FINANCIAL REGULATION DIFFERENCES IN THE EU AND THE US

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INTRODUCTION

As a consequence of the current financial and economic crisis, the EU and the US are in the midst of fundamental institutional and regulatory changes. The stability and efficiency of the financial markets are crucial for the future.

Appropriate regulatory responses given to recurring crises are persistent problems of capitalism. In the period of economic upturn preceding the current crisis, developed countries’ money markets seemingly worked with incredible efficiency and flooded consumers with cheap loans and investors with easy money\(^1\). This created the moral foundation for deregulation. The nightmare of recession seemed but a mirage, and the stringency of the regulatory environment started to ease up amidst general optimism. However, the crisis proved that the processes of recent decades, the increasing complexity of financial markets did not bring increasing profits with decreasing risks as the experts of financial institutions led us to believe. The risk management illusion related to financial innovations (i.e. that with the development of the mathematical basis of modelling and risk management, risks will become more predictable) greatly contributed to the development of these problems. Therefore, the two key reasons of the crisis are markets turning opaque due to the proliferation of financial innovations and 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 making of a global economic turmoil. However, crisis has transformed financial policy issues from the preserve of a narrow community of professionals to matters of public concern, the influence of private sector on financial regulation has diminished and that of the public sector was reinforced (Véron, 2012).

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\(^1\) When cash flow is abundant within the banking system, lowering interest rates and making it easier for banks and lenders to loan money
In legal and economic literature there is no fixed definition for the term “regulation”. In this article regulation is understood as the “employment of legal instruments for the implementation of social-economic policy objectives” (den Hertog, 2010, pp. 3).

According to Brunnermeier et al., there are three main purposes for financial regulation: “(1) to constrain the use of monopoly power and the prevention of serious distortions to competition and the maintenance of market integrity; (2) to protect the essential needs of ordinary people in cases where information is hard or costly to obtain, and mistakes could devastate welfare; and (3) where there are sufficient externalities that the social, and overall, costs of market failure exceed both the private costs of failure and the extra costs of regulation” (Brunnermeier et al., 2009, pp. 2). As for its goals, regulation should on the one hand ensure the safety and stability of the financial system (including the promotion of consumer protection as well); and on the other hand foster the growth and development of the financial markets.

Globalization of financial markets manifests itself in the increasing interconnectedness and interchangeability of financial services providers, which makes financial regulation even more problematic (Pan, 2011).

The design of financial regulation is not straightforward; only the frameworks can be drawn, “financial regulation should be focused, primarily rule-based (because discretion will be hard to use during periods of boom/euphoria), and time and state-varying (light during normal periods, increasing as systemic threats build up) (Brunnermeier et al., 2009:63).

However, it is possible to define the theoretical framework for financial regulation; it is normally imposed in reaction to some prior crisis, rather than founded on theoretical principle. This area has always been “a-theoretical, 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, pp. 165).

The current crisis has proved that the regulatory environment was inappropriate to tackle the complex and often opaque operation of financial markets in recent decades. Money markets seemingly worked efficiently and “easy money” created the moral foundation for deregulation. However, a fundamental reconsideration of global financial regulation emerged as a response to the crisis.

In the aftermath of the crisis, policymakers seemed more concerned about stability issues than financial markets’ competitiveness. On the other hand, when faced with sluggish recovery,
governments are nowadays make sure achieving one goal is not at the expense of the other in order to prevent future financial crises (Pan, 2011).

It is extremely difficult to balance between financial lobby, public will and the haunting image of a global crisis relapse. Financial regulatory responses given 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.

However, regulatory arbitrage might hinder global recovery, and therefore unified financial regulation seems more important than ever. This article briefly describes regulatory packages on both sides of the Atlantic, focusing on specific neuralgic points of the financial sector whose deregulation probably contributed to the crisis.

After comparing and analyzing the European and American frameworks, the article draws conclusions as to what extent the two regulations differ and whether these differences impose difficulties for companies operating in both environments.

**THE IMPORTANCE OF COMPARING EU AND US RESPONSES**

It is obvious that America and Europe play a central role in shaping global finance, accounting 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 fundamental issues, in which they represent contradictory views (CMWG, 2010).

