decreasing the return from broad market movements. Also, see De Haan, J., Oosterloo, S., Schoenmaker, D. (2009, p. 178).

leverage and trading in derivatives. The key difference is that hedge funds do not have any restrictions on the type of instruments or strategies they can use, due to the fact that they are mainly unregulated (or loosely regulated). In this context, we wish to point out that the term "hedge fund" is actually a misnomer. Let us explain why.

The primary aim of hedge funds is to reduce volatility and risk, and then to deliver positive returns under different market conditions (hence, the connection of the verb "*to hedge*" and the name "*hedge fund*"). By acting as counterparty in many different markets, hedge funds play a key role in the reallocation of risks among market participants, which is the main driver of their success[186]. They provide market liquidity and stabilize market conditions by spreading risks across a broad range of investors. This is all feasible thanks to their ability to often take contrary market positions and trading strategies to the ones taken by traditional investment firms, as well as to engage into short-selling. Thus hedge funds often act as a counterbalance to ″market herding″[187]. Finally, hedge funds contribute significantly to financial innovation and to the overall revision of certain basic principles of asset management. In light of all these facts, we think that an appropriate term for these funds would be "speculative funds". In fact, some EU countries (for instance Italy or France) have adopted a similar stance and thus named these funds accordingly (fondi speculativi and fonds spéculatifs, respectively).

As we have already mentioned, hedge funds are not subject to the UCITS regime. There is no direct European legislation dedicated to hedge funds. This is partly because they form a heterogeneous group whose legal nature varies greatly across Member States. Several EU Member States have introduced national regulatory regimes to provide legal certainty for the onshore management and constitution of hedge funds (*e.g.* Italy for its *fondi speculativi*[188]).

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[186] Report of the Alternative Investment Expert Group. (2006, July).

[187] The term refers to large equity market trends which usually begin and end with periods of frenzied buying (bubbles) or selling (crashes). These episodes are generally irrational and emotionally driven.

[188] Italy is a dynamic market for hedge funds, and it was among the first to adopt hedge funds-specific legislation through a Treasury Minister Decree (later amended in 2000, 2003 and 2005) and developed through regulations of the national central bank. In Italy hedge funds may be structured as open or close-ended funds. The law requires investment advisers to be authorized by the central bank, while hedge funds themselves must obtain authorization from the financial market regulator (we will discuss this authority in chapter 6). While advisers are subject to regulatory capital requirements, hedge funds are not. It is important to notice that in Italy it is prohibited to market hedge funds to the general public; an investor cannot invest in a hedge fund if his/hers initial subscription is below a treshold of 500 000 Euros. See: *Decreto del Ministro del Tesoro 24 maggio 1999 n. 228, and the Regolamento Banca d'Italia 20 settembre 1999; then Regolamento recante norme per la determinazione dei criteri generali cui devono essere uniformati i fondi comuni di investimento (adottato dal Ministro del tesoro, del bilancio e della programmazione economica con decreto del 24 maggio 1990, n. 228 e successivamente modificato con decreto del 22 maggio 2000, n. 180; con decreto del 31 gennaio 2003, n. 47 e*

By analyzing some of these legislative texts, we can broadly point to common elements covered by national legislation:

(i) Investment restrictions or product regulation – authorization regimes regulate certain aspects of investment strategies or product performance (*e.g.* diversification limits);

(ii) Fund constitution and administration – the regulatory approach to hedge funds is largely based on the principles laid down in UCITS law;

(iii) Distribution to retail investors – this is where most of the regulatory differences are encountered at national level. For instance, certain Member States prohibit the offering of hedge fund's products to the general public. In other Member States, these products can be offered to the public with the prerequisite that significant restrictions are applied on the asset manager's freedom to determine investment strategies;

(iv) Distribution to qualified investors – Member States' regimes vary in terms of who is eligible to invest and the products that can be promoted, with eligibility often being dependent from the ″professional level″ of the investor.

In the introduction to this section, we have said that we are interested in assessing different channels through which hedge funds impact financial stability. The first channel is leverage[189]. Hedge funds add significant weight to the overall leverage of the system and thus the unwinding of their positions may cause severe problems[190]. With excessive leverage, even a moderate price swing could force hedge funds to liquidate their financial positions, leading to negative effects across the market. The second channel is their relationship with other financial institutions in the financial system. Here we primarily refer to credit institutions (banks) that provide hedge funds with loans and credit lines. Apart from such direct risks, credit institutions face a number of indirect risks from their exposure to hedge funds. This is particularly true for those institutions that engage in securities trading, such as investment banks. This indirect credit risk may arise because of credit risk *vis- à- vis* counterparties with large exposures on hedge funds. This is why credit institutions should strictly obey the

con decreto del 14 ottobre 2005, n. 256. All documents are available at: www.consob.it. Moreover, see *Provvedimento della Banca d'Italia, Regolamento sulla gestione colletiva del risparmio*, 14 April 2005, available at: www.bancaditalia.it

[189] Leverage, from a financial perspective, is the part of debt in relation to equity in a firm's capital structure (the debt-to-equity ratio). The more long-term debt there is, the greater the financial leverage.

[190] The High-Level Group on Financial Supervision in Europe. (2009, February).

prudential requirements imposed by the Basel accords when interacting with hedge funds[191]. These facts make it clear that hedge funds have a ″systemic dimension″. The significance of this dimension depends on the size of the hedge fund, its market position and the spillover effect it can exert. Having in mind this systemic significance that hedge funds bear, we have to ask whether it is still advisable for them to be excluded from regulation? In fact, although hedge funds didn't have a decisive role in the development of the last financial crisis, Europe is advocating for greater hedge fund regulation. The rationale is twofold:

(1) Systemic risk – because of their size and business connections hedge funds can be systemically important; and

(2) Greater transparency of hedge funds and with that greater investor protection.

Does a similar rationale for regulation also apply to private equity funds? In order to answer this question, we first must examine the nature of the private equity business.

Private equity

Private equity can be defined as funds that provide capital and management expertise to different legal entities (companies) to nurture their expansion, the development of new products, or restructure the company's operations, management or ownership[192]. In this sense, private equity creates new value, if the jargon of the industry is used, and subsequently - upon selling its share in the company (after a medium to long holding period) private equity funds generate capital gains[193]. As regards their legal nature, most private equity funds are private,

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[191] Adequate capital requirements should be set and reporting obligations should be applied in order to assess the exact degree of leverage borne by these institutions In addition, supervisors should know which hedge funds are systemically important. With respect to this requirement, there were some suggestions that a pan-European authority should be created that will register hedge funds, asses their strategies and their leverage.

[192] In our analysis we use the term ″private equity″ to encompass different sub-sets of financing stages:

(1) venture capital – focused on the start up of young and early stage businesses. Venture capital investments are often made in individual minority shareholdings with a number of other venture capital funds that invest alongside each other in successive rounds of business financing.

(2) expansion (or growth) capital – focused on providing capital finance through the purchase of holdings in existing, profitable companies by subscribing new capital.

(3) management buy-outs and management buy-ins – buy-outs are typically majority investments made in companies together with the company's existing management (management buy-out, MBO) or with a new management team (management buy-in, MBI).

[193] Report of the Alternative Investment Expert Group. (2006, July). A different definition may be found in the Downes and Goodman Dictionary of Finance and Investment Terms (2006) specific to the US jurisdiction: ″*(private equity fund) is a limited partnership controlled by a private equity firm that acts a general partner and*

closed-end funds with a fixed-life duration (most of these funds typically have a life of ten years that may be extended upon agreement with their investors). Investors in private equity invest their capital for the duration of the fund's life without redemption rights. This makes their investment highly illiquid, and as such mandates a certain level of expertise on behalf of the investor.

Similarly to hedge funds, private equity funds fall outside the standard investor protection regulatory framework.

Private equity funds invest predominantly in unquoted companies (*i.e.* whose shares are not listed on exchanges). A professional team of investors makes these investments. They "create value" by working with, or taking over, the companies that it invests in (the ″investee company″), over a relatively long holding period (*i.e.* three to five years). In addition, the fund manager has significant influence over its investee companies and their management teams and strategies[194]. His scope is to maximize the value of the investee company and generate attractive return for investors by selling the company on an appropriate time.

Who makes up the investment base for private equity? Sources of capital for the European private equity funds originate from institutional (or ″professional″) investors who have the expertise necessary to engage into complex investment transactions (again, these are not general, retail investors). Typically they are: pension funds, insurance undertakings and investment banks. Thus, retail access to this market is traditionally restricted. The remainder of capital is sourced through government funds and wealthy individuals for whom investment in private equity complements their investment portfolio[195].

When discussing regulation of private equity, we have to mention one of the most important reasons in favor of their greater regulation. Namely, private equity funds typically consider companies they invest in as mere "classes of assets". Meaning that in their opinion, these companies are intended for selling. In this context, practice shows that private equity funds

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that gets specific dollar commitments from qualified institutional investors and individual accredited investors. These passive limited partners fund pro rata portions of their commitments when the general partner has identified an appropriate opportunity, which may be venture capital to finance new products and technologies, expanding work capital, making acquisitions, financing leveraged buy outs (LBOs), and other investments in which the equity is not publicly traded."

[194] A private equity manager consists of specialist professionals who are close to the operational life of the investee company and who monitor its progress carefully.

[195] A portfolio is a combined holding of more than one share, bond, commodity, real estate investment or other asset by an individual or institutional investor. The purpose of the portfolio is to reduce risk by diversification.

have a low commitment to the long-term prospects of the company. Consequently, in order to create higher returns for their investors, private equity funds use leverage extensively, which increases the risk of default and bankruptcy of the company. Thus, private equity raises special social concerns in addition to the regulatory ones. Social concerns stem from the fact that their investments allow wealth that is created through the work of many (the company's employees and their management) to be captured (or even destroyed) by a few individuals. Sometimes in private equity dealings it seems as profits are being privatized, and risks are being ″socialized″. Naturally, these concerns have gained the attention of EU regulators. Although private equity funds are not generally considered to pose systemic risks to financial stability (as hedge funds are), some of their dealings have raised questions about the impact of this type of investment on the social economy. Is the pursuit of high investment returns that is sought by private equity funds, compatible with the long-term health of investee companies? And do stakeholders – notably employees, investors, regulators and the public at large – have the information and tools they need to safeguard their own interests?

Regulation of hedge funds and private equity

Let us now turn to the current European regulation of the alternative investments industry. Although often described as a "lightly regulated" market sector at the EU level, the European alternative investments industry is subject to a complex layer of Member State legislations and limited supervisory oversight rather than a EU-wide regime specifically dedicated to this industry[196]. Naturally, certain EU directives affected hedge funds and private equity indirectly (such as the Capital Requirements Directive or the Solvency II Directive which will be discussed in subsection 4.3.3.) but there was no comprehensive regime. We have to note that, hedge funds and private equity, engaged upon a number of self-regulatory initiatives. Hedge funds and private equity associations published their own standards for sound business practices. But, when market conditions begun to deteriorate during the 2007-08 financial crisis, this light regulatory approach became marginalized. Public opinion shifted towards acceptance of the need for more stringent regulation. Set against a backdrop of post-crisis regulatory debates, the European Commission has put forward a proposal for the regulation of the alternative investments industry. This was the Alternative Investment Fund Managers

[196] See Wymeersch, E.(2010).

Directive (AIFMD) proposal[197]. As the name suggest, the Directive regulates alternative investment fund managers, and not investment funds[198]. The scope of the Directive is to regulate all managers of collective investment schemes, irrespective of the type of assets in which they invest. The provisions of the proposed directive aim to support financial stability and improve investor protection. Wymeersch (2010) notes that the regulatory regime presents some analogies with a prudential regime: it relies essentially on substantive rules (meaning detailed rules aimed at the funds) and less on disclosure requirements (aimed at the investor) (Wymeersch, E., 2010, p. 20).

The Directive will not become operative until 2013 and there is still much regulation and guidance that has to be put in place before then. Thus, without entering into the technicalities of the Directive's provisions let us give some tentative comments on whether it was appropriate for the EU to bring the alternative investments industry directly under public control.

First of all, we dismiss the argument that the alternative investment industry does not have to be subject to regulation because of its minor role in the development of the last financial crisis. As argued by Ferran (2010, p. 28): "… *the world's economies cannot afford to sit back and wait for incontestable evidence of an actual systemic problem before acting because by then any regulatory response will be too late. Regulation has to aim at trying to prevent the next crisis, not simply cleaning up the mess from the previous one.*" Hedge funds and private equity should at least be subject to disclosure and transparency obligations. This would allow regulators to identify the concentration of risk in this segment of the financial market. In this respect, many of the fundamental ideas of the AIFMD (such as disclosure to investors, reporting of investment performance, segregation of assets, and so on) are welcomed. In this context, the Directive may give a boost to this industry, as its provisions greatly support investor confidence. But there are also downsizes to the Directive. First of all, the new compliance costs are borne by the industry. If these costs won't be passed on to investors,

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[197] European Commission, COM(2009)207 final.

[198] But Ferran notes that there are certain exemptions from this rule: "*One exemption covers fund managers who manage funds with total assets of less than €100 million or less than €500 million that are not leveraged and with no redemption rights for the first 5 years. Member States must still impose registration and simplified disclosure obligations on these smaller funds. These thresholds are too low to be regarded as a credible attempt to limit the Directive's application only to systemically relevant funds. A limited number of the provisions are relaxed in certain cases and some systemically-oriented requirements apply only in relation to leveraged funds. There may be some scope for further proportionality and differentiation to be introduced into the regulatory framework via the detailed Commission rules and supervisory guidance that must be developed for the regime to become operational.*" See Ferran, E. (2011, p. 19).

returns of hedge funds and private equity will be reduced. For that reason it will make more sense for some funds to operate in third countries or offshore. Such withdrawal would leave European investors seeking out the best alternative investment opportunities.

But, it is too early to come to a final judgment on whether the Directive is appropriate for the European alternative investments industry. For once, we concur with the regulatory approach adopted by European policymakers. A common, EU legislation for hedge funds and private equity is better suited to Europe's needs than a mix of national legislations and industry's self-regulations. However we think that such regulation shouldn't be overtly burdensome. Primarily, our criticism goes to the fact that the Directive does not restrict the general public (or the retail investor) from investing in hedge funds (through UCITS' investments into derivatives based on hedge funds indices or in funds of hedge funds). This, in our opinion, is the main drawback of the Directive.

Any future regulation of hedge funds and private equity should depart from this premise – that these are investments that are not suited for the retail investor. In addition, we support a more flexible approach to regulation of these funds in the EU. That is one that will not rely on ″traditional″ harmonization and well-known integration principles (*i.e.* minimum or maximum harmonization). It is possible that a mix of self-imposed rules of conduct and lighter supranational regulation would be adequate for the European alternative investment industry for the time being.

4.3.3. Insurance undertakings

By contrast to the financial institutions that we have examined in previous sections, insurance undertakings have been long considered as relatively stable and less prone to systemic risks. However, during the last two decades the business of insurance[199] has evolved substantially.

This means that, for instance, in the EU insurance undertakings have multiplied their connections with credit institutions by offering financial products similar to those traditionally offered by banks. This has made them more vulnerable to new types of risks and has consequently made them prone to systemic risk.

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[199] Under the term "insurance business" or "business of insurance", we refer to the various forms or business activities in which insurance undertakings may engage into.

In this subsection we first analyze the business of insurance undertakings and its risks. Then we examine the prudential regulation of insurance undertakings in the EU and its development alongside market changes. In conclusion, we examine in great detail the Solvency II regime designed to protect insurance policyholders (that is, investors in this business) in the EU and ensure a level playing field for insurance undertakings.

EU legislation doesn't provide a comprehensive definition of an insurance undertaking. European regulations refer only to authorization requirements for those legal entities that engage into insurance business[200]. Thus, in order to define what an insurance undertaking is, as a starting point for our analysis, we must turn to legal and economic theory.

From a legal point of view, the term "insurance" refers to a contract by which one party (the *insurer*) undertakes to indemnify another party (the *insured*) against risk of loss, damage, or other liability arising from the occurrence of some specified contingency, and usually to defend the insured or to pay for a defense regardless of whether the insured is ultimately found liable[201]. The insured party usually pays a premium to the insurer in exchange for the insurer's assumption of the insured's risk. The insurance business provides three types of services:

(i) Protection against adverse events,

(ii) Investment services, as premiums are received before the payment of claims, and

(iii) Advice on risk management and administration of pension schemes[202].

There is no dispute on the fact that insurance contributes to economic growth. At the macro level the insurance business helps strengthen the resilience of the economy by facilitating risk transfer. At the micro level it brings benefits in all areas of everyday life by helping individuals to minimize the financial impact of unexpected future events. By pooling the premiums and risks of many different policyholders, and ensuring that risks are diversified across different risk types and locations, insurers spread the financial effects of insured

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[200] *"Insurance undertaking means an undertaking which has received official authorization in accordance with Article 6 of Directive 73/239/EEC or Article 6 of Directive 79/267/EEC."* Article 2 of Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation (OJ L 9/3, 15.1.2003.). See also, Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance (OJ L 345/1, 19.12.2002.).

[201] See Garner, B. A. (Ed.), 2004.

[202] De Haan, J., Oosterloo, S., Schoenmaker, D. (2009, p. 260).

events. In addition, insurers transfer risks to other institutions through the reinsurance process and to capital markets through hedging instruments.

From an economic perspective the ″insurance business″ can be classified into:

(1) Life assurance,

(2) Non-life insurance and,

(3) Reinsurance.

Let us briefly explain each of these categories.

Life assurance is an agreement between an insurance undertaking and a policyholder to pay a specified amount to a designated beneficiary on the insured's death. This type of insurance offers a variety of products with different combinations of protection and investment components. It often involves supplementary insurance products (in particular, insurance against personal injury, insurance against accidents) that are usually underwritten in addition to life assurance. In developed economies life assurance usually functions as a long-term contractual savings deposit. This type of insurance mobilizes savings from households and channels them to the corporate and public sector.

Non-life insurance is usually known as ″general insurance″ or ″property and casualty insurance″. The EU directives that cover non-life insurance do not offer a consistent definition of this activity[203]. Contrary to life assurance, non-life insurance contracts are usually short term with an intense risk-dynamics (meaning that the possibility that the insured event occurs is high) and without the investment or savings component associated with life assurance.

Finally, reinsurance is the insurance of all, or part, of an insurer's risk by a second insurer, who accepts the risk in exchange for a percentage of the original premium.

Unlike other financial sectors insurance is characterized by the reversal of the production cycle. This means that premiums are collected when the contract is entered into, while claims and costs arise only if a contractually pre-specified event (the "insured event") occurs. In addition, insurance undertakings do not engage in the type of asset transformation that banks

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[203] The list of non-life Directives still in force is available at:

http://ec.europa.eu/internal_market/insurance/legis-inforce_en.htm#nonlife do. In fact, insurance undertakings transform illiquid liabilities into liquid assets[204]. In order to understand the nature of their business and the types of risks associated with it, we should first take a look at the balance sheet of an insurance undertaking (to be specific, we concentrate on life assurance).

4(5) Major items in an insurance undertaking's balance sheet

ASSETS	LIABILITIES
1. Unpaid subscribed capital	1. Share capital and reserves
2. Intangible assets	2. Subordinated liabilities
3. Investments in land and buildings and financial investments	3. Net technical provisions
4. Investments for the benefit of life assurance policyholders who bear the investment risk	4. Technical provisions for life assurance policyholders who bear the investment risk
5. Claims	5. Provisions for other risks
6. Other assets	6. Liabilities as part of retained premiums
7. Prepayments and accrued income	7. Other liabilities
	8. Short-term accrued liabilities

* Source: Grm, A. (2003).

From the aspect of a life assurance undertaking, the long-term nature of its liabilities (as a result of the long-term nature of policyholders' claims) allows them to invest in assets with long-term maturity (such as bonds, equities, government securities). The undertaking's fulfillment of its contractual liabilities is determined by the performance of its assets. Policyholders wonder if the insurance premium that they pay will be safely invested and whether they will get back what they've invested at the end of the maturity period.

As for the risks they incur - on the asset side, insurers incur market, credit and liquidity risks related to their investments, as well as other risks related to asset-liability mismatches. On the liability side, insurers incur significant technical risks resulting from actuarial calculations used in estimating future events. Thus, uncertainty is inherent to insurance business,

[204] Goodhart, C., Hartmann, P., Llewellyn, D. T., Rojas-Suarez, L., Weisbrod, S.: Financial Regulation: Why, How and Where Now?, Routledge, London 1998, p. 14.

particularly as regards the amounts of future claims the insurance undertaking will have to pay. This makes insurance undertakings subject to a high level of prudential regulation. This prudential regulation, in the case of insurance, is based on solvency margins that are similar to capital adequacy requirements provided for credit institutions.

We have assessed that prudential regulation of insurance undertakings focuses primarily on solvency requirements. If this is the basis of insurance regulation, how is it reflected in European legislation?

First of all, the creation of European prudential regulation of insurance begun with the adoption of the first generation of "insurance Directives". These directives introduced a common solvency margin that all European insurers had to comply with. In addition, they provided administrative requirements for the authorization of insurers in each Member State where they rendered services, under comparable legal and financial conditions[205]. However, the harmonization success of the first directives was limited. The main reason for this was that host countries were still allowed to impose additional requirements on insurers operating in their jurisdiction. Furthermore, branches of insurance undertakings were subject to dual supervision (from the authorities of both the home and host country) meaning that undertakings were required to obtain additional authorization when operating cross-border. The "second generation of insurance Directives" addressed these problems and facilitated the provision of insurance services across Member States[206]. Still, the directives managed to achieve only partial liberalization, as the majority of EU Member States continued to apply the principle of host country control. Only the third generation of insurance directives managed succeeded in implementing the "single European passport" for insurance undertakings. This passport allowed insurers registered in one Member State (and authorized

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[205] The early stages for a Single market in life insurance were marked by the First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance (OJ L 63, 13.3.1979.). The field of non-life insurance was regulated earlier than assurance, with the First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance (OJ L 228, 16.8.1973.). These Directives are also known as the "Solvency I regime for insurance". See Ayadi, R., Van Der Ende, J. (2006, p. 5).

[206] Council Directive 90/619/EEC of 8 November 1990 on the coordination of laws, regulations and administrative provisions relating to direct life assurance, laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 79/267/EEC (OJ 1990 L 330); and Council Directive 88/357/EEC of 22 June 1988 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 73/239/EEC (OJ L 172, 4.7.1988.).

by its competent authority) to freely offer their products across the EU, directly or indirectly – through branches and subsidiaries.

However, as insurance business is becoming more similar with to other business areas, prudential regulation for insurance must be modernized. EU legislation has to align regulatory with economic capital requirements, improve risk management and enhance transparency for the benefit of insurance policyholders. Also, regulation has to introduce a new approach to measuring assets and liabilities of insurers. The scope of this is to ensure financial soundness of insurance undertakings, and in particular to ensure that they can survive periods of financial duress. Taking all these requirements into account, the new prudential regulation should be based primarily on solvency margins that stipulate the minimum amounts of capital resources that insurers must retain in order to cover the risks to which they are exposed.

In line with these prerequisites, the European Commission initiated a review of the overall financial position of insurance undertakings in Europe, as part of the Solvency II project[207]. The process resulted with the adoption of the Solvency II Directive in November 2009[208]. Solvency II applies to all life and non-life insurance undertakings as well as to reinsurance undertakings. It provides the legal foundation for the new regime and replaces the old regime, usually referred to as Solvency I. The Solvency II Directive is designed to produce a more consistent solvency standard and thus to protect policyholders across the EU in a better way[209]. In the following passage we examine the contents of the new directive in detail.

Solvency II introduces economic, risk-based solvency requirements for insurers. These requirements are more risk-sensitive and have a wider coverage of the real risks encountered by insurance undertaking. This means that the new requirements move away from a "one-model-fits-all" way of estimating the appropriate level of regulatory capital to a more

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[207] The project consists of a recast of 13 Directives that regulate the insurance and reinsurance sector together with new solvency provisions. See European Commission, COM (2007) 361, COM (2008) 119 final. In addition see the final version of the Solvency II Directive available at:

http://register.consilium.europa.eu/pdf/en/09/st03/st03643-re06.en09.pdf

[208] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast), OJ L 335/1, commonly referred to as Solvency II.

[209] Article 27 of the directive identifies protecting policyholders and beneficiaries as the main objective of supervision. Recital 13 adds: "*Financial stability and fair and stable markets are other objectives of insurance and reinsurance regulation and supervision which should also be taken into account but should not undermine the main objective*". In addition article 28 requires consideration of the "*potential impact of (supervisors') decisions on the stability of the financial systems concerned in the European Union, in particular in emergency situations*". See Freshfields Bruckhaus Deringer. (2011, January).

″undertaking-specific″ way of estimation. As a result, capital requirements should reflect the specific risk-profile of each insurance undertaking. Solvency II places greater responsibilities on the sole insurer. They should develop reliable risk management techniques and robust internal controls, in line with the Directive's provisions.. The core idea is to reward the insurers that manage their risks well (*e.g.* they have rigorous policies, use appropriate risk-mitigation techniques or other methods) by allowing them to hold lower levels of capital then under the previous regime. It is clear by now that the regime structurally resembles that of the Basel accords.

4(6) European prudential regulation of insurance undertakings

SOLVENCY II		
PILLAR I	**PILLAR II**	**PILLAR III**
Quantitative requirements - assets and liabilities; market consistent valuation - investments - Solvency Capital Requirement (SCR) - Minimum Capital Requirement (MCR) - own funds	*Supervisory review* - system of governance - own risk and solvency assessment (ORSA) - supervisory review process - supervisory intervention including capital add-on	*Disclosure* - public disclosure; annual solvency and financial condition report - information to be provided for supervisory purposes
Group supervision – all pillars applicable to solo entities and groups		

* Source: PriceWaterhouseCoopers. (2007, p. 5)

As we can see from the graph above, the Solvency II regime has a three-pillar structure. Each of the pillars contains specific provisions that together form a coherent framework of prudential regulation.

Pillar I contains financial requirements and different measurement methods related to the valuation of assets, liabilities, and capital in order to guarantee the insurer's solvency. The pillar proscribes two different capital requirements, each with different purposes and calculation methods:

(1) The Solvency Capital Requirement (SRC), and

(2) The Minimum Capital Requirement (MRC). Let us explain them briefly.

The SRC reflects the level of capital that allows an undertaking to absorb higher losses that derive from the exposure to underwriting or other financial risks. The calculation of SRC is made either through a standard formula (the so called European Standard Formula[210]) or an internal model approved by the insurer's supervisor[211]. What is important to understand is that when an insurance undertaking falls below the SRC it has to restore its capital (″eligible own funds″) to the proscribed level in due time, through a concrete action plan approved by a supervisor (or to lower its risk profile). As for the MCR, this is the lowest capital amount permitted. If capital falls under the MCR level this triggers severe measures from supervisors (*e.g.* winding-up of companies, or transferring the portfolio to a well diversified third party)[212]. The level of MRC is still to be defined.

Pillar II focuses on the ″supervisory review process″ (SRP). Contrary to the quantitative requirements of Pillar I, this pillar comprises qualitative requirements. The scope of the SRP is to enable supervisors to identify which insurers are heading for difficulties. To this end, supervisors evaluate insurers' overall risk profile, ascertain if they hold adequate levels of capital, and whether their risk management and governance systems are adequate to the nature, size and complexity of their business. Thus, Pillar II promotes a more forward-looking approach. This means that solvency requirements will no longer be based solely on historical data, but they will require insurers to project future developments[213].

Pillar III provides greater transparency, information availability and better data comparability. Its rules envisage a new approach to public disclosure through better market discipline and an

[210] The European Standard Formula (ESF) is the new basic calculation method that insurers can use to determine their solvency capital requirement. The final calibration of the ESF will be included in an implementing measure that will contain the technical detail needed for insurers to run the formula in practice. Its calibration will follow after a careful analysis of the results of quantitative impact studies and after consultations with co-legislators and stakeholders.

[211] The SCR is based on a Value-at-Risk measure calibrated to a 99.5% confidence level over a 1-year time horizon. The SCR covers all risks that an insurer faces (*e.g.* insurance, market, credit and operational risk) and will take full account of any risk mitigation techniques applied by the insurer (*e.g.* reinsurance and securitization).

[212] Comite Européen des Assurances. (2007, February).

[213] A new development in this area is the introduction of the "Own Risk and Solvency Assessment" (ORSA). The scope of ORSA is to identify whether the risk profile of an undertaking deviates from the assumptions underlying the regulatory capital calculation. ORSA has a twofold nature:

(i) it is an internal assessment process within the undertaking and as such it's embedded in its strategic decisions;

(ii) it is also a supervisory tool for the competent authorities, which must be informed on its results.

It is envisaged that the ORSA, together with the SRP, will introduce a new discipline to the industry that will help in ensuring the stability and long-term sustainability of the European insurance industry.

open dialogue between European insurers. The new regime proposes a streamlined definition of disclosure requirements assessed differently for life assurance, non-life insurance and reinsurance undertakings. Each year insurers are required to make the reports on their solvency and financial positions (at both group and entity level) public. Exclusively, supervisors may allow undertakings to keep certain information confidential if it could provide undue advantages for competitors.

For the time being, many of the regime's elements are still being implemented at Member State level, thus an overall conclusion on the market impact of the Directive is still impossible. But it is possible to comment first on some of its legal implications and then on the economic aspects of Solvency II based on the Commission's fifth quantitative impact study[214]. We do this in the following paragraph.

As Solvency II wants to achieve a high degree of convergence it is not surprising that the regime relies on maximum harmonization although the Directive alone does not articulate the degree of harmonization to be achieved. By contrast, the Solvency I regime was based on minimum harmonization. However, the proposed use of regulations rather than directives (at the second level of the legislative process) indisputably testifies in favor of greater centralization at the EU level. This means that the EU, once again, recurs to the principle of maximum harmonization and the use of highly centralizing legal instruments in regulation. As for the economic implications of the implementation of the new prudential requirements, these are numerous. Let us note some of them:

(1) Solvency II and International Financial Reporting Standards (IFRS)[215] balance sheet are not fully aligned, meaning that there are items in Solvency II balance sheet (*e.g.* regulatory perspective) that are valued differently than under IFRS (*e.g.* accounting perspective). We expect that this will complicate reporting to a great extent. Possibly it will oppose one of the main ideas behind Solvency II, which is transparency of disclosures in financial reporting

(2) According to the Directive, the SCR and MCR are computed using different methodologies (very complex standard formula for SCR, factor-based formula for MCR). Consequently, some insurers that are solvent now, will probably get the result that their SCR

[214] The study is available at: http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm#march_2011

[215] International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Accounting Standards Board (IASB) that is becoming the global standard for the preparation of financial statements.

is higher than their available capital and than their MCR (which would be a reason for regulatory action under Solvency II) even though there is nothing inherently wrong with their way of doing business. Rather, this is a consequence of poor diversification and "side-effects" of the standard formula.

(3) Some parts of the standard formula are so complicated that the majority of insurance undertakings cannot compute them without simplifications. And even by using simplifications the amount of work is still huge. From an economic aspect, the Solvency II regime will likely benefit only large insurance undertakings, while the smaller ones will experience many difficulties in implementing it (they will lack the techniques, resources and skills). Their compliance costs will increase and as a result, smaller insurers will be put in an unfavorable competitive position.

(4) Some concepts are completely new: market valuation of goodwill (and related capital charge for intangible assets), valuation of management actions, valuation of future events that can be foreseen (renewals, future premiums from existing contracts, etc.), valuation of options and guarantees on life policies. As such they are extremely difficult to implement.

In conclusion, we agree that Solvency II will foster the consistency of prudential requirements of insurers in Europe. In addition, because the EU insurance sector is sizeable and because its linkages with the banking system are growing, Solvency II will have the potential to affect other parts of the financial system, beyond insurance. Naturally, one of the expected benefits of the Solvency II regime regards policyholders – they should be better protected under the new prudential rules. But, the new regime will harmonize national legislation by enforcing a more centralized approach to regulation (maximum harmonization, regulations, etc.). Throughout this dissertation we have argued that such manner of harmonization is likely to result in more uncertainties and difficulties in implementation than benefits. Moreover, we feel that the spread of detailed microprudential rules based on the "marked to market" valuation of risks and balance sheet items will only homogenize the behavior of insurers, undermining systemic resilience of this sector.

CHAPTER'S MAIN FINDINGS

In this chapter we have analyzed the European regulation of financial institutions. As financial institutions form a wide and heterogeneous category, we decided to concentrate on financial intermediaries in particular. Financial intermediaries transform financial assets (from the investor's aspect) acquired in the market, into a different type of asset (that constitutes a liability from the aspect of the financial institution). In addition, our analysis followed the categorization of financial institutions given by the European Central Bank; thus we examined the regulation of monetary financial institutions (MFIs) and other financial institutions (OFIs) and their subcategories, separately.

Different types of institutions require different types of regulation. Nevertheless, in this chapter we have determined that the main type of regulation imposed on European financial institutions is prudential, or microprudential to be precise. This means that regulation is concerned with the stability of individual entities (MFIs) and the protection of clients of the institutions (OFIs). But we believe that the main problem of EU prudential regulation is not the poor quality of microprudential rules but rather the deficit of any macroprudential perspective. A macroprudential perspective to regulation considers the systemic implications of the collective behavior of financial institutions. A critical feature of this approach is the heterogeneity of the financial system. The departing thought is that homogenous behavior undermines the resilience of the system. Invariably, financial institutions start off being heterogeneous but a number of factors – some regulatory, some not – drives them to homogeneity. In this regard systemic risk is endogenous and macroprudential regulation is about identifying those endogenous processes that turn heterogeneity into homogeneity and make the system fragile. In this chapter, we determined that this is exactly the case with EU prudential rules. Through maximum harmonization and centralization (*i.e.* the increasing amount of supranational regulation, often in the form of regulations – the most centralizing EU legal instrument) the EU wants to homogenize financial institutions (the types of assets they may invest into, the levels of capital reserves they must retain, etc.).

We began our analysis with banks, as the most significant representatives of the MFIs. Here, prudential regulation takes the form of capital adequacy requirements. Currently, capital requirements are set in the form of the newly proposed Basel III Capital Accord that, at the time of writing, is yet to be ″filtered down″ and transposed to EU legislation. This will require a revision of the 2006 Capital Requirements Directives (CRD). The reserves of capital proscribed under the CRD act as a buffer against unexpected future losses. But, many argued that the capital adequacy provisions mandated by the CRD were procyclical. This meant that they amplified the effects of economic cycles, making the system prone to instability. By contrast, regulations should be flexible enough to allow banks to hold less regulatory capital during economic downturns, but also to allow them to return almost automatically to proscribed levels of capital when "times are good". The answer lies in the so called "countercyclical buffers" which ensure that capital requirements take account of the macro-financial environment in which banks operate. These buffers will be activated when excessive credit growth is associated with an accumulation of system-wide risk. Its scope is to ensure the banking system has a buffer of capital to available to protect it against future potential losses. In this context, the European Commission has decided to revise the CRD ("CRD IV"). At the time of writing the Directive's revisions are still not adopted, thus it is difficult to foresee their market impact. But, we nevertheless criticize the EU approach to banking regulation – in favor of more centralization and departing from a microprudential perspective. But we wish to stress that we are not against microprudential regulation. We only argue that everything will stay the same if new capital requirements won't be met with better supervision. Regardless of a bank's capital adequacy level, supervisors should always keep in mind the amount and type of risk a bank is taking for profits.

