Diverging financial regulations after the crisis? A comparison of the EU's and the United States' responses*

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The study aims to compare the regulatory changes occurring on both sides of the Atlantic. An inappropriate regulatory environment contributed to the onset of the financial and economic crisis, and therefore the post-crisis regulation attempts to remedy the earlier deficiencies and address the problems that emerged during the crisis. The study evaluates and compares the latest financial regulation initiatives on both sides of the Atlantic and assesses the diverging attitudes to regulation in the EU and the United States in six exemplary areas: remuneration, bank capital requirements, derivatives, credit rating agencies, the regulation of hedge funds, and consumer protection. Fundamental differences in regulation pose a challenge to firms operating in both environments and harmonisation remains elusive. However, in some areas, regulators from both sides of the Atlantic are willing to give broad deference to certain regulations of foreign jurisdictions, instead of their own ones. Regular dialogue between the United States and the European Union points in the right direction, but as the article points out there are many improvements which still need to be made in order to reach a consensus acceptable for financial market actors as well as regulators.

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1 Introduction

Appropriate regulatory responses to recurring crises are a persistent problem of capitalism. In the period of economic upturn preceding the current crisis, developed countries' capital markets seemingly worked with incredible efficiency. This created the moral foundation for deregulation. The nightmare of recession seemed unrealistic, and the stringency of the regulatory environment started to ease, amidst general optimism. However, the crisis proved that the processes of recent decades and the increasing complexity of financial markets did not bring increasing profits with decreasing risks, as experts from financial institutions led us to believe. The two key reasons of the crisis are markets turning opaque due to the proliferation of financial innovations, and the inappropriate regulatory environment *(Biedermann, 2012a)*.

Post-crisis regulation is fundamentally different from that of a more balanced financial and economic era. Since public trust in financial institutions and markets decreased rapidly after 2007, policymakers were pushed to re-evaluate their share in the creation of the global economic turmoil. Although there are other increasingly important actors in the global financial markets, in this article we devote particular attention to the regulatory changes in the European Union (EU) and the United States (US). In response to the recent financial crisis, extensive legislative initiatives were undertaken in many jurisdictions, most notably in the US and the EU, as well as at the international level. This was often accompanied by revamping of existing institutions such as the Basel Committee of Banking Supervisors and the introduction of new organisations such as the Financial Stability Board *(Chatzistavrou et al., 2013)*.

The interconnectedness of financial markets was exposed in light of the recent financial and economic crisis; therefore, several regulatory initiatives of the financial markets have been pushed to the forefront of the global economic cooperation agenda (G20, Bank for International Settlements, the Financial Action Task Force) at the level of political principals *(Véron, 2014)*. The worldwide impact of the economic crisis on financial market regulation has forced US and EU regulators and policymakers to adjust their role in the context of a more interconnected global arena. However, these adjustments have been unbalanced. Policymakers on both sides of the Atlantic were forced to rethink the means of financial regulation, and realize that "national interests can no longer dominate; rather, these interests must be harmonised" *(Stoltenberg et al., 2011:578–579)*. Reaching this theoretical conclusion is not enough, as there are practical steps and legal processes that need to be implemented to create a harmonised environment for financial firms operating in both the EU and the US.

Rule-makers try to avoid regulatory arbitrage by calling for consistency in implementing G20 and other reforms. However, introducing identical or similar requirements in different jurisdictions may lead to some actors becoming subject to multiple overlapping regulatory regimes. The effects could be the following: reducing the quality or usefulness of information available to regulators; introducing unnecessarily duplicate requirements and distorting competition; encouraging participants to make venue choices based on avoidance of administrative complexity; and increasing the compliance burden or costs of compliance for regulated entities without achieving any additional benefits *(GFMA, 2012)*.

This article evaluates and compares the latest financial regulation initiatives on both sides of the Atlantic, and reflects diverging attitudes to regulation in the EU and the United States. Fundamental differences in regulation pose a challenge to firms operating in both environments, and although the present overhaul would be a unique opportunity for the creation of a uniform global financial regulation, it remains elusive to this day.

2 Theoretical framework for financial regulation

This section provides a theoretical background of financial market regulation. Financial market regulation is the subject of fierce debate, for instance on the issue of ideal capital requirement levels *(Dewatripont – Tirole, 1994; Goodhart et al., 1998; or Acharya et al., 2010). Acharya et al. (2010)* presents that excessive regulation involves costs, but the effects, even an unleashed disaster can be observed ex-post only. According to *Šútorová and Teplý (2014)*, “It implies that optimal regulation should be the art of balancing the immeasurable against the unknowable. As a result, effective financial market regulation is basically a ‘mission impossible’ and recurring crises can be still expected in the future”. In the case of financial regulation, it must be highlighted that, despite its importance, global regulatory efforts will not be able to prevent financial markets from future crises and financial upheavals on their own *(Reinhart–Rogoff, 2009; Acharya et al., 2010).*

As for the goals, on the one hand regulation should ensure the safety and stability of the financial system (including the promotion of consumer protection as well), and on the other hand it should foster the growth and development of the financial markets. Consequently, financial regulation should be “focused, primarily rule-based and time and state-varying (light during normal periods, increasing as systemic threats build up)” *(Brunnermeier et al., 2009:59)*. Globalisation of financial markets manifests itself in the increasing interconnectedness and interchangeability of financial service providers, which makes financial regulation even more problematic *(Pan, 2011)*. Rather than being based on a consistent theoretical framework, financial regulation is usually imposed in reaction to some previous crisis. This area has always involved “a pragmatic response by practical officials, and concerned politicians, to immediate problems, following the dictum that – We must not let that happen again” *(Goodhart, 2010:165)*.