This crisis has also induced a wave of new regulations worldwide “to make markets and institutions more transparent, less complex, and less leveraged” (IMF, 2012, pp. 75.). Although the increasing significance of financial markets and financial institutions in the global economy makes uniform international financial regulation more important than ever (Biedermann, 2012b), post-crisis amendments highlight the divergence of regulatory approaches in the United States and the European Union. 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 (Dodd-Frank Act, 2010) is the US legislative response to the financial crisis, elaborating measures agreed at the international level by the G20 and unfolded further by the Financial Stability Board and Basel III. (Sabel et al., 2012). American president Barack Obama announced his intention to reform the American financial sector in June 2009, and
signed Dodd-Frank Act on Wall Street reform and consumer protection a year later. It was supposed to sweeply overhaul the operation of the financial system in the United States. 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 competitiveness of American financial firms.

Its main areas of regulation include rules aimed at correcting structural and systemic errors that have direct or indirect links with the crisis. In order to restore market and consumer confidence, and avoid the "too big to fail" and bailout-related problems, the Act requires banks to set aside funds to prepare for eventual default and sets stricter rules for systematically important institutions. Also, giant financial firms giving financial advice and performing various financial operations on their own account, representing the classic case for 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 the watered down version of the Volcker Rule (originally intended to restrict banks from trading on their own account as well as making speculative investments into 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.

Dodd-Frank Act also introduced transparency reforms for the derivatives market, a comprehensive regulation of swaps, without removing the possibility of excessive leverage from the system.

Similar reform initiatives were launched all over the world. 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 changing capital requirements for banks (Basel III\(^2\) and CRD IV\(^3\)), these three packages will dramatically alter the current operation of financial markets in Europe (Deloitte, 2012).

\(^2\) “Basel III” is a cornerstone in the overhaul of the banking regulation, developed by the Basel Committee on Banking Supervision, to attain stricter supervision and risk management of the banking sector. The financial crisis
European Market Infrastructure Regulation (EMIR) was adopted in 2012 by the European Parliament and Council to improve transparency and risk management on "over the counter" (OTC) derivatives market. EMIR stipulates that OTC derivative contracts (although there are exceptions) must be reported and cleared (unless under the clearing threshold). It also sets additional safety measures for central clearing counterparties and trade repositories (ESMA, 2013).

EMIR concentrates on post-trade regulation of OTC contracts, but pre-trade and trade-related aspects of OTC regulation are 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 implemented from 2007 on, European financial markets became more fragmented, trading (normal and high-frequency as well) taking place on a growing number of platforms. MiFID also contributed to more intense over-the-counter trading and the development of dark pools, thus market transparency decreased. The new regulation proposes the notion of OTF (Organised Trading Facilities) to include places of negotiations that are not yet regulated (it tries to move trading of derivative contracts to regulated markets), 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 (FinanceWatch, 2013).

Banks, businesses, financial service providers, etc. will have to make strategic choices in order to comply with the new regulations on both sides of the Atlantic. Fundamental asymmetries evoke the widespread fear of speculators abusing regulatory arbitrage. But the fragmentation of global financial space seems inevitable as both European and American regulation and implementation processes are speeding up and gradually taking a final shape.

revealed certain procyclical elements of banking regulation, so Basel III aims at mitigating the procyclical nature of regulatory framework while strengthening bank capital requirements and introducing new regulatory requirements on bank liquidity and bank leverage (Ernst and Young, 2010).

3 "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)

4 MiFID was implemented in November 2007, and has been one of the major regulatory instruments for financial markets in Europe. Its revision, resulting in MiFID II, aims to address shortcomings of the original MiFID.
When we try to compare the European and American financial frameworks, we must emphasize 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 EU member states one after the other.

Also, while the United States is more or less coherent and homogenous, the EU is made up of member states with widely varying interests making the legislation process slower and the end result more fragmented. When it comes to financial regulation, Great Britain, as the second most important financial centre after the United States, is often opposed to regulation it considers too rigid and detailed. Prime Minister David Cameron expressed fears in October, 2011 claiming that London's financial centre is under "constant attack through Brussels directives.”

One thing is for sure: the financial crisis has induced a multitude of new financial rules in an urge to prevent excessive risk taking and overly generous bonuses, to shed light on derivatives and discipline hedge funds.

The following part 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.

**REGULATORY CHANGES ON BOTH SIDES OF THE ATLANTIC**

In the following part of the paper certain aspects of European and American financial regulation will be compared and conclusions will be drawn regarding their possible effect on the financial landscape. For Michel Barnier who became European commissioner for the single market in February 2010, the idea that “every financial actor, financial market, financial activity and product” must be properly regulated has been the major task (The Economist, 2012). His words well represent the re-emergence of old suspicions all over Europe regarding “unregulated Anglo-Saxon capitalism” playing a huge role in the financial crisis (Whyte, 2012).