In analyzing the category of OFIs we focused on units for collective investment in transferable securities (UCITS), the alternative investments industry (hedge funds and private equity) and insurance undertakings. Except in the case of alternative investment funds, the European regulatory approach in this area entails detailed (micro)prudential rules, mainly based on the maximum harmonization principle. The regulation of UCITS focuses primarily on investor protection and ″product regulation″ (meaning both on the cross-border marketing of the fund's units and on the type of assets UCITSs may invest into). Some of these instruments (money market instruments, financial derivatives, etc.) raised concerns. Namely, if UCITS are allowed to invest in such complex instruments are they still appropriate for retail investors? The new disclosure regime proposed by the UCITS IV Directive should alleviate such problems. Nevertheless, we feel that it is wrong to open such investment possibilities to retail investors. In fact, the retail investor we'll only perceive that with new investment possibilities, investment risks are better diversified. It is improbable that he/she will also know that at the same time new types of risks are associated with complex financial products.

As for hedge funds and private equity funds, we argue that to regulate such a heterogeneous group with stringent rules may be damaging, as funds will only flow offshore. For once, in this area, we concur with European policymakers. A common, EU legislation for hedge funds and private equity is more appropriate than a mix of national legislations and permissive self-regulations. But, our criticism goes to the fact that recent regulatory proposals (the Alternative

Investment Fund Managers Directive) does not restrict retail investors from investing in hedge funds (through UCITS' investments into derivatives based on hedge funds indices or in funds of hedge funds). This, in our opinion, is the main drawback of the Directive. Any future regulation of alternative investment funds should depart from this premise – that these are investments not suited for the retail investor.

With respect to insurance undertakings European regulators have chosen to implement traditional (micro)prudential requirements. Regulation in this area focuses on "solvency margins" (which are similar to capital adequacy requirements) stipulated under the Solvency II Directive. According to the Directive's provisions assets and liabilities of insurers will be valued as closely as possible to their true economic value ("marked to market"). But it is precisely on such provisions that we base our conclusion that the EU still doesn't understand the relevance of a macroprudential perspective. Regulators must be careful about the application of microprudential rules that respond to market measures of value and risk, as they typically result in homogenous behavior. And with homogenous behavior comes systemic fragility. But we agree that Solvency II will foster the consistency of prudential requirements for insurers. Moreover, the regime is expected to benefit policyholders – they should be better protected under the new prudential rules. But, Solvency II once again harmonizes national legislations through centralization (maximum harmonization, regulations as implementing instruments, etc.).

An overall conclusion in this chapter would state that irrespective of the de Larosière Report (discussed in the 2 chapter) and of recently introduced regulation, the EU is still making mistakes. The way to reduce systemic risk and to build a macroprudential perspective is to encourage heterogeneity in the behavior of institutions. Unintentionally, much of the European (micro)prudential regulation does the opposite. No reasonable amount of capital can remedy a system that inadvertently leads all financial institutions to act in the same way and to be exposed to the same types of risks. And EU regulation of banks, UCITS and insurance undertakings (we purposely exclude alternative investments) stipulates this. In addition, too much attention is put solely on capital requirements, while the issue of liquidity is being completely overlooked.

So what can regulators do? Maybe in creating regulation they should depart from the EU's political motto – "united in diversity", meaning that they should rely less on maximum harmonization and allow heterogeneity in certain aspects. Put differently, the EU should follow maximum harmonization only with respect of key prudential requirements (*e.g.* levels of capital adequacy, solvency margins). In the case of EU regulation of financial institutions, less ambitious regulation would be better.

5. FINANCIAL MARKETS

In this chapter we analyze the regulation of financial markets in the EU. To be more precise, we analyze how the EU tried to shape the economic system of its Member States through regulation during the last two decades, making them more market oriented. In this context, our analysis concentrates exclusively on capital markets (or securities markets to be precise). We leave aside other components of the financial market, such as derivatives markets, money markets and currency markets.

We are interested to determine why Europe adopted the stance that market based economies would better serve the economic needs of Member States. And also, was the EU's intention to create a single financial market through intensive legislation in the first place? Did the EU succeed in making law the "market creator"? To put it in another way, was regulation decisive for market development? Our intention is to explore how the current (post-crisis) situation differs from these perceptions. In the financial markets, regulation is subject to new influences that stem from the new institutional structure (see chapter 2 and the discussion regarding the De Larosière Report). Thus, we wish to ascertain if financial market regulation is also subject to greater centralization (or "more Europe").

The chapter begins with the analysis of financial integration in Europe and its impact on the development of national financial markets in section 5.1. In section 5.2. we explore the historical evolution of the current financial market regulation and its actualities. We discuss the defining features of the post-crisis regulatory reform in this area. Section 5.3. examines the Markets in Financial Instruments Directive (MiFID). In this section we give a brief historical background to the origins of MiFID and of how MiFID became part of EU law. Then we divide the analysis of MiFID into several subsections: subsection 5.3.1. analyzes the key principles and provisions of the Directive concentrating on its regulatory value; subsection 5.3.2. analyzes the impact of the Directive on the so called "market trading venues"; and subsection 5.3.3. gives an overview and critical outlook to the implementation process at Member State level.

5.1. Towards market based economies in the EU

In this section we analyze the impact of European financial integration on Member States' economies. We will discuss the gradual increase in market based financing opportunities and the development of securities markets. Special consideration will be given to a long-standing policy debate: is a market based financial system more adequate than a bank based one to sustain the benefits of financial integration and promote long-run economic growth in Europe? This discussion will set the stage for the analysis of another significant issue: that of "*law as market-creator*". That is, whether EU regulation was decisive in the development of a single financial market (which will be discussed in section 5.2.).

During the last two decades European policymakers favored market based economies (in which funding of non-financial enterprises is done *via* capital markets) as a desirable economic model. Policymakers argued that, market based economies, are associated with flexible financing and that they also benefit small and medium sized enterprises and not only the big ones. Such economies offer e various methods of financing via markets (one of them is, for instance, with the help of private equity funds). By contrast, bank based economies are typically associated with conservative lending, which can sometimes stifle economic growth and financial innovation. In addition, the reliance on bank lending in financing was seen as potentially destabilizing as bank defaults undermine financial stability and limit economic growth. In the years that preceded the last financial crisis more Member States were willing to transform their bank based financial systems to market based ones, in the belief that they will better suit their economic needs. This was in fact a EU-wide trend. European legislation supported this trend significantly. However, this "market commitment" was created on a paradox. The efforts made by Member States to create better market infrastructure was clearly welcomed. But regardless of the modernity of such infrastructure, the ultimate decision regarding "market exit" (that is to raise funding via the financial market) rests solely on the companies. If the companies think that direct funding would be costly in their case, they will simply dismiss such a possibility. And there is nothing EU politics or trends can do about it.

Currently Member States seem to be in a state of directional confusion. This is because the last crisis demonstrated that markets can be equally damaging to financial stability as bank based systems (or even more). The ″market transformation″ trend that we explained above has stopped, at least until the impact of the post-crisis regulatory reforms won't be asserted. Nevertheless, it is important to understand the evolution of European financial markets, and why have Member States adopted a common view that, somehow, market based economies are a better choice?

Before entering the merit of our analysis, we should first start with the definition of basic concepts, such as the one of "financial market". A market, in general, is an aggregate of supply and demand that brings together informed buyers and sellers and sets the single price for certain products or services[216]. Thus, a financial market allows financial assets to move between market participants, together with their associated risks and returns. Black's Law Dictionary offers an additional definition of financial markets, as markets where the exchange of capital and debt instruments is made. EU law doesn't provide a single definition of financial markets, irrespective of its central place in the majority of recent policy measures. European directives only define the term of *"regulated market"* (Directive 93/22/EEC) and further mention securities markets and exchanges (trading venues)[217].

Also, in order to understand the benefits and drawbacks of market based and bank based systems, it is necessary to understand their implications on economic growth. The debate regarding the benefits and/or drawbacks of bank based versus market based systems originates from studies which examine the differences between the UK financial systems (as a representative of market based system) on one hand, and the German financial system (as a representative of a traditional, bank based economy) on the other, through the differences in their organization and the resulting economic performances (Moloney, N., 2008, p. 56). Let us explain: the Anglo-Saxon economies are characterized by dispersed ownership and financing *via* capital markets, while the German economy (and other similar economies, such as the Japanese) are based on stringent shareholders' control and long-term financing via bank lending[218]. Nevertheless, there are authors that argue that the decision to pursue a bank based or market based systems does not affect economic growth significantly. These authors argue that the two systems are not mutually exclusive; in fact they have to "meet" at some point of a country's financial development. Building on this premise, Levine (1997) suggested a more

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[216] See Fitch, T. P. (1990).

[217] See Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, especially Art. 1(13) and Section B of the Annex to the Directive (OJ L 141); Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) (OJ L 96/16); as well as Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145).

[218] For a more thorough insight to this debate, see: Goergen, M. (2007); Black, B. S. (2001); Levine, R. (1997).

functional approach to the market based/bank based dichotomy. He argues that banks and financial markets perform different but complementary services that can positively affect economic growth only when they act in synergy. According to Levine, the type of economic (or financial) system is not important for economic growth; rather it is the overall development and availability of financial services that matters (Levine, R., 1997). In that context, either bank based or market based systems would be essential for explanation of the stages of economic development. In our opinion, a third approach to this discussion, which continues on this trail of thought, may be interesting from the perspective of the EU. The approach has first been developed by La Porta *et al*. (1998) and named as the "legal based" approach. It departs from the premise that finances are nothing more but a set of agreements, the efficiency of which depends on the efficiency of the overall legal system. In fact, it is the legal system that guarantees their enforcement. Consequently, it is the "legal origin" of a country (whether it is a common law or civil law country) that greatly affects and actually determines the type of economic system in practice. And consequently, whether a country will be characterized as a bank based or market based economy. In this sense, we find common law countries to be better suited for market based economic systems. This is because these systems are less rigid and rely less on substantive law (more on principles) and as such can adapt to market changes faster.

Turning the above discussion to the EU, we can broadly say that the EU financial system is bank based. This stems from the fact that in the majority of EU Member States financial markets are less important then other sectors of the system (the underdevelopment of financial markets is even more evident if we compare it with the United States of America) [219]. At the same time credit institutions have developed effective bank-driven substitutes of financing and thus, taken a leading role in the economy (Rajan, R., Zingales, L., 2001). Irrespective of this fact, in the period preceding the last financial crisis the EU strived to make European financial markets more developed and integrated. This orientation towards market based financing was primarily supported by regulation whose primary objective was to build adequate market infrastructure. In addition, certain authors indicate that during the last decades of the 20th century there were two "market forces" that supported the trend:

(1) The process of integration and monetary union, and

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[219] In reality this distinction is not as clear-cut as it is usually presented. For more on this discussion see Fonteyne, W., Decressin, J., Faruqee, H. (Eds.) (2007).

(2) Financial innovation (Moloney, N., 2008, p. 62)[220].

The increase in market activities has been particularly pronounced in the continental Member States. In many of these countries the number of listed companies has grown exponentially; many have introduced new equity markets that meant a change in their economies. Gradually, markets replaced banks in many of their traditional roles. An excellent example of this was securitization (that we have discussed in the 3 chapter). Through securitization bank loans and mortgages were transformed and sold as securities on the financial market. Moreover, there were many qualitative signs of change towards greater reliance on financial markets, such as the adoption of new securities regulation (that was more oriented toward retail investors) and the revision of existing national company laws (that better protected minority shareholders). All of this aimed to make the EU more market oriented.

Where was the beginning of this trend? At the outset of the harmonization program in 1979 bank financing prevailed in the European Community. By early 1980s the financial systems of continental European countries were still largely bank based while other countries in the world, such as the United States of America for instance, exhibited remarkable results of economic growth thanks to capital market development[221]. In bank based systems capital circulated within a set of related companies and institutions, while in market based economies companies often raised money from (or returned it to) the financial market[222]. For instance, in the mid 1990s only a small percentage of borrowing by companies in the US was from banks, while the most part was through the issue of securities. By contrast, most of the companies in continental Europe borrowed from banks, with only a small percentage relying on direct financing.

The promotion of market based financing and capital market development became central to the EU somewhere in the late 90s. From that time, European public policies[223] started to focus on securities markets. During this period, the importance of bank financing decreased due to a

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[220] See also Rajan, R., Zingales, L. (2003).

[221] At that time in Europe, the United Kingdom was the only example of a market based economy.

[222] Hence, bank deposits were more important in continental Europe than in overseas economies. Rajan and Zingales (2003, p. 6) point out that bank deposits relative to GDP were 60% larger in continental Europe than in the US or in the United Kingdom. The reverse was true for the importance of equity markets in these countries.

[223] As we introduce the term "European public policy", or "EU policy", for the first time here we should clarify it. The term refers to the proclaimed principles and objectives that the EU pursues in its activities in the interest of all Member States. The EU is active in a wide range of policy areas: agriculture, budget, economic and monetary affairs, external relations, and so on.

stronger use of market based instruments. But European credit institutions were strongly encouraging this trend as well. In fact, in that period European banks were more than willing to promote and lead securities issues, as favorable market conditions at the turn of the millennium made this activity lucrative. In the late 2000, the European Commission reported that market based financing was overturning the predominance of bank lending in most EU countries[224]. In parallel with this, the integration of capital markets (increased pan-European capital raising by issuers, stronger portfolio diversification and cross-border trading on the demand side) started to develop.

But was this "market" orientation really appropriate for all EU countries? We must have in mind that neither bank based nor market based systems are outcomes of deliberate economic policy choices. Rather, they result from a country's legal environment, market tradition and economic policy. Last but not least, the decision of an individual company on the manner of funding is decisive. What is more important, neither one of these systems represents a better policy choice. A market based economy needs a sound legal, regulatory and monitoring infrastructure to work efficiently. This infrastructure differs greatly within the EU. The newer Member States and acceding countries lag behind (this is true even for Croatia as we will argue in the 6th chapter). At the same time, the potential to take full advantage of a market based system depends upon the economy's industrial structure as well.

For instance new Member States and EU acceding countries are small, and do not have a lot of big businesses (enterprises, companies) that could reap the benefits of a market based system.

By contrast, countries with many large, formally organized companies will have the means to benefit from the economies of scale present in market based economies. So smaller businesses are likely to be worse off. Since companies tend to be smaller and inappropriately organized in the South-Eastern European countries this part of the EU will not feel the benefits of a market based system, unless it undertakes substantive and costly structural reforms. And even then, the sheer size of their economies would still be too small to justify "market orientation". It is not a surprise then that in the aftermath of a crisis, such grand reforms are not on the policy agenda of these EU countries.

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[224] See Communication from the Commission to the European Parliament and of the Council, COM(2000)729.

5.2. Development of financial market regulation

In this section we analyze how EU regulation of financial markets (securities markets in particular) has moved from a basic framework with limited integration success, to a more extensive and detailed regime whose main scope is to complete the ″single market project″. We will discuss the role of law in integrating financial market in Europe. It is important to note that we discuss the regulation of a specific market segment – that is of securities markets. So throughout this section we will use the terms of "financial market regulation" and "securities market regulation" interchangeably.

We argue that regulation, in its narrow "rule-making" sense, was a favored EU policy measure in achieving this goal. In fact, the EU favored the stance of "law as market creator" meaning that through legislation the EU wanted to develop financial markets and achieve their integration. In our opinion this is wrong. Regulations cannot determine market activity and development. They are rather a result of endogenous factors (activities of market participants, market conditions, etc.). Regulation can only create a favorable environment that supports market integration and development.

However, the focus of European policies on the integration of financial markets is understandable. In fact, before its active intervention (through regulation) markets were fragmented alongside national borders, which probably diminished EU's chances for increased economic growth. In this context, European regulation strived to ensure that markets are efficient in allocating capital to where it is most needed. An additional regulatory concern is visible from the EU regulation of financial markets. This is the need for greater investor protection. This is not surprising, since the majority of legislations in this area are designed to promote retail investments in securities markets. Investor protection in securities markets is an important issue; as we have argued in chapter 3, securities are intangible financial assets whose value is contingent on the future performance of the issuer. Therefore investors require fair and relevant financial information concerning the issuer and the security when making their investment decisions. Accordingly, regulation promotes investor confidence by ensuring that they can make well-informed investment decisions in the market.

Let us now turn to the purpose of our discussion – the development of EU financial market regulation. First of all we should explain what we mean under this term. The term ″EU financial market law″ or "securities market law" actually refers to those EU regulations, which address the participants of financial (securities) markets (such as issuers of securities, market intermediaries and investors) as well as the operation of the markets themselves. The idea of a harmonized securities market regulation has been a European imperative since the 1970s. Nevertheless, it took almost twenty years to create a comprehensive regulatory approach adequate to the economic, legal and political context of European financial markets. The attempts made during this period have varied in focus, intensity and the instruments used. Namely, these instruments have changed as securities markets have developed. In the remainder of this section, we wish to give a historical description of these developments. We wish to explain how EU regulation has gradually evolved from "minimum harmonization" towards "maximum harmonization". We wish to demonstrate how market developments have pushed European policymakers not only to integrate national financial markets through regulation, but also to make them more similar (with respect to the infrastructure and instruments traded). In other words, we explain how the EU has decided to recur to greater centralization, not only harmonization, in the area financial markets.

To make our description understandable, we will divide it into four major stages. With every stage the degree of market integration increases, while regulation becomes more centralizing. Our arguments are not entirely deliberate; in fact we base our description on the arguments given by Moloney (2008, p. 11)[225].

First stage – construction of a single securities market

The earliest harmonization of securities market regulation in the EU focused on the admission to official listings and on disclosure requirements in public offerings. In 1966 the Segré Report[226] marked the first significant EU step in securities regulation. The Report pointed to the poor condition of European securities markets and to the benefits that would result from integration. Its success was twofold: it fostered liberalization of capital and gave a new incentive to the harmonization of national securities regulation (Moloney, N., 2008, p. 13). In 1977 the first tentative steps in harmonization were taken through the Commission's Recommendation for a European Code of Conduct Relating to Transactions in Transferable

[225] From the aspect of the evolution of the degree of legislative intervention in the market, we should note that the first two stages used directives as primary regulatory instruments. Consequently, the stages were founded on minimum harmonization. Mutual recognition and home country control were elements added to the second stage (Moloney, N., 2008, p. 11).

[226] Report by a Group of Experts Appointed by the EEC Commission. (1966, November).

Securities[227]. This Recommendation was followed by the first generation of directives in the securities markets. The directives were founded on principles of minimum harmonization and mutual recognition.

Second stage – a single market for investment funds

The second stage begins in 1985 with the Commission's White Paper on the Internal Market[228]. This consultative document determined the measures that would deliver the single market by 1992. The 1985 White Paper was based on the following principles: mutual recognition, minimum harmonization and home-country control. In this stage the scope of EU securities market regulation was broadened – for the first time collective investment schemes were introduced for instance (UCITS). By the end of 1997, it was possible to identify the "core elements" of EU securities market regulation. Nevertheless, large areas of financial market regulation remained unharmonized (*e.g.* control of market manipulation, conduct of business rules, etc.). What was even more preoccupying the implementation of regulation in Member States was uncoordinated and time consuming.

If we were to summarize the regulatory regime created during the first two stages we would conclude that it was inadequate to the demands of increasing integration, the arriving monetary union, and the eventual EU enlargement. The regime had major theoretical shortcomings as well. The main shortcoming was that there was no agreement on which of the two regulatory objectives should be pursued. Namely, it wasn't clear whether regulation should focus primarily on disclosure requirements as means of investor protection, or whether regulation should adopt a proactive role and thus actively correct market failures.

Third stage – the FSAP and the Lamfalussy Report

At this stage EU policymakers wanted to respond to a growing unease among market participants who were not satisfied with the pace of development of the European financial markets. In addition, everyone criticized the limited success of the regulation set up in the first two stages. In fact, the legislation established in these stages was unable to timely adapt

[227] Commission Recommendation 77/534/EEC of 25 July 1977 concerning a European code of conduct relating to transactions in transferable securities, OJ L 212/37.

[228] European Commission, COM(85) 310.

to market movements (meaning that the market moved faster than regulation, making regulation often obsolete). Supervisory cooperation was inadequate and fostered divergent practices, and the introduction of the single currency only emphasized the urgency of new regulatory changes. All these factors placed securities regulation on a higher ladder of the EU agenda of priorities and actually marked a turning point in the EU regulation of finance (Moloney, N., 2004). In this stage the Financial Services Action Plan (FSAP) was adopted. Even more importantly, it is when substantive changes to EU securities regulation occurred. From a regime based on minimum harmonization, it evolved in a far-reaching regulatory regime typically based on maximum harmonization.

Let us first discuss the FSAP. The FSAP prioritized the revision of securities markets regulation in Europe through a comprehensive reform. Generally, the aim was to establish a comprehensive prudential framework for securities in the EU. It comprised 42 measures designed with the intent to change the European securities regulation radically (and to update financial regulation in the EU in general)[229]. The FSAP's measures were implemented through directives, ranging from those that set out the fundamentals of the European securities regulation, to the ones that provided the broader conditions for the functioning of the securities market (Avgouleas, E., 2007, p. 2).

The FSAP had targeted integration aims at first, but it ultimately evolved in an extensive regulatory regime. Moloney (2004, p. 1) argues that the regime gradually changed from its first intentions. In one of her writings she states: *"(FSAP) ... has changed from a skeletal, Member-State driven regime into a detailed, harmonized EU structure which now determines national law."* The rationale of the FSAP seems to be somewhat dualistic – it shifts between integration and protection of the financial market. This dual function meant that the success of the action plan was vulnerable to dual risks: one of excessive intervention which might lead to the inhibition of business activity, and the other of underachievement in its scope of integrating regulatory systems, supervisory standards and legal rules (Ferran, E., 2004, p. 1). From a regulatory aspect this dichotomy deserves careful consideration. As we have argued in chapter 2, the rationale of regulatory intervention determines the functions of regulation in the market, its focus, and ultimately, its efficiency in obtaining objectives of regulation. In the

[229] Communication of the Commission, COM(1999)232. The value of the Commission's Communications is noteworthy. Non-enforceable and thus with minimal legal worth, in the area of financial services regulation it was the Communications that made the most significant impact and even led to regulatory overhauls, *e.g.* the 1985 White Paper, the FSAP, the Lamfalussy model, the 2001 Green Paper on upgrading the ISD, etc.

context of FSAP the resulting regulation for financial markets in the EU evidenced a radical change in the regulatory rationale. This was the decisive shift from a "minimum harmonization", "market-construction" regime to an "interventionist and complex market regulation system".

One of the FSAP's most valuable outcomes was the adoption of the Lamfalussy legislative model of legislation (or the so called ″Lamfalussy approach″ to legislation) based on the Lamfalussy Report of February 2001[230]. The Report followed a simple premise – it separated "principle" from "detailed" provisions in the legislative process. In this way it minimized the room for ambiguity in primary legislation and allowed technical rules to derive from the underlying principles (Aubry, N., McKee, M., 2007, p. 4). In the following paragraph we describe the four-levels of the Lamfalussy legislative approach[231].

Level 1 of the Lamfalussy framework refers to the adoption of directives and regulations, through the ″co-decision procedure″[232]. This way the framework principles are set in a given area of securities law. These principles reflect the "*core political principles*" and political choices made by the Council of Ministers, the European Commission, and the European Parliament; they are specific to each directive or regulation. The Level 1 directive should also describe the "*nature and extent of the technical implementing measures*" that should be taken at Level 2 and the substantive content of the delegation to Level 2, as well as the limits of that delegation (the Lamfalussy Report, 2001, pp. 22, 23). Hence, the drafters of Level 1 legislation should focus on the essential issues to be decided and leave the technical implementing details to Level 2[233].

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[230] The Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (2001, February), hereinafter referred to as the Lamfalussy Report.

[231] We will use the Lamfalussy legislative model once again in section 5.3.on the example of the MiFID, in order to trace its historical background.

[232] Decision-making at European Union level involves various European institutions, in particular: the European Commission, the European Parliament, and the Council of the European Union. The co-decision procedure is the procedure now used for most EU legislation. In this procedure, the Parliament does not merely give its opinion; it shares legislative power equally with the Council.

[233] To draft the technical implementing details set forth broadly in the Level 1 legislation, the Lamfalussy Report recommended the creation of two committees:

(i) the European Securities Committee ("ESC") with a primarily regulatory function, and

(ii) the European Securities and Markets Authority (prior to the De Larosière Report known as the Committee of European Securities Regulators) with an advisory function at Level 2.

In addition to its operation at Level 2 as an advisory committee, the CESR also operates at Level 3 to co-ordinate implementation of EU securities regulation. Members of the CESR are the heads of securities regulators of the Member States.

Level 3 is intended to "*greatly improve the consistency of day to day transposition and implementation of Levels 1 and 2 legislation*" (the Lamfalussy Report, 2001, p. 37). In order to obtain their objectives national supervisors of each Member State participate in the activities of the European Securities and Markets Authority (ESMA).

Finally, Level 4 focuses on the enforcement of EU securities regulation. The major responsibility of enforcement falls on the European Commission as part of her role as ″the guardian of the treaties″.

Fourth stage – post-FSAP

Marked by the Commission's 2005 White Paper[234], in this stage European securities regulation has moved beyond the functional objectives that characterized securities regulation in previous stages (*i.e.* its main focus was to remove obstacles to harmonization). During the FSAP period already the sophistication of legislation has greatly increased. Moloney (2008) for instance argues that during the FSAP period *harmonization* has in fact become *transformative regulation* (*i.e.* the transformation of Member States' economies into market based systems) (Moloney, N., 2008, p. 40). By contrast, the transformative effect of the post-FSAP stage is less pronounced; in this stage policymakers were more eager to promote ″good regulations″ that support market efficiency and stability as well as investor confidence, and to support financial integration.

We are interested in discussing another important regulatory concern that has emerged in the post-FSAP period; and that is the relationship between law in general and the development of financial markets. We ask: is there some causality between the two? Will laws (or regulations in general) deliver significant market change in Europe? The relationship between law and financial markets is heavily contested. The role of law as a ″catalyst″ in financial markets is still empirically unconfirmed, irrespective of the arguments developed around the subject in the last decades[235]. As argued by Ferran (2004, p. 26) the role of law and regulations is secondary – it follows down the path already established by market participants. It would be remarkable for legislative reform to be the key to the development of financial markets,

[234] European Commission, COM(2005)629 final.

[235] Studies of the impact of law on the markets have a long lineage and are numerous. See for example: Stigler, G. (1964); La Porta, R., Lopez de Silanes, F., Shleifer, A., Vishny, R. (1998) . For literature review see Choi, S. J. (2008); Coffee, J. C. (2007).

simply by creating rules and the mechanism of their enforcement. There is no arguing the fact that appropriate legislation can reinforce the development of a market; but this is not an example of law acting as a "creative force". In this context, another relevant study is that of La Porta *et al.*[236] who empirically examine the connections between investor protection laws and strong securities markets.

But what lessons can we draw from this discussion in the EU context? Ferran (2004) argues that the history of securities legislation will not offer an answer to the causality and linkages between the adoption of new securities laws and the development of securities markets (Ferran, E., 2004, pp. 29-41). This means that the uncertainty as to what extent has EU regulation supported securities market development should actually stop the EU in its attempts for further regulatory intervention. As pointed out by Ferran (2004) choices on regulatory reform, particularly when made with uncertainty about how laws can help markets to grow, could have a negative impact rather than a positive one, even in the context of a "regulatory craze" in the aftermath of a crisis (Ferran, E., 2004, p. 43). We support this argument. There is no dispute that EU financial markets need coherent regulation that would support full integration. But this policy goal ultimately depends on market developments rather than on legislative intervention. In the aftermath of the last financial crisis it is not certain which refinements of the existing laws will work best. Perhaps a policy shift may be in order? For instance one that would be built on a simple premise – that substantive rules matter, but that their long-term success (or failure) depends less on the refinement of rules than on how these rules are applied in practice. It is our opinion that a readjustment of the so called "regulatory balance" is in order. This means that more attention should be put on enforcement of rules and supervision and less on regulation, especially if we take in consideration the already extensive body of law that governs financial markets nowadays.

5.3. The Markets in Financial Instruments Directive

In this section we discuss the historical background of the Markets in Financial Instruments Directive (MiFID) [237] and how it became part of EU law. As such, this section works as an

[236] But even their findings do not resolve the issue of causation: whether good investor protection laws produce strong securities markets, or did strong securities markets give incentive for the enactment of better regulation? See La Porta, R., Lopez de Silanes, F., Shleifer, A., Vishny, R (1998).

[237] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L145.

introduction to the analysis of MiFID as a legislative text. We focus on the Directive's principles and key provisions (subsection 5.3.1.) and its impact on trading venues (exchanges) in Europe (subsection 5.3.2.). In addition we discuss its implementation process (subsection 5.3.3.). As we have argued in the previous section, the integration of financial markets or securities markets more precisely was a European priority since the 1960s. However, legislative activity that supported this objective only really progressed in the late 1980s and early 1990s. From that time, regulation in this area ensures that financial intermediaries active in the securities markets perform their role without endangering financial stability or investor confidence. The first European directive that covered the provision of investment services and that was fully aligned with this objective was the 1993 Investment Services Directive. Thus, the analysis of MiFID's background has to begin with an overview of the core objectives of its predecessor, the 1993 Investment Services Directive (ISD)[238].

The Investment Services Directive as MiFID's predecessor

The ISD represents EU's first attempt to harmonize regulation with respect to investment firms and securities market[239]. The negotiation, adoption and implementation of the ISD were politically controversial, because at that time national securities markets were very different and consequently the Directive's objectives were met with skepticism. In our opinion the most significant difference was represented by the fact that some Member States concentrated securities trading on a single venue (*i.e.* the national stock exchange or bourse) by imposing the so called "concentration rule". Other Member States permitted a degree of competition between trading venues.

The ISD left Member States the option of using different trading models: concentration or competition. The abrogation of the "concentration rule" was not one of the Directive's objectives. Rather the ISD key intention was to provide a "European passport" for investment firms that would allow firms authorized by a competent authority in one Member State, to operate freely in other Member States without the need for further, local regulatory

[238] Directive 93/22/EEC of 10.05.1993.

[239] In analyzing investment services regulation we have to keep in mind a general dictum: the provision of services by investment firms must be subject to prudential, contractual and conduct of business rules. Prudential rules regard the minimum authorization and capital requirements; contractual rules apply to the conclusion of agreements between investment firms and their clients; and conduct of business rules relate to the norms of behavior firms have to respect. Tison, M. (2002).

approvals[240]. Thanks to the "passporting regime" investment firms could also provide additional services, known as “non-core” activities, if they were mentioned specifically in the authorization[241].

The ISD’s second objective was to promote cross-border electronic trading. In order to do that the Directive’s provisions permitted the creation of regulated markets which operate without a physical floor and which allow to investment firms and banks situated in other Member States (than the *situs* of the electronic trading venue) to trade on a remote electronic basis.

The third objective of the ISD was comprised in its Art.11. The Article set out common "conduct of business rules" for firms doing cross-border business[242]. The provision of the Article was written in a more abstract manner, in order to allow Member States to supplement it with additional requirements. In this sense, Article 11(2) of the ISD allowed national authorities to apply their own conduct of business rules if they considered it necessary to protect the public interest ("general good").

Naturally, during the years a number of important market developments had taken place, and consequently the ISD regime was ready for an update. In addition, the revision of the ISD was one of the strategic objectives of the Financial Services Action Plan, as European policymakers wanted to establish a coherent prudential regulation for trading in securities. The ISD exhibited significant shortcomings (such as: poor financial literacy of clients, elusive conduct of business rules and poor quality of secondary market regulation) because of which it was inappropriate for a changing and integrating market. With the revision of the ISD the EU wanted to resolve such inefficiencies (*e.g.* the articles of the ISD were outdated, the "concentration rule" was an obstacle to competition, new trading venues emerged besides traditional stock exchanges, etc.).

Although the scope of the revision was clear, the manner in which the revision would be made was more difficult to ascertain. At first, the European Commission hesitated between a radical "regulatory overhaul" and only a systematic review of the regime. In the end it opted for the latter solution. Following this decision, in November 2000, the Commission launched

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[240] A similar passport had previously been given to banks through the Second Banking Directive of 1989, which in addition to liberalizing core banking activities allows banks to provide services related to securities throughout the EU.

[241] These services included: investment advice, advice on mergers and acquisitions, safekeeping and administration of securities, foreign exchange transactions, and other.

[242] See Communication from the Commission, COM(2000)provisional.

a consultation process regarding the ISD reform. In the explanatory memorandum of the consultation document, the Commission justifies the need by arguing that the ISD failed to establish such a regime within which competition and consolidation of trading venues would take place. In this context, the most controversial and debated aspect of reform was the removal of the "concentration rule" and the imposition of new transparency requirements. Many Member States felt that the two changes were interconnected; in their opinion concentration rules coupled with transparency requirements for national exchanges ensured transparency, and if the "concentration rule" would be removed, such transparency would be hindered[243].

The Markets in Financial Instruments Directive

In line with the Lamfalussy process, MiFID comprises two legislative levels and three legislative measures:

(1) The extensive 2004 MiFID Level 1 Directive;

(2) The 2006 MiFID Level 2 Directive which addresses organizational and operational conditions for investment firms; and

(3) The 2006 MiFID Level 2 Regulation covering pre- and post-trade transparency, record-keeping obligations, admission to trading and transaction reporting requirements[244].

The European Commission was determined to minimize the divergent implementation of the Directive at Member State level. Hence, implementing measures followed two years after the Directive's adoption. As the text of the Directive developed, an article was introduced into the implementing Directive (Art.4) whose strict wording was strongly inhibits Member States from "gold-plating" the conduct of business rules. This provision perhaps limits the flexibility of Member States excessively. But, this was the goal of the Commission. The Implementing Regulation was designed to have a strong harmonizing effect, particularly with respect to market transparency requirements and definitions of concepts.

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[243] The most consistent supporters of strong transparency rules were the French and the Italians, while the most consistent supporters of more diversity for market operations were the United Kingdom and the Scandinavian countries. See Aubry, N., McKee, M. (2007, p. 6).