A fundamental reconsideration of global financial regulation has occurred as a response to the crisis. In the aftermath, policymakers seemed more concerned about stability issues rather than financial markets' competitiveness. On the contrary, faced with a sluggish recovery, governments are now trying to make sure achieving one goal does not occur at the expense of the other *(Pan, 2011)*.

It is extremely difficult to balance between financial lobbies, the public will and the haunting image of a global crisis relapse. Financial regulatory responses to the current crisis need to take into account domestic, but also regional and global, features of the financial system. This resulted in somewhat different alterations of the previous regulatory frameworks in Europe and America which need ulterior follow-up and coordination. Since regulatory arbitrage may hinder global recovery, reforms to achieve global financial stability seem more important than ever. The required reforms "mitigating systemic (as opposed to idiosyncratic) risk; alterations in incentive structures; and better data and information to reduce unknowns" are independent, and any set of reforms may only marginally improve global financial stability *(Claessens–Kodres, 2014:15)*.

3 Comparing EU and US responses

It is obvious that the EU and the US play a central role in shaping global finance, as they account for more than two-thirds of all financial services by transaction volumes. Although ties between the two financial markets are almost organic, there are several issues which are being tackled in a fundamentally different manner *(CMWG, 2010)*. The financial crisis triggered a wave of new regulations worldwide "to make markets and institutions more transparent, less complex, and less leveraged" *(IMF, 2012:75)*. Post-crisis amendments highlight the divergence of regulatory approaches in the United States and the European Union, since the American Dodd-Frank Act is more of an all-encompassing law, while the EU is methodically regulating sector by sector *(The Economist, 2012)*.

The *Dodd-Frank Act (2010)* is the US legislative response to the financial crisis, which implements the measures agreed on at international level by the G20 and elaborated further by the Financial Stability Board and the Basel Committee on Banking Supervision *(Sabel, 2012)*. American president Barack Obama announced his intention to reform the American financial sector in June 2009 and signed the Dodd-Frank Act on Wall Street reform and consumer protection a year later. The stated aim of the legislation was "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." As any major financial reform, it received harsh criticism, some arguing that its measures were not sufficient to prevent a similar financial crisis, others contending that it was too rigid and reduced the competitiveness of American financial firms. Furthermore, large financial firms giving financial advice and performing various financial operations on their own account, representing the classic case of conflict of interest, are required to put their clients' interests first. However, this theoretical norm will be difficult to respect since consulting and trading on an own account within the same firm is still considered legal.

The Dodd-Frank Act (among others) introduced a watered-down version of the Volcker Rule (originally intended to restrict banks from trading on their own account as well as making speculative investments in risky funds): banks are only allowed to make higher risk investments with up to 3% of their tier 1 capital. Neither can banks possess more than a 3% stake in any private equity group or hedge fund. The 3% capital threshold is probably not strict enough to limit banks' risky activities and proprietary trading. The Dodd-Frank Act also introduced transparency reforms for the derivatives market, and comprehensive regulation of swaps, without removing the possibility of excessive leverage from the system. The EU proposed initiatives similar to the Volcker Rule. The structural measures submitted by the US (Volcker Rule), UK (ring-fencing[1]), and EU (Liikanen group recommendations/banking structural reform proposal) aim to decrease the probability of bank failure and its systemic implications by reducing complexity and interconnectedness. The Liikanen Report highlighted the need for re-structuring of banks into separate legal entities *(Viñals et al., 2013)* and as a follow-up to the Liikanen report, the Commission established a High-level Expert Group to examine possible reforms to the structure of the EU's banking sector. The Group's mandate was to determine whether, in addition to ongoing regulatory reforms, structural reforms of EU banks would strengthen financial stability and improve efficiency and consumer protection, and, if so, to make proposals as appropriate. The Commission examined the possible reform options and their implications and, on January 2014, it adopted a proposal for a regulation *(European Commission, 2014a).*

The EU took a three-pronged approach based partially on the European Markets Infrastructure Regulation (EMIR) as a cornerstone of the post-crisis reform agenda. Together with the revisions to Markets in Financial Instruments Directive (MiFID) and the increased capital requirements for banks (CRD IV[2] implementing Basel III[3]), these

1 Ring-fencing promotes resolvability at the level of the retail bank, but not necessarily at the group level.

2 "In 2013, the European Union adopted a legislative package to strengthen the regulation of the banking sector and to implement the Basel III agreement in the EU legal framework. The new package replaces the current Capital Requirements Directives (2006/48 and 2006/49) with a Directive and a Regulation and is a major step towards creating a sounder and safer financial system… The package is due to enter into force on 1 January 2014" (EBA, 2013).