Although changes on the institutional side play a crucial role, such as developments of the supervisory structure and macro- and micro-prudential reforms; we will exclusively focus on the regulatory side. In order to highlight the main differences between the US and EU

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5 Based on the Interview with Rita Pupli, Financial Department officer at the Ministry for National Economy
approaches, we will 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**

Before the crisis, in many cases incentive systems in the long run prompted financial institution executives and employees alike 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 how successful the company was 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, and quick gains in market share.

As a result, lending became more and more irresponsible and contracting volumes became 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 largely to a so-called “boom frenzy” which ultimately led to massive irresponsible financial behaviour. One benefit of the current crisis is the actions dealing with the vulnerabilities as a consequence of the practices of the extended period of benign conditions (Brunnemeier et al., 2009).

American legislation tackled the issue in a soft manner. Dodd-Frank Act prescribes a shareholder vote on executive compensation. Pursuant to the Act’s provisions, in their proxy statements joint-stock companies shall, not less frequently than 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 case 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 non-binding either (Fried – Shilon, 2012).

The EU on the other hand took harsher measures to cap bankers’ bonuses. According to the agreement reached late February, 2013, bonuses will be capped at 1:1 on the ratio of bonus to fixed pay for senior management and material risk-takers, but can rise to two years' pay if there
is explicit approval from shareholders\textsuperscript{7} from January, 2014 (BBC News Business, 2013). It is still not clear how this provision will be applied to non-EU-headquartered institutions with operations in the EU.

Capping bonuses could be effective in fighting against short-sighted manager strategies but according to opponents of the above mentioned amendments, it might result in increasing fixed salaries or drive away talent (thus result in a loss of competitiveness for the banking sector).

\textbf{Capital requirements}

The relative importance of banks in world economy in the last two hundred years have been on the rise,\textsuperscript{8} 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 has gathered pace in the decades preceding the current crisis. Banking scale was growing rapidly: between 1870 and 1970, the average bank assets-to-GDP ratio rose from 16\% to over 70\%. Since 1970, the ratio of bank assets-to-GDP has more than doubled over the past 40 years, rising from around 70\% to over 200\% (Haldane, 2012). Banking concentration has also risen dramatically, contributing to the evolution of banks that are “too big to fail” (TBTF).

The existence of TBTF financial institutions 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, too-big-to-fail financial institutions distort competition. And third, the favoured treatment of too-big-to-fail institutions 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 minimize 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 systemically important (TBTF)

\textsuperscript{7} If shareholders representing 50\% of shares participate in the vote and a 66\% majority support the measure. If the minimum number of shareholders cannot be reached, the bonus can also be approved if 75\% of shareholders present support it (FS Regulatory Brief, Bonus Cap Proposal Advances in EU. Available at http://emarketing.pwc.com/reaction/images/FSMarketing/FSRegulatorBriefBonusCapProposalAdvancesinEUsecure.pdf Accessed 17th April 2013)

\textsuperscript{8} Between 1870 and 1970, the average bank assets-to-GDP ratio rose from 16\% to over 70\%. Since 1970, the ratio of bank assets-to-GDP has more than doubled over the past 40 years, rising from around 70\% to over 200\%.
banks encouraged bank risk-taking and expanded banks’ range of activities from the eighties on (Taylor, 2012). The operation of banks became riskier. They started lending to less reliable customers. The hallmark of this excessive risk-taking was the loans to NINJA (No Income No Job or Assets) customers. These loans have started to default in sizeable magnitudes (Talbott, 2010). They used excessive levering: these phenomena are widely considered to have contributed to the global financial crisis.

Reforming minimum capital requirements for banks and certain financial service providers aims at strengthening the resilience of the financial sector that proved to be insufficient during the crisis. The Capital Requirements Directive IV, transposing post-crisis Basel III Accords into EU legislation, establishes numerous changes in the banking regulatory framework (Financial Stability Forum, 2009).

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 were published by the BCBS in 2004 (Basel II) and implemented gradually in most G20 countries until 2010, when Basel III were developed to address shortcomings of the previous regulation framework revealed by the financial crisis (Elliott, 2010a).  