[244] The Directive is to be implemented by Member States, while the Regulation is directly applicable. See: Commission Directive 2006/73/EC, OJ L241/26; Commission Regulation (EC) No 1287/2006, OJ L241/1.

Irrespective of its political aspect, the legislative process of MiFID's adoption went relatively well. Despite the size and complexity of the draft directive its adoption proceeded smoothly, and the text of the Directive was agreed upon in April 2004.

The Markets in Financial Instruments Directive is a far-reaching and ambitious legislation, which covers both investment services and financial markets in Europe. Its provisions change and improve the organization and functioning of investment firms, facilitate cross-border trading and encourage the integration of European financial markets.

There are three groups of market participants to which MiFID applies:

(1) *Liquidity pools* – regulated exchanges, multilateral trading facilities (MTFs) and systematic internalizers (SIs);

(2) *Intermediaries* – agency brokers, advisers, orders reception and transmission, that is firms which are not counterparties in their clients' transactions with liquidity pools;

(3) *Investment firms conducting transactions on behalf of clients as part of an asset management mandate, and market makers who operate on liquidity pools on behalf of clients or on own behalf*.

The Directive covers four main areas:

(1) Conduct of business requirements for investment firms – firms should divide their clients into different categories (*i.e.* "eligible counterparties", "professional" and "retail") and adapt their business conduct depending on the client's category (firms will have more obligations with respect to clients who are not so sophisticated).

(2) Organizational requirements for investment firms and financial markets – such as compliance, risk management, identification and management of conflict of interest, and other;

(3) Transaction reporting to relevant competent authorities of every transaction in all financial instruments;

(4) Transparency requirements in trading in order to ensure a level playing field between different types of trading venues (Casey, J-P., Lannoo, K., 2009, p. 34).

From all the facts mentioned above, it is clear that there are important differences between MiFID and its predecessor. First, the scope of financial instruments governed by the new Directive is broader. MiFID covers all financial instruments, with the exception of foreign exchange instruments and foreign exchange derivatives[245]. Second, MiFID distinguishes investment services and activities from ancillary services, a division that resembles the ″core – non-core division″ made in the ISD. Investment advice and operation of multilateral trading facilities (MTFs) become additional investment services under MiFID[246]. The ISD did not require national regulation of such alternative trading systems (*i.e.* MTFs and others). As a result, they operated under divergent regulatory regimes in practice. This in turn led to legal uncertainty. With the development of alternative trading systems, especially MTFs, it was only natural that their operation became a passportable activity under the MiFID regime[247]. Third, in terms of market participants, MiFID's provisions apply to investment firms and regulated markets. Thus, MiFID is far more detailed and onerous than its predecessor. But MiFID's wordiness is not one of the reasons why the Directive is burdensome - more detailed regulation doesn't necessarily coincide with lesser regulatory quality. Especially after the recent financial turmoil, market actors and potential investors perceive detailed regulation as more protective. At first glance, from the aspect of transition economies whose financial markets are still poorly developed (such as Croatia) detailed legislation is welcomed. In these countries the rights and obligations of market participants should be clearly defined. In this way investor confidence will increase, and with it market activities will intensify. But is this type of regulatory intervention really welcomed in transition economies? For now let us restrain from any conclusions in this respect and let us continue with our analysis of MiFID's fundamentals.

All things considered then, MiFID's intention is clearly to alter substantially the structure of European financial markets[248]. Casey and Lannoo (2009) for instance, consider MiFID to be

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[245] The definition of financial instruments is given by the section C in Annex I, and designated in Art. 4(17) of the Directive.

[246] *″'Investment advice' means the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments″*; *″'Multilateral Trading Facility (MTF)' means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance to non-discretionary rules – in a way that results in a contract in accordance with the provisions of Title II″*; see Art. 4(4), (15) of the Directive.

[247] Annex I, section A of the Directive comprises the following investment services and activities as well: (i) reception and transmission of orders in relation to one or more financial instruments; (ii) execution of orders on behalf of clients; (iii) dealing on own account; (iv) portfolio management; (v) underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis; (vi) placing of financial instruments without a firm commitment basis.

[248] For instance, Moloney (2006, p. 1) argues that the regulatory regime brought forward by MiFID is highly interventionist and that it inclines towards "sophisticated market regulation" rather than "minimum harmonization-based market construction".

groundbreaking from the competitive, economic and legislative point of view[249]. From the competitive aspect, the diversity in preparedness of Member States to implement the Directive will exacerbate existing differences between European financial centers. This means that those centers that are well organized and prepared for MiFID's implementation will remain in the lead. Ultimately, such situation will probably lead to a consolidation between the financial centers. From the legislative point of view MiFID is unique; it is the first EU Directive that makes ample use of secondary legislation. The Directive allows for implementing measures for a whole set of provisions, by which legislators can agree on swift adaptations to basic rules. In addition, MiFID introduces new legal concepts to EU law such as: ″best execution″, conflict of interest, and client suitability. It is likely that these concepts will not remain limited to the area of investment services, but will rather become standard principles.

5.3.1. Principles and key provisions of the MiFID

This subsection examines which are MiFID's basic principles and provisions that will exert a major impact. We first analyze MiFID as a legislative text and deal with its scope and coverage. Then, we analyze the Directive's provisions in line with the concept they support:

(1) Greater competition through market integration,

(2) More sophisticated investor protection, and

(3) Improved conduct of business rules together with the new concept of "best execution".

Naturally, we deal only with the minimal part of the MiFID. It is not our intention to study all of the seventy-three articles comprised in the Level 1 Directive; we cover only those provisions that impose the most significant changes in financial markets regulation.

As we have argued in the previous section, MiFID's provisions expanded the scope and coverage of regulation by including the entire securities trading cycle, and thus leaving minimal space for the possibility of legal uncertainties (Moloney, N., 2006). As every entity that is active within the securities markets is now included in the MiFID regime, the relations

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[249] From the competitive point of view, MiFID dramatically changes the conditions for operators in capital markets – it is noteworthy that it abolishes the monopoly of exchanges as the only trade execution venues. On the other hand, MiFID tightens conduct of business rules through ″best execution″, client suitability and appropriateness provisions, etc. This has profound implications for the structure of European capital markets, as well as for investment products and investors. Economically, MiFID repositions the financial services sector in EU countries. Ibidem.

between these entities had to be leveled out. This fact had to be reflected in their regulation. MiFID succeeded to achieve this through its articles, which regulate the following:

(i) Authorization process – a central element of the Directive is the vesting of the authorization process to the competent authority of each Member State[250]. Authorized investment firms enjoy a broadened passport, which means that they can provide services across the EU, with or without establishing a branch. Put simply, the authorization obtained in one Member State is applicable in other Member States without further requirements. To obtain the authorization firms have to comply with the initial and operating conditions (*i.e.* the prudential rules) laid down by their home country[251]. In this requirement, some authors (for instance Moloney, 2006) see the proof of a more sophisticated approach to regulation adopted under MiFID.

(ii) Regulatory passport – thanks to this provision, MiFID can be regarded as both a "market construction" and a regulatory measure. Measures that can be described as ″market construction″ are those that are necessary to achieve market integration. Similar to the ISD, MiFID's intention to construct an integrated market for investment services is based on the passport regime, but the new Directive enhances passporting[252] even more.

(iii) Home country control – when firms operate beyond national borders the allocation of rule-making, enforcement and supervision becomes critical if we want to ensure that misconducts are controlled (Casey, J-P., Lannoo, K., 2009, p. 179). Thus, a proper allocation of responsibilities and supervision are crucial for market efficiency. In this context we can make a general observation – MiFID regulates the supervision of investment firms more accurately than its predecessor. According to MiFID, all supervisory and enforcement powers (with respect to prudential rules, conduct of business rules and to companies providing cross-border services and branches operating in third countries) are granted to the competent authority in the home country. The host country authority supervises only the conduct of business rules that apply to branches, which provide services within its territory. It is clear

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[250] The authorization process for investment firms is laid down in Articles 5 to 12 of MiFID.

[251] These requirements resemble those first encountered in the ISD – they mainly concern initial capital requirements, organizational requirements, management and qualifying shareholders. Initial capital requirements do not introduce any significant novelties compared to the ISD, except that they provide that firms which perform solely investment advice services, will be subject to less stringent capital requirements, due to their lower risk profile.

[252] Passporting refers to the right of certain types of financial institutions licensed in one EU country (the so called home country) to provide services and open branches elsewhere in the EU without the obligation to comply with additional, local regulatory requirements.

then that this system implies a substantive degree of cooperation between supervisors. We find this interaction between the home and host supervisor to be interesting, so in the following paragraph we examine it more closely.

MiFID greatly expands the responsibility of the home country authority. After the completion of the authorization process, the home Member State remains the chief regulator for all pan-European activities of the firms it has authorized. Furthermore, the home country is responsible for the supervision of national firms operating abroad without establishing a branch. Clearly, the host state has lost many of its supervisory prerogatives that were granted under the ISD regime. Nevertheless, the host country is granted the so called ″precautionary measures″ according to Article 62. These measures apply to cases when the host country has ″clear and demonstrable″ grounds to believe that an authorized investment firm, or its branch, is in breach of any of MiFID's provision while operating in its territory. In such case the host country authority shall inform the home country authority of this misconduct. If the breaches continue nevertheless, the host country authority may use "*all the appropriate measures needed in order to protect investors and the proper functioning of the markets*". We think that the contents of this prerogative are not clear with respect to the severity of measures that apparently will have to be determined in practice.

Finally, as regards home country control, MiFID limits dual supervision to branches – their home country authority is responsible for the enforcement of prudential rules, while the host country authority is responsible for transactional matters. This is a significant step forward in comparison to the ISD regime, where firms operating abroad were subject to the supervision of both home and host States, regardless of whether they acted with or without the establishment of a branch.

As we have already noted, the aim of the Directive is to level out all parties that are involved in the trading of financial instruments on behalf of clients. MiFID applies fully to ″investment firms″ and ″regulated markets″[253]. However it does differentiate them in respect of their authorization regime[254].

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[253] The Directive is only partially applicable to credit institutions otherwise authorized to provide one or more investment services or activities.

[254] Article 4(1)(1) defines an investment firm as: "*any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis*"; Art. 4 (1)(14) defines a regulated market as: "*a multilateral trading system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with*

As we have already mentioned in the previous subsection, MiFID introduces a whole new set of obligations for its addressees. In the short term, the majority of these obligations will impact investment firms more than anyone else. Under MiFID, investment firms will need to distinguish between different categories of clients, and to graduate the severity of conduct of business rules accordingly. These categories are:

(1) *Eligible counterparties (ECP)* – MiFID distinguishes between: *per se* eligible counterparties designated in Article 24(2) of the Directive[255], and entities which may be opted up by the Member State (from the professional clients category) according to specific "opt up" criteria. Clients in this category are not subject to certain conduct of business provisions.

(2) *Professional clients* - Annex II to MiFID contains detailed guidance on how to classify a client as professional. In essence, MiFID's list of *per se* professional clients is a broadened list of eligible counterparties. Professional clients are deemed to have sufficient expertise and knowledge to make their own investment decisions. Consequently, the general conduct of business rules are applied to this category, but in a less stringent way. Authorized institutions such as investment firms, collective investment schemes, and credit institutions, and sophisticated investors such as governments and regional authorities, are classified as professional (although they may request non-professional status), while private actors may choose to be classified as professional on request.

(3) *Retail clients* – defined by Art. 4(12) of the Directive as a: "*client who is not a professional client*". Retail clients are offered the highest level of protection.

Investment firms have to assess the *suitability* and *appropriateness* of the product/service rendered for a specific client category. The suitability test applies to investment advisory services, while the appropriateness test applies to non-advised services[256]. These provisions and their interpretation are the most burdensome part of the MiFID regime. As they introduce new concepts in EU securities regulation, which are not clear, uncertainty has emerged in

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its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorized and functions regularly and in accordance with the provisions of Title III".

[255] These include: investment firms, credit institutions, UCITS and their management companies, insurance undertakings, pension funds and their management companies, and other European regulated entities, central banks and supranational organizations. They need to have their legal status as eligible counterparty explicitly authorized.

[256] The suitability test assesses whether the advice provided or the product bought is suitable to a client's expertise, risk profile and financial situation. The appropriateness test is applied when providing execution-only services and reception and transmission of orders. See Casey, J-P., Lannoo, K. (2009).

practice. For instance, an investment may be appropriate for a client, although it may be unsuitable. And this is where, in our opinion, MiFID's investment protection measures step forward. We discuss them in the following paragraph.

In our opinion, MiFID's investor protection regime is founded on two key elements:

(1) The new conduct of business regime established by Article 19 - this regime covers almost all aspects of the investor/investment firm relationship, from initial marketing and disclosure to clients, to suitability assessments.

(2) The "best execution" obligation introduced by Article 21 - such an obligation is introduced for the first time in European securities regulation and EU law in general. "Best execution" rules are designed to ensure that an investor's trade is executed on the most favorable terms for the investor. As investment firms often hold more information and of better quality than investors, but at the same time they also have conflicting interests with respect to clients, regulators created the concept of "best execution" in order to ensure investor protection[257]. This article requires investment firms to take all reasonable steps when executing orders in order to obtain the best possible result for their clients, taking into account price, costs, speed, likelihood of execution and settlement, and other relevant considerations of the transaction. To this end, investment firms shall establish and implement an order execution policy explaining how, for their client orders, they will obtain the best possible result (Casey, J-P., Lanno, K., 2009, p. 66).

In conjunction with the abolition of the "concentration rule", the concept of "best execution" improves competition among trading venues. This is all critical for investor protection in the EU, given that trading and order execution is increasingly segmented across a range of available trading venues (such as stock exchanges, alternative trading systems that we discuss in the following subsection, and other) (Moloney, N., 2006, p. 5). Hence, best execution serves a dual role in MiFID: it ensures that the outcomes of unavoidable fragmentation do not result with decreased transparency and liquidity of the markets, and it ensures the best

[257] The term "best execution" and its meaning are not completely unknown to EU law. In fact they derive from the concept of "fiduciary duty" known in common contract law – as the relationship between the investment firm and the investor is based on trust and responsibility, and in light of the impossibility to envision all potential situations arising from their relation and the difficulty in monitoring the agent's actions, fiduciary duty ensures that the firm will act in the investor's best interest. The US Securities and Exchange Commission first mentioned implicitly best execution in a litigation case against a broker in 1962, and has later enshrined this concept in 1971 in National Association of Securities Dealers Automated Quotations (NASDAQ). In Europe, the introduction in the London Stock Exchange in the 1986 of the Stock Exchange Automated Quotation System (SEAQ) coincided with the drafting of the first best execution rule in the UK.

possible results for the clients in a competitive environment. It should also be said that MiFID's definition of "best execution" is very flexible, as it allows investment firms to develop their own "best execution policies" in line with their business models. In this we actually find a "principles-based" approach to regulation in MiFID (which is otherwise rules-based and prescriptive) because MiFID establishes different definitions for best possible outcomes according to client categorization[258].

5.3.2. MiFID's regulation of trading venues

Before we discuss regulation of trading venues, we need to make an important observation. Namely, it is expected that at the beginning of MiFID's enforcement the changes introduced will have less impact on trading venues than on investment firms. Nevertheless, the traditional business of trading venues (exchanges) is going to be transformed as never before (Casey, J-P., Lannoo, K., 2009, p. 13). The MiFID regime will transform the relationship between regulation and financial markets. We can conclude this by taking into account the provisions regarding order execution, which impose radical and far-reaching reforms on trading markets. In addition, competition will increase due to the emergence of brokers and dealers that act as internalizers and MTFs. This way exchanges won't have the monopoly on order execution. As a result, trading venues will have to reposition themselves strategically in response to the new activities of investment firms and other market participants.

In this subsection we examine the impact that MiFID is going to have on trading venues. We discuss the abolition of the "concentration rule", its impact to competition and to market liquidity. Special consideration is given to the pre-trade transparency requirements on multilateral trading facilities (MTFs) and investment firms that deal for own account systematically, off-exchange (*i.e.* systematic internalizers or 'SIs'), and post-trade transparency requirements on MTFs and investment firms in respect of shares admitted to trading on a regulated market[259].

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[258] For instance, for retail clients the term "best possible" means the most favorable result in terms of price for instrument, net of the explicit costs associated with the execution. For professional clients, other factors – such as the speed of execution or market impact – may be more important than price. It is noteworthy that an investment firm does not need to provide best execution to eligible counterparties; however they can choose to opt in the best execution regime and to enjoy greater conduct of business protection. See Moloney, N. (2006, p.69).

[259] MiFID's transparency requirements do not apply to non-equity markets. However, Member States have the option to extent and adapt this transparency regime to financial instruments other than equities.

The three principal trading venues to which MiFID applies and among which the Directive wants to create a level-playing field, are:

(1) Systematic Internalizers (SIs) – trading venues alternative to traditional stock exchanges. These activities are reserved for investment firms, banks and market management companies. As a systematic internalizer they execute client orders against their own book (proprietary trading) or against orders of other clients, outside a regulated market or an MTF. This activity needs to be performed on an organized, frequent and systemic basis in order for an investment firm to be treated as a SI[260].

(2) Multilateral Trading Facilities (MTFs) - Article 4(6) defines a MTF as: "…*a multilateral trading system which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract*". MTFs are subject to stringent organizational and authorization requirements, pre- and post-trade transparency requirements and specialized trading requirements. Moreover, MTFs are subject to specialized compliance requirements, which oblige them to monitor and report on the compliance of their users, especially with respect to possible market abuses.

(3) Regulated venues – a regulated venue (market) is defined as: "…*a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying or selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorized and functions regularly*"[261]. As we can see the definition is similar to that of MTFs in its key points. Even transparency requirements for MTFs and regulated markets are dealt with in the same chapter of the Implementing Regulation that gives us the impression of their regulatory similarity. However, regulated markets are subject to additional requirements regarding the admission/removal of financial instruments to/from trading. Thus, let us discuss these additional requirements.

MiFID's regime for the admission of financial instruments to trading on regulated markets follows the stance of the European Commission, which says that the status of a trading venue

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[260] Art. 4(7); a SI can be any broker/dealer trading off their own account in such manner. The Implementing Regulation in Article 21 provides qualitative criteria for recognition of SIs.

[261] Art. 4(14)

should be linked to the quality of the securities admitted to trading. Admission requirements are basic conditions, which are applied to all trading segments and run by a market that applies for the status of a regulated market. Rules governing admission to trading must ensure that any financial instrument admitted to trading in a regulated market is capable of being traded in a fair, orderly and efficient manner and – in case of transferable securities - that it is freely negotiable[262]. The suspension (or removal) of a financial instrument from a regulated market is possible if the instrument doesn't comply with the rules of the regulated market, and only if this action wouldn't cause significant damage to investors' interests or to the orderly functioning of the market[263].

Alongside new trading venues, one of the most widely discussed changes introduced by MiFID regards the new order execution regime. MiFID's provisions make the MTFs, SIs and regulated venues compete for order execution and liquidity. In that regard, the Directive imposes far-reaching reforms on trading markets, order execution and the production and distribution of transparency and other trading data.

As mentioned, the Directive abolishes the "concentration rule" that allowed, across Europe, for securities trading to be concentrated on the main national stock exchanges. This enables greater competition between trading venues and lowers the cost of transacting financial instruments. Nevertheless, this segment of the MiFID regime was fiercely contested as to the merits of competition in order execution and the drawbacks linked to the possibility of "fragmentation". In practice, Member States were divided on the issue whether trading should be centralized or open to competition. In fact, securities' trading has traditionally been centralized on several leading stock exchanges in Europe but new competitive pressures exposed this monopolist position. The European Commission strongly supported a more competitive environment and such views have been implemented into the MiFID. However, the abolition of concentration rules gives rise to the above-mentioned "fragmentation effect". This means that the dissemination of information and order routing to multiple trading venues could result in lower market liquidity, increased volatility and impaired price discovery (Penn, B., 2007, pp. 2-3). But MiFID has predicted this possibility and adopted several tools that mitigate this effect. These are primarily the equal treatment of execution venues in terms of

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[262] The admissions regime has been broaden by the Level 2 Regulation in behalf of particular instruments, namely transferable securities, units in collective investment schemes and derivatives.

[263] Art. 41 of the Directive

transparency requirements and the best execution rules. In addition, MiFID imposes strict pre- and post-trade transparency requirements that also limit the possibility of fragmentation.

Pre- and post-transparency requirements govern the reporting of regulated markets, MTFs and investment firms[264]. While pre-trade transparency requirements are given specifically for different types of execution venues, post-trade transparency requirements are drawn in a similar manner for different venues. A lighter pre-trade transparency regime applies to systematic internalizers (Art. 27), while transparency requirements for MTFs and regulated markets are fully harmonized and more stringent.

To summarize, MiFID's market transparency requirements aim to guarantee that competition between trading venues does not result in fragmented market liquidity. Naturally, they promote investor protection as well. Pre-trade transparency requirements are particularly important for investors, so that they could gain a complete view of market conditions and access more liquid markets. Post-trade transparency obligations require prompt disclosure of information related to transactions conducted. We think that there will be amendments to the MiFID's transparency regime in practice. These will probably result either from additional regulation or from industry's self-regulation; both will have to carefully tailor their approach to transparency requirements in the aftermath of the crisis and back their suggestions on accurate market studies.

All the facts we have laid above lead us to conclude that trading in securities has become highly competitive in the EU as traditional exchanges, alternative trading venues, and investment firms all compete in the execution of client orders (Moloney, N., 2006). Traditional trading venues now have to compete fiercely with new players if they are to retain their clients, which should result with lower transaction prices. This obviously benefits investors. But the industry should experience some benefits as well. And these will probably originate from financial innovation and better service quality that should follow from these market changes.

5.3.3. MiFID's implementation and market impact

The Markets in Financial Instruments Directive is a complex piece of European legislation with far-reaching effects. This is why its implementation requires more coordinated efforts

[264] They apply only to transactions in shares.

from European public authorities but also from market participants. The challenge of MiFID's implementation did not end with its entry into force. This event only marked a new responsibility for national authorities that are now responsible to monitor whether the Directive is implemented in a coordinated manner across Member States (Haas, F., 2007, p. 15).

In this subsection we are interested in assessing whether MiFID is a centralizing measure, based on the principle of "maximum harmonization". We examine why its transposition has been problematic in some aspects. In our opinion the uniformity of national approaches in transposing and of implementing the MiFID may be more important than whether the Directive has been transposed in the time period set by the European Commission. In addition, we give some tentative predictions on MiFID's market impact in the context of the European post-crisis financial reform.

Let us reiterate once again that MiFID actually comprises three legislative measures:

(i) A Level 1 Directive – where Member States have retained a limited ability to adapt MiFID's provisions to their national legal systems,

(ii) A Level 2 Regulation (harmonized approach) and

(iii) A Level 2 Directive (more flexible approach).

We reiterate this, because we wish to suggest again that MiFID is a highly centralizing measure. European regulators opted for a regulation because it guarantees uniformity among EU financial markets. In fact, the provisions of the Regulation are directly applicable, which supports our argument. The Regulation covers those areas where the texts are sufficiently exhaustive to allow direct application at Member State level. Where this is not possible for technical or legal reasons, a ″principles-based , though tightly worded″[265] Directive is applied. So even if the basic analysis of MiFID's text wouldn't bring us to conclude that this is a ″maximum harmonization″ directive, the MiFID implementing directive can be qualified as a ″maximum harmonization″ measure in its aim[266].

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[265] European Commission (2006,February, p. 4);

Retrieved from: http://ec.europa.eu/internal_market/securities/isd/mifid2_en.htm See also Casey, J-P., Lannoo, K. (2006, May).

[266] A maximum harmonization directive is one in which certain articles are phrased so tightly that they allow no flexibility in practice, and where national legislators cannot adopt divergent approaches. In other words, it is similar to a regulation in its intent.

In 2008 evidence given by market participants signaled that MiFID and its implementing Directive have been well and consistently transposed by Member States[267]. Irrespective of these findings, it seems that Member States encountered more problems than market actors in its adoption. This diversity in Member State preparedness has important strategic implications for European financial centers and market participants; only those who are well prepared will benefit from a competitive advantage in the new "MiFID environment".

So what was the degree of Member State preparedness for MiFID's transposition, and more importantly, how has the Directive affect national regulation? This effect varies drastically across Member States. In fact the effect is substantially different depending on the economic system in place. For instance, in Member States with market based economies and substantial market activity, MiFID caused only ″cosmetic″ changes to regulation, meaning there was an adaptation of existing rules. On the other hand, in the countries with more protective market structures, and bank based financing, MiFID required a substantive overhaul of existing regulation.

Irrespective of the type of the country's economic system, the approach used to implement MiFID into national legislation seems to be almost uniform across Member States. The majority of countries has used the ″intelligent copy-out″ approach when transposing the Directive. Let us explain. Essentially, this method allows to regulators to follow the original wording of the Directive, with minimal or no addition of national rules and through interpretation that does not entail ″gold-plating″[268] or super equivalence.

So MiFID does lead to a higher degree of harmonization in the area of investment services and financial markets, as it imposes detailed rules and relies on "maximum harmonization". Its provisions address every segment of the financial market – equity, commodity, derivatives and bond trading. Nevertheless, it is still difficult to offer a consistent prediction of the Directive's impact on the market and the investment industry. This is primarily because the study of MiFID's market impact has been overshadowed by the experience of the last financial crisis. Key issues concerning MiFID's "market revolution" are still unanswerable (*e.g.* the evolution of market liquidity, the efficiency of price discovery mechanisms, the

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[267] See European Commission. (2008, November).

Retrieved from: http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

[268] The term refers to the implementation of EU law in a way that goes beyond the requirements of the original legislation.

effect of best execution and transparency requirements, etc.). It is clear that the Directive has a profound impact on the organization, operations and business strategies not only of investment firms, but also of exchanges and other financial markets intermediaries. Market design and functioning are strongly impacted, as MiFID requires firms to make constant readjustments in order to remain competitive. Nevertheless, in Europe only a few studies are devoted to the analysis of MiFID's strategic implications[269].

One of such studies is that made by Casey and Lannoo (2009). These authors make very informative observations regarding the fundamental changes ushered by MiFID. They concentrate these changes on four main segments:

(1) *Investment firms* – in the short-term they are more likely to feel the implications of MiFID the most, due to the new compliance costs related to the best execution, internalization and re-classification requirements. As a result of higher compliance costs and greater operational complexity, investment firms will be subject to increased consolidation pressures (although smaller firms will continue to operate within a niche and have their market share, because of their proximity to clients).

(2) *Exchanges and other trading venues* – traditional exchanges are still expected to remain the main source of liquidity and price formation. Nevertheless, they will be subject to fierce competition from investment firms and MTFs, in the activities of collecting market data and settlement of transactions. Moreover, the abolition of the monopoly of exchanges in order execution, means that greater competition will emerge between existing European financial centers.

(3) *Market transparency* – trading volumes should increase as a result of greater competition between execution venues and thus, positively impact market transparency. More transparency means more confidence in the quality of price formation, enhanced market efficiency and higher trading volumes.

(4) *National laws and regulation* – although MiFID is more detailed than its predecessor (the ISD) and the strict wording of the Implementing Directive clearly restricts gold-plating, it is possible that this phenomenon of super equivalent requirements will continue on a national level. This possibility is supported by the fact that consumer law and contract law – two areas of law that coincide with the scope and objective of MiFID – remain strictly national. It is

[269] See for example Clifford Chance. (2006, September); Financial Services Authority. (2006, July); JP Morgan (2006).

also possible that market participants will search for less stringent regimes at first. Also it is possible that the effects of MiFID's rules will spill over to sectors related to securities markets and investment services (*e.g.* asset management under the UCITS regime that was discussed in chapter 3).

Irrespective of the absence of relevant studies regarding its market impact so far, MiFID is perceived as a welcomed legislation. In our opinion, this is because MiFID is well adapted to the post-crisis regulatory environment emerging in the EU. In fact, the Directive's detailed regulation of new concepts (such as best execution) and more stringent provisions are optimal measures to convince investors that regulators are attuned to the latest market developments and that they won't allow the same market mistakes to happen again. Given MiFID's large possibilities for adaptation to future developments through secondary legislation, the Directive will probably sustain the pressure of the times. In the end, MiFID's effectiveness cannot be limited to its wording, it is the Directive's correct and strong enforcement that will bring back investor confidence. In this regard, national supervisors, especially their coordination and the convergence of their practice, have a crucial role.

CHAPTER'S MAIN FINDINGS

During the last two decades the EU adopted the premise that market based economies were better suited to fulfill the economic needs of its Member States. As a result, before the emergence of the last financial turmoil, more Member States were working to transform their economic systems, which were mainly bank oriented, to market based. Naturally, we agree that well-developed financial markets are significant for economic growth, since they are a complementary source of funding with banks. But it is our opinion that it would be wrong to imply that a market based economy is equally beneficial for all EU Member States. We argue that neither bank based nor market based systems are natural outcomes but rather they result from conscious economic policy choices and are dependent from a country's legal environment, market tradition and economic policy. Moreover, neither one of them represents a better policy choice in our opinion. On the contrary, only those Member States that have a well-developed industrial structure characterized by large companies have the means to benefit from the economies of scale characteristic for market based economies. Thus, the ultimate decision to raise financing through the financial market, is on the company. If it does not have any benefits from market financing, it will simply dismiss such a possibility. This is not to say that the efforts made by Member States to create better market conditions (infrastructure, institutions, etc.) weren't welcomed. But regardless of the modernity of such infrastructure, the ultimate decision regarding "market exit" (that is to raise funding via the financial market) rests solely on the company. And there is nothing EU politics or trends can do about it. Our argument is even clearer if we turn our focus to EU acceding countries and newer Member States. The Southeastern European countries (such as Croatia), whose companies tend to be inappropriately organized, only significant and costly structural reforms would allow them to reap the benefits of a market based system. It is not realistic to expect such reforms to happen in the aftermath of a crisis, and on the verge of EU accession of some of these countries.

But the promotion of this "market trend" was primarily fostered by EU legislation. For years European regulators adhered to the maxim of "*law as market-creator*", meaning that in their opinion, market development would come as sort of a by-product of the enactment of new legislation. In following this stance, EU financial market regulation has moved from a basic framework with limited integration success, to a more extensive and detailed regime designed to successfully complete the "single market project". In this chapter we have argued that not only has regulation in this area transited from "minimum harmonization" to "maximum harmonization", but also regulation started to show "transformative ambitions". This means that EU financial market regulation wished to shape the present and future of the markets. And the only way to succeed in doing this was to recur to "more Europe" or centralization. A remarkable example of such regulation is the Markets in Financial Instruments Directive (MiFID).

The MiFID is groundbreaking from a competitive, economic and legislative point of view. The Directive sets a comprehensive regulatory regime by covering investment services and financial markets in Europe, in unprecedented detail. But its prescriptiveness and detail shouldn't be seen as burdensome. In fact, stringent regulation of investment services and market activities may well be what investors need in order to get back their confidence in the market. This is especially important for new Member States and EU acceding countries, where financial markets are still underdeveloped, and market actors need strict rules in order to feel confident about their rights and obligations in the market. But, at the same time, we cannot help but think that there is a "catch" to MiFID's implementation in these countries. Admittedly, MiFID will boost investor confidence in these markets, but at the same time its prescriptiveness has the potential to stifle financial development. Let us explain why.

By implementing MiFID in the "old" Member States regulators will only determine the rights and obligations associated with financial instruments that already existed in the markets. The same is true for the markets themselves – it is for years that alternative trading venues have been developing in these countries. Thus, MiFID will only bring clarity and order in an existing economic environment. But in the case of new Member States and EU acceding countries, MiFID will regulate instruments that do not even exist in practice, or whose share in the market is minimal. Furthermore, it will artificially create new trading venues (that should compete with the traditional ones) while the traditional stock exchanges are still struggling for volumes in transactions and liquidity. Moreover, the entities that should take the role of these new venues do not have the needed degree of business tradition nor market expertise in order to be competitive in the EU.

So, by implementing MiFID the Southeastern European countries will actually put faith in the concept of "law as market creator". A concept we have already dismissed in our discussion. Law cannot kick start market development. The role of law in finance (similar to other areas of social life) is secondary – it regulates those relationships that already exist in practice. In this way, law and regulations bring certainty to such relationships. In the case of new EU Member States and acceding countries, such as Croatia, the implementation of MiFID will have the potential to stifle financial innovation and development.

Nevertheless, we are aware that it is too soon to be determined about such arguments. At the time of writing – MiFID's implementation and market impact are overshadowed by a general state of directional confusion as regards financial markets and their regulation. This is because the last crisis has showed that markets could be not equally damaging to financial stability as credit institutions, but even worse. The trend of ″market transformation″ has come to a halt, at least until the impact of the post-crisis regulatory reforms won't be assessed and a new direction in EU financial policy emerges.

6. FINANCE IN ITALY AND CROATIA – A COMPARATIVE OVERVIEW OF REGULATION AND SUPERVISION

In this chapter we give a comparative overview of finance in Italy and Croatia and of the development of financial regulation in these countries. An identical approach is used to assess both countries and in drawing conclusions. Our analysis begins with section 6.1. which gives an overview of the Italian financial system. Subsection 6.1.1. discusses the Italian experience in transposing and implementing EU financial regulation, whilst subsection 6.1.2. analyzes the current objectives pursued through Italian financial regulation and the efficiency of its supervision. In a similar manner, section 6.2. discusses the development of finance in Croatia. In addition, we analyze Croatia's experience in transposing EU financial regulation. Subsection 6.2.2. analyzes the objectives pursued by Croatian financial regulation and its supervisory model. Finally, section 6.3. compares these countries through the assessment of the development, composition and stability of their financial systems. Our comparison is not entirely descriptive or ″neutral″; we make critical observations that are directed primarily to Croatia. We are interested in learning whether the Italian and Croatian financial systems bear potential vulnerabilities, and whether further improvements can be made in specific areas in order to support financial stability. In this sense, we use Italy as a reference point or benchmark. We opted for Italy as this country is one of the "old" EU Member States, in this sense its rich membership experience can be useful to Croatia on the verge of its accession to the EU. Moreover, as a transition economy Croatia can somehow look up to the Italian example of financial development as during EU negotiations this country has managed to preserve the "best interest" of its national financial system in some aspects. Finally, the choice of Italy as a benchmark wasn't deliberate. As we will discuss in the chapter, Italian financial institutions are significant owners of Croatian financial institutions.

6.1. Development of the Italian financial system

We will begin our analysis by discussing the main changes to the Italian financial system during the last two decades and the policy context from which they have resulted. In this sense we are going to consider the principal changes in the structure of finance in Italy over the period of two decades (*i.e.* greater market orientation, changes in financial instruments and market participants, changes of ownership structure in banking, the introduction of financial derivatives, etc.). It is not our intention to describe diachronically the development of the Italian financial system, or to elaborate it in great detail. We rather concentrate on several events (economic or legal) that exerted a major impact on the development process. We give a "context" to such events and explain how they have changed the "design" of the financial system in Italy.