3 "Basel III", developed by the Basel Committee on Banking Supervision, is a cornerstone in the overhaul of banking regulation to achieve stricter supervision and risk management of the banking sector. The financial crisis revealed certain procyclical elements of banking regulation, and accordingly Basel III aims to mitigate the procyclical nature of the regulatory framework, while strengthening bank capital requirements and introducing new regulatory requirements on bank liquidity and bank leverage (Ernst and Young, 2010).

three packages will dramatically alter the current operation of financial markets in Europe *(Deloitte, 2012)*.

The European Market Infrastructure Regulation (EMIR) was adopted in 2012 by the European Parliament and Council to improve transparency and risk management on the "over the counter" (OTC) derivatives market. EMIR stipulates that OTC derivative contracts (with some exceptions) must be reported and cleared (unless they are below the clearing threshold). It also sets additional safety measures for central clearing counterparties and trade repositories *(ESMA, 2013)*.

EMIR concentrates on the post-trade regulation of OTC contracts, but pre-trade and trade-related aspects of OTC regulation were also under review. The European Council concluded an agreement regarding the Markets in Financial Instruments Directive (MiFID) review in June 2013, based on the original aims of making financial markets more efficient, resilient and transparent and investor protection more robust *(Ernst and Young, 2013)*. As a result of the original MiFID, which had to be implemented by 2007, European financial markets became more fragmented, with trading taking place on a growing number of platforms. MiFID also contributed to more intense over-the-counter trading and the development of dark pools, and consequently market transparency decreased. The new regulation proposes the notion of OTF (Organised Trading Facilities) to include platforms that are not yet regulated. It tries to move the trading of derivative contracts to trading venues, and to broaden pre and post-trade transparency rules from listed shares to all instruments *(ABBL, 2013)*. MiFID II also aims to restrict high-frequency trading and excessive speculation on commodity derivatives and improve consumer protection for retail investors who buy financial products *(Finance Watch, 2013)*.

Banks, businesses and financial service providers will have to make strategic choices to comply with the new legislation on both sides of the Atlantic. But fragmentation of the global financial space seems inevitable, as both European and American regulation and implementation processes are speeding up and gradually taking final shape.

When we try to compare the European and American financial frameworks, we must emphasise the different political background: in Europe, the financial crisis has become a sovereign debt crisis. The EU is trying to regulate its financial sector while stabilising collapsing banks and euro-area Member States one after the other. Moreover, while the United States is more or less coherent and homogenous, the EU is composed of 28 Member States with widely varying interests, making the legislation process slower and the end result more fragmented. When it comes to financial regulation, the United Kingdom, as the second most important financial centre after the United States, is often opposed to regulation it considers too rigid and detailed.[4] Prime Minister David Cameron expressed

4 Based on the interview with Rita Pupli, Financial Department officer at the Ministry for National Economy.

fears in October 2011 claiming that London's financial centre is under "constant attack through Brussels directives."[5]

The following part of the study aims at highlighting differences and similarities of post-crisis financial regulation on both sides of the Atlantic associated with certain key phenomena linked directly to the financial crisis after 2007.

4 Regulatory changes on both sides of the Atlantic

We decided to analyse similarities and differences in these six areas, as these key aspects reflect how determined policymakers are to change the flawed logic and systemic problems of pre-crisis financial regulation. At the same time, these are the major areas where the two financial systems can be easily compared based on the text of the legislations, but also on press releases and analyses resulting from regular talks and discussions the two jurisdictions are having in order to harmonise their systems. For the purpose of highlighting the main differences between the US and EU approaches, we compare the regulatory responses in six exemplary areas: remuneration, bank capital requirements, derivatives, credit rating agencies, the regulation of hedge funds, and consumer protection.

Remuneration requirements have attracted significant popular and political attention. Excessive, poorly structured remuneration in financial institutions has been considered as an important ingredient in the development of the global financial crisis. Credit ratings agencies have also been subject to substantial criticism, due to conflicts of interest arising from their business revenue models, and the poor predictive ability of ratings has also been a cause for concerns *(Davis, 2011)*. Bank capital requirements as macroprudential policy tools are gaining more and more attention, since policymakers aim to use these tools to reduce the pro-cyclicality of credit and leverage *(Yellen, 2010; Hanson et al., 2011)*. Creating a new regulatory framework for over-the-counter (OTC) derivatives is an important element of financial regulation, because during the financial crisis, derivatives were portrayed as exacerbating stress in the financial system and global economy. As a result, policymakers set themselves the goal of building a more robust, transparent framework for the global derivatives markets *(Oudéa, 2013)*. Hedge funds played a central role in generating systemic risk during the crisis, and thus changes to their regulation is a crucial element of financial regulation *(Gropp, 2014)*. According to the findings of *Adams, Füss and Gropp (2014)*, it can be concluded that hedge funds may be the most important

5 Reuters: UK threatens veto over EU financial regulation. Available at http://uk.reuters.com/article/ 2011/11/08/ uk-britain-financial-hoban-idUKTRE7A74WO20111108 (accessed on 23.03.2013).

transmitters of shocks during crises, being more important than commercial banks or investment banks. *Evans (2010)* argues that regulatory intervention in consumer protection is an attractive option for policymakers to raise public attention. The global financial crisis has highlighted the need for strong consumer protection and financial literacy. As a result, governments worldwide are looking at practical and effective ways of improving consumer protection in financial services *(Rutledge, 2010)*.