Basel III improves the quality and quantity of capital retained by banks in order to better absorb shocks, introduces a counter-cyclical buffer that can be used in times of crisis, an additional non-risk weighted leverage ratio and liquidity coverage ratio to be met, strengthens risk capture and risk management practices. But the implementation of Basel III rules is advancing very slowly and unevenly. Both American and European regulators face fierce resistance from bankers who claim a longer and period of preparation to implement the required changes (EBIC, 2013).

EU member countries were expected to reach a consensus by the end of 2012, but the ongoing trialogues create uncertainty regarding implementation. European authorities

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9 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).

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

11 Basel II was criticized 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).
envisaged 1 January, 2013 entry into force but since the United States is postponing the implementation of Basel III to an undefined date, the European Banking Industry Committee wrote an open letter to commissioner Michel Barnier. EBIC (2013) pointed out that if Basel III measures’ commencement in the EU and US will be different, that might impact EU-US level playing field and result in a competitive disadvantage for EU banks leading to regulatory arbitrage, as European banks will all be subject to stricter regulatory requirements earlier. Although Basel III capital proposals have promising elements: a leverage ratio, a capital buffer and the proposal 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.

Different accounting standards applied in the US and the EU make the comparison of capital requirements difficult. On some elements of a bank’s balance sheet, IFRS (International Financial Reporting Standards) and US GAAP (US Generally Accepted Accounting Principles) are totally incomparable, presenting EU banks overleveraged (Lannoo, 2010a). However US Securities and Exchange Commission (SEC), a national government agency adopted a roadmap of the application of IFRS by 2014, it will not happen within foreseeable time. ACCA’s research shows that substantial investment in human capital is needed in both industry and the investment community, so IFRS adoption will take much more time (ACCA, 2012).

Another serious problem lies in the very nature of the financial system. Basel regulatory framework can only regulate banks. However, banks can shift financial „promises” to non- 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-Wignall – Atkinson, 2010).

So 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).

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12 According to a joint statement issued by the US federal banking agencies on 9 November 2012, US credit institutions will not be obliged to comply with Basel III capital and liquidity requirements as of 1 January 2013. (EBIC Open letter to Commissioner Barnier, 12 February, 2013).

13 The EU has adopted IFRS, whereas the US continues to apply its own standards (US GAAP).
The derivatives market skyrocketed during the last 25 years. The derivative (forward, swap, futures, option) deal is derived from a basic product (for instance, the basic or underlying product of a futures contract on Goldman Sachs with a December 2013 maturity is the Goldman Sachs share). Derivatives were created as a result of striving for increased yields and lower financing costs. Derivates products 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 to the overly optimistic speculations related to them. Due to high leveraging, investors can lose multiples of their original investment if they take up unfavourable speculative positions. Derivatives are rather opaque financial instruments as underlying risks, and as a result the actual market value of products, are difficult to assess due to their derivative nature. (Biedermann, 2012a)

On top of that, a flourishing market of derivative products developed outside the stock exchange (over-the-counter –OTC), under significantly more ”unregulated” conditions, which made seeing clearly in a sea of increasingly murky transactions all the more difficult. According to Paulo (2011), almost 90% of derivatives are not traded on stock exchanges, but over the counter.

The financial crisis was seriously aggravated by the excessive complexity of some derivatives, the opacity of the markets for many derivatives, the counterparty risks tied to clearing derivatives, and by the excessive use of derivatives such as credit default swaps (CDS) for speculative purposes instead of using them to hedging existing risks (Elliott, 2010b). The lack of appropriate regulation of OTC derivatives transactions (bad incentives) and insufficient risk aversion are addressed both in 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, standardized 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 clearing house.14 The key requirements regarding derivatives are grosso modo the same in European (EMIR) and American (Dodd-Frank Act, Title VII) both regarding trade data

14 A clearing house stands between two parties, guaranteeing a trade if one party defaults.
(information on all transactions must be transmitted to central trade repositories and be available to the supervisory authorities) and clearing requirements (standard derivative contracts must be cleared by a Central Counterparty (CCP) to reduce the risk of default and an OTC derivative cleared by a CCP has to respect higher guarantee 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. In general, these companies do not have to buy their derivatives on exchanges or regulated trading venues, do not have to agree to central clearing (although they can still choose to insist on it), and may put up whatever collateral is agreed with the other side of the transaction (Deloitte, 2012).

However, while the frameworks are very similar, there are significant differences in implementation and technical details. Therefore implementing EMIR will not be enough to fulfil the requirements of Dodd-Frank (and vice versa). Moreover, whereas U.S. capital markets are more alike, the European financial landscape is far from being homogeneous. Applying the same uniform rules for less sophisticated capital markets (e.g. Budapest) and financial centres (e.g. London) in the EU seems exaggerated, even harmful.