At the beginning of European financial integration, the Italian financial system was characterized by several interesting features that made it different from other major EU countries. These features were the result from both the particular regulatory environment in which the Italian financial system functioned, as well as the model of business development pursued by finance in Italy. As regards the latter, we mention two striking features:

(1) One is the large number of small and medium-sized firms active in the Italian productive structure;

(2) The other is that the majority of large Italian companies were state-owned. We would like to point out to an additional, third feature of the Italian financial system, namely:

(3) The limited development of regulated stock and private (corporate) bond markets.

During the last two decades regulation, international trends and domestic economic developments initiated substantive changes in Italy's finance. In this sense the Italian financial system has been modernized in line with European trends prior to the last financial crisis (we have discussed these trends in the 5 chapter). As a result, Italy has intensified its ″market activities″ meaning that it decided to rely more on direct financing and less on ″relationship-based″ forms of intermediation offered by Italian banks to Italian companies.

In the broadest sense, we can say that the Italian financial system is bank based. We found this conclusion on the important role that financial intermediaries, banks to be more precise, have retained in Italy's finance throughout its history. Indeed up to the 1970s banks dominated Italian finance. The orientation of the Italian financial system towards ″credit intermediaries″ and indirect financing, more than ″financial markets″, was more pronounced than in other countries in continental Europe. This argument was evidenced by the high value of banks' financial assets ratio to total financial assets, as well as the fact that household assets were largely held in the form of bank deposits. Moreover, bank loans were the main source of funding for entities of the non-financial sector.

Italy experienced the first wave of disintermediation in the banking sector in the 1980s, when trading in government securities (mainly bonds) increased prominently. On the asset side this meant that the importance of deposits in the portfolios of investors decreased, meaning that investors held a smaller share of deposits. At the same time the share of securities held directly by households increased. This can partly be attributed to the fact that in the 1990s inflation and government deficit decreased, which redirected a substantive part of resources towards financial markets. Naturally, this process was also accelerated by the introduction of the single European currency. At the same time, during the 1990s and 2000s, "direct" securities (*i.e.* those which are issued directly by individual investors and placed directly with final lenders or their agents) have grown much faster than "indirect" securities (*i.e.* those supplied to final lenders by credit intermediaries drawing on their own purchases of primary securities).

As we have already argued, in Italy the growth of securities markets has been rapid and for the most part it reflected the expansion of the public debt during the 1990s (from 58% of GDP in 1980 to its peak of 124% of GDP in 1995). It was fortunate that at the same time the private sector was able to absorb substantive new issues of public debt and the disposal of government securities by the banking system[270]. As a result of these developments, the composition of financial instruments and the importance of various issuers active on the market have changed significantly during the last two decades. At the beginning of the 1980s, bank deposits and short-term securities accounted for the majority of financial assets, whereas by the 2000 their share in total financial assets significantly decreased, giving precedence to long-term securities, such as shares, which almost doubled as a proportion of total financial assets.

The subsequent decline in the share of bank activities in the system was met by a pronounced increase in the weight of other financial institutions. However, it would be wrong to conclude that banks did not continue to play a significant role in Italian finance. Their significance has remained stable thanks to the smart evolution of the intermediation model; namely, through

[270] Bank of Italy. (2003, August, p. 7).

financial groups banks control a large share of investment and mutual funds active in the Italian financial market. In addition, their adherence to the universal banking model means that they are still engaged in the provision of various services to business entities and in financing investments *via* the financial market.

The privatization process of the Italian banking industry partly contributed to this "repositioning" of banks, so let us discuss it. Back in the 1980s publicly (*i.e.* state) owned banks took the majority of total business activities, representing one of the highest ratios in Europe. Today this figure is one of the lowest in Europe, which is a direct result of the privatization process. The privatization was concentrated in the space of a few years, but its institutional development and the period of legal preparations were long and complex. The reform was a two-phase process:

(1) First the rules governing banks in the public sector were aligned with those governing banks in the private sector, then

(2) The transformation of publicly owned banks into privately owned companies was executed.

Nowadays, Italian banks are mostly controlled by other domestic banks, followed by public entities, and then by insurance and other financial entities (as part of a financial group or conglomerate), with only a small percentage of ownership by foreign banks[271]. However, the share of foreign ownership has risen continually for the last two decades. Foreign financial institutions, or banks more precisely, entered the Italian banking system primarily through takeovers of domestic banks or as subsidiaries of international banking groups. These movements were largely driven by international macroeconomic factors and by the ongoing process of European integration.

Another important change in the banking sector, at that time, was simplification. This means that the banking sector went through a process of despecialization during the 1990s, which that mainly resulted from the legislative reforms executed through the 1993 Banking Law and the 1998 Single Act on Financial Intermediation[272]. Alongside former banks and other credit

[271] At the end of 2009 there were 22 subsidiaries of foreign companies and banks operating in Italy, two of which figured among the top ten banking groups, with a market share of 9.7% of total assets. The 81 branches of foreign banks not included in Italian groups held 8.2% of system assets. See Bank of Italy. (2010, May).

[272] These are considered to be the milestones of Italian financial regulation and legislation; the Legislative decree n. 385/93 or the Consolidated Law on Banking (*Testo Unico Bancario* – TUB) and the Legislative decree n.

institutions, the number of non-banking institutions operating in the sector has increased and their market share has grown. ″Other credit intermediaries″ supply leasing, factoring, consumer credit and venture capital services have become more important[273].

With greater orientation towards financial markets in Italy, the composition of financial assets radically transformed. This was a gradual change. The share of Italian financial assets held by households and entrusted to third parties for management was negligible at the beginning of the 1980s. But in the second half of the 1990s the participation of this economic sector in the securities market significantly increased. Asset management and institutional investors have both grown substantially since then, which in turn strengthened the securities and financial markets in general. In the broadest sense, financial markets satisfied the interests of investors (savers) such as households, as they allowed investments to be well diversified even in the case of a modest portfolio of an individual investor. Such opportunities were greatly supported by the emergence of investment funds and the spread of individual portfolio management services in Italy, from the mid 1980s onward.

Continuing our discussion of financial market development in Italy, we have to mention an important milestone in the development of the Italian financial system in general – and that is the introduction of financial derivatives. The first Italian market in financial derivatives was created in 1991 – this was the Italian Futures Market. It was specialized for financial futures and options based on Italian government securities, and also futures contracts indexed on short-term interest rates. In 1998 this market became a part of the *Borsa Italiana* as a result of the privatization process in the financial market. At the end of 1994 an Italian market in futures contracts based on shares (the Italian Derivatives Market) was constituted as an integral part of the Stock Exchange. As a result, the use of these financial instruments expanded rapidly thereafter.

From the arguments laid above, it is clear that the Italian financial system has experienced profound structural changes during the last two decades. Consequently, the current Italian financial system is similar to those of other EU countries. As in most developed economies, nowadays the once clear-cut boundaries separating banking, insurance and securities activities

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58/1998, the so called *Testo unico in materia di intermediazione finanziaria* (TUF) or the Consolidated Law on Finance.

[273] Bank of Italy: Globalization: The role of institution building in the financial sector, Rome, August 2003, p. 10.

are blurred, as a result of the functional integration between the sectors. In Italy the process of financial market integration has come about in a rather articulated fashion, and the process has affected every segment of finance.

With respect to financial intermediaries, ownership integration has been accentuated and realized through transfers of capital shares between institutions or between controlled and controlling firms.

Another significant form of integration among intermediaries has been through the transformation of their legal status even when they continued to perform the same intermediation activities[274].

As regards financial markets, considerable integration has taken place between the banking, insurance and securities market as a result either of the issue or quotation on the official stock exchange or other securities markets of both banks and other institutions.

With regard to financial instruments, it is noteworthy that while many of them have changed their economic function their legal status has remained unchanged. A welcomed improvement was the Italian government initiative through which many distortions in the domestic capital market were addressed. For instance, the relative opacity of corporate ownership and control in Italy has discouraged investments in shares. In this sense, many of the reforms taken in the 1990s related to takeover legislation and disclosure requirements, which improved investors' confidence in the financial markets.

Finally, the Italian financial system has been extensively liberalized. The synergy between the government's economic and financial programs and the European financial integration continue to eliminate remaining market weaknesses and support financial development.

6.1.1. Transposition of EU financial legislation

As we have already mentioned, the Italian experience in transposing and implementing EU legislation in the area of finance is important for Croatia. Every acceding country has to answer a specific question: which type of transposition instruments or techniques available

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274 This is particularly true for the *società di intermediazione mobiliare* or investment firms that have been transformed into banks even though their primary objective is not the issue of deposits or the provision of loans, which are constitutional credit institution's activity according to EU legislation.

should be used in the context of preserving national interests and still enforce European financial regulation effectively? In answering this question Italy's experience offers several guidelines related to the subject of transposition and implementation of EU legislation.

By ″implementation″ we mean the taking of all general and special measures to ensure the operation of EU law in a specific country[275]. This comprises a variety of activities at both supranational and national level, such as: the preparation of a piece of EU legislation, its adoption, subsequent incorporation into national legal orders (*e.g.* transposing directives into national regulatory frameworks) and enforcement of European legislation by competent national authorities.

By ″transposition″ we understand the selection of the appropriate forms and means to achieve the results required by EU law. According to the Art. 249 of the EC Treaty, Member States are free to choose forms and means that are appropriate in their specific context, in order to achieve the objectives mandated by a European directive. In this context, instruments refer to the legal instruments that allow the provisions of a directive to be transposed into national legislation. Legal instruments refer also to general policy rules. The term ″technique″ on the other hand refers to the manner in which directives' provisions are transposed by means of a legal instrument.

Despite their obligation of timeliness and completeness most EU Member States experience problems with the transposition of EC directives which in several Member States take form of a real ″transposition deficit″ (such is the case in the Netherlands, Germany, France and Italy). Apart from the delays in transposition, another important issue is the quality of transposition which is revealed by the number of infringement proceeding initiated against a country by the European Commission.

Relevant literature identifies several techniques typically used by Member States are:

(1) The ″I-to-I″ transposition or the literally copying of parts of the text of a directive into national regulation;

(2) The ″I-to-I″ transposition with minor or major terminology changes or other contextual adjustments;

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[275] We use the term ″EU legislation″ as an abbreviation for European primary and secondary Community law: binding regulations, generally binding directives and generally binding decisions. See Steunenberg, B., Voermans, W. (2006).

(3) Transposition of a European directive through an existing legal regime when the transposition doesn't require a new regulation (*e.g.* by the issuance of a notice);

(4) Transposition through incorporating a directive into the system of existing legislation (known as elaboration)[276].

In the context of transposition techniques, the term "legal instrument" refers to the manner in which a country uses delegated legislation. Not all EU Member States have a comparable concept of delegation with respect to the transfer of powers to adopt generally binding rules. In that regard, it is necessary to put special attention to the relationships between primary legislation and delegated legislation adopted by hierarchically "lower" regulators.

Let us now discuss the Italian experience in EU law transposition. From 1987 onwards Italy systematically prepared for the transposition and implementation of EU laws. The preparations were initiated by the promulgation of the so called *Legge Fabbri* and *Legge La Pergola*[277]. These laws strengthened the political participation of Italy in the EU legislative process. In addition, it politically empowered national actors involved in these processes (ministerial, regional, administrative and parliamentary bodies) with respect to the EU institutions. The enactment of the *Legge La Pergola* was particularly important for the speeding up of the transposition process (*recepimento*) because it established the technique of the adoption of the annual "Community law" (*legge communitaria annuale*). In essence, this technique allows a specific and systematic harmonization of national (*i.e.* Italian) regulations with EU legislation. It allows the Italian government to submit to the Parliament (as a legislative body) a single bill that includes all legislative texts in need of national implementation. This in turn allows Italian authorities to choose from a vast array of transposition techniques, such as:

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[276] In their study Steunenberg and Voermans (2006) distinguish different transposition approaches within these techniques: (i) transposition by referencing, (ii) the annex method (where the directive is included as an annex to a national transposition measure), (iii) straightforward transposition, (iv) using the transposition as a vehicle for additional national policy.

[277] *Legge Fabbri* or Law n. 183/1987 proscribes the organization of Italian authorities as regards Community's policy issues and proscribes the funding for the transposition processes. The subsequent *legge La Pregola* or Law n. 86/1989, further imporoved the administrative and legislative framework neccessary for the transposition of Community legislation in Italy. Its intention was to accellerate the transposition and implementation process for EU directives that governed the completion and functioning of the internal market. It brought in a more systematic approach to the process and imporved the transposition rates of European legislation in Italy. Another set of regulation – the Law 59/1997 or the so called *Leggi Bassanini*[277] was significant with respect to the organization and the acceleration of transposition. The *leggi Bassanini* changed the relationship between the regions in EU affairs. Together with the constitutional reform of 2001, these laws considerably increased the power of Italian regions in the legislative process.

(i) Parliamentary abrogation or modification of existing domestic legislation,

(ii) Delegation of legislative powers to the government,

(iii) Authorization to the government to adopt regulations in subject areas already regulated by primary sources, and

(iv) Administrative acts[278].

Thus, we can conclude that Italy addresses implementation issues through a wide variety of legal instruments[279].

Although the *Legge La Pergola* did succeed to create a more systematic approach to transposition, the annual Community law itself became held up in Parliament, and again Italy failed to adhere to transposition timeframes in many occasions. Here, an important observation has to be made. Namely, in Italy the instability of the political system often hindered the transposition process as well as the timely presentation and the parliamentary approval of the Community law.

In fact Italy's delays in the transposition and implementation of EU legislation have often been a direct result of the complexities of its political system. As in every Member State, the implementation of a directive in Italy requires the adoption of legislations through which the specific objectives of the directive implemented are enforced. This in turn requires a common agreement between the national participants of the transposition process, which often have conflicting views and interests. They have to reach an agreement about how to implement a specific piece of EU law in a manner that would be in line not only with the specific type of EU legislation concerned (whether it is a regulation, directive, or other) but also with EU's regulatory objectives. Administrators and politicians are primary participants of the transposition process in Italy. Whereas ministers sign the ministerial orders and political appointees control the interpretation of the directive, it is the ministry's administration that provides the technical and juridical know-how during transposition (Kaeding, M., 2008). Such bureaucratic complexity delays the transposition process. This complexity however, can be found in all EU countries that are characterized by greater political fragmentation.

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[278] Giuliani, M., Piattoni, S. (2001).

[279] In general, law and legislative decrees represented the majority of all Italian implementing measures whereas ministerial orders were applied in fewer cases. See Steunenberg, B., Voermans, W. (2006., p. 193).

The implementation of EU law is key to European integration and to financial integration as well. In this regard, Siedentopf argues (1988) that the implementation of EU law by Member States into national legal systems is more than a requirement for convergence – it is the actual foundation of the European Community[280].

The EU relies upon the Member States to transpose and implement legislation within their jurisdiction and nowhere is this assignment more important than in the area of the Single Market. EU Member States have to implement regulations in a manner that fully guarantees clarity and certainty in legal situations. To that end, the provisions of a directive must be implemented with unquestionable legal certainty and with precision and clarity as to the rights and obligations of the addressees.

But legal certainty doesn't rely solely on harmonized transposition and implementation. In fact late transposition and any other delay in implementation may have negative effects or endanger the convergence of national legislations and favor discriminatory practices. In this context the European Commission plays a crucial role by providing Member States with information on transposition activities across the EU and by charging defectors for their non-compliance through infringement processes[281].

On several occasions the European Commission has undertaken infringement proceedings against Italy in order to assure timely and appropriate implementation of EU financial regulation[282]. Irrespective of its costly delays in transposition, Italy is still a relevant example for Croatia. This is because of the similarity of national actors involved in the transposition process and as well as other elements that influence this process (such as the similarity of certain constitutional arrangements).

However, acceding countries have to keep in mind that, ultimately, the impact of EU legislation depends on the willingness of Member State authorities to ensure that they are not only transposed on time, but also – that they are enforced effectively. Finally, in all of this the economic and financial interests of the country should be respected as well.

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[280] Siedentopf, H. (1998).

[281] As the European Commission is responsible for ensuring that Community law is correctly applied it has the power to take an action of non-compliance against a Member State that fails to comply with Community law requirements, or to refer the case to the European Court of Justice. The non-compliance means any action or omission of the Member State taken in order to fulfill its obligations under Community legislation.

[282] See http://ec.europa.eu/internal_market/infringements/index_en.htm

6.1.2. Financial regulation and supervision in Italy

When analyzing financial regulation and supervision in Italy one has to give special attention to two regulatory milestones – the Consolidated Law on Banking and the Consolidated Law on Finance[283]. In this section we do not discuss specific provisions of these laws as this would obfuscate our attention; we examine, in a more general manner, the objectives of these laws. Then, our discussion turns to the current model of financial supervision in Italy. Again, we do not discuss all the competences given to every of the supervisory authorities. Rather, we determine their competences in general and try to "sketch" their inter-institutional relationships. Our objective is to determine whether multiple authorities affect the efficiency of supervision, or is the Italian model of supervision effective regardless of its institutional complexities?

Similar to other countries, financial regulation in Italy has also followed the development of the financial system. This means that regulation has become more complex as the system developed, and also that the focus of the rules shifted from one economic sector to the other (*i.e.* banking to securities markets, and *vice versa*) as their importance changed at a specific stage of financial development.

At first glance we can conclude that the majority of Italian financial regulation is dedicated to the prudential regulation of banks. This is not surprising, as we have already determined that Italy is a bank based economy. However, during the last two decades significant Italian financial regulation was subject to significant changes. This was partly a result of the European "market orientation trend" (which we have discussed in chapter 5) and which consequently put more emphasis on securities regulation, rather than banking regulation. The following of EU trends required legislation to be introduced frequently, especially in the area of financial markets, which was seldom done in an uncoordinated manner. The final outcome of these reforms is a specific framework of rules and supervisory authorities which bears the characteristics of more regulatory models and approaches already examined in chapter 2 (in particular, see section 2.2.). In the following paragraphs we explain how this framework has developed.

By the end of the 1980s and the beginning of the 1990s the national central bank, Bank of Italy (*Banca d' Italia*) was determined to revise and update Italian financial regulation in line with EU requirements and, also, to streamline the institutional set up for supervision. This

[283] The Legislative decree n. 385/93 and the Legislative decree n. 58/1998, respectively.

reform was partly under the influence of Europe's "market orientation", but also the Italian legislation in the area of finance was perceived as outdated by competent authorities and market actors. But the changes introduced through the implementation of EU law in this area gradually evolved and went far beyond than what was technically required by the EU. As Italy is a bank based economy, it is only natural that the regulatory reform begun with changes in the area of banking. After that, the reform extended to all other areas of finance.

Between 1990 and 1992 a number of acts adopted by the Italian Parliament radically changed the legal environment for banking. The most significant ones were:

(1) The Consolidated Law on Banking (*Testo Unico Bancario* – TUB) and

(2) The the Consolidated Law on Finance (*Testo unico in materia di intermediazione finanziaria* – TUF). Let us briefly explain the objectives and scope of these laws.

The TUB's provisions are prudential in their nature and they cover both bank and non-bank institutions. The TUF's provisions are actually "rules of conduct" that every financial institution must follow when providing financial services to their clients. The TUB and the TUF adopt the same regulatory approach, namely that of stating only general principles and minimum standards, while leaving it up to competent authorities to specify detailed rules through secondary legislation (according to the legislative hierarchy in Italy).

These two laws share the same regulatory goal, namely that of achieving stability and integrity of financial markets. They do not have "transformative ambitions" (similar to that we have found in MiFID – see chapter 5) meaning their rules do not dictate the design of the Italian financial system. The TUB and the TUF leave it to market competition to determine the shape of the Italian financial industry.

Under the new rules of the TUB the separation between deposit banks and long-term specialized credit institutions is abolished, in favor of a universal banking model. In addition, the TUB legally acknowledged the existence of banking groups, it instituted consolidated supervision, and regulated non-bank financial institutions. The TUB expressly stated the pursued objectives of supervision – sound and prudent management of intermediaries and the overall stability, efficiency and competitiveness of the financial system. It is interesting to mention that TUB's provisions redefine the position of the Bank of Italy with respect to disclosure of its supervisory competences. The Bank was now required to give to the public prior notice of the principles and criteria of its supervisory activities.

Through the enactment of the TUF more than 30 laws were consolidated into a single legislative measure. This finally simplified the regulatory environment for finance. The TUF still comprises the majority of financial regulation and legislation enacted for the past thirty years but in a more streamlined, comprehensive – and most importantly, EU-harmonized manner. The TUF's provisions followed EU trends, and as such, they introduced new rules concerning financial markets, securities trading and investment services in general, as well as other market-related issues.

In the same period, financial supervision had to be reformed in order to better suit the new regulatory objectives pursued by the TUB and the TUF. In fact, supervisory objectives (*le finalità dell'azione di vigilanza*) are defined in the first paragraph of Art. 5 of the TUF. They are: transparency, fairness in market actions and management of financial supervised entities, investor protection and stability, competitiveness and efficiency of the overall financial system. We think that investor protection, financial stability and competitiveness are the three most important objectives of supervision in Italy. Let us explain why.

First, the TUF accentuates the objective of investor protection. If we were to interpret the intention of its provisions related to investor protection we could conclude that that TUF considers the investor (the retail investor more precisely) as the contractual party in a more unfavorable position in a financial contract; one that is more affected by negative externalities (*il contraente più debole*). Consequently, the TUF gives great importance to provisions that allow better information of investors as well as to conduct of business rules that financial institutions have to obey.

Second, when regulation expressly pursues the objective of financial stability it means that it protects the system from systemic shocks. Such regulation is mostly microprudential in its nature, meaning that it covers individual financial institutions. Such are the provisions of the TUB. However, we have argued already that financial stability depends not only from the stability of individual financial entities in the system, but that it is also dependent on their interconnectedness. In this sense, regulation should also focus on the system as a whole. We think that the provisions of the TUF give credible grounds to macroprudential regulation in Italy. The TUF's provisions refer to crisis prevention, heavy leveraging and other imprudent market actions that institutions may engage into, and that make the whole system prone to instability.

Third, by expressly stating the objective of competitiveness and efficiency of market actors in the system, Italian financial regulation acknowledges the connection between supervisory efficiency and the performance of the overall financial system.

Nowadays, multiple authorities and several objectives that are difficult to deduct to a single regulatory and supervisory model (according to our categorization in chapter 2) characterize the Italian model of supervision. Supervision in Italy can best be described as a mixed model, one that is partly based on the type of intermediary monitored (for insurers and pension funds) and partly on regulatory objectives (stability and consumer protection, for banks and investment firms respectively). What is important to notice is that financial supervision in Italy maintains the historical connection between central banking and banking supervision. This means that Italy is one of those EU countries that haven't succumbed to the trend of institutional consolidation (*i.e.* the creation of a single supervisor). Nor has Italy delegated prudential supervision to a separate authority in the system.

Currently, there are five supervisory authorities in Italy:

(1) the Bank of Italy,

(2) the *Commissione Nazionale per le Società e la Borsa* (Consob),

(3) the *Istituto per la Vigilanza sulle Assicurazioni Private e di Interesse Collettivo* (Isvap),
(4) the *Commissione di Vigilanza su Fondi pensione* (Covip), and

(5) the *Autorità Garante della Concorrenza e del Mercato*[284].

The array of instruments and methods used by these authorities is determined by the TUF. According to its provisions there are three different types of supervision:

(i) Regulatory supervision – enforced through general rules imposed onto financial institutions and other subjects,

(ii) Informative supervision – imposing to the supervised subjects disclosure obligations, and
(iii) Investigative supervision – as a form of "on-site" control and supervision of institutions.
Let us now discuss the Italian supervisory authorities. We start with a brief explanation of the inter-institutional relationship between the Italian central bank and its securities and exchange commission. Then we discuss the competences of every authority separately.

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[284] Since our research does not focus on pension funds and competition policy, in our analysis of the Italian supervisory authorities we will not discuss the last two authorities, which monitor the Italian pension funds and market competition respectively.

As we have already said, supervision of banking has always been entrusted to the Italian central bank. In 1974, after the creation of the Italian Securities and Exchange Commission (*Consob*), supervision is shared between these two authorities (following the objectives of regulation, rather than by the legal entity). As a result the Bank of Italy is in charge of the prudential supervision of banks, other financial undertakings and investment firms.

The *Consob* is in charge of transparency and investor protection. In this capacity it has regulatory powers over companies that issue securities as well as banks and investment funds that provide investment services.

The Bank of Italy is greatly involved in Italian financial regulation and supervision. The Bank is responsible for the systemic stability of the financial sector, the stability at the micro-level (*i.e.* of individual financial institutions), the prudential supervision of banks and securities market intermediaries, the oversight of relevant markets for monetary policy, and the payment system. Until 2005 the Bank was responsible for safeguarding competition in the banking sector that was subsequently transferred to the Italian competition authority.

The Bank of Italy determines general regulations concerning capital adequacy requirements, the limitation of risks associated with financial transactions and assets, permissible holdings, administrative and accounting procedures as well as internal control mechanisms. It also issues authorizations to banks and receives regular returns and financial statements as part of the mentioned informative supervision process. As regards investigative supervision, the Bank may carry out inspections and request documents if needed, and it also has the power to propose the dissolution of a bank to the Minister of the Treasury.

The Bank of Italy discloses the principles and criteria of its supervisory activities to the public. It states reasons for its decisions, publishes annual reports on supervision and complies with general transparency rules. Typically, the annual report of the Bank includes an extensive report on recent developments in regulation and of the efficiency of supervision.

The *Consob*, as an independent public authority competent for the Italian financial market, performs normative, supervisory and administrative functions. It issues regulations, enacts resolutions, communications and recommendations; most importantly it supervises the compliance of market participants with laws as to ensure disclosure of information and observance of conduct of business rules. The *Consob* supervises all financial institutions that provide investment services[285]. The objectives of its supervision are: to ensure transparency, proper conduct of business and sound management of authorized institutions. The *Consob* exercises numerous regulatory powers, in particular the following: the provision of investment services and activities; the provision of portfolio and asset management services; the drawing up and publication of prospectuses; the minimum financial resources of regulated markets management companies and central depositories dealing with financial instruments; alternative trading systems, and other. Similar to the central bank, the *Consob* also publishes an annual report in which it documents its annual activities as well announces future guidelines for supervision.

Given their competences it is only natural that the Bank of Italy and *Consob* have to work in synergy in certain areas of finance. Their cooperation is key to the efficient supervision of entities officially authorized to perform investment services, such as banks, investment firms, investment management firms, mutual funds and the *Società di Investimento a Capitale Variabile* (Sicav)[286]. In specifying the purpose of supervision the TUF requires the Bank of Italy and *Consob* to operate in a coordinated manner in order to minimize the regulatory burden and costs borne by investment firms (Masciandaro, D. (Ed.), 2005). Consequently, the *Consob* supervises investment firms (as well as other entities engaging into investment services) as the "lead authority", safeguarding transparency and investor protection in coordination with the Italian central bank that in turn monitors the amount of risks taken by these institutions. In performing regulatory inspections the Italian central bank and the *Consob* must inform each other of the inspections they plan to undertake and their respective results.

In line with the principles of current EU investment services legislation – especially with MiFID's provisions, Italian legislation mandates that institutions, which perform similar activities, be subject to same regulation. Thus, when providing investment services banks are subject to the same rules as investment firms, and asset management companies providing portfolio management services are subject to the same rules as investment firms and banks.

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[285]According to Art. 1 of TUF the definition of investment services comprises the following activities: dealing for own or customer account, management on a client-by-client basis of investments portfolios, placement, with or without firm commitment underwriting or standby commitments to issuers, and reception and transmission of orders and bringing together investors.

[286] Proscribed by Art. 5. of the Testo Unico delle disposizioni in materia di intermediazione finanziaria (Decreto legislativo 24 febbraio 1998., n. 58. Sicav are a type of open-ended collective investment scheme commonly found in Spain, Italy, France and other Western European countries. They are similar to the US open-ended mutual fund. Sicav are regulated under the UCITS IV regime (see chapter 3).

Turning our discussion to insurance undertakings, we can observe that Italian insurers are subject to "institutional supervision". This means that all legal entities that are authorized as insurers are subject to the control of the same authority. The Institute for the supervision of insurance (*Isvap*) supervises insurance undertakings in Italy. The objective of *Isvap* is to guarantee stability and transparency of the insurance industry. Founded in 1982, it is the main supervisory authority of the private insurance and reinsurance business, as well as insurance agents and brokers. Insurance regulations make *Isvap* completely autonomous as regards financing, management and organization. Its primary scope is to ensure the stability of the market and its components (insurance undertakings) as well as the solvency of insurance market participants. It is also determined to protect the interests of consumers (policyholders) and the general public. Similar to the Bank of Italy with respect to banks, the *Isvap* authorizes insurance undertakings and grants authorization for these businesses in order form them to extend their services to other insurance classes. The supervisory competences of the *Isvap* are focused on monitoring the financial position of insures with particular interest in solvency margins, adequate technical provisions in respect of its entire business and to the covering of those provisions by adequate assets. As such, *Isvap's* powers are almost fully harmonized with Solvency II requirements. The *Isvap* has also a "disciplinary role" on the insurance market. This means that it supervises over compliance with the laws and regulations in force and also introduces rules of conduct and issues directives whose enforcement safeguards the link between regulations and insurance practice[287].

In conclusion of this section, we can state that the design of financial supervision in Italy is characterized by a mixed approach. Supervision is based on both regulatory objectives (financial stability and transparency as the two key objectives) and a high degree of central bank's influence and involvement in financial supervision[288]. This is a direct result of national

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[287] Cervellati, E. M. (2003, May).

[288] Some authors argue that this supervisory model in practice results in several regulatory problems. The logically incoherent assignment of mutually conflicting regulatory objectives to a single authority leads to an inefficient functioning of the financial system and of the use of policy instruments available to achieve the former. Di Giorgio *et al.* argue that one of the most striking anomalies of the Italian regulatory and supervisory framework is that the Italian central bank owns relevant shares and equities of banks or financial institutions that control banks. This results from the fact that the Bank of Italy invests in equities both part of its ordinary reserves and part of the contributions of the employees' pension fund. It is obvious that the Bank's financial and supervisory decisions have a decisive effect on the profitability conditions of the supervised institutions, such that the central bank shouldn't be allowed to be a significant shareholder in such entities. As regards the structure of supervisory authorities the same authors argue that there is no reason for the existence of a separate authority for the insurance sector – particularly when considering the nature of contracts of this industry which gradually caused the loss of its business distinctiveness. See Di Giorgio, G., Di Noia, C., Piatti, L. (2000).

economic characteristics and the dominant role of the banking sector in the Italian financial system.

6.2. Development of the Croatian financial system

In this section we analyze some major developments that have took place in the Croatian financial system and discuss the country's progress in financial development. Special emphasis will be given to Croatia's harmonization with European financial regulation. We argue that financial development in Croatia has been greatly improved by the EU accession process. But we also find alarming the "directional confusion" of the Croatian economic policy during it. Even more preoccupying is the complete lack of understanding of the market impact of adopted financial regulation, and the fact that Croatia implemented legislation without recurring to "cherry picking". Namely, Croatia has adopted every single EU legislative measure in the area of finance without consideration which of these measures would be the most adequate or desirable to shape the financial system in accordance with national interests.

Although EU financial regulation is constituted for the most part of directives, which are binding only as to the objective they proscribe, Croatia seems unaware of this fact. We think this because Croatia has been overtly eager in adopting EU financial regulation. It has even succeeded in regulating instruments and transactions that do not exist in practice or whose share is minimal in the financial market (for instance: credit derivatives and contracts for differences[289]). But directives can be adapted to concrete circumstances of national economic systems; a fact that is especially significant for countries that are still going through transition. It is one thing to be overtly diligent and adopt every single piece of EU legislation in the desire to demonstrate political commitment to the accession process. But from the economic aspect this is unnecessary and burdensome. It is not surprising then that the EU has pointed to the "ad hoc approach to economic policies" of the Croatian government, and criticized the fact that serious structural reforms do not figure among the government's top priorities[290]. As we

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[289] A "contract for difference" (or CFD) is a contract between two parties (a *buyer* and a *seller*) that stipulates that the buyer will pay to the seller the difference between the current value of an asset and its value at the time of the contract. If the difference is negative, then the seller pays instead of the buyer. In practice CFD are financial derivatives that allow traders to take advantage of price movements on underlying financial instruments and are often used to speculate on the markets. See Art. 3, par. 1, al. 2 of the Capital Market Act (we shall discuss this Act and its impact later in the chapter).

[290] See European Commission, SEC(2008) 2694.

have argued several times in this thesis, law cannot create market activity. And Croatia should keep this in mind.

As a general observation we may say that Croatia is a transition economy. This means that it has not yet concluded the process of transition to a market economy, although democracy has been constituted and many structural economic reforms have been successfully implemented. But economic and political transition is a long-term "commitment" (we use this term intentionally), one that supposes that Croatian policymakers should already determine the country's future economic and political perspective. However, to persevere in this task is far more challenging, and results do not come easily. In the last two decades the Croatian financial system has experienced radical economic reforms. In our opinion political decisions and the transition process that begun in the 1990s primarily initiated these reforms, a fact that has not changed until present day. In fact, nowadays reforms in the financial system are a direct result of the EU accession process and its political negotiation.

As a transition economy, Croatia has undergone economic liberalization, privatization of government-owned resources and business entities, and created a financial sector, which during its previous political regime was only made of banks and insurance undertakings. The Croatian reform process wasn't only practical (the structuring of an institutional framework) but more importantly, it was ideological – the role of the state had to change and the theoretical basis of its economic policy as well (toward the promotion of privately-owned business entities, and the independency of financial institutions and markets).

One of the sectors that have experienced the most radical changes was the financial sector. Not only that it had to be built *ex novo* and recapitalized with respect to its constituent institutions (banks) but during the 1990s it experienced two serious banking crises which greatly influenced the design of financial regulation and supervision in Croatia.

As argued by Dalić (2002) financial development is a significant part of the transition process. In addition to the restructuring of existing banks according to the postulates of market economy, it comprises the creation of the missing parts of the modern financial system – that is, the capital market (Dalić, M., 2002). In comparison to the financial systems of other EU Member States (especially the group of "old" Member States) the Croatian financial system is somewhat underdeveloped with regard to the type of financial institutions present, and even more so, with regard to financial markets and instruments. Similar to the Italian financial system that we have already examined, the financial system of Croatia is also dominated by credit institutions, or banks to be precise. They are the most active type of financial institutions in the economy, judging by their presence on the overall financial market – money, foreign exchange and capital market, as well as their role in the payment system.

Since the major structural transformation that occurred at the turn of the new millennium, the Croatian banking sector has not experienced more fundamental changes. The banking sector in Croatia is characterized by:

(1) High concentration,

(2) Foreign ownership, and

(3) Universal banking.