4.1 Remuneration

Before the crisis, the incentive systems of numerous financial firms prompted both financial institution executives and employees to undertake short-term risks, instead of taking into consideration the interests of their depositors/shareholders and maintaining sustainable profitability in the long term. Rewards were tied to the success of the company on the market. The indicators of success in this field usually involved market share figures (number of new contracts, income, and profit), increase in client numbers, etc. As a result, lending standards became progressively laxer and contracting volumes were exaggerated (clients were talked into well rated, but rather risky deals) in the hopes of attaining higher bonuses. Even if a financial company or a bank went bankrupt, managers were not obliged to repay their bonuses, moreover: several top executives were paid excessive severance payments (golden parachutes). Many executives tried to conceal the company's liquidity problems (with the help of auditors and credit rating agencies) until the last minute *(Biedermann, 2012b)*. The above described routine contributed significantly to a so-called "boom frenzy" which ultimately led to massive irresponsible financial behaviour.

American legislation tackled the issue in a soft manner. The Dodd-Frank Act prescribes a shareholder vote on executive compensation. Pursuant to the Act's provisions, joint-stock companies shall in their proxy statements, at least once every three years, request shareholders to take a vote to approve the compensation of executives. The result of the vote, however, is not binding for management. The vote on compensation also requires that in the event that shareholders are asked to approve an acquisition, merger, proposed sale, etc., the person making such solicitation shall also disclose how much compensation corporate executives will receive due to the given transaction. These vote results are also non-binding *(Fried–Shilon, 2012)*.

By contrast, the EU took harsher measures to cap bankers' bonuses. The CRD IV package, containing the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR), specifies provisions regarding the compensation policies of financial institutions, including a "bonus cap". The British government sought annulment of the remuneration-related requirements, but as of early 2015, due to the "minimal prospects for success", it decided not to pursue the case any longer *(Osborne, 2014)*. Although capping bonuses may be effective in fighting short-sighted manager strategies, they might result in increasing fixed salaries or drive away talent. If an exodus of bankers takes place, the City of London may lose ground to New York and Asian financial centres.

4.2 Capital requirements

The relative importance of banks in the world economy in the last two hundred years has been on the rise; from financial intermediaries channelling savings into productive activities, they have become fundamental players in most developed countries, boosting or slowing down a country's economic performance. This process gathered pace in the decades preceding the current crisis. The scale of banking grew rapidly: between 1870 and 1970, the average bank assets-to-GDP ratio rose from 16% to over 70% per cent. In the roughly 40 years since 1970, the ratio of bank assets-to-GDP has more than doubled, rising from around 70% to over 200% *(Haldane, 2012)*. Banking concentration has also risen dramatically, contributing to the evolution of banks that are systemically important financial institutions (SIFIs).

The existence of SIFIs involves a three-fold policy challenge. First, such institutions are responsible for systemic risk by blunting incentives to manage risks prudently and by creating a massive contingent liability for governments. Second, SIFIs distort competition. And third, the favoured treatment of SIFIs lowers public trust in the fairness of the system *(Goldstein–Véron, 2011)*.

The operation of banks has its innate risks due to the nature of their activity. Because of the maturity mismatch between bank assets and liabilities, banks are subject to the possibility of runs and systemic risk *(Allen–Carletti, 2009)*. Bank regulation is designed to minimise these risks stemming from the characteristics of banking activities. The relatively lax and pro-cyclical regulatory environment, as well as the moral hazard related to SIFIs encouraged banks' risk-taking and expanded banks' range of activities from the 1980s on *(Taylor, 2012)*. The operation of banks became riskier, as they used excessive leveraging and started lending to less reliable customers. The hallmark of this excessive risk-taking was loans to NINJA (*No Income No Job or Assets*) customers, who then started to default in significant magnitudes *(Talbott, 2010)*. The above phenomena are widely considered to have contributed to the global financial crisis.

Reforming minimum capital requirements for banks and certain financial service providers aims to strengthen the resilience of the financial sector, which proved to be insufficient during the crisis. The ratio between the capital a bank must retain and the risks it incurs in its activities are defined by the Basel Committee on Banking Supervision at the international level. The first Basel Accords were published in 1988 by central bankers from all around the world and were enforced in the Group of Ten countries in 1992 *(BIS, 2009)*. Due to swift transformation in the financial sphere in the following two decades, a more comprehensive, better adapted set of risk and capital management requirements was published by the BCBS in 2004 (Basel II) and implemented gradually in most G20 countries by 2010 *(BIS, 2013)*, when Basel III was developed to address shortcomings of the previous regulatory framework revealed by the financial crisis *(Elliott, 2010a)*.[6]

Basel III improves the quality and quantity of capital retained by banks in order to better absorb shocks,[7] introduces a counter-cyclical buffer that can be used in times of crisis,[8] an additional non-risk weighted leverage ratio and liquidity coverage ratio to be met, and strengthens risk capture and risk management practices. Since Basel III is not legally binding, the Basel Committee member countries are entitled to implement it in their own way, respecting the spirit of Basel III as a general basis. The implementation of Basel III rules is therefore advancing very slowly and unevenly. The progressive "phase in" of specific provisions, particularly on liquidity and leverage, are likely to influence the relative competitiveness of US and EU financial institutions.