Let us illustrate the above concerns and take a closer look on clearing house regulations. According to the 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 requirements) than American ones, which might undermine the competitiveness of European CCPs, putting them at a regulatory disadvantage and encourage regulatory arbitrage.

For example, "EMIR requires EU CCPs to hold sufficient financial resources to be able to withstand the default of the two clearing members to which it has the largest exposure, while the CFTC (Commodity Futures Trading Commission) Final Rule only requires DCOs (derivatives clearing organizations) to hold sufficient financial resources to withstand the default of the clearing member to which it has the largest financial exposure. Although the CFTC has proposed requiring systemically important DCOs to maintain sufficient financial resources to withstand a default by the two clearing members posing the largest combined financial exposure, the CFTC has not finalized this proposal."15

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.\textsuperscript{16}

Transparency plays a pivotal role for both actors, but the US will only publish data on aggregated level with the possibility to gain individual data on a confidential basis, while EU authorities may publish information on single trades (Lannoo, 2010a).

\textbf{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, reigning 94\% of the global market (European Commission, 2008). They have already erred in their forecasts on a number of occasions before and at the beginning of the mortgage crisis, and have rated securities and credit products, among other things, as excellent which soon lost their value, which resulted in a significant loss in their reputation. 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. The first securities to go under were exactly the ones that were backed by subprime mortgage loans, which then led to the collapse of the securities market relying on them, taking down several financial institutions with them in the process. Credit rating agencies played a considerable role in deepening the crisis; the determination (or possibly redetermination) of ratings is not very common; therefore, if there is indeed a change in rating, it is usually late, wide-ranging and significant (Miglionico, 2012). This is how it could have happened that in 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, required by law, were only allowed to have a certain ratio of low-rated investments and as a result were forced to start selling. Those who could have purchased were unable to do so due to strict regulations (as financial institutions are only allowed to keep a certain percentage of their assets in high-risk investments as previously

\textsuperscript{16} Based on the Interview with Károly Mátrai (2013.03.21.)
mentioned). It was therefore the system itself which reinforced negative feedback and elevated panic.

What is of greater concern is the conflict of interest that arises in the advisory business of CRAs. The advisory arms of CRAs help potential issuers to gain a desired rating. Therefore it would be favourable to legally separate the ratings business from ratings advisory services and the increased, improved transparency about the way in which CRAs assess the creditworthiness of structured products (Brunnermeier et al., 2009).

The 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. Certain principles which are shared by the EU and the US are the further need for transparency on rating methodologies, on the performance of ratings, and raw data, organisational requirements concerning conflicts of interest and corporate governance. It can be concluded that the philosophies underlying the interventions are quite different (Lannoo, 2010a).

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. 2006 was the year for reforming CRAs, approving Credit Rating Agency Reform Act of 2006, in order to inject competition and transparency in the rating industry. In light of the 2007-08 global financial crisis and mounting evidence of the responsibility of CRAs in the debacle, the Securities and Exchange Commission decided to propose a new, more stringent set of rules in 2008 regarding disclosure, conflicts of interest and reduction of reliance on ratings in regulation (Cinquegrana, 2009). However some of the rules proposed are controversial.

The EU Regulation on Credit Rating Agencies (CRA Regulation) has been in force since December 2010, which can be considered as one aspect of Europe's response to ensure that no institution, product or market was left unregulated at EU and international levels. The Regulation was amended in May 2011 to adapt it to the creation of the European Securities and Markets Authority (ESMA) (European Commission, 2013). This regulation was the first new EU legislative measure triggered by the financial crisis, importantly it was issued as a regulation, meaning it is directly applicable, rather than a directive, which has to be implemented in national law (Lannoo, 2010b).

The vital differences of 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 the competition will be the quality of ratings. On the contrary, EU authorities aim to promote CRAs accountability through supervision, while raising barriers of entry into the rating business (Lannoo, 2010a).

**Supervision of hedge funds**

The regulation and supervision of hedge funds have played a crucial role; hedge funds have been blamed for their part in the crisis, however their real role is unclear. Hedge funds have fewer assets and less leverage than banks, making it less likely that hedge funds could cause the next crisis.