Due to the slowing of merger and acquisition activities, the number of banks active in the system has fallen only marginally during the last few years. Despite the large number of banks, the banking sector is fairly concentrated as well[291]. As already mentioned, the Croatian banking industry continues to be dominated by foreign ownership. In practice this means that banks in Croatia are subsidiaries of banks registered in foreign countries. To be precise, foreign ownership is limited to few EU countries, with investors from Austria, Italy and France in the lead. At this point we wish to discuss an important issue – and that is why regulators (and governments for that matter) should care about how foreign banks operate in their jurisdiction. In other words, regulators should have a preference on whether foreign banks will operate as single branches or subsidiaries owned by a foreign parent bank. This is because branches and subsidiaries involve different levels of parent bank responsibility and financial support (Cerutti, E., Dell'Ariccia, G., Martínez Pería, M. S., 2007, p. 1670). Croatian authorities have preferred the model of subsidiaries as this allows them to shield the affiliate from the problems of its parent.

As for the non-banking financial sector in Croatia we can observe that it is still relatively small and non-diversified irrespective of its intensive growth during the last decade. The main institutional representatives in this sector are insurance undertakings, pension funds, investment funds and brokers, which are all active in the capital market. In recent years, non-bank financial intermediation, small in size, has expanded rapidly starting from a very low base, thereby increasingly gaining in relative importance. As of June 2007 the nonbank

[291] The four largest banks claimed a market share of roughly 65% of total assets at the end of 2009. For a detailed insight see Croatian National Bank. (2009, August).

financial sector accounted for around 26.5% of total financial sector assets, corresponding roughly to 40% of Croatia's GDP. This increase in the market share of non-bank financial institutions at the expense of banks is particularly remarkable in light of the likewise sharp expansion of the banking sector. The restrictive monetary policy led by the Croatian National Bank during the last decade benefited certain non-bank financial intermediaries, mainly leasing companies. In fact, their rapid growth resulted directly from the central bank's monetary restrictions with respect to regulation of credit activity. It is important to note that the majority of these leasing companies retain close connections with banks in the system. In fact it was banks that were the first founders of leasing companies as they tried to maintain part of their credit activities outside regulation and supervised. However, it was the open-end investment funds that recorded the most dynamic development among all non-bank financial institutions. Their growth was most visible during the boom of Croatia's stock market in 2007; nowadays their net assets amount to roughly 4% of the Croatian GDP.

Similar to other transition countries, Croatia's financial system is challenged by structural imbalances with one of its significant liabilities being an underdeveloped capital market as regards both financial instruments and institutions present in the market. The development of pension and investment funds at the beginning of 2000's created active institutional investors, but the dominant characteristics of the Croatian capital market still remain the same: low market capitalization, small volumes, poorly diversified financial instruments and a high level of ″financial illiteracy″ of the Croatian public (excluding institutional investors). The most desirable form of financing in the Croatian economy is still bank financing (or bank loans to be precise). Direct financing is still an exception. Issues of different types of securities are rarely used, partly due to Croatia's tradition of bank financing and to the sheer unawareness of market participants of the financing possibilities offered by the capital market. For the most part, this is because Croatia still does not have such big businesses or companies, which could benefit from direct financing. In addition, the lack of streamlined conduct of business rules and market practices undermines investor confidence. As a result the Croatian capital market still cannot be compared to those of other EU economies. The primary market confirms the small role that the capital market has in financing the Croatian economy. However the secondary market is more developed, although some market segments are still nonexistent – the most notable being financial derivatives. This, however, is not something that Croatian policymakers should worry about given the dubious role that financial derivatives have played in the recent financial turmoil.

Taking account of the arguments above, we examine the strengths and potential vulnerabilities of the Croatian financial system today. Although the financial sector remains broadly healthy new areas of vulnerability have emerged to which neither Croatian monetary policy nor regulation haven't responded successfully to this date. As bank's profitability and capital adequacy remain stable at recommended levels, significant external imbalances arose as a result of rapid credit growth. The ownership structure of credit institutions and their dependency on foreign funding only exacerbate such imbalances. This is partly because the majority of loans are linked to foreign currency and thus exposed to interest and exchange rate risks. From a macroprudential perspective it seems that Croatian financial institutions (for instance banks) are all subject to the same type of risk – that is currency risk from borrowers. Let us explain why. In the Croatian context currency risk is actually transformed in credit risk. Meaning that, although the asset and liability side of an institution's balance sheet are "leveled out" (*i.e.* banks loans are denominated in Euros, banks borrow in Euros, and deposits are denominated in Euros as well) their counterparties are represented by households and companies who do not make their earnings in Euros but in the domestic currency. In this way if exchange rates would appreciate substantially borrowers would not be able to honor their obligations. Thus, in Croatia there is a pronounced threat of systemic risk because of a currency induced credit risk.

Against this market background higher capital buffers may seem prudent, especially for the most vulnerable institutions or those which bear greater systemic significance. Given the situation of a tightly managed exchange rate regime that targets the stability of the Euro without any support of fiscal policy, the Croatian National Bank has managed to restrain credit expansion with purely administrative measures without a medium-term structural strategy. The leasing sector has finally been put under control with the promulgation of the Leasing Act in 2006[292]. This has closed out a channel of banking regulation circumvention. Since the leasing sector is owned by foreign-owned banking groups that engage in both banking and non-banking activities a better definition of regulatory activities in which the two existing supervisory authorities engage is in order.

In conclusion we argue that Croatia should continue with further structural reforms in line with its position as a EU acceding country. This would support economic development and

[292] Zakon o leasingu, Official Gazette No. 135/06;

Retrieved from: http://www.hanfa.hr/zakoni/leasing_en/leasing_act.pdf perhaps even speed up the transition (Levine, R., 2004). Although the political consensus regarding the essentials of financial reform has been maintained for many years now, there is a distinctive *ad hoc* approach to Croatian economic policy that is visible in the majority of financial issues. Overall, Croatian financial reform has moved slowly, marked by a characteristic gap between legislative intent, actual implementation and intended market impact. Croatian policymakers persistently ignore the fact that a coherent legal reform in the area of finance is key to further development and stability. But this is not all. In fact, Croatia still lacks a coherent economic policy that would support economic growth and stability in the post-accession period. For the time being the attention of policymakers is set exclusively on the political goal of EU membership. There are no studies, policies or other publicly disclosed strategies that discuss the long-term position of Croatia as a EU Member State from a purely economic aspect.

6.2.1. Financial regulation and supervision in Croatia

In this subsection we determine some of the most important "landmarks" in Croatian financial regulation. Then our focus shifts to supervision. We examine the current institutional set up of supervision and the objectives pursued through this activity. In addition, we briefly address an interesting issue in supervision – namely that of institutional consolidation of supervisory authorities. Is the "single supervisor" model appropriate for Croatia? We analyze all of this in the following paragraphs.

As we have already argued Croatian financial regulation followed the development of market economy and was greatly supported by the process of EU accession, where Croatia had to adopt European regulation in the area of finance. A similar path of development can be traced in supervision. Croatian competent authorities exercise the institutional model of supervision but with elements of supervision by objectives[293].

Financial regulation

Croatia's accession process to the EU has been a fortunate event from a regulatory aspect, as it provided a great impetus for a major regulatory reform in the area of finance. In fact, until

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[293] In contrast of its economic and financial development, this area is very similar to the Italian regulatory and supervisory model.

recently financial regulation in Croatia was rarely on the agenda of academics and practitioners. There are few studies or articles discussing this topic in Croatia[294]. What was even worse, many had problems to identify the exact subject of financial regulation, or to distinguish financial regulation from substantive law (such as company law, or contract law, etc.). This theoretical confusion was thankfully streamlined during EU negotiations, and after more than a decade of no visible regulatory policy Croatia quickly adapted to European regulation.

In an effort to harmonize Croatian legislation with EU legislation as part of the accession process, the Croatian Parliament has continued to adopt a number of new financial regulations, laws more precisely, from 2007 onwards. Consequently, significant changes have taken place in the financial sector from an institutional and administrative aspect. We recapitulate these changes in the following paragraphs.

From the perspective of the banking sector, the adoption of the Credit Institutions Act (*Zakon o kreditnim institucijama*)[295] marked the full harmonization with EU legislation and standards. It was through this Act that the requirements of the EU Capital Requirements Directives were implemented in national legislation. In order to "round up" the regulation of credit institutions in 2010 the Electronic money act (*Zakon o elektroničkom novcu*) was adopted[296].

Another significant piece of legislation in Croatia that we wish to discuss more in detail is the Financial Conglomerates Act (*Zakon o financijskim konglomeratima*)[297] that was adopted in 2009, and with whose adoption Croatia successfully concluded EU negotiations with respect to the area of financial services[298]. Through this Act financial conglomerates were regulated with a *lex specialis* for the first time in Croatia. The Act finally defines the term of "financial

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[294] At this point it is particularly important to stress that studies related to international, European or domestic financial regulation and supervision are scarce in Croatia. There is no complete study of the historical development of the Croatian regulatory and supervisory model and no theoretical study of the future of regulation and supervision as regards the convergence with European standards. A valuable reference is Prohaska, Z., Olgić Draženović, B. (2004).

[295] Official Gazette No. 117/08; 74/09.

[296] Official Gazette No. 139/10.

[297] Official Gazette 147/08. Available only in Croatian. Retrieved from: http://www.hnb.hr/propisi/zakoni-htm-pdf/h-zakon-o-konglomeratima.pdf

[298] Namely, the adoption of the Financial Conglomerates Act meant that Croatia has successfully transposed and implemented the provisions of Directive 2002/87/EC into national legislation. See Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council (OJ L 35/1).

conglomerate" and authorizes them to operate on the basis of provisions governing activities of credit institutions, investment companies, and insurance undertakings (as well as other companies which form a financial conglomerate). As financial conglomerates are often managed on a business-line basis that does not fully coincide with the conglomerate's legal structures, management of such entities should be carefully considered and supplementary supervision should be exercised. In addition, since the activities of these complex entities cross national borders and in this sense create potential for regulatory arbitrage, the transparency of rules imposed on them and the coordination among competent authorities in their supervision is a priority. However, the issue of financial conglomerates and their regulation has received little attention among the Croatian expert public. This is surprising, as the relevance of regional, cross-border conglomerates has become very important for the stability of the Croatian financial system. In fact, nowadays, several financial institutions in Croatia (*e.g.* the credit institution of Zagrebačka banka which is connected to Allianz insurers) represent parts of larger European financial conglomerates. In this context, the appropriate supervision and monitoring of the regulatory compliance of these entities as "solo entities" cannot suffice anymore. Competent authorities in Croatia have to keep in mind that in such cases a consolidated approach to supervision is in order. By "consolidated supervision" we mean supervision that is based on consolidated financial reports[299]. Still, the Croatian National Bank hasn't made any official statements regarding the results of such enhanced supervision exercised according the Act's provisions, nor of its future monitoring activities in this area that should be taken in coordination with the other Croatian supervisor (that will be discussed in the passages below) depending on the composition of an entity. Perhaps this is partly due to the fact that although the Act is already in force, its provisions regulating the activities and supervision of financial conglomerates that have their registered office in a EU Member State will enter into force only upon Croatia's EU accession.

The end of 2008 completed the transformation of savings and loan cooperatives into credit unions or savings banks. This process was initiated with the Credit Unions Act (*Zakon o kreditnim unijama*)[300] and the related amendments to the Banking Act (*Zakon o bankama*)

[299] See Korže, B. (2008).

[300] Official Gazette No. 141/06.Available in Croatian at:

http://www.hnb.hr/propisi/zakoni-htm-pdf/h-zakon%20o-kreditnim%20unijama.pdf. We find the fact that Croatia has credit unions very interesting (at the end of 2010 there were approximately 23 credit unions authorized in Croatia). Credit unions are a type of commercial banks organized on a cooperative basis, which are owned and controlled by their members and operated for the purpose of providing service to members. As such adopted in 2006[301], which was later revised by the Credit Institutions Act. In 2008 further progress has been made in the field of insurance where a good level of convergence with EU standards has been reached in the outstanding areas of non-life insurances, insurance mediation and supervision of reinsurance companies by amending the Insurance Act[302] and through the adoption of related implementing legislation.

But the most radical change in Croatian financial regulation happened in 2009 when the new Croatian Capital Markets Act (*Zakon o tržištu kapitala*, Official Gazette No. 88/08, 146/08 and 74/09; the Act) came into force. The Act entirely replaces the former Securities Markets Act (*Zakon o tržištu vrijednosnih papira*, Official Gazette No. 84/02 and 138/06; ZTVP). With its adoption Croatian legislation has become fully aligned with EU regulatory requirements in the area of financial markets (in particular with the Market Abuse and Prospectus Directive as well as with the requirements of the MiFID). In order to upgrade the Croatian capital markets regime, the Act incorporates a line of EU guidelines and regulations governing credit institutions, investors' protection, securities, conflicts of interest, investment firms, and more.

Supervision

From the gaining of its political independence in 1991, the Croatian National Bank (*Hrvatska Narodna Banka - HNB*)[303] was the only authority responsible for the prudential supervision of credit institutions. During the years similar authorities were established in other sectors, as Croatia was committed to follow the model of institutional supervision. As a result, at the beginning of the 2000's there were six separate authorities that supervised different types of financial institutions in Croatia:

(1) The Securities Commission of the Republic of Croatia,

(2) The Agency for Supervision of Pension Funds and Insurances,

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they are found in some of the most developed economies – for instance in the USA, Germany, France and Italy. However credit unions are troublesome from the perspective of the Croatian National Bank as many of them often do business outside the business framework envisaged by regulation and as such are put through rigorous supervision and often sanctioned for their infringements.

[301] Official Gazette No. 84/02.

[302] Zakon o izmjenama i dopunama Zakona o osiguranju, Official Gazette No. 87/08.

[303] Act on the Croatian National Bank, Official Gazette No. 75/08.

(3) The Directorate for Supervision of Insurance Companies,

(4) The State Agency for Deposit Insurance and Bank Rehabilitation, and

(5) The Croatian Ministry of Finance.

This was supervision based on a pure institutional model.

But the trend towards institutional consolidation in supervision was caught on early in Croatia. The consolidation of supervisory authorities was a gradual process that evolved in two stages. The first stage was realized already in 2003 with the formation of the Committee for Coordination of Financial Services Regulation. This Committee comprised representatives from all of six supervisory authorities. Its function was to improve the coordination between existing authorities and to put a timeframe to the institutional transition to a single supervisor for financial markets and institutions other than banks. The second stage was characterized by institutional consolidation in the area of financial markets. At the end of this stage the Croatian Financial Services Supervisory Agency (*Hrvatska agencija za nadzor financijskih usluga* – Hanfa) emerged[304]. The Croatian National Bank retained its function of prudential regulation and supervision of credit institutions, *i.e.* banks, whilst the newly established Agency was entrusted with investor protection and regulation of non-bank financial institutions. Hence, supervision by objectives started to gain greater importance in Croatia.

Nowadays there are two supervisory authorities in Croatia:

(1) The Croatian National Bank, and

(2) The Croatian Financial Services Agency.

However, there is a third element in the Croatian framework for supervision that is also important. This is the State Agency for Deposit Insurance and Bank Rehabilitation responsible for the supervision of the deposit guarantee schemes[305].

In the following paragraphs we separately examine the responsibilities and obligations of each of the two supervisors.

The Croatian National Bank is a politically and institutionally independent public legal entity and a national supervisory authority with autonomy as regards the pursuit of its objectives[306].

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[304] Act on Croatian Financial Services Supervisory Agency, Official Gazette No. 140/05.

[305] It is interesting to note that this is the same Agency that was established with the intent to rehabilitate banks during the first banking crisis in Croatia in the late 1990s. Since then the Agency hasn't changed its name although the Agency now retains only its role of deposit insurer.

It acts as a both regulatory and supervisory authority in the area of banking. This means that in addition to monitoring responsibilities, the central bank issues subordinate legislation that regulates banking operations and establishes standards for the sound and safe functioning of credit institutions. In April, 2001 a new law on the Croatian National Bank was adopted[307] that emphasized its operational autonomy and independence and further improved its supervisory functions.

In addition to the supervision of banks and other credit institutions, the central bank supervises banking groups on the basis of consolidated financial statements and supervisory reports. Furthermore, the central bank authorizes (and withdraws the authorization) credit institutions, credit unions, payment institutions and payment transaction settlement systems. Prudential regulation, as exercised by the Croatian National Bank, implies the creation (or adoption) of new regulation and the alignment with international regulatory standards (primarily those of the European Union). In its supervisory competences the central bank analyzes financial reports and records of banks as well as other data, which it collects through on-site supervision or off-site supervision (*i.e.* by written submission of these documents by banks).

The Croatian National Bank maintains good cooperation with all other EU supervisors. To this end, the central bank has concluded several Memoranda of Understanding (MoU) with the home supervisors of all EU countries whose credit institutions have a significant share in the Croatian financial system, and which are thus systematically important for financial stability (these are Austria, Italy and Hungary respectively). In addition, the national central bank has signed an agreement of cooperation in September 2006 with the *Hanfa* in order to support coordination of supervisory actions of the two authorities and further safeguard financial stability of the financial system[308].

Turning our discussion to the *Hanfa*, we can define it as an independent public legal entity, accountable to the Croatian Parliament (as is the Croatian National Bank). As mentioned above, the Agency has replaced different agencies which supervised the non-bank financial sector until 2006. Thus, from an institutional aspect, *Hanfa* combines the previous agencies'

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[306] Art. 2, Act on the Croatian National Bank. Retrieved from: http://www.hnb.hr/propisi/zakoni-htm-pdf/e-zakon-hnb--7-2008.pdf

[307] Official Gazette 36/01.

[308] All Memoranda available at: http://www.hnb.hr/supervizija/suradnja

responsibilities for component entities. The *Hanfa's* objective is to promote and preserve the overall stability of the financial system, and to supervise the legality of the activities of the non-bank financial institutions (Art. 13 of the Act). In exercising its powers the Agency follows the principles of transparency, confidence among market participants and public to disclosure of its decisions.

The second paragraph of Art. 14 of the Act states a very important premise: "*The Agency shall acquaint the public with the role and manner of functioning of the financial system, including the development of awareness of the benefits and risks that are connected with the various types of investments and financial activities.*"

The Agency was criticized more than once, on the basis of this provision. Reflecting upon its meaning, it is clear that the legislator's intention was for the Agency to act as a "mentor" to the Croatian public as regards financial market functions, the benefits and risk associated with market activities. This was immensely important as until the mid-2000's the Croatian financial market was significantly undiversified and underdeveloped. In the interest of these objectives the Agency provides rapid approach to all kinds of information that might be useful to financial services investors and to the public. However, it has to be stressed that *Hanfa* should never (nor was this the legislator's intention for that matter) act as an "adviser" to the public in these matters as this would undermine its institutional independency[309].

As regards its regulatory competences, the Agency is authorized to adopt regulations and guidelines on the enforcement of different laws governing financial markets, as well as to adopt by-laws in order to prescribe the conditions, manners or procedures for the performance of supervision within its competences.

As for its supervisory activities, the Agency acts in coordination with the Croatian National Bank on the basis of the above mentioned cooperation agreement. Furthermore, *Hanfa* participates and collaborates with other European and international institutions in this area.

So for the time being supervision in Croatia is entrusted to two separate, non-concurrent authorities. But as EU membership approaches and Croatian finances become more complex, should Croatia adopt the European trend of institutional consolidation in supervision? In conclusion, let us briefly address the question whether, in the future, a single authority should exercise supervision in Croatia? We argue against such a possibility. Indeed we do not find

[309] However, on several occasions the Agency failed to act in the public's interest hindering the long-term stability of the market as a result of clear regulatory (or political) capture.

any reason why supervision of the banking and non-bank financial sector should be vested in a single authority. Thinking about it, there are two possible results of such a decision: (i) the consolidation under the roof of the central bank, and (ii) the consolidation in a different supervisory authority (created by merging the existing ones). Admittedly, there was a period in recent economic history when the tendency of setting up single supervisors came to dominate. The trend was adopted by some of the most reputable countries when it comes to finance and its organization – for instance the United Kingdom, Luxembourg, Germany, and others. But at the same time, many European countries continued to exercise financial supervision through separate authorities. As we have mentioned above, when Croatian policymakers planned the institutional consolidation of supervision, their first intention was to make it happen in three (not two) stages[310]. We have discussed the first two in this subsection; but what should we conclude about the aim of the third one? Our argument against the possibility of creating a single supervisor in Croatia draws from several studies conducted in the area over the years[311].

When considering the possibility of creating a single supervisor, a country has to primarily consider the role of the central bank in the financial system. In fact, the degree of institutional consolidation of supervision is decided based on the position of the central bank (Masciandaro, D., 2005, p. 1). If the involvement of the central bank in supervision and its reputation are high, then the degree of consolidation is likely to be low (and *vice versa*). In Croatia the national central bank has a high reputation as well as experience in exercising supervision (and thus in valuing data collected by on-site and off-site inspections), thus we find no arguments in favor of consolidation. However, we should take into account the "small country" argument as well. This argument states that the lower the overall economic size of a country the more likely is the probability of institutional consolidation in supervision. In this context a single supervisor in Croatia would make sense. Put bluntly, when expertise in financial supervision is in short supply (as in Croatia), it may be better utilized if it is concentrated within a single authority. But we nevertheless adhere to our opinion and on this

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[310] The final, third stage – as described by Prohaska and Olgić Draženović (2004) should be the complete consolidation of regulatory and supervisory functions within a single institution. Judging by this intention, it seems that Croatian regulators clearly predicted a positive future for Croatia's financial market. It was planned that by the end of the first decade of the 21. Century, Croatia's financial market will be well developed, diversified and dominated by financial conglomerates. As such, it would be only logical to exercise supervision following the "single supervisor" model.

[311] See for instance: Masciandaro, D. (2005); Masciandaro, D., Quintyn, M. (2009, January); Llewellyn, D. T. (2006, June).

reasoning we interpose the "legal neighbor" effect. This concept states that consolidation of supervision is more likely to happen in Common law countries than in Civil law ones. This concept also holds in the case of Croatia.

In order to give a more plausible explanation to our arguments we wish to point to the political-economic concept. According to it, the decision regarding the institutional set up of supervision seems to be related to the influence of both the central bank and the political governance. The concept states that consolidation is more likely to occur in countries characterized by good public sector governance and where the central bank is only weakly involved in supervision (Masciandaro, D., Quintyn, M. 2009, January, p. 14). These facts do not hold in the case of Croatia. As such, supervision should remain vested into two (non-competing) authorities. If we add the fact that the general premise for effective supervision is exhaustive, good-quality information (which the Croatian National Bank does dispose of) as well as recent events (such as the deployment of the single supervisor in the United Kingdom) to our arguments, we are only more determined in our conclusion.

At last, economic reasons do not suffice for making the decision of transiting to a "single supervisor" model. Politics and economic history matter as well. This means that in deciding on this matter, countries should primarily take account of their own institutional, political and economic circumstances. Reorganization of the supervisory set up may be, at times, completely inappropriate. In the foreseeable future this will be true for Croatia irrespective of its EU accession. Croatia has far more pressing financial and economic issues (we discuss them in the following section) that should be resolved first.

6.3. Comparative overview of finance in Italy and Croatia

Let us now discuss the current "state" of the Italian and Croatian financial systems. We wish to "quantify" the Italian and Croatian financial system and comment various economic indicators based on a static, one-year period (2009). This time-period has been chosen deliberately, based on two facts. First, in 2009 the first effects of the financial crisis were not only visible, but they could also be examined. Second, at the time of writing many economic publications for 2010 (such as central bank's annual reports) weren't still published, or their results were only provisional.

Thus, by examining economic data available for 2009 we compare the two financial systems:

(1) According to the size and Gross Domestic Product (GDP) of the overall economy, and

(2) According to the size and activity of the most important economic sectors – namely the banking and non-banking sector.

In collecting the data and other relevant information we rely on Eurostat's statistical reports and publications of national central banks. To facilitate the comparison between these two countries, data is often shown as percentage of the country's GDP.

In our analysis Italy serves mainly as a benchmark or reference point for our later comments regarding Croatia. This is why we do not make many critical observations regarding the Italian financial system. Our focus is primarily on Croatia. The intention is to assess the financial situation in Croatia by comparing it with Italy, so that we could discuss whether the size and composition of the Croatian financial system are appropriate. Also, this allows us to determine potential vulnerabilities and point to its strengths.

At first glance the comparison between these two countries – Italy a well developed, industrialized EU Member States, and Croatia as a transition economy, on the verge of EU accession – seems somewhat inappropriate. However such a comparison is viable as both financial systems operate in similar legal environments and both rely on more traditional forms of financial intermediation. As such, both the Italian and Croatian economic systems are bank based. This similarity is reflected in their national financial regulations. Namely, the majority of their rules are oriented towards prudential regulation of banking. Furthermore they both transpose and implement EU law in the area of finance, which makes their regulatory framework highly compatible. Similarities are present in their respective models of financial supervision. Both countries rely on the model of institutional supervision mixed with elements of supervision by objectives.

Finally, the strongest argument why we decided to make a comparison between Italy and Croatia is the fact that Italian financial institutions (banks) are the second largest shareholder of financial institutions in Croatia.

Italy

The publications of the International Monetary Fund (IMF) describe the Italian financial system as well diversified and advanced. According to IMF's country report this is partly due to the fact that Italy's financial system wasn't subject to systemic vulnerabilities during the second half of the 2000s but was actually characterized by considerable growth (International

Monetary Fund, 2006, March). Naturally, one can argue that such strength and stability of the system was greatly supported by European financial integration and the successful adoption of new regulations in the area of finance as well as better supervisory standards.

Italy is a bank based economy whose Gross Domestic Product amounted to around 1,5 trillions of Euros in 2009[312]. In Italy the capital market is less developed than the banking sector and only a small portion of financing (primarily of legal entities, or companies) is raised through the issuance of securities. For instance, in 2009, market capitalization amounted to 30 % of Italy's GDP. Just to compare, in the same year market capitalization amounted to 103.39% of GDP in the United States of America, to 63.52% of GDP in Japan and to 61.48% of GDP in all the EU countries (the "EU 27"). We can safely say that in Italy bank financing predominates.

Italian banks

In order for us to gain a perspective on the size of the Italian banking sector we should say that at the end of 2009 total bank assets amounted to 241% of GDP. In addition, the banking sector controls a substantial portion of the non-banking sector as well (for instance, the insurance sector and the asset management industry). At the end of 2009 there were 788 banks operating in Italy and 75 banking groups[313].

The two major groups (the *UniCredit* and *Intesa Sanpaolo*) hold 33.9% of the banking system's assets in Italy. The other three medium sized groups (that is the *Banca Monte dei Paschi di Siena, Banco Popolare* and the *Unione di Banche Italiane*) account for 18.6% of banks' assets.

While the presence of Italian banks abroad is significant, especially in the Euro area countries (particularly in Germany and Austria) and in the Central and Eastern European countries

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[312] Data available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/national_accounts/data/database

[313] In Italy (but also in other EU countries) a growing number of banks belongs to banking groups, which comprise:

(1) the Italian parent bank and its banking, financial and instrumental subsidiaries, or

(2) the Italian financial parent company and its banking, financial and instrumental subsidiaries, provided that the group of subsidiaries includes at least one bank and the banking and financial companies have a significant stake in it.

See: http://www.bancaditalia.it/vigilanza/regolamentati/banche;internal&action=_setlanguage.action?LANGUAGE=en

(such as Croatia), the share of foreign banks in Italy (both branches and subsidiaries) is not substantive. At the end of 2009 there were 22 subsidiaries of foreign financial companies and banks operating in Italy, two of which figured among the top ten banking groups with a market share of 9.7% of total banks' assets. The rest were branches of foreign banks that are not included in Italian groups (81 of them) and which held 8.2% of system assets.

The restructuring of the banking system that begun in the 1990s has helped improve the efficiency and competition of Italian banking and has brought its performance broadly in line with other major European countries. The degree of concentration[314] was not immune to the European trend, and thanks to a pronounced activity in mergers and acquisitions the Herfindahl-Hirschman index rose to 760 (out of 10,000)[315].

6(1) The structure of the Italian financial system (as of 31st December 2009)

	Banking Group Members*	Investment Group Members	Non-group Members	Total
BANKING GROUPS	-	-	-	75
INVESTMENT FIRM GROUPS	-	-	-	18
BANKS	217	-	571	788
- Limited company banks	*191*	-	*58*	*247*
- Cooperative banks (banche popolari)	*16*	-	*22*	*38*
- Mutual banks (banche di credito cooperativo)	*9*	-	*412*	*421*
- Branches of foreign banks	*1*	-	*81*	*82*
INVESTMENT FIRMS	15	20	80	115
ASSET MANAGEMENT COM. AND SICAVS	39	5	160	204
FINAN. COMPANIES *(special register under Art.107 of the Con. Law on Banking)*	64	-	108	172
ELECTRONIC MONEY INSTITUTIONS	-	-	3	3
OTHER SUPERVISED INTERMEDIARIES**	-	-	2	2

314 Concentration is defined as the share of the amounts of assets, loans and deposits of individual bank groups in the total amount of the respective balance sheet items of all banks.

315 The Herfindahl-Hirschman index (HHI) is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in a market, and then summing the resulting numbers. The HHI number can range from close to zero to 10,000. The closer a market is to being a monopoly, the higher the market's concentration (and the lower its competition).

FINAN. COMPANIES *(general register under Art.106 of the Con. Law on Banking)*	72	2	1337	1411

Note: **Italian owned groups or Italian sub-groups owned by foreign companies; includes parent undertakings (banks or investment firms); ** Bancoposta & Cassa Depositi e Prestiti*

* Source: Bank of Italy. (2010, May)

In 2009 the Italian banking sector was resilient to the slowdown of economic growth mostly because of its stable performance during the acute phase of the 2007-08 financial crisis. In fact, the impact of the recent world financial crisis on the Italian banking system has been relatively moderate in comparison with other countries. The explanation of this is quite simple. Italian banks had very few "toxic" assets in their balance sheets (*i.e.* assets whose value was affected the most by the crisis, such as financial derivatives). The amount of financial derivatives held by Italian "monetary financial institutions" in 2009 stood at 5.70% of GDP. Furthermore Italian banks engage less into securitizations – one of the main culprits of the crisis. In 2009 total issues of loan-based securitizations amounted to around 37 billion Euros. In addition their lower dependence on risky financial instruments and transactions, the specialization of Italian banks in retail lending activities and a prudent regulatory framework, guaranteed their stability during the economic downturn. That said, what are the main balance sheet components of Italian banks?

The majority of banks' assets are represented by loans to households (82% of GDP) and other monetary financial institutions (43% of GDP). The third largest group of assets is represented by debt securities, of which government securities take the greatest share in banks' proprietary holdings. For instance, in 2003 (this is the last year that there is available data on this subject) banks' holdings of securities issued by general government amounted to 238.272,0 millions of Euros, which represents around 15% of GDP. The majority of banks' liabilities are deposits of residents (80% of GDP). Deposits of monetary financial institutions come second (51% of GDP), while deposits of the central government amount to only 0.9% of GDP.

Before we discuss the Italian non-banking sector we should say a word about the level of capitalization of Italian banks. Overall, the capital position of the Italian banking system is good. At the end of 2009 consolidated regulatory capital amounted to 5.9% of total banks' assets (or 217.4 billion Euros). From a European perspective, capital ratios of large Italian banks seem low. But this discrepancy of views results from both Italian prudential regulations that are more stringent when including some instruments in the Tier 1 capital, and the fact that some large European banks have experienced a very substantial public recapitalization. But, on the other hand, the financial leverage of the largest Italian groups, measured by the ratio of total balance sheet assets to Tier 1 capital is lower than the European average – 22 as against 31 (Bank of Italy, 2009, p. 154).

Non-bank financial institutions in Italy

If we consider the Italian non-banking sector – investment funds and insurance undertakings, as well as the alternative investments industry (hedge funds and private equity) – we can conclude that this sector is small by European standards, both in the number of institutions and in the terms of total assets. In total there are 891 open-end investment funds in Italy (of which 283 belong to the alternative investments industry) that are operated by Italian asset management companies. At first glance it seems as investment funds are not dramatically underrepresented when compared to monetary financial institutions and banks. However, the difference in their assets is substantive if we look at them as percentages in the GDP. For instance, total assets of investment funds in Italy amounted to 16% of GDP in 2009, of which assets of hedge funds amount to 1.8% of the sector's total assets. To make another comparison (according to OECD data) at the end of 2008 the financial assets of both insurance undertakings and open-end investment funds equaled to 20% of total liabilities held by Italian households[316]. The size of the sector results with a relatively undiversified distribution structure in Italy and a limited range of financial instruments available.

6(2) Market structure of Italian Investment funds [(1)]

	Number of funds (2)	Net Assets (Mill. of EUR)	% Of GDP
HARMONIZED OPEN-END FUNDS	608	185,501	12,27
- *Equity*	*200*	*25,946*	*1,8*
- *Balanced*	*62*	*14,104*	*0,9*
- *Bond*	*184*	*75,736*	*5,0*
- *Money Market*	*34*	*55,849*	*3,7*
- *Flexible*	*128*	*13,866*	*0,9*
NON-HARMONIZED OPEN-END FUNDS	283	30,631	2,0

[316] Compared with 83% in France, 54% in Germany or 46% in the United Kingdom.

HEDGE FUNDS	*163*	*12,085*	*0,8*
- *Of which: Funds of Funds*	*145*	*9,601*	*0,7*
OTHER	*120*	*18,546*	*1,2*
- *Of which: reserved to qualified investors*	*67*	*5,963*	*0,4*
TOTAL OPEN-END FUNDS	891	216,132	14,2
CLOSED-END SECURITIES FUNDS	117	5,321	0,3
- *Of which: Funds of Funds*	*109*	*5,101*	*0,3*
CLOSED-END REAL ESTATE FUNDS			
- Of which: reserved to qualified investors	*266*	*26,338*	*1,7*
	239	*20,046*	*1,3*
TOTAL CLOSED-END FUNDS	383	31,659	2,1
TOTAL	1,274	247,791	16,3
MEMORANDUM ITEM:			
- *Foreign funds controlled by Italian intermediaries (4)*	*734*	*159,182*	*10,5*
- *Of which: Hedge funds*	*27*	*4,666*	*0,3*
Note: *Sources – Bank of Italy, Assogestioni and Author's calculations* *(1) Includes SICAVs; (2) For Italian funds, those in operation at the end of the year. For foreign funds, those acquired by Italian investors; (3) Side-pocket accounts are included in net assets; they are not included in number of funds; (4) Funds run by management companies resident in Luxembourg or Ireland. Net assets refer to the value of units held and subscribed, respectively, by Italian and foreign investors.*			

* Source: Bank of Italy. (2010, May).