Both American and European regulators face fierce resistance from bankers who claim to need a longer period of preparation to implement the required changes *(EBIC, 2013)*. Although the Basel III capital proposals have promising elements, including a leverage ratio, a capital buffer and a mechanism to deal with pro-cyclicality through dynamic provisioning based on expected losses, it might face the same fate as Basel II which never properly came into effect.[9]

While in the EU the CRD IV framework applies to all credit institutions and investment firms, in the United States the scope of implementation is narrower: smaller bank holding companies and some savings and loans companies will be exempt from the relevant provisions. While some EU requirements are more liberal, others are more rigorous (scope of application of the Basel framework, capital buffers and eligibility criteria for recognising real estate collateral) as compared to the minimum requirements stipulated in the Basel III framework. The Basel Committee on Banking Supervision assessed European implementation,[10] and claimed it to be materially non-compliant with the minimum standards of Basel III, deviating from both the letter and the spirit of the Basel framework. Special emphasis is put on the methodology used to calculate CVA risk capital requirements *(BiS, 2014)*. The identified deviations, especially those more rigorous than US Final Rules,[11] might pose serious challenges for financial institutions operating in both environments.

6 Basel II did not enter into force until January 2008 in the EU and April 2010 in the US. In response to the crisis and to remedy some shortcomings of Basel II, the BCBS adopted the Basel III Accord in September 2010 (Paulo, 2011).

7 The definition of what counts as "Tier I" capital is also stricter.

8 Basel II was criticised for being pro-cyclical from the start (minimum capital requirements were usually underestimated in boom periods, and banks could not go below the minimum capital requirements even in times of crisis).

9 In the United States, Basel II was never fully implemented, and therefore the Final US Rules will replace a Basel I-based capital system.

10 For the full implementation of CRD IV and the CRR, the EU relies upon the timely issuance of EBA standards and guidelines.

11 In July 2013, the Board of Governors of the Federal Reserve System (the "Federal Reserve") and other bank regulatory agencies approved final rules ("Final US Rules") which codify the US Federal regulatory agencies' regulatory capital rules into a single, comprehensive regulatory framework (Sabel, 2013).

The different accounting standards which are applied in the US and the EU make the comparison of capital requirements all the more difficult.[12] In relation to some elements of a bank's balance sheet, IFRS (International Financial Reporting Standards) and US GAAP (US Generally Accepted Accounting Principles) are totally incomparable *(Lannoo, 2010a)*.

Another serious problem lies in the very nature of the financial system. The Basel regulatory framework can only regulate banks. However, banks can shift financial "promises" to non-regulated or less-regulated insurance companies in various jurisdictions. There are several other actors on the financial market that might act like banks (e.g. some hedge funds issue securities in their own name and take deposits of investors and invest with leverage on behalf of investors). This shadow banking system does not operate according to the same rules as the banking system does *(Blundell et al., 2010)*.

Hence, even if stricter rules are applied to banks, other bank-related and shadow banking institutions will continue operating outside these rules, and previously well regulated banking activities might be taken over. In other words, the new banking standards may encourage certain activities to move to the nonbank sector, where banking standards do not apply *(IMF, 2012)*.

4.3 Derivatives

A derivative security (forwards, swaps, futures, options) generally refers to a financial contract whose value is derived from the value of an underlying asset. Derivatives allow users to meet the demand for cost-effective protection against risks associated with movements in the prices of the underlying, and thus users of derivatives can hedge against fluctuations in exchange and interest rates, equity and commodity prices, as well as credit worthiness. The derivatives market has skyrocketed during the last 25 years, and the rapid improvements in computer technology in the 1990s allowed asset managers to design and develop increasingly sophisticated derivatives as part of their risk management tools *(Chui, 2012).* They generally ensured much higher yields before the crisis than deposit interest, and offered a wide range of investment opportunities with high returns compared to the amount invested. This, however, was not due to the ”risk-free” nature of derivatives transactions, but rather to the overly optimistic speculations related to such. Due to high leveraging, investors can lose multiples of their original investment if they take up unfavourable speculative positions *(Biedermann, 2012a)*.

Moreover, a flourishing market in derivative products developed outside the regulated markets (over-the-counter, OTC), under significantly more ”unregulated” conditions, which made the markets more opaque. According to *Paulo (2011)*, almost 90% of derivatives are not traded on regulated markets, but over the counter.