Title IV of the Dodd-Frank Act, entitled the Private Fund Investment Advisers Registration Act of 2010 (PFIARA), and SEC rules implementing the Act touched the regulatory landscape for the private fund industry in the US. Title IV has restricted a banking entity from having an ownership interest in or be 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). PFIARA authorised the SEC to promulgate rules requiring registration of private funds. Under PFIARA, hedge funds with more than $150 million Assets Under Management (AUM) are required to register as investment advisers and have to disclose information about their trades and portfolios to the SEC. 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). EU regulation is stricter; however US proposals seem to go in the same direction as the EU (Lannoo, 2010a).

EU proposed a very detailed directive for the regulation on Alternative Investment Funds Managers Directive (AIFMD), including hedge funds and private equity, which came into force on 21 July 2011. This means that each EU Member State is now required to transpose the AIFMD into national law by 22 July 2013. The AIFMD lays down rules for the authorisation, ongoing operation and transparency of managers of alternative investment funds (AIFs). By adding reciprocity provision, the whole non-harmonised funds sector is covered. The AIFMD will apply to a non-EU fund manager if it is (1) managing or marketing one or more AIFs
established in the EU to investors in the EU; or (2) marketing one or more AIFs established outside the EU to investors in the EU. As a result, nearly all funds will be caught by the AIFMD unless a specific exemption applies (Norton Rose, 2012).

Interestingly, opponents of hedge funds regulation on both sides argued the same way: the danger of competitiveness loss of the domestic capital markets (Lannoo, 2010a). The lack of systemic risk makes it unclear what role of direct hedge fund regulation could play. Nevertheless, recent regulatory initiatives in Europe and the United States attempt to address many perceived shortcomings of regulation and seek to harmonize international banking regulation more strenuously than before the crisis.

**Consumer protection**

Before the crisis, 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 misled or taken advantage of. The proliferation of financial innovations and the inadequate regulatory environment made financial markets opaque for average clients.

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 realized 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 consumer protection and financial education at the top of their agenda during recent years (Chakrabarty, 2013). However, governments will not manage without financial service providers. Financial consumer protection also requires a proactive attitude from financial service providers in order to make certain that consumers (1) receive information to allow them to make informed decisions, (2) are not subject to unfair or deceptive practices and (3) have access to recourse mechanisms when it comes to resolving disputes (World Bank, 2012).

Regulatory response to lacunae in the consumer protection system in the United States were addressed and treated as a central problem in 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) that were responsible for consumer protection and the security of national financial institutions, often placing emphasis on the latter category. The Bureau is supposed to watch over federal consumer financial laws being enforced consistently so that consumers may access fair, transparent and competitive markets for financial products (Legal Information Institute, 2010). 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, 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 investor compensation, deposit guarantees, unified mortgage lending information sheet for a better comparison of services, stricter regulations of complex retail investment products, etc (EC 2010a, 2010b, 2011, 2012).

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 getting a mortgage).

**CONCLUSION**

In order to stabilise financial markets, the EU and the US are in the midst of a fundamental institutional and regulatory overhaul. Politicians are trying to eliminate the negative consequences of the crisis and reform a flawed system. The crisis brought into focus the interconnections between financial markets and clearly pointed out that regulators, supervisors and financial centers 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 complexity and compatibility of different regulatory schemes are very problematic. In a global financial market, where interconnectedness and interchangeability of financial service providers has been increasing, corresponding different sets of rules is a time and money-consuming duty. The process is accompanied with salient administrative costs and the uncertainties about the future regulations.

By comparing six exemplary areas of the regulatory responses in the US and the EU, we conclude that many regulations are inter-related and have overlapping areas and goals, but some basic differences represent a huge legal and technical challenge for companies operating both in Europe and overseas, having to implement two sets of regulations simultaneously.

Unfortunately financial markets are faced once again with a fragmented global regulatory environment. The surge in financial regulation activities after the crisis represented a huge opportunity for creating a uniform global financial environment. Although capital markets continue to integrate, international cooperation in implementing similar reforms is lagging behind.

In spite of differences, there is reason for hope. Substituted compliance\textsuperscript{17} could be the solution. As an example, Dodd-Frank and EMIR OTC derivative rules are similar in their intentions but different when it comes to practical implementation. In recent months, a stalemate unfolded, threatening to leave US entities unable to clear through European infrastructure and vice versa. The tug-of-war was resolved when both jurisdictions declared that certain sections of Dodd-Frank and EMIR are equivalent.

Nevertheless, international agreement on cross-border regulatory issues remains elusive. The EU and the United States share similar objectives but implement them in a different way.

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