The general size of the Italian insurance sector is small by comparison with the Euro area as a whole. The total number of undertakings pursuing insurance and reinsurance business in Italy amounted to 241 in 2009. The assets of Italian insurance undertakings were worth approximately 734 billion Euros at the end of 2008, which roughly amounted to 48% of GDP in Italy[317]. By comparison, in the Euro area insurance undertakings (together with pension funds!) amounted to 72.60% of total GDP, while in the EU 27 this percentage stood at 83.89.

The majority of assets of Italian insurers (if we look at the consolidated balance sheet) is represented by investments (85% of the total assets), of which around 43% were "available-for-sale" financial assets. Italian life assurance undertakings mostly invested in bonds; approximately 78.5 of total investments. The same was true for non-life insures, were investments in bonds accounted for 49% of their total investments.

[317] Data according to the consolidated balance sheet of Italian insurers.

As for the liabilities of Italian insurers, the majority was represented by technical provisions (69.9% of total liabilities) and by financial liabilities (around 20% of total liabilities).

Links between insurers and banks within financial groups and in distributing agreements are quite common, as a way of diversifying sources of income and exploiting synergies in the placement of financial products. In 2009, Italy had six financial conglomerates[318]; three primarily oriented towards the insurance business (*Generali*, *Unipol* and *Mediolanum*), two focused on banking (*Intesa Sanpaolo* and *Carige*) and one focusing on investment services (*Azimut*) (Bank of Italy, 2010, May, p. 162).

Based on the discussion above, we can make a brief conclusion about the "general state" of the Italian financial system (without detailed critical observations) we could argue that finance in Italy appear sound and with no immediate systemic threats. There is no doubt that a great part of this stability is merit of a robust banking sector. Italian banks have shown resilience to weak economic growth despite the fact that the quality of their assets has deteriorated during recession. Their commitment to strengthen their sources of fund-raising and their capital base allows them to withstand unfavorable macroeconomic scenarios in the future. Considering their assets (and when matching them with liabilities) Italian banks have a good short-term liquidity position. The high proportion of retail funding confers stability. Looking forward, Italian banks will have to strengthen capital base even more. In fact, Italian banks like their foreign counterparts will have to make considerable efforts to comply with the new capital adequacy requirements of Basel III (and the CRD IV). Until now, they have done this by employing various measures: capital increases, retained earnings, etc. But, in a cyclical expansions characterized by substantive market and credit risk, it will be essential to consolidate the expansion of own funds. And this shouldn't put Italian banks in a more unfavorable position in comparison to other European banks.

The Italian insurance industry has had rapid growth rates in premiums and strong profitability for the past years; the pre-crisis prospects in this sector were immensely favorable. Overall, Italian insurers have low levels of exposure to potential instability on the financial markets. However, since banks own the majority of the life assurance undertakings, their capital buffers should cover possible solvency shortfalls. In this context, Italian insurers will

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[318] Financial conglomerates are large financial groups active across different financial sectors, and often across borders. They are important because these firms are often systemically important, either in one Member State of the European Union or for the European Union as a whole.

nevertheless have to persevere in their efforts to strengthen solvency margins and promote better risk management practices in line with new EU prudential requirements (Solvency II).

Croatia

Let us now turn our analysis to the Croatian financial system. As we have already said, this financial system is substantially different than that of Italy. First of all the difference is dramatic if we talk about the system's development, especially with respect to financial institutions (credit institutions in particular) and financial instruments. Moreover this is a financial system heavily marked with transition problems (the most notable being the ownership structure of the banking sector) and unrealistic expectations from national policymakers as to the performance of its capital market. We wish to say that as a small, transition economy without a significant number of large private companies that could benefit from direct financing, it is not realistic to expect that Croatia will have a thriving capital market in the foreseeable future. Governments and policymakers who argue the contrary are just disregarding the state of the Croatian real economy. But the orientation towards bank financing shouldn't be perceived as something outdated. In fact, for a small country such as Croatia, banks could prove to be very efficient intermediaries. A couple of paragraphs above, we have seen that bank financing largely supports Italy's economy as well. Unfortunately, unlike Italy Croatia has a serious problem with the ownership structure of its banks, which impedes it to maximize the benefits of bank financing. The largely foreign owned banks are making loans predominantly to households in order to finance their consumption (of mainly imported goods) and have little interest in reviving the Croatian real economy through corporate financing. This is not the case of Italy. The prevalently domestically owned banks and other financial intermediaries are working in the interest of Italian non-financial corporations. This is not to say that they do not encourage consumption by Italian households as well. But in our opinion, the activities of Italian financial intermediaries are complementary with the movements in the real economy. This is not the case in Croatia. But we will discuss the ramifications of this issue later on in the section.

Upon gaining political independence, Croatia was confronted with a rudimentary financial system in terms of structure, size and operations. Corporate governance and supervision had to be created in line with Western-oriented expectations. The judicial system had to improve its transparency and capital markets had to be developed in order to provide additional financial resources to enterprises. All these problems, and more of them, had to be addressed at the beginning of the transition process. But many of them remain still unresolved.

Croatia is a bank based economy whose GDP amounted to 45.3 millions of Euros (or 333 mill of Croatian kuna) in 2009. The IMF has recently described Croatian economy as "*highly vulnerable*" and the financial sector as "*exposed to liquidity, contagion and currency risks*" (International Monetary Fund, 2011, July, pp. 2, 8). But why is it that a bank based economy, whose capital market is far less developed, where non-financial companies rarely rely on direct financing and where "toxic" financial instruments are non-existent, is so prone to instability?

First of all, one of the most significant sources of instability is the dependence on foreign banks for funding, irrespective of the fact that the "loan-to-deposit" ratio (LTD)[319], currently at 107%, is quite good. But we must deduct reserves that the banks must subtract from these deposits if we wish to assess funds available for loans that stem from deposits accurately. In recent years, the national central bank has led a proactive prudential policy, which has contributed to the stability of the financial system.

The Croatian National Bank (CNB) adopted a number of administrative measures during the period of intensive credit growth, in order to reinforce capital and liquidity buffers and limit banks' borrowing abroad[320]. In this we see a developing macroprudential framework; however, this framework has largely an *ad hoc* nature, and doesn't follow a thought out strategy. Nevertheless, building even stronger buffers is of immense importance for the stability of the Croatian financial system, because of its high degree of euroization.

Since the large degree of euroized lending to mostly un-hedged borrowers (households and companies) exposes banks to credit risks, the CNB has no other choice but to concentrate on the exchange rate stability with little room for active monetary policy[321]. In this context, the CNB relies largely on administrative measures, meaning on different regulatory requirements,

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[319] This is a commonly used figure for assessing a bank's liquidity. If the ratio is too high it means that banks might not have enough liquidity to cover unforeseen requirements for additional funds. On the other hand, if the ratio is too low, banks may not be earning as much as they could be.

[320] Some of these measures were: marginal reserve requirements, special reserve requirements, credit ceilings, and other.

[321] We have already mentioned that the Croatian economy is largely euroized. It is not surprising then that the monetary policy in Croatia is based on a Euro nominal exchange rate as anchor.

to insure stability of the banking sector. As a result the costs of regulatory compliance borne by banks in Croatia are high[322].

But let us not go too quickly ahead with our critical observations. First we should examine the Croatian financial system in detail.

Croatian banks

As we have already stated, the Croatian financial system is bank based which does not surprise. As a transition economy, in its previous economic regime, Croatia did not have many fundamental elements of a modern financial system; thus they had to be built *ex novo*. The existing financial institutions – banks, had to be recapitalized and accustomed to a new business environment. The path that led the banks to a "market economy environment" was privatization. After two decades of seemingly successful bank-privatization the result was almost total loss of bank ownership in a bank based economic system. So while greater presence of foreign banks, together with their expertise, was at first welcomed by both supervisors and the broader public, in the last couple of years there is a growing discontent with the present situation in the banking sector.

So the largely private and foreign-owned banking sector remained the key financial player up until today, and 2009 was no exception. At the end of 2009 there were 39 credit institutions operating in Croatia: 32 banks, two savings banks and five housing savings banks. There were six large banks that accounted for 82.7% of total bank assets; three were medium-sized and 23 were small banks[323]. Although at first glance the number of foreign owned banks is smaller than the number of domestic privately owned ones (the ratio is 15:17) the truth is that assets of foreign owned banks accounted for 90.9% of total bank assets in 2009[324]. It is not surprising then that the Croatian banking sector is concentrated. There are not many studies focusing on the subject of banking sector concentration in Croatia, and the few available put

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322 They amount approximately to a third of total bank liabilities. For a detailed insight see Bokan, N., Grgurić, L., Krznar, I., Lang, M. (2009).

323 Depending on the size of the share of bank assets in the total assets of all banks at the end of a specified period, banks in Croatia (inlcuding savings banks) can be divided into three peer groups for the purpose of this analysis: (i) large, (ii) medium-sized, and (iii) small banks. Large banks are those whose assets exceed 5% of the total assets of all banks; medium-sized banks are those whose assets are greater than 1% and less than 5% of the total assets of all banks, and small banks are banks whose assets are less than 1% of the totoal assets of all banks.

324 The leading country – in terms of bank ownership – is Austria with six banks and 60.4% of total bank assets. Italy is second, with five banks under its control and 19.4% of total bank assets.

forward opposing conclusions[325]. Our opinion follows the conclusion expressed in a study made by Žiković (2007). Namely, taking into account that in 2009 the HHI stood at 1407 units, reaching its record high from the end of 2001, we deem the level of banking sector concentration to be extremely high. One could argue that they damage free market competition in banking. If we look at the group of the ten largest banks, we can freely speak of a "massive concentration". The highest degree of concentration that these banks exhibit is in loans (93.2%) with the degree of deposits and assets concentration at 92.2% and 92.7% respectively. In light of these facts we argue that further increases in banking competition in Croatia cannot be taken for granted. This should preoccupy Croatian supervisors and incentive them to take corrective action. This is because foreign banks are accustomed to earn high profits in Croatia, and they will not be willing to undermine their position with more competition. As argued by Kraft (2004) this is particularly troubling when keeping the perspective of medium-term growth in mind. In fact, the development of corporate banking requires greater risk-taking than foreign banks have been willing to take so far. What banks in Croatia have done until present is to transfer as much risk as possible on clients. Also they have failed to develop many business lines that are typical in advanced countries. Some argue that European financial integration will help competition. However, even with the participation in the Single Market as a EU Member State, Croatian authorities will continue to be responsible for maintaining competition in its local market. In this sense, the Croatian National Bank, as the competent authority, should put the analysis of local competitive conditions and the creation of regulatory remedies, high on its agenda.

Let us now look at the structure of banks' balance sheet in Croatia. Total bank assets stood at roughly 378.881,2 billions of Euros in 2009, which amounted to 138.1% of Croatia's GDP. The majority of assets (65% of total assets) were represented by "loans to other clients". Namely, these are loans to households, which amount to around 73.6% of GDP. It is clear that banks in Croatia have an important role in lending. For the greatest part these loans go to households and the government. The second most significant assets are deposits held with the central bank. This is a direct by-product of the macroprudential measures that we have

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[325] Some authors argue that the degree of concentration in the banking sector is already preoccupying. See for instance Žiković, S. (2007). Other authors are not worried with the degree of concentration but rather with the maintenance of competition in the banking sector. See Kraft, E. (2004). And then, there are the eternal optimists, in whose opinion the degree of banking concentration in Croatia is not something to worry about since it is lower than the degree of concentration found in other transition economies, with a comparable economic size. See for instance: Hrvatska udruga banaka. (2007).

mentioned before. During 2008 the Croatian National Bank imposed marginal reserve requirements, foreign currency liquidity measures, and other that were aimed at preserving the liquidity and stability of the system. These measures were lowered or phased-out during 2009. Regardless of the central bank's measures employed to curb excessive credit growth, the amount of total credit by monetary financial institutions to residents stood at 75% of GDP.

6(3) Structure of bank assets (end of 2009)

Type of asset	Share in %
MONEY ASSETS AND DEPOSITS WITH THE CNB	12.5
- Money assets	*1.4*
- Deposits with the CNB	*11.1*
DEPOSITS WITH BANKING INSTITUTIONS	8.6
MINISTRY OF FINANCE T-BILLS AND CNB BILLS	2.5
SECURITIES AND OTHER FINANCIAL INSTRUMENTS HELD FOR TRADING	1.5
SECURITIES AND OTHER FINANCIAL INSTRUMENTS AVAILABLE FOR SALE	3.7
SECURITIES AND OTHER FINANCIAL INSTRUMENTS HELD TO MATURITY	1.1
SECURITIES AND OTHER FINANCIAL INSTRUMENTS NOT TRADED IN ACTIVE MARKETS BUT CARRIED AT FAIRE VALUE	0.4
DERIVATIVE FINANCIAL ASSETS	0.1
LOANS TO FINANCIAL INSTITUTIONS	1.6
LOANS TO OTHER CLIENTS	65.0
INVESTMENTS IN SUBSIDIARIES, ASSOCIATES AND JOINT VENTURES	0.5
FORECLOSED AND REPOSSESSED ASSETS	0.2
TANGIBLE ASSETS *(NET OF DEPRECIATION)*	1.2
INTERESTS, FEES AND OTHER ASSETS	1.9
NET OF: COLLECTIVELY ASSESSED IMPAIRMENT PROVISIONS	-0.8
Total assets:	**100**

* Source: Croatian National Bank. (2009).

What is interesting to observe during 2009 when examining bank assets is their currency structure. In 2009, the share of foreign currency assets and *kuna* assets with a currency clause increased. The percentage of loans in foreign currency and *kuna* loans with a currency clause roughly amounted to 80% of total loans (the majority of these loans was euro or euro-indexed loans). This situation in bank assets often causes insecurity as national policymakers or international counterparts (such as the International Monetary Fund) often have depreciation expectations. But in order to determine this situation as preoccupying we should first have a look at the composition of banks' liabilities, as well as their level of regulatory capital. This will help us to conclude whether the existing currency-mismatch between bank assets and liabilities is really preoccupying.

At the end of 2009 bank liabilities stood at roughly 320 billion Croatian kuna, and amounted to 97.9% of GDP. The majority of liabilities were represented by deposits (who made up 77.2% of Croatia's GDP) and between them the greatest share went to time and savings deposits – typically held by households. As for the currency structure of these deposits we can observe that the majority were foreign currency deposits and *kuna* deposits whose vale is safeguarded by a currency clause (67.7% of total deposits).

6(4) Structure of bank liabilities (end of 2009; in million Croatian kuna and %)

Type of liability	Share in %
LOANS FROM FINANCIAL INSTITUTIONS	5.6
- Short-term	*2.7*
- Long-term	*2.9*
DEPOSITS	67.8
- Giro-account and current account	*9.1*
- Savings	*6.5*
- Time deposits	*52.2*
OTHER LOANS	8.4
- Short-term	*1.6*
- Long-term	*6.8*
DERIVATIVE FINANCIAL LIABILITIES AND OTHER FINAN. LIABILITIES HELD FOR TRADING	0.1
DEBT SECURITIES ISSUED	0.0
- Short-term	*0.0*
- Long-term	*0.0*
SUBORDINATED INSTRUMENTS ISSUED	0.1

HYBRID INSTRUMENTS ISSUED	0.8
INTERESTS, FEES AND OTHER LIABILITIES	3.3
Total liabilities	*86.1*
Total capital	*13.9*
Total liabilities and capital	**100**

*Source: Croatian National Bank. (2009).

Another important component in the structure of liabilities is the share of economic and regulatory capital. At the end of 2009 it stood at 13.9% of total liabilities. This resulted from both:

(1) Significant investments by banks' shareholders and the withholding of a major share of profit generated from 2006 onwards, and

(2) A range of prudential measures of the CNB that encouraged banks to substitute debt by capital investments.

Finally, in 2009 there was a pronounced growth of foreign currency liabilities and liabilities with a currency clause. At the end of the period they stood at 68% of total bank liabilities.

All of these facts lead us to conclude that the Croatian banking system in 2009 remained confronted with considerable interest rate and currency-induced credit risk, as the majority of bank loans were denominated or indexed (currency clauses) to foreign currency. Clearly this makes the Croatian banking sector extremely prone to financial distress. In this sense, is a remedy in the form of high-levels of regulatory capital possible?

In 2009 regulatory capital stood at 50.5 billion Croatian kuna, which amounted to 13% of total bank assets. In 2009 the capital adequacy ratio stood at 15.6%. In Croatia, regulatory capital is mostly comprised of core Tier 1 capital, while in 2009 no bank reported the retaining of supplementary Tier 2 capital. Almost 98.7% of all capital requirements accounted only for credit risk.

Regardless of their sufficient capitalization, negligible involvement with complex financial instruments (such as financial derivatives that account for 0.1% of both banks' assets and liabilities) and the fact that there is a seeming "currency match" between funding and borrowing (both activities are euroized) we conclude that the Croatian banking system is fragile and prone to systemic instabilities. Admittedly, the almost totally foreign-owned banking sector has endured economic duress relatively well, and here an important role has been played by the central bank's proactive prudential measures. However, recession has eroded the quality of banks' assets, with the overall nonperforming loan (NPL) ratio reaching 11%, and the NPL in the corporate sector 18% at the end of 2009.

The main risk arises from weak growth prospects and further deterioration in asset quality that will put pressures on banks' capitalization. Further weakening of the Croatian kuna poses another risk for asset quality, since the majority of loans are denominated in, or linked to, foreign currency. There is also liquidity risk related to significant dependence on parent banks for financing.

While the absence of subsidiaries with parents in debt-distressed Euro zone periphery reduces Croatia's exposure to contagion risks, dependence on external financing exposes local banks to third-party risks through higher funding costs or lower inflows. In addition, problems in a parent bank could be transmitted to local banks, given the high concentration of exposures to only a few countries (namely, Austria and Italy). While "reputational risks"[326] may render it unlikely that parent banks would not support their subsidiaries, the level and degree of their support would depend on general market conditions and cannot be taken for granted. But in our opinion, the most pressing problem is that banks' activity of largely euroized lending is extended to un-hedged borrowers. Thus, any depreciation of the Croatian *kuna* exposes banks to a great risk of nonperforming loans. Exchange rate-related shocks are relevant for both the corporate sector and households, who both rely on income in Croatian *kuna*. Households are especially vulnerable as their rising debt ratio negatively affects their debt servicing capacity. This way, any currency risk in the Croatian banking system is actually transformed into credit risk. Although the current level of capitalization seems sufficient to withstand a range of shocks the Croatian National Bank should insist on building high capital buffers and improving the quality of regulatory capital (primarily its liquidity). Also, as all credit institutions face the same type of risk due to the homogeneity in the structure of their balance sheets, it is due time for Croatian authorities to put forward a coherent macroprudential policy.

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[326] This type of risk is related to the trustworthiness of business. In this context, reputational risk means that the parent company's business would be negatively affected if they were to abandon their subsidiaries at the first sign of difficulties.

Non-bank financial institutions in Croatia

The sector of non-bank financial institutions (NBFI) is far less developed in Croatia than the banking sector. In fact the size of the sector amounted to mere 30% of GDP at the end of 2009. Some NBFI are direct subsidiaries of foreign parent banks while other are owned by local banks, and there are important intragroup linkages in terms of ownership and activity (*e.g.* mortgage loan borrowers are required to provide collateral in the form of life and hazard insurance, and banks insure their credit risks). It is interesting to observe that the full scope of cross-sector exposures and cross-ownership is not known. In this sense, a study that would map bank groups in Croatia, together with ownership and exposure links would help identify the extent of risk exposures deriving from this sector.

At the end of 2009 there were 130 open-end investment funds registered in Croatia, two closed-end investment funds, as well as two funds established according to special legislation[327]. It is interesting to observe that regardless of its modest capital market development, in 2009 Croatia had two private equity funds, albeit no hedge funds.

In 2009 net assets of open-end investment funds stood at roughly 12 million Croatian *kuna*, which amounted to 3.6% of Croatian GDP. The most significant share in these assets belongs to cash funds (around 50% of total net assets) and then to equity funds (around 23%). As for close-end investment funds their total assets amounted to 1.8 billion Croatian *kuna* (0.5% of GDP). The biggest share in the total assets of these funds goes to real estate funds (28.9%).

It is clear that investment funds still have to position themselves on the market and gain greater market share. For the time being Croatian investors are quite vulnerable because of the high level of their indebtedness. And any surplus of household income is typically invested in more traditional types of assets (such as bank savings deposits). Even when they do turn to investment funds for greater profit, they usually chose funds whose investments are less prone to risks (such as bonds or cash). However, many investors recur to insurance as a specific type of long-term investment in Croatia. Thus in the following paragraphs, we examine the Croatian insurance business.

In 2009 there were 27 insurance undertakings and two reinsurance undertakings operating in Croatia, of which eight undertakings focused exclusively on life assurance. In the same period, non-residents owned the majority of the undertakings (21 of them to be precise).

[327] These are the Fund for Croatian Homeland War Veterans and Members of their Families and the Retired Pensions' Fund.

Market concentration is high, with foreign-controlled undertakings having grown in relative importance. The non-life insurance sector is reasonably well developed, but life assurance (perhaps perceived as a type of luxury good) is lagging behind. We wish to make an additional observation. When extending mortgage loans banks typically require the borrower to purchase a life insurance policy as collateral. The intent is to ensure coverage of mortgage payments through the payable benefit. While this practice has been customary in other countries, especially where collateral recovery is slow, its use as an obligatory collateral requirement needs to be reassessed in the context of Croatia. We wish to suggest that such collateral has to be based on fair pricing, and shouldn't promote the insurance business within existing financial groups. In this sense there is room for more investor protection in the insurance business as customers are not sufficiently informed and protected of this practice.

At the end of 2009 total assets of the insurance sector amounted to 28.8 billion Croatian *kuna*. This means that the insurance business amounts to 8.6% of the GDP. Out of the total value, almost 47% was accounted for by life assurance, while 50.7% was made up by non-life insurance. Reinsurance accounted for 3.1% of total assets. In the same period, the amount of total liabilities approximately equaled that of total assets. Technical provisions had the largest share in the liability structure (71.3%) followed by capital and reserves (18.9%).

Having in mind all of these facts regarding the structure and composition of the Croatian financial system, what measures can we suggest could in order to improve it? First of all Croatian policymakers (both supervisors and the government) should focus on both structural reforms and regulatory ones (toward a macroprudential policy). In line with recent European requirements of greater macroprudential regulation we wish to comment on potential regulatory improvements. Croatian policymakers and regulators should safeguard systemic stability through targeted measures of regulation and enforced supervision. Foreign currency reserves need to be enhanced to counter risks arising from high external vulnerabilities. In the foreseeable future we cannot envisage that there should be a relaxation of prudential buffers, as the degree of euroization in the financial sector is not going to decrease. Especially risks in the banking sector require continued strong regulatory and supervisory measures. While the financial sector appears resilient due to optimal capital buffers, it faces credit risk arising from weak growth prospects and serious liquidity risks due to reliance on financing from parent banks. In this, close cooperation with home supervisors is the key of containing such risks.

An area that also requires closer attention is the supervision of bank groups that include non-banking operations. When a bank group includes such operations, the Croatian National Bank and the *Hanfa* cooperate through information exchange based on their Memorandum of Understanding. But the cross-sector risk exposures and close ownership links between banks and NBFI call for stronger coordination between the central bank and the *Hanfa*. Supervisors should have a better understanding of the risks bank and non-bank operations pose to the institutions they supervise. In this we also see an argument in favor of an immediate macroprudential policy that would better assess such cross-sectoral risks.

Keeping in mind *Hanfa's* current regulatory weaknesses we suggest that the Croatian National Bank should take and preserve its role of lead supervisor for the time being. Its experience in supervisory activities, collection and management of relevant financial data, and the overall reliance on bank-based financing in Croatia, are all arguments in favor of this opinion. Moreover, the prospect of greater macroprudential regulation reinforces the position of the central bank even more. At the same time, *Hanfa* should make more efforts to intensify investor education and improve financial literacy in Croatia without compromising its impartiality. In the end, Croatian policymakers and the legislator should do more to empower the Agency and to strengthen its position (but not competitively!) with respect to the national central bank.

CHAPTER'S MAIN FINDINGS

In this chapter we have given a comparative overview of finance in Italy and Croatia. Our analysis focused not only on their financial sectors but also on the evolution of their financial regulation. In this we have observed how part of the regulation was initiated by developments in the domestic financial system, whilst a substantive part results from the process of EU regulatory harmonization.

At first glance it seems very difficult to compare these two countries. Italy is a well-developed, industrialized economy and member of the "old" EU Member States whose economic credentials are certainly high. Croatia, on the other hand, is a transition economy and a EU acceding country, burdened with all the political and economic difficulties one associates to this position. Nevertheless their comparison is possible. Both countries have a similar legal environment (the Roman *ius civile*) and both rely on more traditional forms of financial intermediation. As such, both the Italian and Croatian economic systems are bank based. We argue that this similarity is reflected in their national financial regulations as well. Namely, the majority of their rules are oriented towards prudential regulation of banking.

Movements in the domestic banking sector primarily supported the development of banking regulation in both countries. Italy consolidated its "scattered" legislation for credit institutions, while Croatia created banking regulation *ex novo*, at the beginning of its economic transition.

But the first regulatory differences between these two countries are visible in the manner in which they transpose and implement EU financial regulation. While Italy has often been perceived as a "transposition laggard" (which has much to do with Italian political complexities affecting the legislative process) we think that it has approached EU law transposition with caution and moderation. This country was (and still is!) fully aware that directives mostly form EU financial regulation. And, as we have said already, directives are binding only as to the objective they proscribe. Thus countries can model them, conform them or even "cherry-pick" their provisions (as long as they do not impair the directive's objective!) when transposing EU directives into national law. As we have ascertained, Italy has always kept in mind its national interest in the process of regulatory harmonization. By contrast, Croatia has been hit by a "regulatory frenzy" for the pas couple of years. Partly, this is because of its membership-negotiation process, and partly because – in our opinion – Croatia still lacks a coherent approach to financial regulation. In an effort to harmonize with EU law as quickly as possible (this is part of the accession process) Croatia has continued to adopt a number of new financial regulations or to revise existing one in line with EU requirements. But in doing this it has completely forgotten that what needed to be transposed were directives (not regulations!) and as such they could be adapted to domestic circumstances. Without any defined financial or economic policy goals, and always with an *ad hoc* approach in the area of finance, Croatia has succeeded in regulating even financial instruments, transactions and markets that are virtually non-existent in the Croatian financial system. For instance, credit default swaps or financial contracts for differences are all regulated under Croatian law, but they are not used in practice. It is unnecessary and burdensome to regulate something that does not even exist in practice. As we have argued several times in this thesis, law cannot create market activity. And Croatia should keep this in mind.

Even when it comes to supervision, Croatia has shown some intent to comply with the newest European trends. In fact, the working group gathered by the Croatian Ministry of Finance at the beginning of the 2000s and which developed the strategy of the institutional consolidation of supervision (which has been successfully implemented as a two-stage process) has clearly expressed its favorable opinion on the possibility of creating a "single supervisor" in the foreseeable future. Although we have carefully weighted the *pro* and *contra* of such an institutional arrangement for supervision by analyzing relevant literature, we have found no argument in favor of such a solution in the case of Croatia. Supervision should remain vested into two (non-competing) authorities. If departing from the general premise that effective supervision requires exhaustive, good-quality information (which the Croatian National Bank does dispose of) as well as some recent events (such as the deployment of the single supervisor in the United Kingdom which was considered unfathomable only a few years ago) to our arguments, we are even more determined in our conclusion. At last, economic reasons do not suffice for making the decision of transiting to a "single supervisor". Politics and economic history should matter as well. This means that in deciding on this matter, countries should primarily take account of their own institutional, political and economic circumstances. Reorganization of the supervisory set up may be, at times, completely inappropriate. In the foreseeable future this will be true for Croatia, irrespective of the EU accession. Croatia has far more pressing financial and economic issues that should be resolved first; so let us elaborate on them.

At the beginning of transition, which in the case of Croatia coincides with its political independence, the country was confronted with a fragile financial system in terms of structure, size and operations. Corporate governance and supervision had to be created in line with Western-oriented expectations. The judicial system had to improve its transparency and capital markets had to be developed in order to provide additional financial resources to the enterprise sector. All these problems, and more of them, had to be addressed at the beginning of the transition process. But many of them remain still unresolved. As a result finance in Croatia are substantially different than in Italy. First of all the difference is dramatic if we talk about the system's development, especially with respect to financial institutions and financial instruments available. Moreover the Croatian financial system is heavily marked with transition problems (the most notable being the ownership structure of the banking sector) and unrealistic expectations as to the performance of its capital market from national policymakers without any regard to the actual state of the Croatian real economy.

But the biggest problem isn't economic transition itself. The biggest problems are policymakers' choices made during the second half of the 1990s and the beginning of 2000s. These choices resulted with almost total loss of bank ownership in a system largely constituted by banks.

Regardless of their appropriate capitalization, negligible involvement with complex financial instruments (such as financial derivatives that account for 0.1% of both banks' assets and liabilities) and the fact that there is a "currency match" between funding and borrowing (both activities are highly euroized) we cannot but conclude that the Croatian banking system is prone to systemic instabilities. Admittedly, the almost totally foreign-owned banking sector has endured economic duress relatively well, and in this an important role has been played by the central bank's prudential measures. From today's perspective these measures seem proactive, but at the time of their employment (end of 2007, beginning 2008) they were the only manner in which the central bank could curb excessive credit growth and limit the potential for credit risk.

The biggest problem is that banks' activity of lending in foreign currency is extended to un-hedged borrowers. Thus, any depreciation of the Croatian *kuna* exposes banks to a great risk of nonperforming loans. Exchange rate-related shocks are relevant for both the corporate sector and households, who both rely on income in Croatian *kuna*. Households are especially vulnerable as their rising debt ratio negatively affects their debt servicing capacity. This way, any currency risk in the Croatian banking system is actually transformed into credit risk. Although the current level of capitalization seems sufficient to withstand a range of shocks the Croatian National Bank should insist on building high capital buffers and improving the quality of regulatory capital (primarily its liquidity).

In the end, what can Croatia learn from Italy? Well, first of all, that sometimes it is better to be perceived as a "transposition laggard" then to transpose and implement every EU legislative measure in haste, without considering its costs and benefits and ultimate impact on the domestic financial system. Without going into political connotations, we argue that it is possible to attain EU membership and still preserve certain national differences in the area of finance. Not only, it is possible to implement EU law – according to the legislator's intent and coherently with other Member States – in a manner that will best suit national circumstances and support economic stability. It is unrealistic for transition economies, such as Croatia, to think of EU financial regulation as "market creator". This is not the objective of EU regulation, as we have already mentioned. Its regulatory intent, from the perspective of transition economies, is to prepare these economies to function as a part of a bigger "economic community". In our opinion EU financial regulation gives acceding countries legal certainty with respect to institutions, instruments, transactions or markets that perhaps they are not familiar with because they do not exist in their national financial systems. But it cannot create these elements *ex nihilo*. And in this fact lies the second lesson. It is not probable that Croatia (or any other transition economy) will develop a strong capital market through the mere adoption of EU laws. If Croatia wants to achieve this goal it will have to recur to serious and costly structural reforms that would greatly enhance the role of the private sector in the economy. Even then, it remains to be seen if the capital market would gain importance in the context of a wider European capital market after accession.

The fact is that Croatia is a small economy and doesn't have such big companies that could benefit from direct financing *via* the capital market. But this is not something policymakers should worry about. As we have argued, Italy is also a bank based economy. Still its private sector is the backbone of its economy (by contrast, bank financing and thriving private companies are not considered compatible in Croatia). Without going into the details of the recent economic slowdown in Italy, it is still possible to consider the development of Italy's financial system as a benchmark for Croatia. Admittedly, the Italian capital market is far more developed than the Croatian, but again the majority of securities traded on the Italian market are government securities or those of state owned companies. Moreover the Italian capital market is part of a bigger stock exchange group (namely the London Stock Exchange group since 1997), which is immensely important from the aspect of transaction volumes and liquidity. But there is nothing wrong in being a bank based economy to begin with. Thus, Croatian policymakers and regulators should cease to have unrealistic expectations regarding the capital market, and concentrate more on redefining the current "state" of finance in Croatia. With this argument we come to the third lesson. And that is that it is not advisable for a small, bank based economy to rely on foreign ownership of banks and other financial institutions in the system.

When we add up the degree of euroization and the dependency on foreign funding to this fact, it is clear that the stability of the Croatian financial system is unsustainable in the long run. And no amount of regulatory requirements or level of capital adequacy proscribed by the Croatian National Bank will change this. What Croatia should do is use EU laws to create a well thought macroprudential framework that would guarantee financial stability in the existing circumstances even after accession, and in the future process of monetary integration. In the meantime, perhaps Croatia should diversify the type of institutions present in the system. It could establish new types of credit institutions or non-bank intermediaries (in doing this Croatia could look up to Italy). Even in the present situation in the banking sector the state has room for maneuver and the possibility to regain a more significant role in the sector.

Croatia is on the verge of full EU membership, and in this sense policymakers should pay less attention to those who warn them of "financial protectionism".

7. CONCLUSION

The recent economic and financial crisis has demonstrated that the European financial system was far more complex than we believed. The former has revealed that the current condition of the European (and global) economy was flawed at many levels (to name a few: theoretical, institutional, political, practical and unfortunately, ethical). *In this sense we can argue that the crisis did not result from a specific failure or set of failures that were exogenous to the system; rather it was a product of the system itself – its organization, principles, and institutional mechanisms*. Although this dissertation does not discuss the controversial issue of the exact causes of the financial turmoil we have recently experienced, it does however take account of the many lessons that can be drawn for financial regulation and supervision.

It is a known fact that in the wake of any economic or financial crisis, regulation and supervision are usually put in the spotlight, as the instinctive response of authorities and policymakers is to re-regulate, and to do so in a more prescriptive and stringent manner. In this sense the last crisis was no exception. In fact, by reading relevant literature that was published during that period, one could conclude that if the financial system were re-regulated in a much stricter and detailed manner, all problems would be solved, or at least would have minor consequences. Still, it is impossible and unadvisable to organize future financial activity in these terms. If we know that elements within the current framework of regulation supported systemically dangerous behavior, making the existing regulation stricter or spreading it more widely would only exacerbate such vulnerabilities. Thus, the primary objective of policymakers should not be just *more* regulation but more *effective* regulation. The crucial question is then how do we make regulation more effective?