12 The EU has adopted IFRS, whereas the US continues to apply its own standards (US GAAP).

The financial crisis was seriously aggravated by the excessive use of derivatives such as credit default swaps (CDS) for speculative purposes, instead their use for hedging existing risks *(Elliott, 2010b)*. The lack of appropriate regulation of OTC derivatives transactions and insufficient risk aversion are addressed both in the European and American regulatory efforts.

There is a general effort to bring to light as many transactions that were previously concluded on unregulated platforms as possible. In Europe, standardised derivatives will have to take place on MTFs (multi-lateral trading facilities), in the US on SEFs (Swap Execution Facilities) and reduce counterparty risk by obligating trading parties to clear transactions via a central counterparty.[13] The key requirements regarding derivatives are by and large the same in the European (EMIR) and American (Dodd-Frank Act, Title VII) regimes both regarding trade data and clearing requirements. These rules are compulsory for both financial and non-financial companies which conclude more than a certain threshold number of derivative transactions. Both jurisdictions granted a wide exemption for commercial users of derivatives who are hedging their underlying business risks *(Deloitte, 2012)*.

However, while the frameworks are very similar, there are significant differences in implementation and technical details. *Jones (2014)* wrote about a Transatlantic tug-of-war over derivatives, since both the EU and the United States reiterated their commitment several times to bring about a coherent and smooth global market of derivatives (Path Forward,[14] Financial Markets Regulatory Dialogue[15] press releases[16]) and still no compromise is in sight. United States CCPs are still not allowed to clear EU derivatives contracts without the added cost of complying with European rules as well. Another key challenge is minimising divergences with regard to margin for uncleared swaps.

Moreover, whereas US capital markets are more alike, the European financial landscape is far from being homogeneous. The fragmentation of European markets pose challenges (among others) to the regulation of central counterparties (CCPs). According to the

13 A central counterparty stands between two parties, guaranteeing a trade if one party defaults.

14 In 2013, EU and United States regulators signed the “Path Forward” agreement, a promise to harmonise their derivatives rules in an attempt to avoid fragmenting the sector.

15 The Financial Market Regulatory Dialogue has been the forum for discussion of EU and US regulators since 2002. It brings together representatives of the European Commission (DG MARKT), the European Supervisory Authorities (ESAs – European Banking Authority, European Insurance and Occupational Pensions Authority, European Securities and Markets Authority) and the US Treasury and independent regulatory agencies, including the Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation, and Securities and Exchange Commission (SEC). The members of the EU-US regulatory dialogue hold regular exchange of information on regulatory developments on both sides of the Atlantic.

16 United States (U.S.) – European Union (EU) Financial Markets Regulatory Dialogue Joint Statement of 15 January, 2015: “Participants highlighted EU and US efforts to implement OTC derivatives reforms and their continued efforts to settle remaining issues related to cross-border market participants, transactions, and infrastructures. Both sides welcomed the extension of the transitional period for capital requirements for exposures to central counterparties (CCPs). The extension allows the EU to continue to engage with CFTC and SEC staffs to move forward on equivalence decisions for US CCPs. EC and CFTC staffs committed to resolving soon issues related to equivalence for US-based CCPs under the European Markets and Infrastructure Regulation (EMIR) on the basis of an effective system of substituted compliance for dually-registered CCPs” (p. 2.)

European Association of CCP Clearing Houses (EACH), an umbrella group for Europe's 23 clearing houses, European requirements are more onerous (more expensive and burdensome) than American ones, which might undermine the competitiveness of European CCPs, putting them at a regulatory disadvantage and encouraging regulatory arbitrage.

As for the differences in EMIR's effect, according to *Károly Mátrai,* director (Risk Management and Economy) of the Hungarian central clearing house (KELER), some provisions might raise serious difficulties for the operation of smaller clearing houses.[17]

4.4 Credit rating agencies

The importance of the analysis of credit ratings agencies (hereinafter referred to as CRAs) stems from the consensus on blaming them for part of the financial crisis *(Lannoo, 2010a)*. The market is currently dominated by three large credit rating agencies, which reign over 94% of the global market *(European Commission, 2008)*. They had already erred in their forecasts on a number of occasions before and at the beginning of the mortgage crisis, and rated securities and credit products which soon lost their value, as excellent. Moody's, Fitch and Standard & Poor's gave premium category ratings even to those collateralised debt obligations, the underlying subprime mortgagors of which were already insolvent. Between the second half of 2007 and the first half of 2008, the rating of several securities changed from AAA (obligation will be met with a very high probability) to CCC (significant credit risk) over the course of a single day (in the period in question, mortgage-backed securities were downgraded in a total value of USD 1.9 trillion) *(Morris, 2008)*.

Many institutions were only allowed to have a certain ratio of low-rated investments and were forced to start selling following the downgrade. Those who could have purchased were unable to do so due to strict regulations. It was therefore the system itself which reinforced negative feedback and elevated panic. What is of more concern is the conflict of interest that arises in the advisory business of CRAs. The advisory arms of CRAs might help potential issuers gain a desired rating. Therefore, it would be desirable to legally separate the ratings business from ratings advisory services *(Brunnermeier et al., 2009)*.

Implementation of the regulation differs significantly between the US and the EU. In spite of extensive US-EU dialogue on financial regulation, regulation of the CRAs remains an area of fundamental divergence between the two parties. The key differences in the two approaches stem from different perception of the rating business. US authorities prefer market discipline through transparency and competition, establishing a state-sanctioned oligopoly, in which the basis of competition will be the quality of ratings. By contrast, EU

17 Based on the interview with Károly Mátrai (21st March, 2013).

authorities aim to promote CRAs' accountability through supervision, while raising barriers of entry into the rating business *(Lannoo, 2010b)*.

US regulation has employed credit ratings since the 1930s without supervising CRAs, in response to the 1929 market crash. Between the 1930s and the 1970s, the use of ratings in regulation did not change significantly; consequently the US regulation has grown to be highly dependent upon ratings in areas such as securities, pensions, banking, real estate, and insurance (*Cinquegrana, 2009)*. However, in light of the 2007-08 global financial crisis and mounting evidence of the responsibility of CRAs in the debacle, the United States Securities and Exchange Commission – in the hope of reducing the overwhelming influence of CRAs over US and global economy – decided in 2011 to try and erase compulsory reliance on credit rating agencies from financial regulation rulebooks where possible. The overall aim is "to remove or replace all references to CRA ratings in laws and regulations and give alternatives where possible" *(Finance and Strategy, 2013)*. The new rules also support financial market actors to elaborate their own credit assessments. The EU has also taken significant steps to remove the hard wiring of CRA ratings from its rules and regulations through the adoption of the CRA III Regulation *(FSB, 2013)*. Just like in the United States, rating agencies can be held liable if their reports cause damage to an investor or an issuer due to infringement of CRA Regulation or gross negligence. The third CRA package also tries to reduce overreliance by encouraging self-assessment of financial institutions. The Regulation will improve the independence of CRAs and help eliminate conflicts of interest by introducing mandatory rotation for certain complex structured financial instruments (re-securitisations). There are also limitations as regards the shareholding of rating agencies. The EU is also supporting the use of smaller CRAs in order to reduce high market concentration of the three largest agencies. To mitigate the risk of conflicts of interest, the new rules also prohibit a shareholder of a CRA with 10% or more of the capital or voting rights from holding 10% or more of a rated entity *(European Commission, 2013)*. The issue of the third-country regime was the most debated point during the negotiation of the CRA Regulation, that is why the 2012 decision of the EU to recognise the legal and supervisory framework of the US for credit rating agencies as equivalent to the EU requirements came as a surprise for many observers.

4.5 Supervision of hedge funds

Hedge funds were blamed for their part in the crisis, but their real role is unclear. Hedge funds have fewer assets and less leverage than banks, making it less likely that hedge funds might cause the next crisis. As already mentioned, Title IV of the Dodd-Frank Act restricts a banking entity from having an ownership interest in or being a sponsor of a private equity or hedge fund if such investments amount to more than 3% of the bank's Tier 1 capital or the bank's interest is more than 3% of the total ownership of the fund *(Kaal, 2010).*

Hedge funds with more than USD 150 million in Assets Under Management (AUM) are required to register as investment advisers and must disclose information on their trades and portfolios to the SEC (Securities and Exchange Comission). The Dodd-Frank Act also directs the SEC to set up rules for the registration and reporting of hedge fund managers who were previously exempt from registration. By obligatory registration, the SEC may collect necessary information in order to curtail those who operate in the "shadows of our markets", prevent fraud, limit systemic risk, and provide information to investors. In addition to making registration mandatory, the Dodd-Frank Act requires registered hedge fund advisors to file periodic reports *(Kaal, 2013).*

The EU's directive on Alternative Investment Fund Managers (AIFMD) came into effect in July 2014, standardising the managers' operation and defining provisions on selling their funds within the European Economic Area. In order to register and to obtain a "passport", the fund managers must enrol in their home jurisdiction. Possessing a passport authorises selling funds across the EU. However, not all jurisdictions are favourable for non-EU funds: the UK, the Netherlands and Northern European requirements are easier to handle, while Southern Europeans are more restrictive. Managers are also discouraged by a range of authorisation fees and administrative hurdles.[18] Previous UCITS[19] passporting fees were minimal, and thus charges varying from one member state to the other have puzzled several managers. As a result, several US managers are only entering the UK and Switzerland, and "waiting for the playing field to settle down".

4.6 Consumer protection

Before the crisis, on the one hand, low financial literacy on the consumer side and increased financial product complexity on the financial service provider side led to consumers who felt or were actually misled or taken advantage of. On the other hand, unregulated or inadequately supervised financial service providers (with growing conflicts of interest) and the spread of misaligned incentives taking into account short-term economic performance only, also increased the possibility of consumers facing fraud or abuse *(OECD, 2011)*.

Policymakers seem to have realised that creating a sense of safety for consumers is a basic ingredient of any well-operating financial system and that consumer confidence boosts growth and innovation over the long term. Therefore developed countries have put

18 Austria, for example, charges a fee of at least EUR 1,100 (USD 1,409) for processing documents and an annual fee of EUR 600 for monitoring compliance. Britain and Hungary, by contrast, do not charge an initial fee, though they require fund managers which set up a local branch to pay "periodic" fees (Cohn, 2014, The Reuters article).