In this regard the last financial crisis was a somewhat fortunate event. As noted already, this is because it finally disclosed significant gaps in the current state of knowledge about the nature of financial systems and economic policy in general. In addition it revealed that existing financial regulation and supervision have only exacerbated the negative effects of the crisis. If financial regulation is to become more effective it should first turn to the vast experience that financial history brings. This means that the scope of financial regulation and then supervision should recognize factors that are common to financial crises throughout history, and then try to envisage potential future problems. Regulation (as "law in the books") should be able to make such predictions based on the information it receives from supervision (as "law in practice"). Building on these premises this dissertation thesis examined the current state of European financial regulation and its enforcement through supervision.

Our research has led us to conclude that financial activity typically takes place in imperfect markets where consumer welfare is often encroached. Consequently, financial regulation and supervision are imposed as ″legal remedies″ to information asymmetries, inefficiencies, and various risks that markets and institutions are inherently prone to. Financial regulation allows consumers of financial products to make better-informed financial decisions and encourages market participants to align their behavior with social objectives. In order to achieve these goals *we argue that the general principles of regulation and the purpose and functions of particular aspects of regulation need to be clearly specified, and the particular institutional framework for the implementation of these regulations should be tailored to the circumstances of each financial sector* (banking, securities markets, insurance, etc.).

We concentrated primarily on financial regulation developed as part of EU law, and the manner in which regulation is enforced across EU Member States. As regards supervision, our interest centered on its institutional set up in across EU countries. At the same time we examined how EU trends regarding this institutional set up affect national supervision. We argued that in the EU, the greatest share of responsibility for the effective enforcement of supranational, EU regulation still rests with the national governments. Although Member States follow the premise of ″central regulation – local supervision″, their national authorities still have the liberty to implement EU laws in ways they determine to be consistent with the objectives of their national economic policy. Naturally, they may do so only in the case of directives, and not in the case of regulations, which are the most binding of all legislative measures in the EU. In turn, the objectives of individual national economic policy do not have to benefit the whole EU necessarily. This clearly represents a problem, as it exacerbates the tension between the supranational and national level of governance, and among Member States.

It is not surprising then that *the EU is recurring ever more to greater centralization in the field of financial regulation and supervision at the expense of national discretions through the "maximum harmonization" principle. We think that European policymakers consider centralization, or "more Europe", as the only way to sustain financial integration in an enlarging EU that is often accused of "democratic deficit" in its decisions.*

Based on our research, *we consider centralization together with institutional consolidation to be the two main characteristics of EU financial regulation and supervision nowadays* (and in the foreseeable future). The undisputable objective of EU financial regulation has become to harmonize national financial systems to the greatest extent possible. By affecting every area of finance they intend to create "uniformity" between national financial systems with respect to their constituting elements (*i.e.* financial assets, instruments, institutions, markets). In the eyes of EU policymakers such "uniformity" should allow for greater legal certainty, and legal certainty should doubtlessly result with financial stability.

The crucial questions may well be the following - is "more Europe" the basis for financial stability in the EU? What are the effects of centralization on different components of the financial system? Which are the measures used to achieve such centralization? Even more controversial is the question as to whether all Member States will benefit from such "regulatory uniformity". From a broader perspective it is hard to deny that during the years EU financial regulation has changed its nature. Departing from the principles of "minimum harmonization" and "mutual recognition", regulation has become ever more centralizing and based on the principle of "maximum harmonization". In recent years centralization has become *de rigueur* even in supervisory arrangements. The chapters of this dissertation thesis examine the impact of these developments on each of the constituting elements of a financial system. Judged by our findings, when it comes to financial integration and the Single Market, the EU is resolute to limit national discretions. Especially in the post-crisis period, in the field of financial regulation and supervision, the EU is acting as an ambitious political community with greater binding powers than we have experienced so far.

In the following paragraphs we will first demonstrate how the findings of the dissertation support the arguments we have made above. Then we will comment further on EU financial regulation and supervision, perhaps even from a "political economy" perspective. This is because we wish to make a few observations regarding the appropriateness of centralized regulation and supervision for different EU countries. Naturally, in this comment, our interest focuses on transition economies, or Croatia to be more precise.

* * *

In order to assess EU financial regulation and supervision, their nature, development and the main changes that have occurred over the years we first had to pose a classical question; when talking about financial regulation, which options and discretions are to be left to national supervisors without the fear of hindering harmonization? We have argued that with time the number of national discretions in regulation has substantially decreased as a result of "maximum harmonization" and centralization requirements. Our argument is clearly evidenced by *the 2009 de Larosière Report. Under the guise of creating a macroprudential supervisor in Europe, the Report has actually succeeded in minimizing the competencies of national authorities, not only with respect to regulation, but to supervision as well*. Until the Report financial supervision was the only area in which national determination prevailed over supranational tendencies. This is because policymakers in Europe could not justify centralized supervision whilst troubled financial institutions were still being rescued with local taxpayers' funds. Admittedly, the Report does not deprive national supervisors of their powers over domestic financial institutions in practice (*i.e.* microprudential supervision), but the overall mechanism changed substantially from a legal aspect. This means that the newly established European authorities (in line with the Report's recommendations) will have the competencies to greatly influence their decisions. This will only exacerbate the existing tension between the EU and Member States. In the EU national interests differ, and the Report's intention to converge supervision on the basis of stringent standards and more centralization can do more harm than good in the long run. Furthermore, such an arrangement cannot be appropriate for all EU countries.

But the EU, apparently, is determined on its path towards more centralization. This intent is clearly visible in the area of financial assets' regulation. At the beginning of the Single Market project and financial integration, the EU's intention was to standardize the types of financial assets available in Member States, as well as the rights and obligations associated with each type of financial asset. In achieving this goal the favored tool was legislation. As a result directives and regulations were (and still are) enacted with respect to securities, bank deposits, loans, financial derivatives, and so on. *Although EU's intervention in this area was based on "minimum harmonization" in its beginning (and paired with "mutual recognition"), the intervention gradually evolved towards greater centralization*. This means that almost all of the recent regulation of financial assets is based on the principle of "maximum harmonization". The importance of this lies in the fact that such regulation creates "legal uniformity". Naturally, *"legal uniformity" cannot be equally beneficial for all types of financial assets. Whilst, in our opinion, securities regulation can reap the most positive effects of such harmonization, regulation of other assets (bank deposits and loans) should be more flexible and allow for some acceptable degree of "national diversity"*.

The same is true with respect to EU's regulation of financial institutions. We think that regulatory centralization in this area is particularly problematic. Let us explain why.

Invariably, financial institutions in the EU start off as heterogeneous, but then a number of factors – some regulatory, some not – drives them to homogeneity (with respect of the types of assets they may invest into, the levels of capital reserves they must retain, etc.). The significance of this is that – paradoxically – homogeneity makes the financial system prone to systemic risk. *We argue that the way to reduce systemic risk, and to build a macroprudential perspective, is to encourage heterogeneity in the behavior of institutions. However, much of the European (micro) prudential regulation does the opposite. No reasonable amount of prudential capital can remedy a system that leads all financial institutions to act in the same way and to be exposed to the same types of risks. Judging by this measure, less ambitious (i.e. centralizing) regulation of financial institutions in the EU would be more appropriate.*

As we can see from the above arguments we have found evidence of centralization with respect to financial assets and institutions. But is this true for financial markets? As the foundations of the EU are equally dependent on political and economic (or better said, financial) integration it doesn't take much to conclude that centralization affects financial markets as well. Consequently, during the years regulation in this area has been transformed from a basic framework with limited integration success, to a more extensive and detailed regime designed to successfully complete the "Single Market project". *Not only has EU regulation of financial markets transited from "minimum harmonization" to "maximum harmonization", but also that regulation started to show "transformative ambitions". This means that regulation wished to shape the present and future of financial markets in the EU. And the only way to succeed in doing this was to recur to "more Europe" or more centralization.*

A remarkable example of such "transformative regulation" on the basis of centralization is the Markets in Financial Instruments Directive (MiFID). Although the MiFID is certainly remarkable from a competitive, economic and legislative aspect, we nevertheless think that there is a "catch" to it. As we have already mentioned, great centralization surely cannot benefit all Member States equally. And in fact, in our opinion, MiFID benefits the "old" Member States, while the new members and EU acceding countries are left in a "directional confusion". Let us explain why.

By implementing MiFID, the "old" Member States only bring clarity and order in an existing economic environment. The Directive simply regulates existing financial instruments and markets. But in the case of new Member States and EU acceding countries, MiFID regulates instruments that do not even exist in practice, or whose share in the market is minimal.

Furthermore, it artificially creates new, competitive trading venues while the stock exchanges of these countries are still struggling for volumes in transactions and liquidity. *So, by implementing MiFID the new Member States and EU acceding countries are actually putting faith in the concept of "law as market creator". A concept we have dismissed in our arguments. We have set it aside, because it is our opinion that law cannot kick start market development. The role of law in finance (similar to other areas of social life) is secondary – it regulates those relationships that already exist in practice*. In this way, law and regulations bring legal certainty to these relationships. *By contrast, the implementation of MiFID in the new Member States and acceding countries doesn't have the same effect; it only has the potential to create confusion*.

* * *

From a macro-perspective, we can state that EU financial regulation affects different economies very differently. This is immensely important from the perspective of transition countries, such as Croatia. Although these countries have successfully completed their political transition and are now (or will be very soon) part of the EU, their economic transition is far from over. Typically the size of these economies is small, but nevertheless they usually rely heavily on their financial systems, where financial institutions in turn are foreign EU-owned, for the most part. As a result, often transition economies are exposed to crises that are "imported" from foreign countries where they originate in the parent company and then transfer to branches and subsidiaries located in transition countries. In the majority of cases these crises affect banking sectors. This is why legal reform – or the creation of an appropriate regulatory framework for finance – should be an integral part of the political transition of these countries. In the case of Croatia, however, we have come to the conclusion that domestic policymakers haven't put much thought to this issue. By comparing Croatia with other EU countries (and we have chosen Italy as our benchmark) we have determined that for the past decade *Croatia has been subject to a "regulatory frenzy" without any defined financial or economic policy goals*. In an effort to harmonize with EU law as quickly as possible, Croatia has often forgotten that what needed to be transposed were directives (not regulations!) for the most part, and as such they could be adapted to domestic circumstances. With an *ad hoc* approach in the area of finance, Croatia has succeeded in regulating even financial instruments, transactions and markets that are non-existent in the Croatian financial system. This was unnecessary and burdensome. *Even when it comes to supervision, Croatia has shown some intent to comply with the trend of institutional consolidation, exhibited in* *many EU Member States. But there are no arguments in favor of such a solution in the case of Croatia*. Our research of financial regulation and supervision in Croatia shows that this country was more than willing to conform to its role as an *ad hoc* "rule-taker" rather than active "rule-maker". This is a clearly unacceptable position, as the stakes associated with the implementation of EU financial regulation are high, given the large foreign (mostly EU) ownership of the Croatian financial system.

In our opinion and from Croatia's perspective – and for now we shall put aside the very important goals of political security and wider international support that comes with EU membership – European integration will not result with overwhelming results in the economy. But this shouldn't be new to Croatia. Judging by recent experiences of transition economies dealing with financial duress as EU members, at time it even seemed that these countries were hit the hardest – economic union prevented them to resort to needed measures of monetary policy that would give a quick boost to their economies, while the rest of EU countries did not extend them much support. Part of the reason for this lies in the fact that the EU is actually "caught in the middle" – economically more integrated then any other region in world history but with political governance still in progress. So where does this leave transition economies, or Croatia for that matter?

While the "EU commitment" can enhance the performances of national economies, this result is not given. In our opinion European integration, with its political and economic agenda focused on more centralization and regulatory power, clashes with the needs of transition economies. This is because integration does not seek to facilitate or alleviate their transition process but rather to accommodate financial interests seeking new markets at low costs, less responsibilities and minimum commitment. This is clearly evident from the current state of finance in Croatia, where foreign owned banks (which represent the majority of financial institutions) are not at all interested in developing more risky activities of corporate banking that would revive the private sector in the Croatian economy. They rather stick to the safe (and generous!) profits made by extending loans to households and encouraging consumption.

The perspective of EU membership puts completely different requirements in front of transition economies, than those put before other EU countries. It requires them to give predominance to the needs of European enterprises, banks and other financial intermediaries, before they have even managed to secure their own social and economic objectives. Hence, the "EU commitment" requires them to forsake an immense part of their national determination in economy and to serve primarily "common needs". And this is not something that transition economies, such as Croatia, should do. We wish to point out strongly that by this we do not mean that transition economies should not be part of the EU. We only wish to suggest that the "uniformity" brought by EU financial regulation and supervision will damage transition economies the most. Again, putting aside the political aspect of their membership negotiations, we think that the economic requirements put before these countries should have been different. In addition we think that in the case of Croatia and other transition economies "uniformity" shouldn't have been the goal of EU regulation; the goal should have been to enhance the operation of national economic systems. Simply put, transition economies are too diverse from other "ordinary" EU Member States to be molded into a "single rulebook".

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All things considered, it is evident that EU financial regulation and supervision have come to a turning point in their development, and here we do not refer (solely) to the trend of centralization. The point that we wish to put forward is that, in the aftermath of the crisis, the EU is facing a trilemma that could shake the core of its political, not only economic, governance. We shall refer to it as *the "regulatory trilemma"; meaning that the EU cannot pursue financial integration, systemic stability (through macroprudential regulation) and national regulatory autonomy at the same time*. If the EU wishes to push financial integration further, Member States will have to give up a significant share of their regulatory autonomy. On the other hand, if the EU wishes to maintain systemic stability and deepen macroprudential regulation, it will have to count on a more independent role of Member States in supervision. Most of EU's troubles in the area of finance derive from its reluctance to face up to these choices, as policymakers worry that this would only exacerbate the tension between the national – supranational level.

Let us be clear on our choice in this trilemma – when in doubt, national discretions and regulatory autonomy should prevail over financial integration. This means that Member States should have the right to protect their national financial systems, and when this right clashes with the requirements of financial integration, it is the latter that should give way. And this was clearly evidenced by recent events – when European economies came under stress the responses were predominantly national. *But we emphasize an important requirement in our argument; namely, this choice shouldn't hinder systemic stability or impede the functioning of macroprudential regulation. Nor should it be a euphemism for financial protectionism.* At first glance one may think that leaving sizeable national regulatory autonomy would sign the end of EU-wide financial stability. This is not true. It is our opinion that only by giving more power to national supervisors that will conscientiously supervise the enforcement of EU regulations "at home" the EU can support financial stability.

And with this we have come to the ultimate paradox of regulation. While rules based on "maximum harmonization" provide legal clarity, we argue that a more flexible approach to regulation would be more effective. This is because in the EU strict rule enforcement is not feasible in the long run, due to the great diversity between EU countries. The differences in the implementation of EU financial regulations at Member State level should not be seen as aberrations from the path of financial integration, but rather as natural outcomes of varying national circumstances. Naturally, the prerequisite to this is that in the implementation process the Member States do not drift away from the legislative intent of a specific measure. There is a possibility for a different role of the EU; one that could accommodate the needs of an enlarging union even better. Let us explain. EU financial regulation relies both on "hard rules" and principles-based administrative discretion. The effectiveness of this combination depends on the legitimacy of those who promulgate and adopt the regulation. As the legitimacy of the EU has been questioned by Member States on different occasions (typically when advocating for greater national discretions) we believe that regulation based on "maximum harmonization" and centralizing in its nature can do more harm than good. Perhaps common financial regulation could be more flexible in its nature. As such it could be coordinated at the EU level to reflect the demands of financial integration, while rigid rules could be left to the national level. A "single rulebook" in the area of finance advocated by the EU does not have to entail full harmonization of all rules. It could entail a harmonized core set of standards, applied in a coordinated manner across Member States and supervised by national authorities. In this context the role of EU policymakers, institutions and authorities involved in the legislative process could change. They could be responsible for the coordination of the implementation process, and act as a forum for "peer monitoring". This would not mean that the EU has lost some of its supranational powers – to the contrary. EU coordination of national rules and implementation processes should be seen as essential. *Thus, we argue that centralization is not the appropriate way forward in the development of EU financial regulation. A thin layer of supranational regulations (based on minimum harmonization and co-opetition) that leaves room for maneuver by national authorities would guarantee better regulation and greater efficiency.* What the EU needs is smart harmonization, not maximum harmonization.

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The last financial crisis has challenged our understanding of financial regulation and supervision in EU countries and of the complex relationship between financial and political integration within the EU. But it has also given an opportunity to further explore the interdependence between (de)centralization and financial stability. For now, it seems as the debate regarding "regulatory control" between the national – supranational level is over in favor of greater supranational control of regulation. This means that the nature of regulation changes radically – after years of "mutual recognition" and "minimum harmonization" regulation is now based on the principle of "maximum harmonization". The move to centralization is perhaps most evident in financial supervision, traditionally left to Member States' competences, which now retreat in favor of supranational authorities envisaged by the de Larosière Report.

All of these events are exacerbating the fragile balance between national interests and further financial integration in the EU. It is difficult to predict all of the obstacles that the new institutional set up for EU financial regulation and supervision will face. What is evident is that the forces driving centralization have considerable political support. Much will depend from experimentation and foresight in this "de Larosière environment". But it remains to be seen whether this environment will benefit equally all EU Member States. We fear that excessive centralization and "regulatory uniformity" will blur the specific interests of smaller EU countries (especially new Member States and transition economies) in the bigger picture of the "European common good" (that is financial stability for the purpose of our discussion).

We think that the role of nation states cannot be dismissed. European policymakers cannot proceed on the assumption that the EU may be on the way of becoming a perfectly integrated "super-state". We must accept the restraints of integration – both from their political and economic aspect. The nation states live, and even when part of a *sui generis* political and economic integration such as the EU, we need to acknowledge their diversity and protect their right to safeguard domestic interests.

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OBSEŽNEJŠI POVZETEK

V zadnjih letih je med akademiki in praktiki živahna razprava o regulaciji in nadzoru financ v posameznih državah, v EU in na svetu nasploh. Glavni razlog za to zanimanje temelji na spoznanju, da imata ustrezna zakonodaja in nadzor financ odločilno vlogo pri zagotavljanju finančne stabilnosti. Finančna stabilnost je namreč postala novi cilj ekonomske politike, čeprav še ni povsem določeno, kakšni instrumenti se bodo za to uporabljali in kdo jih bo uporabljal. Vendar se ne glede na to vsi strinjajo, da sta regulacija in nadzor finančnih sektorjev nenadomestljiva za finančno stabilnost. Regulacija je varuh stabilnosti finančnega sistema prek jasnih in dobro premišljenih pravil, medtem ko nadzor (»supervision«) zagotavlja, da se bodo ta pravila uporabljale v praksi.

Ni nobeno presenečenje, da sta času krize v središču pozornosti regulacija in nadzor. V takšnih razmerah je instinktivni odgovor finančnih oblasti in politike na novo regulirati, in sicer strožje in natančneje. V tem smislu ni sedanja kriza nobena izjema. Če namreč prebiramo ustrezna besedila, razprave in knjige, ki se objavljajo v tem času, bi lahko prišli do sklepa, da bi problemov ne bi bilo, ali da bi bili mnogo blažji, če bi bil finančni sistem strožje in natančneje reguliran. Vendar pa je verjetno nemogoče, in tudi ni priporočljivo, da bi preprosto v skladu s tem postavili prihodnjo finančno ureditev. Tisto, kar se mora napraviti, je verjetno doseči bolj učinkovito regulativo in ne morda samo uvesti več regulative.

Vendar zakaj sta sploh za finance potrebna bolj ostra regulativa in bolj oster nadzor? Da bi odgovorili na to vprašanje, se moramo najprej pripraviti – razložiti nekaj osnovnih stvari. Finance so del tako imenovane informacijske dejavnosti. Če se, na primer, posojilojemalec in posojilodajalec ali investitor brez težav najdeta, ne bi potrebovali niti finančnih institucij niti finančnih trgov. Vendar ker ni tako, potrebujemo finančne institucije in finančne trge, da bi se prihranki s posredovanjem finančnih transakcij alocirali. Finančni trgi pomagajo, da gospodarska dejavnost narašča, ker spodbujajo varčevanje (ustvarjajo finančna aktiva), tako da je lahko trošenje v prihodnje večje na osnovi današnjih investicij. Finance reguliramo in nadziramo mnogo bolj pozorni kot druge dele gospodarstva, ker je značilna za finance tolikšna informacijska asimetrija, ki lahko privede do tako resnega napačnega delovanja trga, da lahko privede do velikih negativnih socialnih posledic. Tako sta finančna regulacija in finančni nadzor "zakonsko zdravilo" za informacijsko asimetrijo, neučinkovitost in različna tržna tveganja, ki so jim podvrženi trgi in institucije ali finance nasploh.

V tem smisla je zadnja finančna kriza srečni dogodek. In sicer zato, ker so se razgrnili resne pomanjkljivosti v sedanjem znanju o naravi finančnega sistema in ekonomske politike. Poleg tega se je pokazalo, da sta sedanja finančna regulativa in sedanji finančni nadzor še poudarila negativne učinke finančne krize. Da bi postala finančna regulativa bolj učinkovita, bi se morala najprej obrniti obsežnim izkušnjam, ki nam jih daje finančna zgodovina. Spoznali bi dejavnike, ki so skupni vsem finančnim krizam, ki jih poznamo iz zgodovine in na tej osnovi bi lahko predvideli možne probleme v prihodnosti.

Doslej povedano je ozadje temeljnega cilja disertacije, ki je raziskati in oceniti dosedanje spremembe in sedanje stanje finančne regulacije in finančnega nadzora v EU. Tako ocenjujemo načine, kako se izvajata regulacija in nadzor na nadnacionalni ravni in na ravni posameznih držav EU. To seveda ne pomen, da posebej analiziramo nacionalne regulatorne sistema, kar bi povzročilo zmedo in s tem bilo neučinkovito za namen raziskave. Naš cilj je določiti, ali je sedanji evropski regulatorni in nadzorni sistem (to pomeni na nadnacionalni ravni) skupaj z njegovo teoretično utemeljitvijo ter s cilji in instrumenti ustrezen za zagotavljanje finančne stabilnosti v EU, in sicer na nacionalni in nadnacionalni ravni, in ali koristi vsem finančnim sektorjem. Težišče raziskave je na nadnacionalnem (EU pravila in ureditve). Ko obravnavamo države članice EU, mislimo samo na Hrvaško in Italijo. Na prvi pogled je videti, da je težko primerjati ti državi. Vendar je ta primerjava možna. Obe državi namreč imata podobno zakonsko okolje (Rimski *ius civile*) in obe državi imata bolj tradicionalno finančno posredništvo – v obeh primerih gre za bančni gospodarstvi. Mislimo, da se ta značilnost zrcali v nacionalni finančni regulativi. Poleg tega ne smemo pozabiti, da so italijanske finančne institucije lastnice velikega dela hrvaškega bančnega sektorja. Zato smo se odločili, da je Italija lahko merilo za Hrvaško pri procesu zakonske harmonizacije z zakonsko ureditvijo EU.

V širšem smislu lahko rečemo, da se disertacija osredotoča na štiri ključne sestavne dele financ, in sicer na:

(1) finančna aktiva,

(2) finančne transakcije,

(3) finančne institucije in

(4) finančne trge.

Interdisciplinarna analiza, in sicer s finančnega, ekonomskega in pravega vidika ter z vidika prava EU, omogoča pravilno spoznanje, kaj sta ustrezna regulacija in učinkovit nadzor, ki podpirata finančno stabilnost v EU in sta hkrati napotilo za prilagoditve prihodnjim članicam EU – predvsem tranzicijskim državam, kot je Hrvaška.

S disertacijo ali tezo disertacije želimo več stvari:

(1) Kritično pregledati sedanje stanje v EU, kar zadeva finančno regulacijo in finančni nadzor ter kaj lahko pričakujemo glede tega v prihodnje. Pri tem želimo posvetiti posebno pozornost kompleksnim strukturnim reformam, ki jih načrtujejo v EU in ki pomenijo prehod *od izključno regulacije in nadzora na micro ravni na regulacijo in nadzor na makro ravni.* Poleg tega analiziramo, kako so se vzporedno s spremembami finančnih trgov spremenili v zadnjih dveh desetletjih glavni evropski integracijski mehanizmi, in sicer minimalna harmonizacija, vzajemno priznanje in, kot najpomembnejše, nadzor domače države. Opozarjamo na slabosti teh sprememb in ocenimo, kako je do teh sprememb prišlo ter kako te spremembe podpirajo večjo centralizacijo znotraj EU.

(2) Želimo oceniti, ali je bil enako uspešen cilj EU dokončati enoten trg s pomočjo evropske zakonodaje (predvsem se bomo osredotočili na direktive EU) tudi kar zadeva finančna aktiva, finančne transakcije, institucije in finančne trge. Zanima nas, *ali je bila regulatorna harmonizacija na vseh teh področjih enako koristna, ali pa je morda 'zakonska standardizacija' povzročila kakšne neželene posledice, ki so lahko vzrok nestabilnosti?*

(3) Želimo ugotoviti, kako deluje finančna zakonodaja EU na nacionalni ravni in kaj so glavni skupni elementi nadzora v večini držav EU. S tem želimo priti do učinkovitega vodnika za države, ki se pripravljajo za vstop v EU, kot je na primer Hrvaška. *Tako bomo ugotovili, ali je bil konvergenčni proces na področju financ, to je uveljavljanje zahtev EU na tem področju, koristen za tranzicijsko državo. Če je bil, kaj so najpomembnejši dosežki in/ali slabosti.* Želimo kritično oceniti sedanje stanje financ na Hrvaškem in predlagati način, kako lahko finančna regulacija skupaj z nadzorom zagotavlja ekonomsko stabilnost.

Z raziskovanjem smo ugotovili, da se finančne dejavnosti dogajajo na nepopolnem trgu, na katerem je pogosto prizadeto blagostanje potrošnikov. Od tod potreba po finančni regulaciji in nadzoru, ki zagotavljata koristnikom finančnih 'produktov', da se lahko zaradi boljših in več informacij bolje odločijo, ko gre za finančne odločitve, in nadalje lahko uskladijo svoje obnašanje z družbenimi cilji. Da bi se dosegli ti cilji, *ugotavljamo, da morajo biti splošna načela regulacije in funkcija posameznega vidika regulacije jasno opredeljeni. Specifični* *institucionalni okvir za uveljavitev ustrezne regulacije mora biti tako postavljen, da ustreza vsakemu od finančnih sektorjev (bankam, trgom vrednostih papirjev, zavarovalnicam…).*

V disertaciji nas predvsem zanima finančna regulacija, ki se je razvila kot del zakonske ureditve EU, in način, kako se regulacija uveljavlja v državah-članicah EU. Kar zadeva nadzor, nas zanima predvsem institucionalna ureditev v državah-članicah EU. Iz naših raziskovanja sledi, *da morata biti dandanes centralizacija in institucionalna konsolidacija najpomembnejši značilnosti regulacije in nadzora v EU. In enako tudi v bližnji prihodnosti.* Nesporen cilj finančne regulacije EU je čim večje harmonizacija nacionalnih finančnih sistemov. S tem, da posega na vsa področja financ, namerava ustvariti 'uniformiranost' nacionalnih finančnih sistemov glede na njegove sestavne dele, kakor so finančna aktiva, finančne instrumente, institucije, trge. V očeh politikov bi takšna 'uniformiranost' zagotavljala večjo zakonsko gotovost, ki bi gotovo pomenila večjo finančno stabilnost.

Vendar pa povzroča takšna naravnanost probleme EU. V EU namreč največji del odgovornosti za učinkovito uveljavitev nadnacionalnosti ostaja na nacionalnih vladah. Čeprav se članice držijo načela 'centralna regulacija-lokalni nadzor', imajo kljub temu nacionalne oblasti svobodo uvesti v svoj pravni red zakone EU na način, za katerega mislijo, da je v skladu s cilji njihove nacionalne politike. Razume se, da to lahko počnejo samo pri direktivah in ne v primeru zakonov ('regulations'), ki so najbolj zavezujoči od vseh pravnih norm EU. V nasprotju s tem, pa ni nujno, da cilji ekonomskih politik posameznih držav koristijo EU kot celoti. To je seveda problem, saj prispeva k napetostim med nadnacionalno in nacionalno ravnijo vladanja ter med državami članicami.

Zato ne preseneča, da se *EU zateka vedno bolj k centralizaciji na področju finančne regulacije in finančnega nadzora v škodo nacionalni diskreciji prek načela 'maksimalne harmonizacije'. Mislimo namreč, da evropski politiki jemljejo centralizacijo, ali načelo "več Evrope", kot edini način za doseganje finančne integracije v razširjajoči se Evropi. Zaradi tega je EU pogosto obtožena pri njenih odločitvah za "demokratski deficit". Tako* je verjetno zelo pomembno vprašanje, ali je res "več Evrope" osnova za finančno stabilnost v EU? Kakšne so posledice centralizacije na različne sestavine finančnega sistema? Na kakšen način naj se doseže takšna centralizacija? Še bolj sporno ali nejasno je vprašanje, ali bo takšna "regulatorna uniformiranost" koristila vsem državam-članicam? Težko je zanikati, da se je v letih do sedaj spremenila narava finančna regulacija EU. Začelo se je namreč z "minimalno harmonizacijo" in "vzajemnim priznavanjem", vendar je regulacija postajala vedno bolj centralizirana. Uveljavlja se načelo "maksimalne harmonizacije". V zadnjih letih je postala centralizacija pravilo, *de rigueur,* tudi pri ureditvah nadzora. Disertacija proučuje posledice tega razvoja na vsakega od sestavnih delov finančnega sistema. Na osnovi naših raziskovanj lahko rečemo, da je EU odločena omejiti nacionalne diskrecije, ko gre za finančno integracijo in enotni ("single") trg. Posebej v času po krizi deluje EU, ko gre za finančno regulacijo in finančni nadzor, kot politična oblast z mnogo več zavezujočimi odločitvami, kot je to veljalo doslej.

EU je očitno izbrala pot večje centralizacije. Ta namera je posebej jasno vidna pri regulaciji finančnih aktiv. Finančna aktiva so zanimiva, ker so neoprijemljiva in njihova "ne vidljivost" kliče po ostrejši regulaciji. V začetku procesa integracije v Evropi je bil cilj standardizirati tista finančna aktiva, ki jih je mogoče najti pri državah-članicah, in harmonizirati pravice in obveznosti, povezane s tem aktivi. Priljubljeno orodje, da bi se to doseglo, je bila zakonodaja. Kot posledica tega so se, in se še vedno, direktive in zakoni nanašali na vrednostne papirje, depozite bank, posojila, finančne derivate in tako naprej. *Čeprav je bil v začetku poseg EU na to področje v skladu z načelom "minimalna harmonizacija" (in v skladu z "vzajemnim priznanjem"), je ta poseg postopoma drsel proti večji centralizaciji.* To pomeni, da skoraj vsa nedavna regulativa, ki zadeva finančna aktiva, temelji na načelu "maksimalne harmonizacije". Pomembnost tega je v tem, da takšna naravnanost regulative ustvarja "zakonsko uniformiranost". Vendar pa *"zakonska uniformiranost" ne more biti enako koristna za vse vrste finančnih aktiv. Medtem ko, takšno je naše mnenje, je lahko največ koristi od takšne harmonizacije pri regulaciji vrednostnih papirjev, pa bi morala biti regulacija drugih aktiv (depoziti in posojila bank)bolj prožna. Morala bi puščati prostor za "nacionalne različnosti".*

Enako velja, kar zadeva evropsko regulacijo finančnih institucij. Mislimo, da je še posebej problematična regulatorna centralizacija tega področja. Poskusimo razložiti, zakaj. Skoraj povsod so bile na začetku finančne institucije v EU heterogene, vendar pa je zatem več dejavnikov, in sicer nekaj regulatornih in nekaj drugih, privedlo do homogenizacije, kar zadeva vrsto finančnega premoženja, ki ga lahko imajo, velikost kapitala in podobno. Pomembnost tega je paradoksno v tem, da je zaradi homogenosti finančni sistem bolj izpostavljen sistemskemu tveganju. *Trdimo namreč, da je pot, ki lahko privede do zmanjšanja sistemskega tveganja, v tem, da spodbujamo heterogenost v obnašanju institucij. Vendar pa večina evropskih regulacij preudarnega obnašanja finančnih institucij ravna prav nasprotno. Nikakršen razumno velik kapital ne more ozdraviti sistema, ki žene finančne institucije, da ravnajo enako in se izpostavljajo isti vrsti tveganja. Če imamo to v mislih, lahko rečemo, da* *bi bila ustreznejša manj ambiciozna, to pomeni manj centralizirana, regulacija finančnih institucij v EU.*

Kot lahko vidimo iz ravnokar povedanega, obstajajo dokazi o centralizaciji, kar zadeva finančna aktiva in finančne institucije. Vendar ali je to res tudi za finančne trge? Ker je temelj EU tako politična kakor tudi ekonomska ali morda bolje finančna integracija, ni prav nerazumljivo, da imamo centralizacijo tudi pri finančnih trgih. Tako se je postopoma regulacija tega področja preoblikovala od začetne omejene integracije k mnogo bolj podrobnemu in obsežnemu režimu integracije, kar se je uspešno končalo s projektom "Single Market". *Ne samo da je evropska regulacija finančnih trgov prešla od "minimalne harmonizacije" k "maksimalni harmonizaciji", ampak je pričela regulacija kazati "ambicije preoblikovanja". To pomeni, da želi regulacija oblikovati sedanjost in prihodnost finančnih trgov v EU. Edini način, da bi ji to uspelo, je, da se zateka k "več Evrope" in več centralizacije.*

Značilen primer takšne "transformativne ali preoblikovalne regulacije" na osnovi centralizacije je direktive MiFID (Markets in Financial Instruments Directives). Čeprav je MiFID pomemben s konkurenčnega, ekonomskega in zakonodajnega vidika, kljub temu mislimo, da je v njem problem. Kot smo že omenili, velika centralizacija gotovo ne more koristiti vsem državam-članicam enako. Dejansko je tako, da MiFID koristi "starim" državam-članicam, medtem ko so nove članice prepuščene "direktivni zmešnjavi". Poskusimo razložiti, zakaj mislimo tako.

S tem ko so uveljavile MiFID, so "stare" članice samo vnesle več jasnosti in reda v obstoječe ekonomsko okolje. Direktiva samo regulira obstoječe finančne instrumente in trge. Toda v primeru novih članic in držav, ki se pripravljajo za vstop v EU, MiFID regulira instrumente, ki jih ni v praksi ali so nepomembni. Poleg tega umetno ustvarja nove konkurenčne poti trgovanja ("trading venues"), čeprav se njihova borza vrednostnih papirjev otepa s problemi obsega transakcij in likvidnosti trga. *Tako se nove države-članice in tiste države, ki se pripravljajo za vstop v EU, s tem, da vneseje v svoj pravni red MiFID, prepuščajo veri v pojmovanje, da je "zakon ustvarjalec trga". Gre za pojmovanje, ki smo ga zavrgli z argumenti. Zakon namreč ne more biti tisti, ki sproži razvoj trgov. Vloga prava v financah, in podobno je v drugih področjih družbenega življenja, je drugotnega pomena. Pravo ureja tiste odnose, ki že obstajajo.* Na ta način pravo in regulacija vnašata pravno gotovost v te odnose. *V nasprotju s tem pa MiFID nima enakega učinka, ko gre za nove države-članice ali države, ki se pripravljajo za vstop v EU. Ima samo možnost, da ustvari zmedo.*

Če se obrnemo k tranzicijskim ekonomijam z vidika zahtev EU za regulacijo in nadzor financ, lahko rečemo, da finančna regulacija učinkuje različno na različne države. To je nadvse pomembno za tranzicijske države, kot je na primer Hrvaška. Čeprav so te države uspešno končale politično tranzicijo in so zdaj del EU, ali pa bodo kmalu to postale, njihova ekonomska tranzicija še zdaleč ni končana. Čeprav so ta gospodarstva zelo majhna, se kljub temu naslanjajo na svoj finančni sistem, kjer so v največjem delu njihove finančne institucije v tujem lastništvu. Zaradi tega so pogosto ta gospodarstva izpostavljena šokom, ki se uvažajo iz tujine. Nastajajo pri bankah materah in se prenašajo na podružnice in banke-hčere v tranzicijskih državah. V največ primerih takšni šoki ali krize prizadenejo bančni sektor. Zaradi tega mora biti pravna reforma ali vzpostavitev ustreznega regulatornega okvira za finance sestavni del politične tranzicije teh držav. Na Hrvaškem smo ugotovili, da politiki o tem niso prav dosti mislili. Če namreč primerjamo Hrvaško z drugimi državami EU, in za primerjavo smo se odločili za Italijo, lahko ugotovimo, *da je bila značilno za Hravaško v zadnjih desetih letih "regulatorna mrzlica" in da ni bilo nikakršnega cilja, kar zadeva ekonomsko in finančno politiko.* V naporih, da bi se harmonizirali z zakoni EU kar se da hitro, smo na Hrvaškem pogosto pozabili, da so direktive in ne predpisi tisto, kar moramo prenesti k sebi, kar seveda pomeni, da je možna prilagoditev pravne ureditve domačim razmeram. Z *ad hoc* odnosom do financ, je Hrvaški uspelo regulirati tudi finančne instrumente, transakcije in trge, ki jih ni v hrvaškem finančnem sistemu. To je bilo nepotrebno in bilo je dodatno breme. *Celo v primeru nadzora je Hrvaška pokazala namen, da se prilagodi težnji po institucionalni konsolidaciji, kar je sicer značilno za mnoge države EU. Vendar pa nič ne govori v prid takšne rešitve za Hrvaško.* Proučevanje finančne regulacije in nadzora na Hrvaškem kaže, da je bila Hrvaška več kot voljna prilagoditi se vlogi *ad hoc* "prevzemnika pravil" in ne morda vlogi "ustvarjalca pravil". To je seveda nesprejemljiva vloga, saj gre pri prevzemu finančne regulacije EU za veliko stvar, posebno če upoštevamo veliko tuje lastništvo, predvsem lastništvo držav EU, finančnih institucij.

Po našem mnenju in z vidika Hrvaške evropska integracija ne bo prinesla pomembnih prednosti za gospodarstvo. Pri tem seveda puščamo ob strani zelo pomembno dobre strani, kar zadeva politično varnost in druge prednosti, ki jih prinaša članstvo v EU. Vendar pa to, da ne moremo pričakovati velikih ekonomskih prednosti, ni nekaj posebnega za Hrvaško. Če imamo v mislih nedavne izkušnje tranzicijskih držav, je včasih videti, da so bile najbolj prizadete tranzicijske države, ki so članice EU. Niso se namreč mogle zateči k potrebnim ukrepom ekonomske politike. To velja predvsem ali še posebej za države evrskega območja.

Eden od razlogov za takšno stanje lahko najdemo v dejstvu, da sta EU in evrsko območje nedokončana projekta. EU in evrsko območje sta ekonomsko integrirana, medtem ko je politična integracija na začetku. Kaj to pomeni za tranzicijske države in za Hrvaško?

Čeprav lahko "naravnanost k Evropi" izboljša gospodarske rezultate države, pa to ni kar tako zagotovljeno. Po našem mnenju je lahko evropska integracija, ki je s svojimi političnimi in ekonomskimi cilji naravnana na več centralizacije in več regulatorne moči, v nasprotju s potrebami tranzicijskih ekonomij. Cilj integracije namreč ni olajšati proces tranzicije, ampak je predvsem v tem, da EU išče nove trge in področja z nizkimi stroški ter z manj odgovornosti. S tem se ustreže finančnim interesom. To je očitno, če imamo v mislih sedanje stanje financ na Hrvaškem, kjer banke v tujem lastništvu, in tudi sicer vse finančne institucije, niso zainteresirane, da bi šle v bolj tvegane posle, povezane s kreditiranjem podjetij, kar bi oživilo privatni del hrvaškega gospodarstva. Ostajajo pri manj tveganem – pri dajanju posojil gospodinjstvom in s tem pri spodbujanju trošenja. To je sicer razumljivo, saj gospodarstvo ne temelji na altruizmu.

Članstvo v EU, ki je pred Hrvaško in drugimi tranzicijskimi državami, postavlja pred njih popolnoma drugačne zahteve. Od njih namreč terja, da dajo prednost potrebam evropskih podjetij, bank in drugih finančnih posrednikov, preden so si zagotovile in uveljavile svoje ekonomske in socialne cilje. Tako "naravnanost k Evropi" terja od njih, da opustijo velik del nacionalnih interesov v gospodarstvu in se podredijo "skupnim potrebam". Vendar je to nekaj, česar Hrvaška in druge tranzicijske države, naj ne bi napravile. Pri tem želimo poudariti, da s tem ne mislimo, da tranzicijske države naj ne bi bile v EU. Želimo samo poudariti, da "uniformiranost", ki jo prinašata finančna regulacija in finančni nadzor, najbolj škodi tranzicijskim državam. Če povemo še enkrat, in pustimo ob strani politični vidik članstva v EU, bi morale biti ekonomske zahteve drugačne za tranzicijske države. Poleg tega mislimo, da v primeru Hrvaške in drugih tranzicijskih držav "uniformiranost" ne bi smela biti cilj zakonodaje EU. Cilj naj bi bil izboljšanje delovanje ekonomskega sistema. Tranzicijska gospodarstva so precej drugačna od gospodarstev drugih držav EU, da bi se lahko spravila v iste zakonski okvir.

Če vse to upoštevamo, je očitno, da sta prišla finančna regulativa in finančni nadzor EU do kritične točke in pri tem ne mislimo samo na težnjo k centralizaciji. Stvar, ki jo želimo poudariti, je namreč to, da je pred EU izbira med tremi možnostmi ('trilemma'), ki bi lahko pretresla jedro ne samo načina odločanja o gospodarskih zadevah ampak tudi političnega odločanja. *To označujemo kot regulatorna »trilemma«, kar pomeni, da EU ne more hkrati* *težiti finančni integraciji, sistemski stabilnosti s pomočjo makro nadzora in nacionalni avtonomiji na področju zakonodaje.* Če namreč želi EU nadaljevati s finančno integracijo, potem bodo morale države-članice opustiti pomemben del svoje regulatorne avtonomije. Če EU želi na drugi strani vzdrževati sistemsko stabilnost in razširiti obseg makro nadzora, potem se mora nasloniti na večjo neodvisnost držav-članic pri nadzoru. Največ težav EU na področju financ izvirajo od tod, ker se ne želi soočiti s z omenjenimi izbirami. Politiki se bojijo, da bi to povečalo napetosti med nacionalno in nadnacionalno ravnijo.

Kar zadeva omenjeno izbiro med tremi željami ('trilemma'), mislimo, da morata nacionalna diskrecija in regulatorna avtonomija biti pred finančno integracijo. To pomeni, da morajo imeti države-članice pravico zaščititi nacionalni finančni sistem in ko pride ta pravica v nasprotje z zahtevami finančne integracije, potem je finančna integracija tista, ki se mora žrtvovati. To se je sicer jasno videlo pri zadnjih dogodkih, ko so prišla evropska gospodarstva v težave in ko je bil odgovor predvsem nacionalen. *Vendar pri tem poudarjamo pomembno zahtevo, in sicer da takšna izbira ne sme biti ovira za sistemsko stabilnost in ne sme preprečevati nadzora na makro ravni. Prav tako to ne sme biti evfemizem za finančni protekcionizem.* Na prvi pogled bi lahko kdo mislil, da bi prepustitev regulacije nacionalni avtonomiji pomenila konec finančne stabilnosti na ravni EU. To seveda ni res. Mislimo namreč, da samo prepustitev več moči nacionalnim nadzornikom, ki bodo »doma« skrbno nadzorovali uveljavitev regulative EU, lahko zagotovi finančno stabilnost EU.

S tem smo prišli še do zadnjega paradoksa regulacije. Čeprav "rules based" ureditev in "maksimalna harmonizacija" zagotavljata pravno jasnost, trdimo, da je bolj fleksibilna regulacija bolj učinkovita. To je zaradi tega, ker zaradi velikih razlik med državami EU na dolgi rok ne sme ostati pri tem, da strogo uveljavlja pravila. Na razlike v prenosu ("implementaciji") evropske finančne regulative v države-članice ne smemo gledati kot da to pomeni stranpot finančne integracije, ampak bolj kot na logično posledico različnih nacionalnih značilnosti in/ali razmer. Seveda je pogoj za to, da proces implementacije držav-članic ne drsi stran od cilja zakonodaje. Obstaja možnost za različno vlogo EU, in sicer tudi za takšno vlogo, da bi se bolje prilagajala potrebam povečane unije. Poskusimo to razložiti.

Evropska finančna regulacija temelji na »trdih pravilih« in na administrativni diskreciji na osnovnih načelih ("principle-based"). Učinkovitost te kombinacije je odvisna od legitimnosti tistih, ki sprejemajo in uvajajo takšno regulacijo. Ker je legitimnost EU včasih vprašljiva s strani držav-članic, mislimo¸ da lahko regulacija, ki temelji na "maksimalni harmonizaciji" in centralizaciji, napravi več škode kot koristi. Morda bi lahko bila sploh skupna finančna regulacija bolj fleksibilna. Kot takšna bi se lahko koordinirala na ravni EU, medtem ko bi se trda pravila prepuščala nacionalni ravni. Načelo "single rulebook" na področju financ, ki ga zagovarja EU, ne pomeni popolno harmonizacijo vseh pravil ali zakonov. Lahko imamo harmonizirano tisto, kar je temeljno ali najpomembnejše ("core-standards"), ki se na koordiniran način uveljavljajo v vseh državah EU in nadzira s strani nacionalnih oblasti. V tem smislu se lahko vloga politike EU, njenih institucij in oblastnih organov, ko gre za zakonodajni proces, spremeni. Lahko ostanejo odgovorni za koordinacijo in implementacijo in delujejo kot forum za "peer monitoring". To ne bi pomenilo, da bi EU izgubila nekaj svoje nadnacionalne moči. Vloga EU pri koordinaciji nacionalnih zakonodaj ali pravil in pri implementaciji ostaja neokrnjena. *Tako trdimo, da centralizacija ni ustrezna pot naprej v razvoju finančne regulacije EU. Tanka plast nadnacionalne zakonodaje, ki temelji na minimalni harmonizaciji in sodelovanju, in ki prepušča prostor nacionalnim oblastem bi zagotavljala boljšo regulacijo in večjo učinkovitost.* Kar EU potrebuje je pametna harmonizacija in ne maksimalna harmonizacija.

Na koncu želimo opozoriti na nekaj kritičnih opažanj, kar zadeva razvoj regulative v Evropi v času krize. Res je sicer, da je zadnja finančna kriza privedla do ponovnega premisleka o našem razumevanju finančne regulacije in finančnega nadzora in o zapletenem odnosu med finančno in politično integracijo v okviru EU. Vendar nam je hkrati dala možnost, da nadalje raziščemo soodvisnost med (de)centralizacijo in finančno stabilnostjo. Za zdaj je videti, da je razprava o "regulatornem nadzoru" med nacionalno in nadnacionalno ravnijo privedla do tega, da sta nadnacionalna regulacija in nadnacionalni nadzor boljša. To pomeni, da se značaj regulacije po mnogih letih "vzajemnega priznanja" in "minimalne harmonizacije" radikalno spreminja. Regulacija temelji na "maksimalni harmonizaciji". Premik k centralizaciji je morda najbolj viden pri finančnem nadzoru, ki se je tradicionalno prepuščal državam-članicam. Umika se nadnacionalnim oblastem, kot predvideva de Larosièrovo poročilo.

Vse to dogajanje še bolj poudarja krhkost ravnovesje med nacionalnimi interesi in nadaljnjo finančno integracijo v EU. Težko je napovedati vse ovire, ki jih bo imela nova institucionalna ureditev EU za finančno regulacijo in finančni nadzor. Kar je možno videti, je, da so dobile sile, ki zagovarjajo centralizacijo, pomembno politično podporo. Veliko bo odvisno od življenja ali prakse in kako daljnovidno je že omenjeno de Larosièrovo poročilo. Vendar bomo šele videli, ali bo to enako koristilo vsem državam EU. Bojimo se, da bosta prekomerna centralizacija in "regulatorna uniformiranost" zabrisala specifične interese manjših držav EU, predvsem tranzicijskih držav, v tistem, kar se označuje kot "evropsko skupno dobro", in sicer finančna stabilnost, če mislimo na predmet disertacije.

Mislimo, da ni mogoče ne upoštevati vloge majhnih držav. Evropski politiki ne morejo izhajati iz predpostavke, da je EU na poti, da postane popolno integrirana »super država«. Pri integraciji moramo upoštevati omejitve, ki jih postavljata tako politika kot ekonomija. Nacionalne države so še vedno resničnost in čeprav gre v primeru EU za delno politično in ekonomsko integracijo *sui generis,* moramo upoštevati njihovo različnost in moramo zagotavljati, da lahko zasledujejo domače interese.

COMPREHENSIVE SUMMARY

In the past years vivid discussions took place among academics and practitioners regarding financial regulation and supervision in individual countries, in the European Union and in the world as a whole. The foremost reason for such interest in this subject derives from the decisive role that appropriate legislation and supervision have in ensuring financial stability. Financial stability had been introduced as the new policy goal although what instruments are to be used and who would do that has not been quite fixed yet. But all agree that regulation and supervision of financial sectors are indispensable for financial stability. This is because *regulation* safeguards the stability of the financial system through clear and well-conceived rules, whilst *supervision* ensures the application of these rules to particular institutions (or groups of institutions) in practice.

It is no surprise then that in the wake of any economic or financial crisis, regulation and supervision are usually put in the spotlight, as the instinctive response of authorities and policymakers is to re-regulate, and to do so in a more prescriptive and stringent manner. In this sense the last crisis was no exception. In fact, by reading relevant literature that was published during that period, one could conclude that if the financial system were re-regulated in a much stricter and detailed manner, all problems would be solved, or at least would have minor consequences. Still, it is impossible and unadvisable to organize future financial activity in these terms. What policymakers should achieve is not *more* regulation but more *effective* regulation.

But why is finance subject to much more stringent regulation and supervision in the first place? In order to answer this question, we need to set the stage with a few explanations. Finance is part of the information industry. So, for instance, if borrowers and investors with complementary needs could find themselves easily in an economy, then we wouldn't need financial institutions and markets. Since this is obviously not the case, we need *financial institutions* and *financial markets* to allocate savings through *financial transactions*. Financial markets help economies to grow by mobilizing savings (*i.e.* creating *financial assets*) so that consumption could be higher in the future as a result of today's investments. We regulate and supervise finance more attentively than any other economic sector, because finance exhibits such information asymmetries that can cause serious market failures that can have socially devastating consequences. Consequently, financial regulation and supervision are imposed as

″legal remedies″ to information asymmetries, inefficiencies, and various risks that markets and institutions (or finance in general) are inherently prone to.

In this regard the last financial crisis was a somewhat fortunate event. This is because it finally disclosed significant gaps in the current state of knowledge about the nature of financial systems and economic policy in general. In addition it revealed that existing financial regulation and supervision have only exacerbated the negative effects of the crisis. If financial regulation is to become more effective it should first turn to the vast experience that financial history brings. This means that the scope of financial regulation and then supervision should recognize factors that are common to financial crises throughout history, and then try to envisage potential future problems.

Against this background the fundamental objective of this dissertation is to explore and assess the changes and the current state of financial regulation and supervision in the EU. Therefore we assess the manner in which regulation and supervision are exercised at both supranational and Member State level. However, this does not mean that we analyze national regulatory systems separately, as this would be confusing and ultimately prove inefficient for our research intent. Rather, the objective is to determine whether the existing European regulatory and supervisory system (at the *supranational* level) with its theoretical rationale, objectives and instruments, is adequate to sustain financial stability across the EU (at both *national* and supranational level) and whether it benefits all financial sectors. Our focus is primarily on supranational, EU rules and arrangements; when it shifts to "EU countries", it is on Italy and Croatia. At first glance it seems very difficult to compare these two countries. Nevertheless their comparison is possible. Namely, both countries have a similar legal environment (the Roman *ius civile*) and both rely on more traditional forms of financial intermediation (both are bank based economies). We think that this similarity is reflected in their national financial regulations as well. And let us not forget that Italian financial institutions own a significant share of the Croatian banking sector. Thus we concluded that Italy could be used as a benchmark for Croatia in its process of EU regulatory harmonization.

In the broadest sense we can say that the dissertation focuses on four key building blocks in finance:

(1) Financial assets,

(2) Financial transactions,

(3) Financial institutions and

(4) Financial markets.

An interdisciplinary analysis, from the financial, economic, legal and EU law-point of view, of these building blocks enables proper assessment what is the appropriate regulation and efficient supervision that supports financial stability across the EU and at the same time accommodates the needs of future EU members (particularly those of transition economies such as Croatia).

As for the purposes of the thesis, they are:

(1) To critically overview the current state of EU financial regulation and supervision and the prospects of their future developments. In doing this we give special attention to the complex structural reforms that are put forward by EU authorities and which make the transition *from exclusively microprudential regulation toward macroprudential regulation*. In addition, we analyze how the main European integration principles (*i.e.* minimal harmonization, mutual recognition and most importantly, home country control) have changed in the last two decades parallel to the changes on the financial markets. We expose weaknesses of these changes, and assess how all these changes happened, and how they support greater centralization within the EU.

(2) To assess whether the objective of completing a Single Market through European legislation (we will focus primarily on EU directives) has been equally successful with respect to financial assets, transactions, institutions and markets. Furthermore, *has the regulatory harmonization in all of these areas been equally beneficial, or has "legal standardization" caused certain unintended practical consequences that bear the potential for instability*?

(3) To ascertain how EU financial regulation functions at national level and what are the main elements of supervision common to the majority of EU countries. We do this in order to draw effective guidelines for acceding countries, such as Croatia. *We determine whether convergence with EU requirements in the area of finance has been beneficial from the aspect of a transition economy, and if it was, what are its main accomplishments as well as drawbacks*? It is our intention to critically assess the current state of finance in Croatia and suggest the manner in which financial regulation (paired with supervision) can sustain economic stability.

Our research has led us to conclude that financial activity typically takes place in imperfect markets where consumer welfare is often encroached. Consequently, financial regulation and supervision are imposed as ″legal remedies″ to information asymmetries, inefficiencies, and various risks that markets and institutions are inherently prone to. Financial regulation allows consumers of financial products to make better-informed financial decisions and encourages market participants to align their behavior with social objectives. In order to achieve these goals *we argue that the general principles of regulation and the purpose and functions of particular aspects of regulation need to be clearly specified, and the particular institutional framework for the implementation of these regulations should be tailored to the circumstances of each financial sector* (banking, securities markets, insurance, etc.).

We concentrated primarily on financial regulation developed as part of EU law, and the manner in which regulation is enforced across EU Member States. As regards supervision, our interest centered on its institutional set up in across EU countries. At the same time we examined how EU trends regarding this institutional set up affect national supervision. Based on our research, *we consider centralization together with institutional consolidation to be the two main characteristics of EU financial regulation and supervision nowadays* (and in the foreseeable future). The undisputable objective of EU financial regulation has become to harmonize national financial systems to the greatest extent possible. By affecting every area of finance they intend to create "uniformity" between national financial systems with respect to their constituting elements (*i.e.* financial assets, instruments, institutions, markets). In the eyes of EU policymakers such "uniformity" should allow for greater legal certainty, and legal certainty should doubtlessly result with financial stability.

However, such an approach creates problems to the EU. Namely in the EU, the greatest share of responsibility for the effective enforcement of supranational, EU regulation still rests with the national governments. Although Member States follow the premise of ″central regulation – local supervision″, their national authorities still have the liberty to implement EU laws in ways they determine to be consistent with the objectives of their national economic policy. Naturally, they may do so only in the case of directives, and not in the case of regulations, which are the most binding of all legislative measures in the EU. In turn, the objectives of individual national economic policy do not have to benefit the whole EU necessarily. This clearly represents a problem, as it exacerbates the tension between the supranational and national level of governance, and among Member States.

It is not surprising then that *the EU is recurring ever more to greater centralization in the field of financial regulation and supervision at the expense of national discretions through the "maximum harmonization" principle. We think that European policymakers consider* *centralization, or "more Europe", as the only way to sustain financial integration in an enlarging EU that is often accused of "democratic deficit" in its decisions.* The crucial questions may well be the following - is "more Europe" the basis for financial stability in the EU? What are the effects of centralization on different components of the financial system? Which are the measures used to achieve such centralization? Even more controversial is the question as to whether all Member States will benefit from such "regulatory uniformity". From a broader perspective it is hard to deny that during the years EU financial regulation has changed its nature. Departing from the principles of "minimum harmonization" and "mutual recognition", regulation has become ever more centralizing and based on the principle of "maximum harmonization". In recent years centralization has become *de rigueur* even in supervisory arrangements. The chapters of this dissertation thesis examine the impact of these developments on each of the constituting elements of a financial system. Judged by our findings, when it comes to financial integration and the Single Market, the EU is resolute to limit national discretions. Especially in the post-crisis period, in the field of financial regulation and supervision, the EU is acting as an ambitious political community with greater binding powers than we have experienced so far.

The EU, apparently, is determined on its path towards more centralization. This intent is clearly visible in the area of financial assets' regulation. Financial assets are interesting because they are typically intangible thus their ″invisibility″ inevitably calls for closer regulation. At the beginning of integration it was EU's intention to standardize the types of financial assets available in Member States, and to harmonize the rights and obligations associated with each type of asset. In achieving this goal the favored tool was legislation. As a result directives and regulations were (and still are) enacted with respect to securities, bank deposits, loans, financial derivatives, and so on. *Although EU's intervention in this area was based on "minimum harmonization" in its beginning (and paired with "mutual recognition"), the intervention gradually evolved towards greater centralization*. This means that almost all of the recent regulation of financial assets is based on the principle of "maximum harmonization". The importance of this lies in the fact that such regulation creates "legal uniformity". Naturally, *"legal uniformity" cannot be equally beneficial for all types of financial assets. Whilst, in our opinion, securities regulation can reap the most positive effects of such harmonization, regulation of other assets (bank deposits and loans) should be more flexible and allow for some acceptable degree of "national diversity".*

The same is true with respect to EU's regulation of financial institutions. We think that regulatory centralization in this area is particularly problematic. Let us explain why. Invariably, financial institutions in the EU start off as heterogeneous, but then a number of factors – some regulatory, some not – drives them to homogeneity (with respect of the types of assets they may invest into, the levels of capital reserves they must retain, etc.). The significance of this is that – paradoxically – homogeneity makes the financial system prone to systemic risk. *We argue that the way to reduce systemic risk, and to build a macroprudential perspective, is to encourage heterogeneity in the behavior of institutions. However, much of the European (micro) prudential regulation does the opposite. No reasonable amount of prudential capital can remedy a system that leads all financial institutions to act in the same way and to be exposed to the same types of risks. Judging by this measure, less ambitious (i.e. centralizing) regulation of financial institutions in the EU would be more appropriate.*

As we can see from the above arguments we have found evidence of centralization with respect to financial assets and institutions. But is this true for financial markets? As the foundations of the EU are equally dependent on political and economic (or better said, financial) integration it doesn't take much to conclude that centralization affects financial markets as well. Consequently, during the years regulation in this area has been transformed from a basic framework with limited integration success, to a more extensive and detailed regime designed to successfully complete the "Single Market project". *Not only has EU regulation of financial markets transited from "minimum harmonization" to "maximum harmonization", but also that regulation started to show "transformative ambitions". This means that regulation wished to shape the present and future of financial markets in the EU. And the only way to succeed in doing this was to recur to "more Europe" or more centralization.*

A remarkable example of such "transformative regulation" on the basis of centralization is the Markets in Financial Instruments Directive (MiFID). Although the MiFID is certainly remarkable from a competitive, economic and legislative aspect, we nevertheless think that there is a "catch" to it. As we have already mentioned, great centralization surely cannot benefit all Member States equally. And in fact, in our opinion, MiFID benefits the "old" Member States, while the new members and EU acceding countries are left in a "directional confusion". Let us explain why.

By implementing MiFID, the "old" Member States only bring clarity and order in an existing economic environment. The Directive simply regulates existing financial instruments and markets. But in the case of new Member States and EU acceding countries, MiFID regulates instruments that do not even exist in practice, or whose share in the market is minimal. Furthermore, it artificially creates new, competitive trading venues while the stock exchanges of these countries are still struggling for volumes in transactions and liquidity. *So, by implementing MiFID the new Member States and EU acceding countries are actually putting faith in the concept of "law as market creator". A concept we have dismissed in our arguments. We have set it aside, because it is our opinion that law cannot kick start market development. The role of law in finance (similar to other areas of social life) is secondary – it regulates those relationships that already exist in practice*. In this way, law and regulations bring legal certainty to these relationships. *By contrast, the implementation of MiFID in the new Member States and acceding countries doesn't have the same effect; it only has the potential to create confusion*.

Turning our focus on transition economies and their interaction with EU regulatory and supervisory requirements, we can state that EU financial regulation affects different economies very differently. This is immensely important from the perspective of transition countries, such as Croatia. Although these countries have successfully completed their political transition and are now (or will be very soon) part of the EU, their economic transition is far from over. Typically the size of these economies is small, but nevertheless they usually rely heavily on their financial systems, where financial institutions in turn are foreign EU-owned, for the most part. As a result, often transition economies are exposed to crises that are "imported" from foreign countries where they originate in the parent company and then transfer to branches and subsidiaries located in transition countries. In the majority of cases these crises affect banking sectors. This is why legal reform – or the creation of an appropriate regulatory framework for finance – should be an integral part of the political transition of these countries. In the case of Croatia, however, we have come to the conclusion that domestic policymakers haven't put much thought to this issue. By comparing Croatia with other EU countries (and we have chosen Italy as our benchmark) we have determined that for the past decade *Croatia has been subject to a "regulatory frenzy" without any defined financial or economic policy goals*. In an effort to harmonize with EU law as quickly as possible, Croatia has often forgotten that what needed to be transposed were directives (not regulations!) for the most part, and as such they could be adapted to domestic circumstances. With an *ad hoc* approach in the area of finance, Croatia has succeeded in regulating even financial instruments, transactions and markets that are non-existent in the Croatian financial system. This was unnecessary and burdensome. *Even when it comes to supervision, Croatia has shown some intent to comply with the trend of institutional consolidation, exhibited in many EU Member States. But there are no arguments in favor of such a solution in the case of Croatia*. Our research of financial regulation and supervision in Croatia shows that this country was more than willing to conform to its role as an *ad hoc* "rule-taker" rather than active "rule-maker". This is a clearly unacceptable position, as the stakes associated with the implementation of EU financial regulation are high, given the large foreign (mostly EU) ownership of the Croatian financial system.

In our opinion and from Croatia's perspective – and for now we shall put aside the very important goals of political security and wider international support that comes with EU membership – European integration will not result with overwhelming results in the economy. But this shouldn't be new to Croatia. Judging by recent experiences of transition economies dealing with financial duress as EU members, at time it even seemed that these countries were hit the hardest – economic union prevented them to resort to needed measures of monetary policy that would give a quick boost to their economies, while the rest of EU countries did not extend them much support. Part of the reason for this lies in the fact that the EU is actually "caught in the middle" – economically more integrated then any other region in world history but with political governance still in progress. So where does this leave transition economies, or Croatia for that matter?

While the "EU commitment" can enhance the performances of national economies, this result is not given. In our opinion European integration, with its political and economic agenda focused on more centralization and regulatory power, clashes with the needs of transition economies. This is because integration does not seek to facilitate or alleviate their transition process but rather to accommodate financial interests seeking new markets at low costs, less responsibilities and minimum commitment. This is clearly evident from the current state of finance in Croatia, where foreign owned banks (which represent the majority of financial institutions) are not at all interested in developing more risky activities of corporate banking that would revive the private sector in the Croatian economy. They rather stick to the safe (and generous!) profits made by extending loans to households and encouraging consumption.

The perspective of EU membership puts completely different requirements in front of transition economies, than those put before other EU countries. It requires them to give predominance to the needs of European enterprises, banks and other financial intermediaries, before they have even managed to secure their own social and economic objectives. Hence, the "EU commitment" requires them to forsake an immense part of their national determination in economy and to serve primarily "common needs". And this is not something that transition economies, such as Croatia, should do. We wish to point out strongly that by this we do not mean that transition economies should not be part of the EU. We only wish to suggest that the "uniformity" brought by EU financial regulation and supervision will damage transition economies the most. Again, putting aside the political aspect of their membership negotiations, we think that the economic requirements put before these countries should have been different. In addition we think that in the case of Croatia and other transition economies "uniformity" shouldn't have been the goal of EU regulation; the goal should have been to enhance the operation of national economic systems. Simply put, transition economies are too diverse from other "ordinary" EU Member States to be molded into a "single rulebook".

All things considered, it is evident that EU financial regulation and supervision have come to a turning point in their development, and here we do not refer (solely) to the trend of centralization. The point that we wish to put forward is that, in the aftermath of the crisis, the EU is facing a trilemma that could shake the core of its political, not only economic, governance. We shall refer to it as *the "regulatory trilemma"; meaning that the EU cannot pursue financial integration, systemic stability (through macroprudential regulation) and national regulatory autonomy at the same time*. If the EU wishes to push financial integration further, Member States will have to give up a significant share of their regulatory autonomy. On the other hand, if the EU wishes to maintain systemic stability and deepen macroprudential regulation, it will have to count on a more independent role of Member States in supervision. Most of EU's troubles in the area of finance derive from its reluctance to face up to these choices, as policymakers worry that this would only exacerbate the tension between the national – supranational level.

Let us be clear on our choice in this trilemma – national discretions and regulatory autonomy should prevail over financial integration. This means that Member States should have the right to protect their national financial systems, and when this right clashes with the requirements of financial integration, it is the latter that should give way. And this was clearly evidenced by recent events – when European economies came under stress the responses were predominantly national. *But we emphasize an important requirement in our argument; namely, this choice shouldn't hinder systemic stability or impede the functioning of macroprudential regulation. Nor should it be a euphemism for financial protectionism.* At first glance one may think that leaving sizeable national regulatory autonomy would sign the end of EU-wide financial stability. This is not true. It is our opinion that only by giving more power to national supervisors that will conscientiously supervise the enforcement of EU regulations "at home" the EU can support financial stability.

And with this we have come to the ultimate paradox of regulation. While rules based on "maximum harmonization" provide legal clarity, we argue that a more flexible approach to regulation would be more effective. This is because in the EU strict rule enforcement is not feasible in the long run, due to the great diversity between EU countries. The differences in the implementation of EU financial regulations at Member State level should not be seen as aberrations from the path of financial integration, but rather as natural outcomes of different national circumstances. Naturally, the prerequisite to this is that in the implementation process the Member States do not drift away from the legislative intent of a specific measure. There is a possibility for a different role of the EU; one that could accommodate the needs of an enlarging union even better. Let us explain. EU financial regulation relies both on "hard rules" and principles-based administrative discretion. The effectiveness of this combination depends on the legitimacy of those who promulgate and adopt such regulation. As the legitimacy of the EU has been questioned by Member States on different occasions we believe that regulation based on "maximum harmonization" and centralizing in its nature can do more harm than good. Perhaps common financial regulation could be more flexible in its nature. As such it could be coordinated at the EU level to reflect the demands of financial integration, while rigid rules could be left to the national level. A "single rulebook" in the area of finance advocated by the EU does not have to entail full harmonization of all rules. It could entail a harmonized set of core-standards, applied in a coordinated manner across Member States and supervised by national authorities. In this context the role of EU policymakers, institutions and authorities involved in the legislative process could change. They could be responsible for the coordination of the implementation process, and act as a forum for "peer monitoring". This would not mean that the EU has lost some of its supranational powers – to the contrary. EU coordination of national rules and implementation processes should be seen as essential. *Thus, we argue that centralization is not the appropriate way forward in the development of EU financial regulation. A thin layer of supranational regulations (based on minimum harmonization and co-opetition) that leaves room for maneuver by national authorities would guarantee better regulation and greater efficiency.* What the EU needs is smart harmonization, not maximum harmonization.

In the end, we wish to note a few critical observations with respect to the post-crisis regulatory developments observed in Europe. It is true that the recent financial crisis has challenged our understanding of financial regulation and supervision and of the complex relationship between financial and political integration within the EU. But it has also given an opportunity to further explore the interdependence between (de)centralization and financial stability. For now, it seems as the debate regarding "regulatory control" between the national – supranational level is over in favor of greater supranational control of regulation. This means that the nature of regulation changes radically – after years of "mutual recognition" and "minimum harmonization" regulation is now based on the principle of "maximum harmonization". The move to centralization is perhaps most evident in financial supervision, traditionally left to Member States' competences, which now retreat in favor of supranational authorities envisaged by the de Larosière Report.

All of these events are exacerbating the fragile balance between national interests and further financial integration in the EU. It is difficult to predict all of the obstacles that the new institutional set up for EU financial regulation and supervision will face. What is evident is that the forces driving centralization have considerable political support. Much will depend from practice and foresight in this "de Larosière environment". But it remains to be seen whether this environment will benefit equally all EU Member States. We fear that excessive centralization and "regulatory uniformity" will blur the specific interests of smaller EU countries (especially new Member States and transition economies) in the bigger picture of the "European common good" (that is financial stability for the purpose of this dissertation).

We think that the role of nation states still cannot be dismissed. European policymakers cannot proceed on the assumption that the EU may be on the way of becoming a perfectly integrated "super-state". We must accept the restraints of integration – both from their political and economic aspect. The nation states are still a reality, and even when part of a *sui generis* political and economic integration such as the EU, we need to acknowledge their diversity and protect their right to safeguard domestic interests.