19 "UCITS" or "undertakings for the collective investment in transferable securities" are investment funds regulated at the European Union level. They account for around 75% of all collective investments by small investors in Europe. The legislative instrument covering these funds is Directive 2014/91/EU (European Commission, 2014b).

consumer protection and financial education at the top of their agenda in recent years *(Chakrabarty, 2013)*.

Regulatory responses to the regulatory vacuum in the consumer protection system in the United States were addressed and treated as a central problem in the Dodd-Frank Act. Among other consumer friendly initiatives, the flagship initiative of the Act was to create the Consumer Financial Protection Bureau *(CFPB, 2013)* to consolidate consumer protection powers from seven federal agencies *(Puzzanghera, 2011).* Although its initial steps were hampered by harsh Republican opposition (arguing that the Bureau was given too much power and it would limit credit availability and limit consumers' financial product choices), the Bureau is considered a relatively successful agency contributing actively to consumer protection *(Singletary, 2012)*.

Consumer protection in the field of financial products in the EU falls within the jurisdiction of the new European Supervisory Authorities *(Kastner, 2013)*. These ESAs cooperate with national supervisory bodies to protect financial consumers. The European Commission has been coming up with consumer-friendly proposals regarding deposit guarantees, a unified mortgage lending information sheet for a better comparison of services, stricter regulations of complex retail investment products, etc. *(European Commission, 2010a; 2010b; 2011; 2012).*

In 2014, the directive ensuring that all European citizens have access to a basic bank account was considered a great achievement in the field of consumer protection *(EurActiv, 2014)*. As Directive 2014/92/EU (the "Payment Accounts Directive") has been adopted, the EU aims to harmonise the opening of bank accounts for European citizens in all credit institutions, to make banking fees transparent and to facilitate account switching. Consequently, the consumer rights of EU citizens will be improved in the field of (1) access to payment accounts, (2) comparability of payment account fees and (3) payment account switching. However, making consumer protection and education a central issue when reforming the financial system cannot conceal the fact that consumers – even if they are financially well-informed – are usually not in a position to dictate certain contractual terms (e.g. when taking out a mortgage).

5 Conclusions

In order to stabilise the financial markets, the EU and the US are in the midst of a fundamental institutional and regulatory overhaul. The crisis brought into focus the interconnections between financial markets and clearly highlighted that regulators, supervisors and financial centres across the globe need closer cooperation *(Calvino, 2013)*.

The US and Europe play a central role in shaping global finance, accounting for more than two-thirds of all financial services. Although ties between the two financial markets are almost organic, there are several fundamental issues where regulatory frameworks differ. Alterations can partly be explained by the different political background and decision-making mechanisms, but also by diverging attitudes.

The divergence of regulatory schemes is very problematic: corresponding the different sets of rules is a time-consuming and money-consuming task (salient administrative costs, uncertainties about the future regulations). Both the EU and the United States are well aware of disadvantages stemming from the differences in regulation. That is one reason why the two entities initiated the regular the Financial Markets Regulatory Dialogue back in 2002. It is obvious that if a country requires adaptation to its financial regulation from third countries, it becomes a “rule-maker”. “Rule-takers” adjust to standards set by other actors. Therefore, making or taking financial regulation reflects an economic actor’s ability to influence others to accept its rules *(Quaglia, 2014)*. In our case, although the EU and the United States share similar objectives, they both prefer the role of rule-maker to that of passive “downloaders” of rules set by the other. Nevertheless, international agreement on cross-border regulatory issues is of fundamental importance: differences represent a huge legal and technical challenge for companies operating both in Europe and overseas, which have to implement two sets of regulations simultaneously.

The surge in financial regulation activities after the crisis represents a huge opportunity to create a more uniform global financial environment. By comparing six exemplary areas of the regulatory responses in the US and the EU, we conclude that several rules are inter-related and have overlapping goals, but that divergence in their implementation poses a serious challenge for firms operating in both environments. In some areas, regulators have managed to recognise each other’s legal and supervisory framework as equivalent through continuous dialogue and cooperation (e.g. credit rating agencies). Regarding other, similarly crucial fields, disparities persist (e.g. central counterparties and derivatives).

Consequently, as financial markets continue to integrate, regulators face similar problems in the EU and the United States, but their implementation sometimes diverge and differ. Regular bilateral cooperation (FMRD) and thoroughly described third-party requirements as well as established substituted compliance/equivalence[20] procedures point in the right direction. Since it is in both jurisdictions’ interest to promote financial firms’ smooth cross-border operation, reciprocal recognition of financial rules is hopefully within reach.

20 Substituted compliance: if a relevant body determines that a foreign jurisdiction’s rules are comparable to its own rules, it is basically referring to the idea that broad deference should be given to a foreign jurisdiction’s full regulatory regime – in lieu of one’s own regulatory regime – so long as it is comparable in its objectives (This approach in the EU jargon is referred to as “equivalence”) CFTC, Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations (CFTC, 2012).

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